

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Sen. Rev. & Tax. Comm. Analyst: Jeani Brent Bill Number: SB 1229

Related Bills: See Prior Analysis Telephone: 845-3410 Amended Date: 6/30/1999

Attorney: Patrick Kusiak Sponsor: _____

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/Auto. Extension/Revivor Fee/Exempt Org

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED April 12, 1999 STILL APPLIES.

OTHER - See comments below.

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 all 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.

Board Position:

<input checked="" type="checkbox"/> S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ PENDING

Department Director

Date

Gerald Goldberg

7/27/1999

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.
13. General maintenance of the R&TC, including repealing obsolete provisions, updating cross-references, and making consistent references to federal law.
14. Clarify that payment of estimated tax by corporations and exempt organizations is not a prerequisite for receiving an extension of time to file a return.
15. Clarify that exempt organizations that are subject to tax on unrelated business taxable income are required to make estimated tax payments.
16. Eliminate the requirement for the revivor fee for exempt organizations and require all exempt organizations seeking revivor to submit a new exemption application when requested by the department.
17. Specify that an organization's exempt status may be revoked for failure to file any return required or failure to pay any tax due and exempt status may be reestablished only upon the filing of all returns or the payment of all taxes due.

SUMMARY OF AMENDMENT

The June 30, 1999, amendments made the following changes:

- A. Added the language, identified as #14 above, relating to extensions of time to file returns.
- B. Added the language, identified as #15 above, relating to exempt organization requirements for the payment of estimated tax.
- C. Added the language, identified as #16 above, relating to revivor fees.
- D. Added the language, identified as #17 above, relating to the revocation of exempt status.
- E. Removed the provisions that would change the definition of wages under the Unemployment Insurance Code (UIC). This change was made because AB 1634 also contains provisions that would make changes to the same UIC sections and the department would like all the definition of wages changes in the same bill to prevent double-joining issues.
- F. Removed Revenue and Taxation Code Section 17560, which contained code maintenance changes, to avoid double-joining issues with AB 1208, the general conformity bill.
- G. Added changes to the manufacturer's investment credit (MIC) that were inadvertently left out of AB 2798 (Stats. 1998, Ch. 323). AB 2798 extended the MIC to manufacturers of custom or prepackaged computer software partly by adding computers and computer peripheral equipment to the definition of

"qualified property." However, AB 2798 failed to modify a reference to "qualified property" contained in another subdivision relating to certain capitalized labor costs qualifying for the MIC. The amendments would modify the reference to "qualified property" to ensure that the reference includes the change made by AB 2798 regarding computers and computer peripheral equipment, as well as restore the capitalized labor costs qualifying for the MIC to the same class of taxpayers who qualified for such items prior to the enactment of AB 2798. The amendments also would provide that these MIC changes would apply to the same taxable or income years as does AB 2798 – those beginning on or after January 1, 1998.

- H. Placed the provisions that specify that a taxpayer who uses the head of household filing status or surviving spouse filing status cannot claim the dependent parent credit into the correct subdivision (e).
- I. Corrected a typographical error by changing "part-time resident" to "part-year resident."
- J. Changed the term single proprietorship to the correct term, sole proprietorship.
- K. Corrected several code maintenance provisions by striking out the unnecessary language and correcting incorrect references.
- L. Clarified the operative date for the commercial domicile provision by specifying that the provision applies to taxable "or income" years and provided an operative date for the federal adjustment/corrected tax return provisions.

Issues #14, #15, #16 and #17 will be discussed separately in this analysis. Except for the items discussed in this analysis, the department's analysis of the bill as amended April 12, 1999, still applies. The combined revenue estimate and Board positions are included below.

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 June 30, 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.	Extensions Of Time To File Returns	*	*	*
15.	Exempt Orgs/Payment Of Estimated Tax	*	*	*
16.	Revivor Fees	-Negl.	-Negl.	-Negl.
17.	Revocation Of Exempt Status	+Negl.	+Negl.	+Negl.

* = No revenue effect

** = No identifiable revenue impact

*** = Revenue losses cannot be quantified

-Negl. = Negligible revenue loss

+Negl. = Negligible revenue gain

BOARD POSITION

Support.

The Franchise Tax Board voted at various meetings to sponsor the legislative proposals included in this bill.

ISSUE #14: Extension of Time To File ReturnsEFFECTIVE DATE

The provision relating to extension of time to file returns would be effective on January 1, 2000, and would apply to all returns required to be filed or taxes due after that date.

LEGISLATIVE HISTORY

AB 3224 (Stats. 1992, Ch. 662) amended Revenue and Taxation Code (R&TC) Section 25402, renumbered as Section 18604 by Senate Bill 3 (Stats. 1993, Ch. 31), to

allow extensions of time to file returns required under the Bank and Corporation Tax Law (B&CTL) without specific written requests by taxpayers.

SPECIFIC FINDINGS

Existing state law authorizes the department to grant a reasonable extension of time for filing any return, declaration, statement, or other document required by the B&CTL up to a maximum extension of seven months. A separate section of law authorizes the department to grant a reasonable extension of time to exempt organizations for filing their annual information return or statement. This section does not specify a maximum extension time. Since the enactment of AB 3224, corporations and exempt organizations are allowed an automatic (paperless) extension with the condition that they file a return within the maximum extension period of seven months from the original due date.

If the return is not filed on or prior to the extended due date, the automatic extension does not apply. A late filing penalty plus interest is assessed, computed from the original due date of the return. The extension of time applies only to the due date of the return and does not extend the time for payment of the tax due. Tax is due on the original due date of the return without regard to extension. If the tax is not paid, underpayment of tax penalties will be imposed.

The specific language within the code section granting an automatic extension to corporate taxpayers conditions the automatic extension upon the payment of the estimated tax due. Prior to the automatic paperless extension statute, payment was required in order to be granted an extension of time to file. Current practice is that an automatic extension to file is allowed without verification of payment of tax due. FTB Notice 92-11, issued on October 23, 1992, clarified that the extension of time to file was not an extension of time to make payment and that the only condition for receiving an extension of time to file was that the return be filed within seven months of the original due date of the return. Therefore, the provision requiring payment as a prerequisite for the extension of time to file should have been deleted when AB 3224 was enacted, but was not.

This bill would delete the language that provides that payment of estimated tax is a prerequisite for receiving an extension of time to file a return. This bill also would repeal a redundant section of law that authorizes the department to grant a reasonable extension of time to exempt organizations for filing their annual information return or statement, allowing a single section of law to be all encompassing for entities subject to the B&CTL.

Policy Considerations

This bill would eliminate an apparent contradiction between the statutory law and department forms and instructions that have been in use since March 15, 1993. Eliminating this ambiguity would prevent potential confusion.

Implementation Considerations

Implementation of this provision would assist the department by clarifying the law and could be handled during normal annual updates.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

This provision would not impact state tax revenue.

ISSUE #15: Exempt Organizations/Payment Of Estimated Tax

EFFECTIVE DATE

The provision relating to estimated tax payments would apply to taxable and income years beginning on or after January 1, 2000, as specified by R&TC Section 18415.

BACKGROUND

Under **both state and federal law**, certain nonprofit organizations may apply for and be granted an exemption from income tax. Such organizations may be in the form of an association, a trust, or a corporation. The California Corporations Code governs the formation of corporations in California. A corporation may be incorporated as a "for profit" corporation or a "nonprofit" corporation. "For profit" corporations cannot qualify for tax-exempt status. California nonprofit corporations are either public benefit corporations, mutual benefit corporations or religious corporations.

Under current state law, nonprofit organizations are not automatically exempt from taxation. A nonprofit organization must apply for tax-exempt status with the department. A determination is made by the department based upon the facts and circumstances. **For California purposes** the exemption for nonprofit organizations is included in the B&CTL beginning with Section 23701 in Chapter 4, Article 1.

Under state income tax law, exempt organizations are required to file various returns with the department and Attorney General (AG). The type of return required to be filed with the department may vary depending upon the purpose of the organization and amount of gross receipts. Taxes also may be due based on the return filed. With certain exceptions, all exempt entities with annual gross receipts normally exceeding \$25,000 must file a Form 199 annual information return. Additionally, homeowners' associations, political organizations and some mutual or cooperative organizations that are exempt under federal law but not exempt under California law also may be required to file Form 100 for corporate income tax and pay any tax due. Moreover, if an exempt organization, other than a homeowners' association or a political organization, has income from an unrelated business of \$1,000 or more per year, that organization is required to file Form 109 and pay any tax attributable to the income shown on that form.

Certain organizations such as churches and exempt organizations that have gross receipts of not more than \$25,000 are excluded from having to file the information return and instead may be required to submit a notarized statement

containing such information as the name of the organization, its major activities, its source of income, and the section of the Internal Revenue Code under which it is exempt.

Section 23731, imposing tax on exempt organizations with unrelated business taxable income (UBTI), was added to the R&TC in 1951. The section specified that every exempt organization described in that section would be subject to the franchise tax (imposed under Section 23151) or the corporation income tax (imposed under Section 23501) upon its UBTI. Section 23151 specifically excluded exempt organizations from imposition of the franchise tax; therefore, exempt organizations were subject only to the tax provided in Section 23501, the corporation income tax.

In 1971, Section 23731 was amended and specified that every exempt organization (other than exempt trusts) described in that section was subject to tax at the "rates" imposed by Sections 23151 and 23501, rather than subject to imposition of "tax" under those sections.

A regulation for Section 23731 was adopted effective August 13, 1973, and clarified that taxes imposed by Section 23731 are taxes imposed under the corporation income tax, Section 23501, and that all provisions of the corporation income tax law and the regulations thereunder were applicable to the assessment and collection of the UBTI tax. The regulation, which still exists, specifies that exempt organizations subject to the UBTI tax are subject to the same provisions, including penalties, as are provided under the corporation income tax law.

SPECIFIC FINDINGS

Every exempt organization or trust is subject to the tax imposed upon its UBTI, defined as income earned by the exempt organization which is not related to its exempt function.

Exempt corporations pay tax on the UBTI at a rate of 8.84%, the current corporate income tax rate. Exempt trusts subject to UBTI pay tax using the graduated rate scheduled under the Personal Income Tax Law (PITL), currently 1% to 9.3%.

Section 23038 defines "corporation" and specifically excludes exempt organizations other than trusts exempt under Section 23701d.

The term "estimated tax" means the amount that the "corporation" estimates as the amount of tax imposed by the B&CTL. Regulation 25561 provides that "[i]n the case of a corporation subject to the tax imposed by Chapter 3 (Corporation Income Tax), the term 'estimated tax' is the amount which the corporation estimates as the tax imposed by the Bank and Corporation Tax Law, without regard to the minimum tax."

Taxpayers, including exempt trusts, under the PITL are subject to withholding requirements, but also must make estimated tax payments if at least 80% of their tax liability is not satisfied by withholding, or there is no withholding.

Exempt organizations (both exempt corporations and exempt trusts) which have UBTI should logically be required to make estimated payments depending upon the amount of their tax liabilities. However, while long-standing departmental practice,

based upon the earlier versions of the relevant statutory provisions discussed above and Regulation 23731, has consistently required all exempt organizations to make estimated tax payments under the same circumstances in which other taxpayers under the PITL and B&CTL (corporate income tax only) are so required, Section 23501 technically does not "impose" the UBTI and thus estimated tax payments may arguably not be legally required. Of course, this is fundamentally inconsistent with the fact that such organizations are clearly subject to the estimate penalty provisions, since Sections 19145 and 19147 of the Administration of Franchise and Income Tax Laws (AFITL), which deal with estimated payment penalties, make specific reference to "the tax imposed under Section 23731." Accordingly, while exempt organizations are subject to penalties for failure to make estimated payments, there is no clear statutory language under which they are technically required to make estimated tax payments.

This bill would add "or organization described in Section 23731" where appropriate and strike the word "rates" to clarify that exempt organizations are subject to not only the rates, but the "tax imposed" by that section, and are required to make estimated tax payments.

Current law provides procedures only for "corporations" to make estimated tax payments. Exempt organizations are excluded from the statutory definition of a "corporation," yet are subject by statute to penalties for failing to make estimated payments. Thus, the laws regarding estimate payments by exempt organizations are technically inconsistent.

Policy Consideration

While exempt organizations are subject to penalties for failure to make estimated payments, there is no clear statutory language under which they are technically required to make estimated tax payments.

Implementation Considerations

Implementing this provision would assist the department by clarifying the law and could be handled during normal annual updates.

Technical Consideration

Amendment 1 would make a minor grammatical change to clarify that, for certain estimated tax purposes, "an organization described in Section 23731" is subject to the same treatment as a "corporation (other than a bank or financial corporation)."

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

This provision would not impact state tax revenue.

ISSUE #16: Revivor Fee For Exempt Organizations

EFFECTIVE DATE

The provision relating to the revivor fee for exempt organizations would be effective on January 1, 2000, and would apply to all returns required to be filed or taxes due after that date.

SPECIFIC FINDINGS

Under the Government Code, the AG is required to maintain a Registry of Charitable Trusts (RCT). Charitable corporations and trustees holding property for charitable purposes over which the AG has enforcement or supervisory powers are required to file reports regarding donations received and other aspects of their activity. The department may be directed to assess the minimum tax for an exempt organization (an RCT assessment) for failure to adhere to required practices.

Under federal law, if an organization fails to meet specified criteria, the Internal Revenue Service (IRS) may deny it exempt status or may revoke the exempt status of an organization that no longer meets the criteria.

Under **current state law**, the department has the authority to suspend a corporation's powers, rights, and privileges, including those of an exempt corporation, if it fails to file required tax returns and pay its taxes.

For a corporation to be revived from a suspended status, the corporation must file all tax returns and pay the delinquent taxes. A suspended corporation, including an exempt corporation, loses the right to defend any suit that may be brought against it.

State law (B&CTL Section 23775) provides for the suspension or forfeiture of the powers, rights and privileges of domestic exempt organizations or foreign exempt corporations in the following three situations:

1. failure to file an annual Form 199 or statement as required by state law;
2. failure to pay any amount due because of the filing of that information return;
or
3. failure to pay an RCT assessment.

State law provides for the revivor of exempt organizations suspended or forfeited for the three reasons addressed above, if the exempt organization:

- files an application for revivor and pays a \$10 revivor fee;
- files any information returns, statements, notifications or amounts due which were not previously submitted or paid; and
- files, when required by the department, a new exemption application which includes a \$25 fee.

For exempt organizations suspended or forfeited for any other reason, the revivor request is processed without the \$10 revivor fee and without a new exemption application. Exempt organizations such as a homeowner's association that is required to file a tax return but fails to do so would be suspended or forfeited. However, this exempt organization could seek relief from suspension or forfeiture

under Sections 23301 and 23301.5, which do not require the exempt organization to pay a \$10 revivor fee or file a new exemption application.

The \$10 revivor fee is only imposed on exempt organizations when the suspension occurs under the three limited situations identified above. Exempt organizations suspended under any other situation and for-profit corporations do not pay a similar fee.

The provision permitting the department to require a new exemption application also is limited to those exempt organizations suspended under Section 23775. Therefore, exempt organizations, such as homeowner's associations' suspended under Section 23301 or 23301.5, are not required to submit a new exemption application to the department as a condition of their revivor.

This bill would eliminate the requirement for the \$10 revivor fee and require all exempt organizations to submit a new exemption application when requested by the department.

Policy Considerations

The current law is inequitable in that not all exempt organizations are subject to the revivor fee, and for-profit corporations are not assessed a similar fee. Elimination of the fee would allow the department to treat all suspended exempt organizations seeking relief in the same manner.

Also, statutory authority to request a new application for exemption is limited to the same exempt organizations that are required to pay the revivor fee. Therefore, the department cannot request certain exempt organizations to file a new application for exemption after being suspended.

Extending the statutory authority to request a new application for exemption from all exempt organizations that have been suspended would allow the department to treat all exempt organizations that seek revivor in the same manner.

Implementation Considerations

Implementation of this provision would assist the department's exempt section in its administration of the law and could be implemented during annual updates.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

Based on data and assumptions discussed below, in any given year, the revenue impact of this provision would be a loss of approximately \$2,500.

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

Tax Revenue Discussion

The number of suspended tax-exempt organizations that would no longer be required to pay a \$10 revivor fee would determine the net revenue impact of this provision. Based on departmental data, about 250 tax-exempt organizations are revived each year. Under current law, each pays a \$10 revivor fee that would be eliminated under this bill.

ISSUE #17: Revocation of Exempt Organization Status

EFFECTIVE DATE

The provision relating to the revocation provisions for exempt organizations would be effective on January 1, 2000, and would apply to all returns required to be filed or taxes due after that date.

SPECIFIC FINDINGS

Under current state law, the department may revoke an organization's exempt status:

1. for failure to file a required Form 199 or failure to pay any liability attributable to that information return;
2. for failure to file a report with the AG or failure to pay an assessment issued by the RCT;
3. where the IRS has revoked federal exempt status;
4. for not operating within its exempt purpose;
5. where the department receives information that the organization is inactive; or
6. for failure to complete incorporation proceedings within a specified period of time after being granted exemption, usually 60 days.

Current state law does not allow the department to revoke an organization's exempt status for failure to file a required Form 100 (California Corporation Franchise or Income Tax Return) or Form 109 (California Exempt Organization Business Income Tax Return) or failure to pay tax attributable to those returns.

Any organization whose status is revoked for improper activities will be taxable as a corporation or trust so long as its exempt status is not reestablished.

An organization that has had its California exempt status revoked may reestablish its exempt status by paying a filing fee, submitting a new application for exemption and any information or returns not previously submitted which caused the revocation; and, if the revocation was due to engagement in activities other than those permitted, submitting satisfactory proof that it has corrected its nonexempt activities and will operate only in an exempt manner.

Although the department has the authority to revoke the exempt status of an organization for failing to file Form 199 or pay tax attributable to it, and for various other specified causes, the department does not have authority to revoke exempt status for failure to file Forms 100 or 109 or pay the tax attributable to those forms.

This bill would specify that an organization's exempt status may be revoked for failure to file any return required or failure to pay any tax due and that if exempt status is revoked in these circumstances, exempt status may be reestablished only upon the filing of any returns or the payment of any taxes due.

Policy Considerations

This provision would enhance compliance by giving the department authority to revoke an exempt organization's exempt status for failure to pay any tax due or for failing to file any return due (rather than only certain taxes and returns). This expanded administrative authority also would provide an additional incentive for exempt organizations to timely file returns and pay all taxes due.

Implementation Considerations

Implementation of this provision would assist the department's administration of exempt organizations and could be implemented during annual updates.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

Based on data and assumptions discussed below, in any given year, the revenue impact of this bill would be a gain of approximately \$2,000.

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

Tax Revenue Discussion

The number of organizations whose tax-exempt status is revoked that must file a new application and pay a filing fee of \$25 to reestablish tax-exempt status would determine the net revenue impact of this provision.

This bill would provide the department with discretionary authority to revoke the tax-exempt status of certain additional organizations under specified conditions. To the extent tax-exempt status is actually revoked and the organization wants to reestablish its exempt status, a filing fee of \$25 would be required with a new application. The number of additional tax-exempt organizations that would become subject to revocation provisions under this bill is estimated at 22,000. Approximately 65% of these are estimated to have gross receipts of less than \$25,000 and, therefore, would have no filing requirement. Of the remaining 7,700, if 1% were to have their tax-exempt statuses revoked and decide to reestablish exempt status, a filing fee of \$25 each would be required, generating up to \$2,000 [80 applications x \$25]. Also, it is possible that the consequence of revocation may accelerate the collection of taxes owed to some degree.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1229
As Amended June 30, 1999

AMENDMENT 1

On page 73, strike line 10 and insert:

corporation (other than a bank or financial corporation) or