

April 1, 2004

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Election Code Section 9005, we have reviewed the statutory initiative relating to the treatment under the Personal Income Tax (PIT) law of court-ordered child support payments, as well as the establishment of certain administrative requirements with respect to the Franchise Tax Board (FTB) (File No. SA2004RF0014). The measure would (1) allow court-ordered child support payments to be deductible from income for PIT purposes and (2) establish a series of guidelines and procedures regarding taxpayers' disputes with the FTB.

Provisions of the Initiative

Child Support Payments

General Background. Payments for the support of children are ordered by courts in situations where the parents of a child are not living together (due to legal separation, divorce, or other circumstances). The court-ordered payments are intended to recognize the joint responsibility of both parents for the child and are paid by the noncustodial parent to the custodial parent for the purpose of paying expenses related to care of the child.

In 2003, there were 1.2 million children in the state whose custodians were to receive court-ordered child support. The amount of child support owed in 2003 was approximately \$2.7 billion. Of this amount, approximately \$1.2 billion was actually collected, with the amount not paid considered to be child support debt ("arrearages") and subject to the court enforcement and collection system. In 2003, the cumulative amount of child support arrearages totaled \$18.4 billion.

Current Tax Treatment of Child Support Payments. Under current law, the PIT is levied on income earned by California residents and on the income of nonresidents earned in the state. Under the PIT, deductions from income are allowed for certain items including local taxes, mortgage interest, charitable donations, and medical expenses in excess of a specified percentage of income. General living expenses are not deductible from income. In particular, expenses associated with children—such as food and clothing—are not deductible. Such expenses are important, however, in helping to establish a child’s dependent status.

Court-ordered child support payments are not deductible from income for the non-custodial parent who pays them. Thus, for tax purposes, they are treated in a manner similar to the treatment of general child-related expenses incurred by parents or custodians. Likewise, court-ordered child support payments received by the custodial parent are not taxable as income. As a result, the money paid for child support is only taxable when first earned by the noncustodial parent, and thus is not double-taxed.

Tax-Related Impacts of the Initiative. The initiative specifies that court-ordered child support payments are deductible from income by the payor for tax purposes. Thus, moneys used for general expenses pursuant to court-ordered child support would be treated differently than other general child-related expenses.

Administrative Requirements

The initiative contains numerous tax administration requirements dealing with tax disputes. Some of the administrative changes would not affect the FTB’s current approach regarding these disagreements, but others would require the commitment of additional resources or restrict the reallocation of existing resources. To this extent, these administrative requirements would likely result in additional costs to FTB. These administrative changes are:

- Liens must be issued through a court order and with the taxpayer present at the hearing. Such liens may not exceed the amount of the disputed tax. Except in the case of fraud, liens must be released within 60 to 90 days after the resolution of the tax dispute. Currently, FTB may issue liens without a court order.
- Notices to the taxpayer must be delivered by certified or registered mail and the taxpayer must be given access to any records pertaining to the taxpayer.
- Installment agreements cannot reduce a taxpayer’s income below his county’s “average standard of living.”

- In the event of marriage or other partnership dissolution, all tax disputes must be resolved with all parties present.
- The auditor who commences working on a tax case must complete the case, unless the taxpayer consents to a new auditor or the original auditor no longer works for the FTB.
- All taxpayer records must be maintained by the FTB in the location nearest the taxpayer and full access must be provided.
- The FTB must ensure that those with at least the equivalent of a twelfth grade education can understand the tax system.
- Interest and penalties due to a delay in the resolution of a tax dispute could not be added to a taxpayer's liability if the delay is a result of action or inaction on the part of FTB. The FTB is prohibited from delaying any audit in order to increase tax liabilities.
- Taxpayers may file a petition with any court in the taxpayer's county of residence in order to ascertain the propriety of any FTB action with respect to the taxpayer.
- The FTB is required to know and understand the tax laws it administers and provide an explanation of them to the taxpayer.

Fiscal Effect of the Initiative

The fiscal impact of the child-support-related portion of the initiative would be partially dependent on the extent to which deductibility increases compliance with court-ordered child support. We estimate that the fiscal impact on the state of deducting court-ordered child support payments for PIT purposes would be a General Fund revenue reduction in the low tens of millions of dollars annually, beginning in 2005-06. This revenue reduction could be offset by minor decreases in state welfare costs as a result of increased child support compliance due to the deductibility of these payments.

The fiscal impacts of the administrative aspects of the initiative are highly dependent on the interpretation of these components as well as their implementation. It is likely that the administrative measures would require increases in both personnel and other operating expenses by FTB, resulting in annual General Fund administrative costs in excess of \$10 million.

Summary of Fiscal Effects. The measure would have the following major General Fund fiscal effects:

- Reductions in state revenues from the deductibility of child support payments in the low tens of millions of dollars annually.
- Annual tax administration costs likely in excess of \$10 million annually.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Donna Arduin
Director of Finance