Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Lara	Analyst:	Jessica Deitchman	Bill Number:	SB 567
Related Bills:	See Prior Analysis	Telephone:	845-6310	Amended Date	May 3, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Changes to Charitable Reminder Trusts/Eliminate Step-up in Basis/Cap Highly Compensated Executives Pay at $1,000,000

SUMMARY

This bill would do the following:

Provision No. 1: Modify the definition of a Charitable Remainder Annuity Trust (CRAT)

Provision No. 2: Eliminate the “step-up” in basis for inherited property for certain taxpayers

Provision No. 3: Cap the Deduction for Highly Compensated Executives' Pay at $1,000,000

The bill would make a number of non-substantive technical changes, and expresses legislative intent to enact legislation for taxable years beginning on or after January 1, 2017, to modify the way payments are taxed to related parties, as defined in Section 267, 318, or 707 of the Internal Revenue Code.

RECOMMENDATION – NO POSITION

SUMMARY OF AMENDMENTS

The May 3, 2017, amendments removed the provisions in the bill that would have sunset the water’s-edge election. Except for the “This Bill” section and the “Economic Impact” section relating to the water’s edge election, the remainder of the department’s analysis of the bill as introduced February 17, 2017, still applies. The “Implementation Considerations,” “Technical Considerations,” “Fiscal Impact,” “Economic Impact,” and “Policy Concerns” sections for each remaining provision have been restated for convenience.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Fiscal Year	2017-18	2018-19	2019-20
Provision 1: Modify the Definition of a Charitable Remainder Annuity Trust	**See Economic Impact Section below**	**See Economic Impact Section below**	**See Economic Impact Section below**
Provision 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers	**+ $1.0**	**+ $3.9**	**+ $7.9**
Provision 3: Cap the Deduction for Highly Compensated Executives Pay at $1,000,000	**+ $110**	**+ $100**	**+ $100**
$ In Millions Total	**+ $111**	**+ $103.9**	**+ $107.9**

PROVISION NO. 1: Modify the Definition of a Charitable Remainder Annuity Trust

THIS PROVISION

This provision would, under the Personal Income Tax Law (PITL), for taxable years beginning on or after January 1, 2018, modify the definition of a CRAT by increasing the remainder value of the trust required to be contributed to charity from at least 10 percent to at least 40 percent of the initial net fair market value (FMV) of all property placed in the trust.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

Because this provision fails to specify otherwise, the new requirement would apply to all existing CRATs as of the provision's operative date, as well as trusts created on or after that date. If the author intends for the provision to apply to trusts formed on or after January 1, 2018, this bill should be amended.

FISCAL IMPACT

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue loss:

Estimated Revenue Impact of SB 567 Provision No. 1: Modify the Definition of a Charitable Remainder Annuity Trust Assumed Enactment After June 30, 2017		
2017-18	2018-19	2019-20
a/	a/	a/

a/ The estimated revenue impact of increasing the remainder interest from at least 10 percent to at least 40 percent, would be a revenue loss, in an unknown amount.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

When a CRAT is set up, the donor of the assets to the trust is allowed a charitable contribution deduction in the year of the contribution of the asset for the present value of the remainder interest. The revenue impact of this proposal would be dependent upon the FMV of the donation in the year of the contribution. In determining the FMV of the charitable contributions to a CRAT, the FMV of the contribution is reduced by the present value of the CRAT's annuity payments.

The Franchise Tax Board lacks the tax data necessary to calculate the present value of the annuity payment or the value of the remainder interests. However, it is probable this proposal would result in a net revenue loss since it is likely many taxpayers would have the means to increase their charitable contribution to meet the minimum remainder requirements. The remaining taxpayers may already meet the minimum remainder requirements or may restructure their trusts to meet the remainder interest specified in this proposal. This would increase the total charitable deductions claimed resulting in a net revenue loss.

POLICY CONCERNS

This provision of the bill would require specific rules for CRATs for which federal law has no counterpart, thus increasing nonconformity.

PROVISION NO. 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers

THIS PROVISION

Under the PITL, this provision would, for property acquired or inherited from decedents who died on or after January 1, 2018, preclude a “step-up” basis adjustment and require the use of the decedent's carryover basis for individuals with adjusted gross income in the taxable year of the decedent's death of:

- $2,000,000 or greater in the case of a joint return or surviving spouse,
- $1,500,000 or greater in the case of a head of household, and
- $1,000,000 or greater for all other filers.

Under the Corporation Tax Law (CTL), taxpayers other than individuals, with total income of $1,000,000 or greater for the taxable year of the decedent's death, would be precluded from the step-up basis adjustment.

In addition, for both the PITL and CTL, the basis of property acquired or inherited from decedents who died on or after January 1, 2018, would no longer be increased for any federal estate tax paid on the property.

IMPLEMENTATION CONSIDERATIONS

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

This provision uses terms that are undefined, i.e., "total income" and "taxable year of decedent's death." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended that the bill be amended.

FISCAL IMPACT

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $1.0	+ $3.9	+ $7.9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on the proration of the Joint Committee on Taxation's (JCT) federal tax expenditure estimate for the personal income tax exclusion of capital gain at death JCT did not score this exclusion for corporations). In January 2017, the JCT estimated the federal revenue impact of the exclusion to be $35 billion in 2018. To determine California's share of the federal loss, federally reported data was used to calculate that 14 percent of nationally reported capital gain income was from California, then federal and state tax rates were analyzed to estimate a federal/state tax rate adjustment of 53 percent, resulting in an estimated revenue impact of $2.6 billion. It is assumed that 20 percent, or $525 million by value, of estates would be settled in the year of death, 30 percent in the year following, and the remainder over the next five years. Of the amount settled in the year of death, it is assumed that 2 percent, or $11 million, would be inherited by taxpayers that would no longer be allowed to step-up the basis in their inherited property. When property is inherited, it may be sold in the year inherited, the next year, or any other year after that (or potentially never). For purposes of this estimate, it is assumed 15 percent of inherited property would be sold in the year the property is received and a small percent would be sold each year thereafter, or potentially never sold, resulting in $1.7 million in estimated revenue gain in taxable year 2018, $5 million in taxable year 2019, $10 million in taxable year 2020, and increasing each year thereafter.

The calendar year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

<u>PROVISION NO. 3: Cap the Deduction for Highly Compensated Executives Pay at $1,000,000</u>

THIS PROVISION

This provision would modify existing federal conformity to the deduction limitation on excess compensation for highly compensated executives. Exceptions for commissions, other performance-based compensation and compensation payable under a written binding contract would not apply under state law.

TECHNICAL CONSIDERATIONS

To correct a cross referencing error, the following amendment is recommended:

On page 4, line 17, before "(m)(4)(C)" insert "162".

FISCAL IMPACT

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 3: Cap the Deduction for Highly Compensated Executives Pay at $1,000,000 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $110	+ $100	+ $100

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on a proration of the Economic Policy Institute's (EPI) estimate for the deduction of executive compensation. Using EPI data, the estimated federal impact of the deduction for executive performance based compensation would be $6.0 billion in 2017.

To determine the impact on California, nationally reported data was used to calculate that 7 percent of federal income was from California. Then the estimate was reduced by 74 percent to reflect the differences between federal and state tax rates for a total of $110 million. It is assumed that the reduced deduction amount would be offset by a 25 percent increase in the usage of available state net operating losses and credits available, resulting in an estimated revenue gain of $80 million in 2017.

The tax year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

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