

Taxpayer Use and Administration of the Revised 540 2EZ Tax Form

LEGISLATIVE ANALYST'S OFFICE



Introduction

This report has been prepared in response to Chapter 844, Statutes of 2004 (SB 1534, Johnson). Chapter 844 expands the income eligibility criteria for use of the 540 2EZ tax form in filing resident personal income taxes (PITs). The measure also requires the Legislative Analyst's Office (LAO) to study the impact of the law change. Specifically, the legislation mandates that the LAO, in consultation with the Franchise Tax Board (FTB), submit a study to the Legislature regarding:

- The number of filers using the revised 540 2EZ form.
- The effectiveness of the revised 540 2EZ form in the simplification of tax preparation for taxpayers eligible to use that form.
- The impact the revised 540 2EZ form has had on FTB's administration of the PIT.

In this report, we provide background information on the administration of the PIT and discuss our findings related to the effects of Chapter 844 on tax preparation and tax administration. Also, we provide information to address some of the issues raised by AB 249 (DeVore), a measure passed by the Legislature in 2006, but vetoed by the Governor. If enacted, AB 249 (DeVore) would have directed our office to further examine taxpayer use of the 540 2EZ form.

Background

In California, an individual must file a PIT return if either their gross income or their adjusted gross income (AGI) is more than a specified amount based on their filing status. For example, a single individual, under the age of 65 years, with no dependents and who cannot be claimed by another person, must file a PIT return if the filer's gross income is at least \$14,138, or AGI is at least \$11,310.

The 540 2EZ Form Is the Shortest of the Tax Forms Available to Taxpayers. Several forms are available to resident filers including the 540 form, the 540A form, and the 540 2EZ form. The ways that taxpayers can access these tax forms are described in the nearby box.

Taxpayers Can Access Personal Income Tax Forms in Many Ways. Generally, there are many ways taxpayers can access the 540, 540A, and 540 2EZ tax forms. Similar to other tax forms, these include:

- The Franchise Tax Board's (FTB's) Web site.
- Telephoning FTB.
- Tax preparation software that asks users a series of questions to determine eligibility for various tax forms.
- Professional tax preparers.
- The Voluntary Income Tax Assistance Program, which assists disabled, lower-income, and non-English speaking taxpayers in completing simple federal and state resident income tax returns.
- The FTB's Public Distribution Program distributes publications, booklets, and forms to libraries, post offices, some colleges, and a number of government entities such as the Employment Development Department, the Department of Motor Vehicles, and the Internal Revenue Service.

All resident taxpayers may file the 540 form, while only resident taxpayers that meet certain criteria may file either the 540A or 540 2EZ forms. Some of the eligibility requirements for the 540 2EZ form are described in more detail in Figure 1. The 540A and 540 2EZ forms were designed to be used by taxpayers with less complex PIT situations and are therefore shorter and relatively easier for taxpayers to complete. The 540A form and the 540 2EZ form account for 4 percent and 13 percent of total PIT filings, respectively.

The 540 form is the longest and most complex of the resident forms with 68 questions for the taxpayer to answer. The 540A form, by comparison, leaves out 13 of the questions on the 540 form—asking only 55 questions. The 540 2EZ form is the shortest of the three resident forms, asking only 30 questions of taxpayers. With decreasing form length, there are an increasing number of restrictions on its use. The 540 2EZ form is the most restrictive of the resident forms in that it allows no adjustments to income (such as alimony payments and moving costs). By contrast, the least restrictive resident form, the 540 form, may be used to report all standard PIT transactions.

Figure 1

Selected Eligibility Criteria for the 540 2EZ Tax Form

Residency	California resident the entire year
Filing Status	Single, head of household (HOH), married filing jointly, or widowed
Annual Income	Amount: <ul style="list-style-type: none">• Up to \$100,000 if single or HOH• Up to \$200,000 if married filing jointly or widowed Acceptable Sources of Income: <ul style="list-style-type: none">• Wages, salaries, and tips• Taxable interest, dividends, and pensions• Unemployment compensation• Social security benefits• Capital gains (from mutual funds only)
Other Restrictions	No adjustments to income No itemized deductions

Chapter 844 Expanded 540 2EZ Form Eligibility. The changes implemented by Chapter 844 increased the number of PIT taxpayers who are eligible to use the shorter 540 2EZ form and thereby sought to ease the tax preparation process for those individuals. Specifically, the legislation increased the ceiling amounts of AGI reportable on the 540 2EZ form from \$50,000 to \$100,000 for single and head of household (HOH) taxpayers, and from \$100,000 to \$200,000 for married taxpayers filing jointly and widowed taxpayers. This increase in the AGI ceiling increased the number of filers eligible to use the 540 2EZ form by about one million taxpayers—from about three million to about four million. The legislation did not result in any changes to the 540 2EZ form itself.

Impact of Expanding Taxpayer Eligibility to Use 540 2EZ Form

Below we summarize our findings from our review of the changes implemented by Chapter 844. These findings include the impact of Chapter 844 on taxpayer use of the 540 2EZ form and FTB’s administration of the form.

Expanded Eligibility Slightly Increased Use of 540 2EZ Form by Newly Eligible Taxpayers. Despite Chapter 844 increasing the number of taxpayers eligible to use the 540 2EZ form by about one million taxpayers in 2004 (as shown in Figure 2), most of the actual additional 170,000 filings of the form in 2004 was by taxpayers eligible to use the form prior to the passage of Chapter 844. Less than one-half of the increase in 540 2EZ forms filed (approximately 76,000 additional taxpayers in 2004 and increasing to more than 130,000 new filers in 2007) can be attributed to the expansion of income eligibility made by Chapter 844. More than 90 percent of the 76,000 additional taxpayers using the 540 2EZ form due to implementation of the bill were single and HOH filers with AGIs between \$50,000 and \$100,000, as illustrated in Figure 3. Newly eligible married or widowed filers in the \$100,000 to \$200,000 AGI bracket made up the remaining new filers.

Figure 2

540 2EZ Form Eligibility and Use

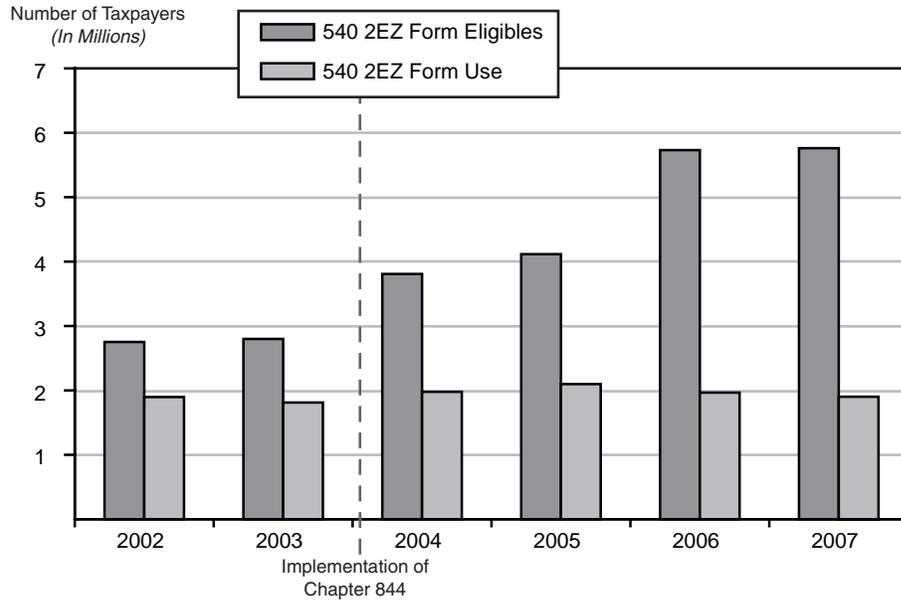
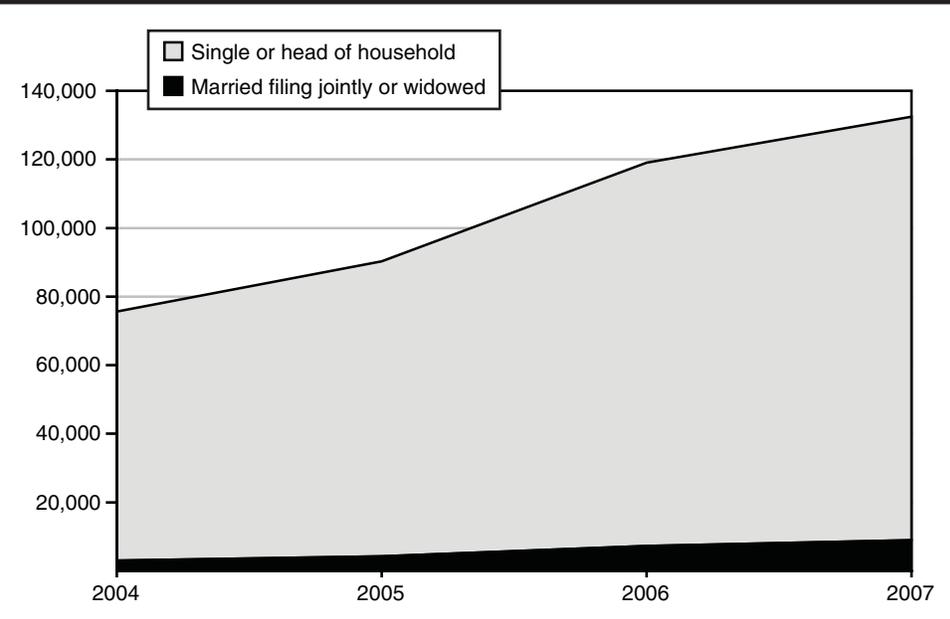


Figure 3

Additional Filers Using the 540 2EZ Form Due to Chapter 844



Although the total number of filers using the 540 2EZ form has been relatively stable since 2002, the percentage of filers using the 540 2EZ form compared to the number of total eligible filers has actually declined from more than two-thirds in 2002 to one-third in 2007. This decline in use can be seen in Figure 2.

540 2EZ Form Revision Potentially Simplified Tax Preparation. Chapter 844 increased the number of taxpayers eligible to use the 540 2EZ form by one million and as a result potentially simplified the preparation of taxes for these taxpayers. This eligibility expansion, however, did not result in a significant number of taxpayers using the easier process. In addition, as noted earlier, actual use of the form by eligible taxpayers has declined since 2004. Moreover, many taxpayers using the 540 2EZ form used a professional tax preparer, rather than preparing the return themselves. For instance, in 2007, more than one-half of those using the 540 2EZ form used a tax preparer.

Revised 540 2EZ Form Has Had No Impact on FTB Administration. The FTB's administration of the PIT through tax form dissemination, receipt, and collection and audit processes are not different due to the implementation of Chapter 844. This is because the expansion of income eligibility did not result in any direct changes to the 540 2EZ form and consequently FTB's administrative processes.

Some Filers Eligible to Use the 540 2EZ Form Are Excluded by Instructions

The instructions for the 540 2EZ form include information about who is eligible to file using the 540 2EZ form. The eligibility criteria cautions that several taxpayer circumstances would make a taxpayer ineligible to file using the 540 2EZ form. Included in this list of disqualified tax situations are individuals who can be claimed by another taxpayer as a dependent and either: (1) have a dependent themselves or (2) make less than certain AGI thresholds. According to the 540 2EZ form instructions, these individuals are not eligible to file using the 540 2EZ form. These individuals, however, are eligible to use the 540 2EZ form according to the tax law.

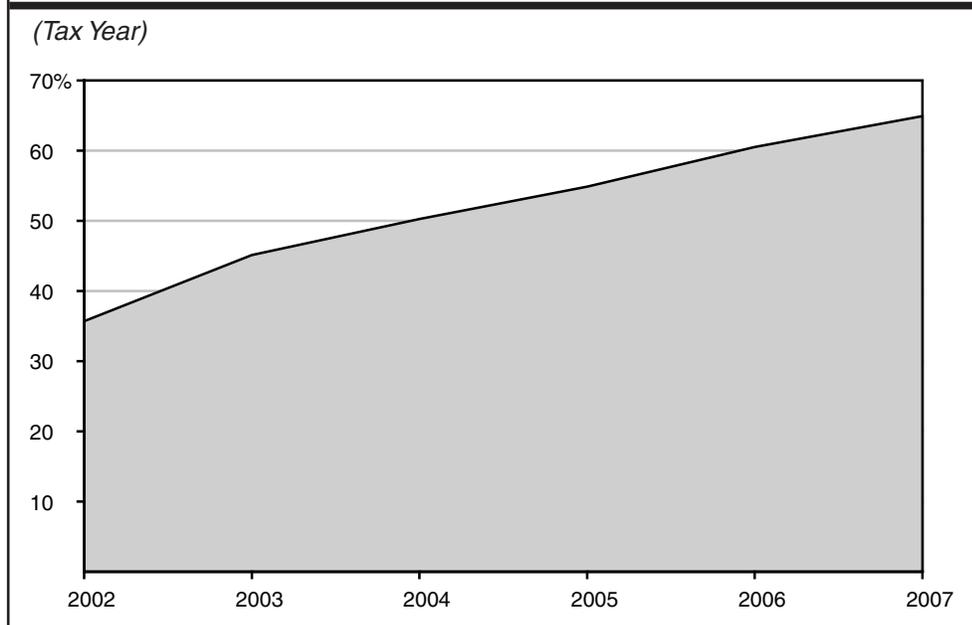
According to FTB, the reason it writes the instructions this way is because it is more difficult for these individuals to extract (from the tax tables currently provided in the 540 2EZ form instructions) the amounts for the personal exemption credit and the dependent exemption. Yet, in 2007, there were more than 630,000 taxpayers that made less than the AGI thresholds provided in the 540 2EZ form instructions, and it is likely that a portion of them had tax circumstances that would have allowed them to use the 540 2EZ form.

Taxpayer Electronic Filing of the 540 2EZ Form Has Increased

Electronic filing of the 540 2EZ form has been used more extensively in recent years—increasing from a little more than one-third of all 540 2EZ form filings in 2002 to nearly two-thirds of all filings in 2007, as shown in Figure 4.

Figure 4

Percentage of 540 2EZ Form Filers Who Filed Electronically



Also, an expanded set of 540 2EZ form tools are available for taxpayers. On FTB's Web site, the 540 2EZ form is available as a fileable form. This means that it can be filled out online and then (1) printed and filed by United States mail or (2) filed electronically. The 540 2EZ form is also available as a calculable online form. In this format, the form performs standard addition and subtraction of the form's lines for the taxpayer. For the first time in tax year 2007, the 540 2EZ form available on FTB's Web site could be saved when partially completed, with the data retained on the taxpayer's computer. This added functionality removes the need to reenter all data each time the taxpayer works on the form.

Additional Steps to Increase Use of 540 2EZ Form

The expansion of income eligibility by Chapter 844 for the 540 2EZ form has produced a large increase in the number of individuals eligible to use the form, but a smaller increase in actual use of the form. To the extent that the Legislature made the changes to increase the ease of filing by individual taxpayers, Chapter 844's impact has been limited by the large number of eligible users of the form who use a tax preparer. Individuals using tax preparers would typically be indifferent to the length of the tax form. If increasing use of the form remains a goal of the Legislature, then we offer three additional steps that could be taken.

Revision of 540 2EZ Form Instructions. If the Legislature wanted to further increase the number of filers using the 540 2EZ form, the instructional language provided with the 540 2EZ form could be corrected. As mentioned earlier, the instructions for the 540 2EZ form caution that certain individuals who can be claimed by another taxpayer as a dependent can not file using the 540 2EZ form. However, these individuals are eligible to use the 540 2EZ form according to the tax law. By providing taxpayers with the neces-

sary tax tables, a greater number of filers could use the 540 2EZ form. One option that would result in minimal additional costs would be to provide the tax tables online with a reference to the tables in the existing 540 2EZ form instruction booklet. Since the table would only be available online, it would not increase state printing and mailing costs.

Savable and Calculable Form Generated by Question and Answer. To further simplify tax preparation, the state could make available a “smart” 540 2EZ form. A smart 540 2EZ form could be generated by the taxpayer answering a series of automated questions online at FTB’s Web site. The answers provided by the taxpayer would then be automatically loaded by the system into a 540 2EZ form, and the appropriate taxes owed calculated for subsequent verification and signature by the taxpayer. Such a form could be saved, printed, and mailed or filed electronically.

Engage in Low-Cost Outreach. The state could engage in low-cost outreach to taxpayers about the ease of preparing and filing the 540 2EZ form. Educational advertisements posted on free video web hosting sites like www.YouTube.com could help encourage more eligible taxpayers to self-prepare the shorter 540 2EZ form.



This report was prepared by Crystal Taylor and reviewed by Farra Bracht and Michael Cohen.

The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656.

This report and others, as well as an E-mail subscription service, are available on the LAO's Internet site at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.