Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Sen. Rev. & Tax. Comm.	Analyst:	Jeani Brent	Bill Number:	SB 1229
Related Bills:	See Legislative History	Telephone:	845-3410	Amended Date:	04/12/1999
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Alimony Ded./Excess SDI/Federal Adjs./AMT Depr./Voly Con/Water's Edge/Sub. Housing/Unitary Div./Returns/Commercial Domicile/Head of Household/ 1998 Leg. Clean Up/Code Maintenance/Wages Definition

SUMMARY OF BILL

This bill, sponsored by the Franchise Tax Board, would make the following changes:

1. Provide that nonresidents prorate the deduction for alimony payments in the same manner as the nonresident tax is prorated.
2. Retain the program to refund excess state disability insurance through the tax return while ensuring that taxpayers who fail to claim the credit on their return still would be identified as quickly as possible to receive a refund of their excess contributions.
3. Make several changes relating to federal adjustments regarding defining the final federal determination date and requirements for taxpayers to notify the department of any federal changes to their tax return.
4. Make a technical correction to the alternative minimum tax (AMT) provisions to refer to the depreciation provisions under the Bank and Corporation Tax Law (B&CTL) rather than those under the Internal Revenue Code (IRC).
5. Clear up inconsistencies regarding voluntary contribution funds and delete redundant and unnecessary language.
6. Specify that for purposes of determining the correct amount of tax for water's-edge electors, the presumption of correctness attaches to <u>all</u> federal audit determinations, including determinations made at the audit, appeals, and/or competent authority levels.
7. Clarify that substandard housing could be housing that is either (1) occupied, or (2) unoccupied or abandoned.
8. Eliminate obsolete language regarding pending litigation related to the provision allowing elimination from income of certain unitary corporation intercompany dividends.
9. Eliminate ambiguity with respect to the due date for filing a tax return by requiring corporate taxpayers to file their income tax return "on or before the 15th day of the third month following the close of its income year."
10. Remove the commercial domicile restriction from Revenue and Taxation Code (R&TC) Section 24410, permitting all corporations, regardless of where commercially domiciled, to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax.
11. Specify that a taxpayer that uses the Head of Household (HOH) filing status or surviving spouse filing status cannot claim the dependent parent credit.
12. Clean up technical issues made necessary by the enactment of various bills affecting the R&TC in the 1998 legislative session.

Board Position:			Department Director	Date
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13. General maintenance of the R&TC, including repealing obsolete provisions, updating cross-references, and making consistent references to federal law.
14. Clarify the definition of wages in the Unemployment Insurance Code (UIC) requirement amended by AB 3086 (Stats. 1994, Ch. 1049) regarding which amounts must be included in the Report of Wages by specifically including amounts withheld from pensions, annuities, and other forms of deferred compensation.

SUMMARY OF AMENDMENT

The April 12, 1999, amendments added the provisions identified as #1 through #5 and #9 through #14 above.

Issues #1 through #5 and #9 through #14 will be discussed separately in this analysis. The discussion of items #6 through #8 above, presented in the department's analysis of the bill as introduced, still applies.

LEGISLATIVE HISTORY

SB 2234, which contained provisions of importance to the Franchise Tax Board, was vetoed by the Governor on September 29, 1998. The Governor stated in his veto message that, while he supported the provisions of SB 2234, the bill unfortunately would have deleted the provision that had been enacted by AB 2797 (Stats. 1998, Ch. 322) that eliminated the adjusted current earnings depreciation calculation when determining a business' alternative minimum tax.

This bill contains the provisions of SB 2234, except that the provisions of SB 2234 have been modified to (1) ensure that no provisions enacted in 1998 would be deleted, (2) remove the cigarette tax provisions, and (3) reflect later enactment. The provisions that were included in SB 2234 and are included in this bill are those identified above as issue #1, relating to the deduction for nonresident alimony payments; issue #2, relating to excess state disability insurance refunds; issue #3, relating to federal adjustments; issue #4, relating to AMT depreciation; issue #5, relating to voluntary contributions; issue # 12, relating to 1998 legislation clean-up; and issue #14, relating to AB 3086 cleanup.

REVENUE ESTIMATE

Based on data and assumptions discussed below, revenue losses from this bill are estimated to be as follows:

Estimated Revenue Impact of SB 1229 Amended April 12, 1999 (In $Millions)				
		1999/00	2000/01	2001/02
1.	Nonresident Alimony Deduction	-$5	-$2	-$2
2.	Excess SDI	*	*	*
3.	Fed. Adjustments/Corrected Tax Return	*	*	*
4.	AMT Depreciation	*	*	*
5.	Voluntary Contributions	*	*	*
6.	Water's Edge	**	**	**
7.	Substandard Housing	*	*	*
8.	Unitary Corp. Intercompany Dividends	*	*	*
9.	Due Date for Tax Returns	*	*	*
10.	Commercial Domicile	***	***	***
11.	Dependent Parent Credit	-Negl.	-Negl.	-Negl.
12.	1998 Legislation Clean Up	*	*	*
13.	Code Maintenance	*	*	*
14.	Definition of Wages/AB 3086 Clean-Up	*	*	*

* = No revenue effect
** = No identifiable revenue impact
*** = Revenue Losses cannot be quantified
-Negl. = Negligible revenue loss

BOARD POSITION

Support.

The Franchise Tax Board voted at its November 17, 1997, meeting to sponsor the language in this bill identified as issue #4, relating to AMT depreciation, issue #5, relating to voluntary contributions, and issue #14, relating to AB 3086 cleanup.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor the language in this bill identified as issue #10, relating to commercial domicile.

The Franchise Tax Board voted at its February 4, 1998, meeting to sponsor the language in this bill identified as issue #3, relating to federal adjustments.

The Franchise Tax Board voted at its March 26, 1998, meeting to sponsor the language in this bill identified as issue #1, relating to the deduction for nonresident alimony payments, and issue #2, relating to excess state disability insurance refunds.

The Franchise Tax Board voted at its December 16, 1998, meeting to sponsor the language in this bill identified as issue #6, relating to water's edge; issue #7, relating to substandard housing; issue #8, relating to unitary corporation intercompany dividends; issue #9, relating to due dates for returns; issue #11, relating to dependent parent credit; and issue #13, relating to code maintenance.

ISSUE #1: Nonresident Alimony

EFFECTIVE DATE

This bill provides language that would apply the nonresident alimony deduction changes to all taxable years in which the statute of limitations for issuing proposed assessments or allowing claims for refund remains open. The purpose of the retroactive application is to avoid potential disputes with taxpayers over the continued enforcement of an unconstitutional statute.

LEGISLATIVE HISTORY

AB 2380 (Stats. 1984, Ch. 938) added the nonresident alimony deduction provisions.

SPECIFIC FINDINGS

Federal Constitution

The United States Constitution, under what is known as the Privileges and Immunities Clause, provides that the citizens of each state shall be entitled to all the privileges and immunities of the citizens of the several states. The United States Supreme Court has interpreted this clause, as it applies to taxes, as follows:

> "...One right thereby secured is the right of a citizen of any State to remove to and carry on business in another without being subjected in property or person to taxes more onerous than the citizens of the latter State are subjected to."[1]

In *Lunding*, the Supreme Court struck down a New York statute which denied nonresidents an alimony deduction in computing New York adjusted gross income. The court held that New York's categorical denial of the deduction to nonresidents violated the Privilege and Immunities clause of the Federal Constitution,[2] stating that New York had not substantially justified its discriminatory treatment of nonresidents. In striking down the New York statute, the Court accepted the petitioners' determination that the deduction should be allowed in the same ratio that their business income was attributable to New York sources.[3]

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1 *Lunding Et Ux. v. New York Appeals Tribunal et al.*(1998) 118 S.Ct. 766 (citations and internal quotation marks omitted).

2 Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical.

3 It is unclear whether in *Lunding* the petitioner computed his deduction by applying the ratio of New York to total business income or adjusted gross income, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

State Law

The existing California Personal Income Tax Law (PITL) imposes tax on the basis of residency and source. Residents and part-year residents (while they are residents) are taxed on all income earned, regardless of source. Nonresidents and part-year residents (while they are nonresidents) are taxed only on income from sources within California.

Existing law imposes an income tax on the income of nonresidents that is derived from or attributable to sources within this state. "Income from sources within this state" is defined by regulation as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce. The law provides six personal income tax rate brackets ranging from 1% to 9.3%.

Existing law requires nonresident taxpayers to include income from all sources to determine the rate at which California tax is imposed on their California source income. The total taxable income is computed as if the nonresident were a resident for the entire year. The amount of tax that would be imposed on the total income is prorated based upon the ratio of California-sourced adjusted gross income to total adjusted gross income from all sources to determine the tax imposed on the California-sourced taxable income. The California tax before personal exemption is the tax that bears the same ratio to total tax, as California source adjusted gross income bears to total adjusted gross income. This method effectively results in the nonresident or part-year resident computing their tax at the same graduated tax brackets as used for computing the tax of a resident.

In determining California-sourced income, **existing law** does not allow a deduction for alimony payments made by a nonresident or a part-year resident (while a nonresident) even if paid to a California resident. This provision denying a deduction was first introduced in 1957. The justification appears to have been that California does not tax nonresident taxpayers on alimony income and, thus, should not allow nonresidents an alimony deduction.

California's categorical denial of an alimony deduction to nonresidents is unique in that business and investment expenses are allowed as deductions in computing California adjusted gross income if the expenses are attributable to the production of California source income. Itemized deductions are, in effect, allowed in the ratio that California adjusted gross income bears to total adjusted gross income because the California method requires that tax on total taxable income (which includes total itemized deductions) be prorated by the ratio of California adjusted gross income to total adjusted gross income.

The effect of **existing state law** is identical to the New York statute, and there appear to be no arguments that could reasonably be advanced to support its application that were not presented to and rejected by the Court in *Lunding*. Thus, it appears that the existing state law that denies the alimony deduction to nonresidents facially violates the Privilege and Immunities Clause of the Federal Constitution.

The California Constitution prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional, unless a state appellate court has determined that such statute is unconstitutional.

This bill would provide that nonresidents prorate the deduction for alimony payments in the same manner as the tax is prorated. This ratio would compare California-sourced adjusted gross income (without regard to the alimony deduction) to total adjusted gross income from all sources (without regard to the alimony deduction).

This bill also would provide that a part-year resident would be allowed an alimony deduction for the full amount paid during the portion of the year the individual is a resident and a prorated amount for the portion of the year the individual is a nonresident.

Policy Considerations

The California Constitution does not permit the Franchise Tax Board to take any action that could be construed as a refusal to enforce the existing law that denies the nonresident alimony deduction.[4] While the "refuse to enforce" phrase of Article 3, Section 3.5 is nowhere defined, it certainly precludes the Franchise Tax Board from allowing claims for refund based upon application of the methodology the Court embraced in *Lunding*.

This bill, coupled with the retroactive operative date, would relieve the Franchise Tax Board from defending R&TC Section 17302 in administrative and judicial proceedings and thus would avoid the expenditure of resources in disputes when the probable outcome would be that Section 17302 would be declared by an appellate court to be unconstitutional.

This bill would avoid discrimination against nonresident taxpayers currently denied an alimony deduction.

By allowing a pro-rata deduction for alimony, California would place alimony on a par with other deductions that are allowed to offset, either directly or indirectly, California source income and would recognize that the amount of alimony paid generally correlates with a taxpayer's total income or wealth and, thus, bears some relationship to earnings, regardless of their source.

Implementation Considerations

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

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[4] In *Appeal of Stephen C. Eldridge*, the Board of Equalization held, in a decision not to be cited as precedent, that it could not refuse to enforce Section 17302 on constitutional grounds, referring to the prohibition imposed on administrative agencies by Article 3, Section 3.5, of the California Constitution. In that case, a New York resident argued that Section 17302 violated the Privileges and Immunities clause of the Federal Constitution and provided a New York Supreme Court decision holding that New York's alimony statute was unconstitutional, *Matter of Lance J. Friedsam v. State Tax Comm.*, (N.Y. Sup. Ct., App. Div., 3d Dept., No. 44145 December 15, 1983.)

additional amended returns for the years for which the statute of limitations is open, but this workload is not expected to be significant.

FISCAL IMPACT

Departmental Costs

The nonresident alimony provision would not significantly impact the department's costs.

Tax Revenue Estimate

The nonresident alimony provision is estimated to result in losses under the PITL as shown in the following table.

Retroactive to Open Years Enactment Assumed After June 30, 1999 $ Millions		
1999-00	2000-01	2001-02
-$5	-$2	-$2

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

Revenue Discussion

This estimate was calculated from a microsimulation analysis of nonresident returns on which an alimony deduction was claimed. The tax liability of each return was recalculated using the proposed method of accounting for alimony payments. This provision would allow taxpayers to file amended returns for all open years (back to 1995, or earlier if the statute of limitations remains open under a waiver or other extension). For this estimate, it is assumed that the probability of filing an amended return would be about 10% for the 1995 tax year and that the probability would increase incrementally to 50% for 1998. It is assumed that for tax years 1999 and beyond, taxpayers would be in full compliance.

ISSUE #2: Excess State Disability Insurance Refunds

EFFECTIVE DATE

The excess state disability insurance provision would take effect January 1, 1999, and would apply to returns for the 1999 taxable year filed in 2000. It is expected that the improved method for crediting refunds would be implemented for the 2000 taxable year processed in 2001.

BACKGROUND

The State Disability Insurance Fund, created under the Unemployment Insurance Code, is funded by contributions withheld from the first $31,767 in wages paid to each covered employee in California. Employers are required to withhold the disability insurance contributions from the wages of each employee up to the taxable wage limits and remit the funds to the Employment Development Department

(EDD) quarterly. The tax rate and maximum withholdings due from an employee was $412.97 for 1993 and 1994 (1.3% of $31,767), $317.67 per year for taxable years 1995 and 1996 (1% of $31,767) and $158.84 for 1997, 1998, and 1999 (.5% of 31,767). However, if a taxpayer has more than one employer and earns more than $31,767 during a year, the taxpayer's employers could jointly withhold more than the maximum required. The taxpayer is entitled to a refund of the excess amount.

Taxpayers may claim a refund of excess state disability insurance payments on their state income tax return. Prior to 1995, income tax form instructions did not specifically notify 540A and 540EZ filers that a credit was available for excess state disability insurance and that they must file Form 540 to claim a refund of excess state disability insurance. For tax year 1995, 540A and 540EZ tax booklets informed taxpayers that they must file Form 540 to claim the credit. For tax year 1996 and after, Form 540A allows taxpayers to claim the excess state disability insurance credit, while the Form 540EZ provides instructions informing taxpayers that they may file a Form 540, 540A or 540NR to claim the excess state disability insurance credit.

SB 1682 (Ch. 1157, Stats. 1996) requires the EDD, in conjunction with the Franchise Tax Board (the department), to identify taxpayers who overpaid state disability insurance and issue refunds. According to the author's office at that time, the legislative intent of the bill was to remove from the tax forms all lines requiring taxpayers to claim excess state disability insurance and to create an automatic process whereby taxpayers would receive automatic refunds without filing a claim. The law:

- Required retroactive refunds, with interest from April 15th of the tax year following the overpayment, to be paid by October 15, 1997, for tax years 1993, 1994, and 1995 to taxpayers who filed Forms 540A or 540EZ and did not claim their state disability insurance overpayments; and

- Beginning with the 1996 tax year, required the director of the EDD to identify and refund to taxpayers overpayments of state disability insurance, with interest from January 1 of the tax year following the overpayment at a rate equal to the earnings rate of funds placed in the State Disability Insurance Fund.

Although the Form 540 provided taxpayers an opportunity to claim refunds, the department and the EDD found that a significant number of taxpayers neglected to claim the credit. Therefore, the department and the EDD administratively agreed in November 1996 to identify and refund (without interest) any overpayment of state disability insurance where taxpayers had filed Form 540 or 540NR.

To date, the department, in conjunction with the EDD, has reviewed 1.16 million potential overpayments for prior years and credited approximately 708,000 state disability insurance overpayments that had not previously been claimed. Based on time constraints and resource limitations, the department has continued collaborating with the EDD to retroactively process state disability insurance overpayments, with the understanding that a more efficient long-term processing solution would be explored for future years.

<u>SPECIFIC FINDINGS</u>

The Revenue and Taxation Code provides that any excess state disability insurance contribution shall be credited against income tax and applied to the year the excess contribution occurred. Any overpayment of taxes may be refunded. Denial of the credit may be appealed to EDD.

The Revenue and Taxation Code provides that interest shall be allowed on overpayments of tax at an adjusted rate established in accordance with the rate of interest paid by the Internal Revenue Service on refunds. If any overpayment of tax is refunded or credited within 45 days after the date the return is filed, or within 45 days of the last date for filing the return, whichever is later, no interest will be allowed on the overpayment.

Prior to the enactment of SB 1682, the **Unemployment Insurance Code** did not allow interest to be paid on state disability insurance overpayments. Additionally, taxpayers with two or more employers were required, within three years from the last day prescribed for filing a tax return, to claim a refund of state disability insurance overpayments by filing a personal income tax Form 540 for the taxable year in which the overpayment was made. However, as a result of SB 1682, for 1996 and future years, the Director of the EDD is required to identify and refund overpayments of state disability insurance to taxpayers with interest from January 1 of the year following the year of the overpayment at a rate equal to the earnings rate of funds placed in the State Disability Insurance Fund.

The Government Code authorizes an offset claim procedure whereby the Controller may collect money due the state by deducting the amount of the debt from any money that the state may owe the debtor, i.e., state disability insurance or income tax refunds. The department administers this program for the Controller. If a taxpayer owes income tax, any excess state disability insurance will be applied against tax owed or against other amounts owed, as identified by the offset program.

The Unemployment Insurance Code provides for reimbursement of the department's administrative costs for processing tax forms on which taxpayers claim excess state disability insurance.

Currently, taxpayers who have had excess state disability insurance withheld by their employer may receive a refund in two ways: claim the excess state disability insurance credit on a timely filed Form 540 or 540A return or, for those taxpayers who fail to request credit due to them, receive a refund through a process administered jointly by the EDD and the department to identify and refund amounts due but not claimed on the tax return.

Currently, the **Unemployment Insurance Code** requires, for tax years beginning on or after 1996, that the Director of the EDD identify and refund overpayments, with interest from January 1 of the tax year following the overpayment, to taxpayers who have overpaid state disability insurance contributions but who have not filed for refunds. However, the EDD does not have an automated system in place and does not have all of the information needed to make direct refunds to taxpayers. Thus, the EDD has contracted with the department to process the refunds. However, the interest rate paid, and the date from which interest is calculated, by the State Disability Insurance Fund is different from the interest rate and calculation date for computing interest on income tax refunds. The department would like to implement a system where overpayments of state disability insurance are credited immediately upon receipt of a tax return. However, the current interest rate calculation prevents implementation of this process.

This bill would clarify that payments need not be made directly from the State Disability Insurance Fund and that interest would be paid according to the method and rate for overpayments of tax rather than the method and rate applicable to overpayments of amounts creditable to the State Disability Insurance Fund.

Policy Considerations

This bill would retain the program to refund excess state disability insurance through the tax return while ensuring that taxpayers who fail to claim the credit on their return still would be identified as quickly as possible to receive a refund of their excess contributions. Moreover, this bill would allow interest at the same rate and under the same conditions as if a taxpayer had excessive income tax withheld from his or her paycheck. The bill would allow the EDD and the department to continue to work collaboratively to find the most effective and efficient ways to credit excess state disability insurance money that is due to taxpayers.

Implementation Considerations

Department staff is developing plans to implement the excess state disability provision during the earliest possible taxable year. The provisions regarding interest would be implemented for refunds issued for the 1999 taxable year, which would be processed in 2000. Department staff anticipates that provisions for crediting excess state disability insurance upon receipt of a return would be implemented for returns filed for the 2000 taxable year processed in 2001.

FISCAL IMPACT

Departmental Costs

Departmental costs are difficult to determine until further implementation plans are developed. However, it is anticipated that the department’s costs to implement the excess state disability provision would be reimbursed through an agreement with the EDD.

Tax Revenue Estimate

Any refunds directly paid from the Personal Income Tax Fund would be reimbursed by the State Disability Insurance Fund. Thus, the excess state disability provision would not have any revenue impact under the PITL or the B&CTL.

ISSUE #3: Federal Adjustments

EFFECTIVE DATE

The federal adjustments provision would apply to federal determinations that become final on or after January 1, 1999.

LEGISLATIVE HISTORY

Enactment of SB 571 (Stats. 1992, Ch. 335) created parallel but not duplicate code sections regarding the reporting of federal changes in Section 18451 of the PITL and Section 25432 of the B&CTL. PIT taxpayers were required to report only changes or corrections that affected the amount of tax payable (either a refund or assessment) while B&CT taxpayers were required to report all changes (an exemption clause was included in the PITL). Upon the creation of the AFITL by SB 3 (Stats. 1993, Ch. 31), these two code sections were combined. The exemption clause found in the prior PITL was modified to require only the reporting of changes that increased the amount of tax payable and was made applicable to all taxpayers. Thus, B&CT taxpayers no longer were required to report all changes.

SPECIFIC FINDINGS

Current state law requires the taxpayer to notify the department if the amount of gross income or deductions reported to the Internal Revenue Service (IRS) for any year is changed, either by the taxpayer or federal authorities. However, a change in the amount of gross income or deductions that does not result in an increase in the amount of California tax payable by the taxpayer is arguably not required to be reported to the department.

The taxpayer can report a change by sending the department a copy of the federal change documents or by filing an amended tax return. If required to be reported, the change must be reported within six months after a “final federal determination” of this change or correction. “Final federal determination” is defined in regulations (Cal. Code of Regs., Title 18, Section 18586.3) as an irrevocable determination or adjustment of a taxpayer’s federal tax liability from which there exists no further right of appeal, either administrative or judicial. The regulation lists three examples of different types of final federal determinations:

- A closing agreement pursuant to Internal Revenue Code (IRC) Section 7121,
- A notice of deficiency (IRC Section 6213(a)) or the expiration of the appeal period for the judgment of the court of last resort, or
- The assessment of a deficiency pursuant to a waiver filed under IRC Section 6213(d).

Changes that must be reported to California when they increase the amount of tax payable include:

- Amendments made on a return filed by the taxpayer with the IRS,
- Results of a revenue agent's examination or other changes or corrections by the IRS,
- Change or correction by any other officer of the U.S. or other competent authority, or
- Renegotiation of a contract or subcontract with the U.S.

If a change is timely reported by the taxpayer, the department has two years from the date the change is reported to assess any additional tax resulting from the change. If a taxpayer does not report the change as required, or fails to file an amended return with the state, the statute of limitations for assessment by the department is suspended and the department may issue an assessment at any time. If the taxpayer advises the department of a change, but does so only after the expiration of the six-month period for reporting, the department has four years from the date the change is reported to issue an assessment with respect to the change.

A change in the amount of gross income or deductions which results in a federal refund of tax is not required to be reported to the department. However, in order for a state refund to be allowed the taxpayer must file a claim for refund resulting from a change within two years from the date of the final federal determination.

Through reciprocity arrangements with the IRS, the department generally receives directly from the IRS copies of examination reports of individuals with California addresses. Department staff reviews the reports and issues applicable assessments, not waiting for notice from the taxpayer. However, the department does not always receive copies of examination reports for bank and corporation taxpayers with business locations in multiple states or with out-of-state addresses.

This bill would make the period to assess additional tax resulting from a federal change the same whether information is received from the taxpayer or the IRS. If the department receives notification from the IRS within six months of the final federal determination, the department would have two years from the date the change is reported to issue an assessment. If the department receives notification from the IRS after the six-month period, the department would have four years from the date the change is reported to issue an assessment.

This bill would define the final federal determination date. The date of final federal determination would be the date on which each adjustment or resolution (assessment, refund or no change) resulting from an IRS examination is assessed pursuant to IRC Section 6203 (commonly known as the 23C date).

This bill would clarify that notification of a change or correction by the taxpayer or IRS must be sufficiently detailed to allow computation of the resulting California tax change. This provision clarifies that the statute of limitations starts when sufficient notice is provided to the department by the taxpayer or the IRS.

This bill would clarify that taxpayers must notify the department of any federal change that increases tax for any year and to require B&CT taxpayers to report all changes or corrections to gross income or deductions, even if the changes or corrections do not result in an increase in tax payable for any year. This bill would not otherwise change the period of time allowed for assessments or refunds.

This bill would clarify that taxpayers who are required to report federal changes are required to (1) report each final federal determination, and (2) report changes to any item reportable on the federal income tax return.

This bill also would remove an unclear phrase from R&TC Section 19060.

Policy Considerations

When the Franchise Tax Board sponsored SB 571 (Stats. 1992, Ch. 335), it recognized that PIT and B&CT taxpayers should be treated differently. However, when SB 3 (Stats. 1993, Ch. 31) combined former R&TC Sections 18451 and 25432, the exemption clause contained in the prior PIT law was inadvertently made applicable to all taxpayers.

The date that each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC Section 6203 is a fixed date that can easily be determined by both the taxpayer and the department. Using this date for the final federal determination date would clarify when the statute of limitations begins and ends.

The statute of limitations would be the same regardless of how the department receives the federal information.

Implementation Considerations

The federal adjustments provision would reduce disputes between taxpayers and the department by defining the final federal determination date. Taxpayers can easily identify the date since the taxpayer receives an assessment, refund or “no change” report once the adjustment or resolution is assessed pursuant to IRC Section 6203 (commonly known as the “23C date”). The department can identify this date by checking for corresponding entries on the IRS Master File. Taxpayers and the department can verify the date by requesting a copy of Form 23C (or its equivalent) from the IRS.

The federal adjustments provision also would reduce disputes between taxpayers and the department by clarifying current law.

The federal adjustments provision would reinstate the provisions of the B&CTL that existed prior to the creation of the AFITL, providing department staff with the information necessary to verify that income or losses are reported correctly in subsequent years.

Implementation of the federal adjustments provision would occur during the department’s normal annual system update.

FISCAL IMPACT

Departmental Costs

The federal adjustments provision would not significantly impact the department’s costs.

Tax Revenue Estimate

Requiring taxpayers to notify the department of all federal adjustments (unless exempt under the PIT exclusion) encourages taxpayers to report accurately in subsequent years and also enables department staff to conduct effective examinations of tax returns. To the extent this bill improves compliance and/or the effectiveness of audits, it potentially could generate additional revenue annually. However, no data are available to measure or even suggest an order of magnitude.

ISSUE #4: Alternative Minimum Tax Depreciation

EFFECTIVE DATE

The alternative minimum tax (AMT) provision would apply to taxable or income years beginning on or after January 1, 1999.

BACKGROUND

In 1987, California enacted legislation that established AMT in lieu of the previous tax on preference income (AB 53 (Stats. 1987, Ch. 1138)). The California legislation substantially conformed state law to the AMT provisions adopted at the federal level as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income could avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

SPECIFIC FINDINGS

Existing state and federal laws generally allow as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business or property held for the production of income.

Existing federal law uses the Modified Accelerated Cost Recovery System (MACRS) for property placed in service after 1986. Under MACRS, the depreciation deduction is computed using the "applicable depreciation method," the "applicable recovery period," and the "applicable convention." MACRS provides three applicable depreciation methods: 200% declining balance, 150% declining balance, and straight-line. The applicable recovery period ranges from three to 50 years, depending on the type of property. The applicable convention requires that property placed in service be treated as being placed in service on the mid-point of either the taxable year (half-year convention), the month (mid-month convention), or the quarter (mid-quarter convention).

Existing federal law provides an alternative depreciation system (ADS), which provides generally longer recovery periods than the standard MACRS and requires the straight-line depreciation method. Six types of property are subject to ADS.

Existing federal law requires that taxpayers subject to AMT compute depreciation differently for AMT than for regular tax. For most depreciable real property and property depreciated under the straight-line method for purposes of the regular tax, AMT depreciation is computed under ADS. For all other property, AMT depreciation is computed under ADS except that the 150% declining balance method is substituted for straight-line depreciation (switching to straight-line in the year necessary to maximize the allowance). This 150% declining balance method is not allowed if the straight-line method was used for regular tax purposes. This restriction prevents the possibility of AMT depreciation being greater than regular tax depreciation.

Existing state law provides that, with respect to reading state law that is conformed to federal law, due account be made for differences in federal and state terminology, effective dates, substitutions of income for taxable year, and other obvious differences. **Existing state law** also provides that any reference to a specific provision of the IRC shall include any modifications of that provision.

Existing state PITL generally conforms to the federal MACRS, uniform capitalization rules, and to the federal AMT depreciation rules.

Existing state B&CTL does not conform to the federal MACRS or ADS. Instead, property must be depreciated over its estimated useful life, which is the period over which the asset reasonably may be expected to be useful in the trade or business. Taxpayers may elect to use the useful life specified under the federal class life Asset Depreciation Range system (ADR). ADR groups assets into more than 100 classes and assigns an asset guideline period, or useful life, to each class.

Existing B&CTL conforms to the federal AMT depreciation. The B&CTL provisions, by conformity, refer to depreciation computed under IRC sections 167 and 168 for regular tax purposes. Since regular tax computations under the B&CTL do not utilize the federal depreciation rules of IRC Sections 167 and 168, the California rules are inconsistent with the depreciation rules for corporations for regular tax purposes.

This bill would replace the references to federal law for California AMT purposes with references to the depreciation provisions under the B&CTL.

Policy Considerations

Clarifying references aids the administration of the law by alleviating any potential confusion that may otherwise occur.

Implementation Considerations

Implementing the AMT provision would not affect the department’s programs and operations.

FISCAL IMPACT

Departmental Costs

No departmental costs are associated with the AMT provision.

Tax Revenue Estimate

The AMT provision would not impact state tax revenue.

ISSUE #5: VOLUNTARY CONTRIBUTIONS

EFFECTIVE DATE

The voluntary contribution provisions would apply to taxable years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 2366 (Stats. 1998, Ch. 818) enacted the most recent voluntary contribution fund, the Emergency Food Assistance Program Fund.

Specific Findings

Existing state law allows taxpayers to designate contributions to 12 voluntary contribution funds on their 1998 individual state income tax returns filed in 1999. The AFITL requires the department to collect the contributions and notify the Controller's Office of the amounts to transfer into the individual fund accounts.

Except for the California Seniors Special Fund, **existing state law** requires that, in the event that payments and credits reported on the return do not exceed the individual's tax liability, the return is treated as if no designation has been made.

Except for the California Seniors Special Fund and the California Mexican American Veterans' Memorial Beautification and Enhancement Account, **existing state law** requires that contributions with no specified designee be transferred to the General Fund.

Except for the California Seniors Special Fund, **existing state law** requires that if contributions are made to more than one account and insufficient moneys exist for each designated contribution, the moneys would be prorated among those designated funds.

The State Children's Trust Fund, the California Fund for Senior Citizens and the Fish and Game Preservation Fund require the individual be notified in cases where 1) no designee is identified; 2) the contribution amount is transferred to the General Fund; and 3) the discrepancy between the amount actually available for designation and the amount designated exceeds $10.

Because of the inconsistencies between the various voluntary contribution funds, occasionally, the department must refund the total designation amount to the taxpayer.

This bill would create a general provision under the AFITL directing that 1) voluntary contributions with no specified designee be transferred to the General Fund; and 2) when more than one voluntary contribution is designated and insufficient moneys exist to satisfy the total amount designated, the amount would be allocated among the designees on a pro rata basis. **This bill** would delete language in voluntary contribution sections that would become redundant and unnecessary as a result of the general provision created by this bill.

Policy Considerations

This bill would establish a general provision ensuring that all current and future voluntary contribution funds would be administered in the same manner, unless otherwise specified.

Implementation Considerations

Procedural, schedule, and instruction changes could be incorporated during the department's normal annual update.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

The voluntary contribution provisions would not impact the state's income tax revenue.

ISSUE #9: Due Date for Tax Returns

EFFECTIVE DATE

As a tax levy, this bill would become effective upon enactment. The due date for tax returns provision would apply to returns required to be filed on or after the date the bill becomes effective.

SPECIFIC FINDINGS

All due dates in **federal law** and most due dates in **state law** are expressed as "the 15th day of the [appropriate] month following the close of the [calendar, fiscal, income, or taxable] year."

Existing state law pertaining to the filing of individual and fiduciary income tax returns requires the return to be filed on or before the 15th day of April following the close of the calendar year. For taxpayers filing on a fiscal year basis, returns must be filed on or before the 15th day of the fourth month following the close of the fiscal year. The department may grant an extension of time to file the return, but no extension shall be for more than six months.

Existing state laws pertaining to the filing of returns by a partnership, limited partnership, and limited liability company require the returns to be filed on or before the 15th day of the fourth month following the close of the taxable or income year. In the case of a cooperative association, returns shall be filed on or before the 15th day of the ninth month following the close of its income year. Finally, with respect to a tax-exempt organization, returns for tax on unrelated business income shall be filed on or before the 15th day of the fifth month following the close of the income year.

Existing state law pertaining to the filing of income tax returns by a taxpayer subject to the B&CTL requires the return to be filed within two months and 15 days after the close of its income year. This wording, applied literally, could result in a due date that is other than the 15th day of the month. The income year of a business entity may end at some time other than the end of the month when the existence of the entity is terminated, requiring a "short period" return to be filed. For example, an entity terminating its income year on the 10th or the 20th of the month would have a due date for its final return on the 25th of the third month or the 5th of the fourth month, respectively, following termination.

This bill would require a taxpayer to file an income tax return "on or before the 15th day of the third month following the close of its income year."

Policy Consideration

The due date for tax returns provision is a technical correction that would conform to federal law and other provisions of state law to eliminate ambiguity with respect to the due date for filing a tax return. During the 1997-1998 Legislative session, a similar proposal, AB 1694, passed into law to conform the language pertaining to the filing requirements of a partnership, limited partnership, and limited liability company to federal law.

Implementation Considerations

Implementing the due date for tax returns would not affect the department's programs and operations.

FISCAL IMPACT

Departmental Costs

No departmental costs are associated with the due date for tax returns.

Tax Revenue Estimate

The due date for tax returns would not impact the state's income tax revenue.

ISSUE #10: Commercial Domicile

EFFECTIVE DATE

This bill provides language that would apply the commercial domicile provisions to all income years in which the Franchise Tax Board may propose an assessment or allow a claim for refund.

BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended generally to be "in lieu of" all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the B&CTL and is not included in a unitary group's combined report.

Many insurance companies have adopted a structure in which the parent corporation (which is subject to the B&CTL) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited from doing so for regulatory reasons.

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend deduction was enacted in the B&CTL, to the extent the dividends arose from activities in California.

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is at least 20% but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation's recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.

Current state law (B&CTL) provides for the use of an apportionment formula when assigning *business* income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness* income from intangible property is generally allocated to the taxpayer's commercial domicile. *Nonbusiness* income from tangible property is generally allocated to the physical location of the property.

California Regulation Section 25120(c)(4) applies transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends also will be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose which furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., 3/2/83).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **The B&CTL**

(Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

The B&CTL (Section 24402) excludes from taxable income a portion of any dividends received in income years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. In making this computation, a formula is used, allocating within and without the state certain items, such as federal income tax, which affect earnings and profits but which do not affect the income taxable for California tax purposes.

Once California deductible dividends have been computed, the deduction is further limited in a manner similar to the federal stock ownership rules. One hundred percent of the computed deduction is allowed when received from a corporation more than 50% owned by the recipient; 80% of the computed deduction is allowed when received from a corporation which is at least 20% but less than 50% owned; and 70% of the computed deduction is allowed when received from a corporation less than 20% owned.

Under the B&CTL (Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula.

The rationale for Section 24410 is to provide similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402. Section 24410 essentially determines the hypothetical amount of income subject to tax that would have been properly imposed on an insurance company if it were in fact subject to the franchise tax, and treats the gross premiums tax as having been imposed on that income.

When Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer’s principal trade or business (i.e., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 (1945)). Earlier versions of California regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in Section 25120, and that the (former) Franchise Tax Board regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, supra.). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be facially discriminatory against interstate commerce, without legitimate local purpose, and thus unconstitutional (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine (1997) 520 U.S. 564, 137 L. Ed. 2d 852). Thus, it is likely that Section 24410 would be found unconstitutional, to the extent the deduction is allowed only to a California domiciled corporation, as discriminatory against interstate commerce.

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

This bill would remove the commercial domicile restriction from Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax.

Policy Considerations

There does not appear to be specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance stock. Further, the objective of Section 24410 appears to be the same as the objective of Section 24402: to provide relief from double taxation. The commercial domicile restriction of Section 24410 was probably included because, at the time of enactment, such dividends were generally thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this bill would make the tax policy of Section 24410 consistent with Section 24402.

Implementation Considerations

If the commercial domicile restriction in Section 24410 is not removed from California law, the department is required by the state's Constitution to enforce the restriction until an appellate court declares California law to be in violation of federal law. In fact, the department recently lost such a case at trial court and has filed an appeal with the appellate court. Removing the commercial domicile restriction in Section 24410 would prevent the department from incurring litigation costs on the constitutionality of Section 24410. Further, this bill would relieve taxpayers from using resources to defend against the administrative application of a law that is probably unconstitutional.

Implementation of the commercial domicile provisions would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

The commercial domicile provisions would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of the commercial domicile provisions would be determined by the amount of insurance dividends (from insurance subsidiaries operating in California) deducted by recipient corporations domiciled outside California, the average apportionment factor of each recipient, and the franchise tax rate.

The commercial domicile provisions would result in annual revenue losses that cannot be quantified. Sufficient data do not exist to estimate the magnitude of losses. Even without the provision, revenue losses are likely as the result of cases testing the constitutionality of the current statute under which only commercially domiciled corporations are allowed the deduction.

It is assumed the commercial domicile provisions would be enacted after June 30, 1999, and effective for all years for which the statute of limitations remains open. For issues of this sort, generally it is assumed the statute would be open for roughly six income years.

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

ISSUE #11: Dependent Parent Credit

EFFECTIVE DATE

This provision would apply to taxable years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

When originally enacted the dependent parent credit was specifically denied to a person claiming the head of household (HOH) filing status. This restriction was later removed from the credit by SB 426 (Stats. 1991, Ch. 472) as being duplicative since the statute also required the taxpayer to be married and filing a separate return.

SPECIFIC FINDINGS

Federal law has no comparable credit provisions for the dependent parent credit.

Current state law provides a dependent parent credit comparable to the joint custody head of household credit. The dependent parent credit is equal to the lesser of 30% of the net tax or $200, as adjusted for inflation[5], to a taxpayer who:

- is married at the close of the taxable year and files a separate return;
- did not have a spouse as a member of his/her household for the last six months of the taxable year;
- maintains during the taxable year a household, whether or not it is the taxpayer's home, as the principal place of abode of a dependent mother or father; and
- furnishes over one-half of the cost of maintaining the household during the taxable year.

The requirement that the taxpayer must be married and file a "separate return" was intended to restrict the credit for married persons to those who use the filing status "married filing separately." However, some married taxpayers have argued that the HOH filing status meets the "separate return" requirement and therefore they are entitled to both the HOH filing status and the dependent parent credit.

This bill would specify that a taxpayer that uses the HOH filing status or surviving spouse filing status cannot claim the dependent parent credit. This change is consistent with the original intent of the dependent parent credit.

Policy Considerations

This dependent parent credit provision would prevent married taxpayers from using the HOH filing status and claiming the dependent parent credit, thus precluding a double tax benefit.

Implementation Considerations

This dependent parent credit provision would not significantly impact the department's programs or operations. Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

This dependent parent credit provision would result in insignificant revenue gains.

Tax Revenue Discussion

The revenue gain from eliminating the double tax benefit would depend on the number of taxpayers claiming the dependent parent credit when applying the HOH filing status. These data are not known, but due to the total number of

[5] $269, $275 and $281 for 1996, 1997 and 1998 taxable years respectively.

credit claims (115 in 1996), the potential revenue gain from elimination of double benefit claims is estimated to be insignificant.

ISSUE #12: 1998 Legislation Clean Up

EFFECTIVE DATE

Unless stated otherwise, these clean-up provisions would apply to taxable or income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

During the 1998 legislative session, numerous bills were enacted that affected the PITL, the AFITL, and the B&CTL. The enactment of these bills created some technical problems because they contained minor technical errors. As discussed below, this bill would correct the technical issues created by 1998 legislation.

1. Make the following technical clean-up changes made necessary by the enactment of AB 2797 (Stats. 1998, Ch. 322) and AB 2798 (Stats. 1998, Ch. 323).

   A. AB 2798, as enacted, modified the apportionment formula for all other economic development area tax incentives, including the Local Agency Military Base Recovery Areas (LAMBRA) net operating loss, but inadvertently left out the modifications for the apportionment formula for the LAMBRA tax credits. This provision would make the appropriate apportionment formula changes to the LAMBRA credits.

   B. Make a technical correction to the minimum franchise tax provisions contained in AB 2798 by clarifying the type of corporation that would be included in the definition of "qualified new corporation" by clearly specifying that the business must be incorporated under the laws of this state or must have qualified to transact intrastate business in this state. Also, this bill would specify that the reduced tax applies only to businesses that are incorporated on or after January 1, 1999.

   C. Make a technical correction to the Scholarshare provision contained in AB 2797 by adding the words "and this part."

   D. Make a technical correction to the life insurance premiums provision contained in AB 2797 by replacing the word "of" with "or" in the last subdivision.

   E. Make a technical correction to the enterprise zone sales or use tax credit to change “either a bank or corporation” to be “a corporation” since banks are included in the definition of corporation.

2. Make the following technical clean-up changes made necessary by the enactment of AB 3 (Stats. 1998, Ch. 1012).

   A. Make a technical correction to the LAMBRA net operating loss and LAMBRA business expense deduction by deleting the sunset and repeal date intended to be deleted by AB 3.

B. Make a technical correction to the LAMBRA sales or use tax credit provisions in the B&CTL by replacing the term "taxable year" with "income year."

3. Make changes that AB 1613 (Stats. 1998, Ch. 792) made to PITL provisions relating to Scholarshare, but inadvertently failed to include in the equivalent B&CTL provisions. Also make changes that AB 2812 (Stats. 1998, Ch. 954) made to the B&CTL Scholarshare provisions, but failed to include in the PITL provisions.

4. Make changes to the enterprise zone NOL provisions by including a reference to other economic development area NOL sections. Also this bill would replace the word “Includes” with “includes” and would replace the term “taxable year” with “income year.”

Policy Considerations

These clean-up provisions would aid the administration of the law by simplifying reporting requirements for LAMBRA taxpayers and alleviating any potential confusion that may result from these other technical issues.

Implementation Considerations

Implementing these clean-up provisions would not affect the department’s programs and operations.

Fiscal Impact on State Budget

Departmental Costs

No departmental costs are associated with these clean-up provisions.

Tax Revenue Estimate

These clean-up provisions would not impact the state’s income tax revenue.

ISSUE #13: Code Maintenance

EFFECTIVE DATE

The code maintenance provisions would be operative January 1, 1999.

BACKGROUND

During the period from 1983 through 1998, numerous sections within the PITL, the AFITL, and the B&CTL have become obsolete. In addition, due to changes in the manner of adopting federal law by reference, the phrasing of certain older sections is inconsistent with the current methodology. Certain cross-references to other sections need to be updated for changes that have taken place that were not changed when the referenced section was modified. Along with numerous minor purely language style changes, five different technical issues resulting from the incomplete modifications have been identified.

SPECIFIC FINDINGS

When enacted in 1992, Section 23335's original reference to subdivisions (c) and (d) of Section 25401 (now Section 18601) related to dissolving or withdrawing taxpayers and taxpayers filing as part of a unitary business. However, when Section 18601 was amended, an amendment necessary to reflect the changes in Section 23335 was overlooked, thereby unintentionally limiting its application to taxpayers filing short period returns and S corporations when all final returns should be treated by the department as a request for a tax clearance certificate.

Section 19053 provides that any tax imposed pursuant to the B&CTL relating to commencing corporations, corporate reorganizations, and corporations that resume business after ceasing operations, and based on the net income as disclosed by the return, cannot be considered a deficiency assessment. This section is unnecessary and obsolete since the term "deficiency" is defined in Section 19043.

The term “assessment” as defined by Sections 17013 and 23043 includes “proposed additional assessments” and the term “proposed additional assessment” is used in Sections 19089 (regarding effect of bankruptcy) and 19411 (regarding recovery of erroneous refunds). However, the department does not issue “proposed additional assessments” in its processes. This incorrect terminology may cause confusion. When the department proposes an assessment under the PITL, AFITL, B&CTL and Taxpayer Bill of Rights (TBR), it proposes a deficiency. The term “deficiency” is used throughout the codes administered by the department in conjunction with a “proposed” assessment, except in the following sections: 19089, 19106 (regarding interest on unpaid penalty), and 19411. These inconsistencies may cause confusion. Section 19089 makes reference to a “period” for mailing a notice of proposed assessment. In context, the correct terminology is “period of limitations” and should be so stated. This incomplete terminology may cause confusion.

Probate Code Section 9201 contains an erroneous code section reference when referring to eligible claims under the PITL. In addition, Probate Code Section 9203 contains an erroneous code section reference regarding the statutory rate of interest for certain premature distributions. Both of these code sections were renumbered when the AFITL was created; however, the Probate Code references were not amended to reflect the renumbered sections.

Certain sections of the R&TC relating to exempt organizations contain various inaccurate code section references and an outdated provision relating to the exemption for a qualified group legal services plan.

This bill would repeal obsolete provisions, amend sections to update cross-references and amend sections to adopt federal law by reference in a consistent manner. Among the specific changes are:

1. Amend R&TC Section 23335 to delete reference to subdivisions (c) and (d) of Section 18601, thus causing the deemed request for a tax clearance certificate to be applicable for all final returns filed under Section 18601.

2. Repeal Section 19053 of the AFITL as unnecessary and obsolete.

3. Repeal Sections 17013 and 23043 to remove the non-comprehensive and non-substantive definition of “assessment” because it is unnecessary.

4. Amend Sections 19089, 19106 and 19411 to remove the incorrect reference to proposed “additional” assessments and to specify that the proposed assessments at issue are proposed “deficiency” assessments. Also, amend Section 19089 to clarify that the period for mailing the notice of proposed deficiency assessment is the “period of limitations.”

5. Amend Probate Code Section 9201 to correct the reference from R&TC Section 19266 to R&TC Section 19517 and amend Probate Code Section 9203 to correct the reference from R&TC Section 19269 to R&TC Section 19521.

6. Amend the various individual R&TC sections on exempt organizations to correct inaccurate references and repeal the outdated section on a qualified group legal services plan.

Policy Considerations

These suggestions are code maintenance type changes. Unless the code is maintained by removing unintentional inconsistencies and out-dated laws, the code may become unnecessarily confusing for taxpayers and department staff. It is beneficial to good tax administration that the law be as clear as possible. To the extent that this bill helps in that endeavor, this bill is a good-government proposal: good for department staff and taxpayers.

These code maintenance technical amendments and the repeal of obsolete sections will make the PITL, the AFITL, and the B&CTL easier for users of the statutes to determine the meaning of current California law.

Implementation Considerations

These code maintenance changes would be accomplished during the normal annual update of the department’s systems.

Fiscal Impact

Departmental Costs

These code maintenance changes would not impact the department’s costs.

Tax Revenue Estimate

These code maintenance changes would not impact state income tax revenue.

ISSUE #14: Definition of Wages/AB 3086 Clean-Up

EFFECTIVE DATE

The definition of wages provision would apply to taxable years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

Assembly Bill 3086 (Stats. 1994, Ch. 1049) modified employer reporting requirements for wage information and Personal Income Tax (PIT) withholding to the Employment Development Department (EDD). AB 3086 amended the UIC to state that the Report of Wages shall include "individual amounts required to be withheld under Section 13020." Although UIC Section 13020 provides the general statutory requirement for withholding of wages and the method for computing the amount of withholding, the term "wages" generally is defined in UIC Section 13009. In addition to these sections, UIC Section 13028 provides that income from pensions, annuities, and other deferred income are "wages" subject to withholding generally upon the election of the recipient.

A problem arises because UIC Sections 1088 and 13021, which require the Report of Wages to be filed, do not specifically reference UIC Section 13028 for purposes of defining which "wages" must be included in the Report of Wages. In addition to other changes, AB 3086 did the following:

1. Changed the name of the Quarterly Contribution Return to the Report of Contributions.

2. Eliminated the filing of the Annual Reconciliation of Personal Income Tax Withheld form and the submission of the state copy of the employees Wage and Tax Statements (W-2). In its place, an employer files an Annual Reconciliation Return, which reports cumulative amounts for total wages, employer contributions, State Disability Insurance contributions, and PIT withholding amounts.

3. Added individual PIT withholding amounts to the existing wage report requirements.

These changes were part of a joint planning effort by EDD and the department to improve the accuracy, responsiveness, accessibility, and effectiveness of both PIT and employment tax systems. The changes were intended to ease the reporting burden of California employers while enabling EDD to capture more complete and timely information.

This bill would amend UIC Sections 1088 and 13021 to specifically include Section 13028 in the cross-referenced amounts required to be withheld. Additionally, this bill would amend UIC Section 13028 to provide that pensions, annuities, and other deferred income shall be treated as payments of wages. Thus, this bill would clarify which "wages" must be included in the Report of Wages by specifically including amounts received from pensions, annuities, and other forms of deferred compensation.

Policy Considerations

The intent of AB 3086 (Stats. 1994, Ch. 1049) was to simplify the reporting requirements in the Report of Wages to capture complete wage and withholding amounts on a timely basis. Confusion exists among tax practitioners and pension managers as to which amounts are properly required to be included in the Report of Wages. This bill would remove those doubts and implement the intent of AB 3086 to simplify reporting requirements. In addition, the timely filed wage information is used by the department to automate withholding verification when income tax returns are processed.

Implementation Considerations

Implementing this provision would not significantly impact the department's programs and operations.

Fiscal Impact on State Budget

Departmental Costs

No departmental costs are associated with this provision.

Tax Revenue Estimate

This provision would not impact the state's income tax revenue.