September 6, 2006

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

Attention: Ms. Patricia Galvan
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 child support payments, as well as the establishment of certain administrative requirements with respect to the Franchise Tax Board (FTB) (File No. SA2006RF0031).

Background

Child Support Payments. Payments for the support of children can be voluntary, privately arbitrated, or court-ordered. Child support payments are ordered by the courts in situations where the parents of a child are not living together (due to legal separation, divorce, or other circumstances) and no voluntary support agreement exists. 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 expenses related to care of the child.

In 2005, there were 1.9 million children in the state whose custodians were to receive court-ordered child support. The amount of court-ordered child support owed in 2005 was approximately $2.7 billion. Of this amount, approximately $1.3 billion was actually paid, with the amount not paid considered to be child support debt ("arrearages") and subject to the court enforcement and collection system.

Current Tax Treatment of Child Support Payments. Under current law, PIT is levied on income earned by California residents and on the income of nonresidents earned in the state. Under 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, however, are not deductible from income. In particular, expenses associated with children—such as food and clothing—are not deductible.

Proposal

Tax-Related Provisions. The initiative specifies that child support payments are deductible from income by the payer for tax purposes. Thus, monies used for general expenses pursuant to child support would be treated differently than other general child-related expenses.

Administrative Requirements. The initiative contains several tax administration requirements that would affect how FTB handles disputes with taxpayers and how the Department of Child and Social Services (DCSS) handles child support payment arrangements. One particular significant change is that liens would have to be issued through a court order and with the taxpayer present at the hearing. (Currently, FTB can issue such liens administratively.)

Other changes include:

- Installment agreements that reduce an individual's income below his/her county's "average standard of living" are restricted.
- All notices to the taxpayer must be delivered by certified or registered mail.
- In the event of marriage or other partnership dissolution, all tax disputes must be resolved with all parties present.

Fiscal Effect of the Initiative

Revenues

The revenue effect of the child support-related portion of the initiative involving tax deductibility would be dependent upon several factors, such as the number of payers of child support that claim itemized deductions on their income taxes, the average marginal tax rate of these taxpayers, and the extent to which deductibility increases compliance with court-ordered child support. Assuming that "deductibility" would be interpreted as an itemized deduction, the fiscal impact on the state of deducting court-ordered child support payments for PIT purposes would be an annual General Fund revenue reduction ranging from about $100 million to $200 million, beginning in 2007-08. The actual amount would depend, in large part, on whether the deduction would be subject to an income threshold.

There could also be reductions in PIT and child support revenues due to changes in the tax administration procedures FTB and DCSS would be allowed to undertake, such as their ability to impose liens on property. The amount of the associated annual revenue loss is uncertain but potentially significant, and would be highly dependent upon the manner in which the provisions of the initiative are interpreted. However, these annual revenue losses could be in the high tens of millions of dollars.

Costs

The administrative aspects of the initiative would require increases in both personnel and other operating expenses by FTB. The costs associated with these provisions are highly dependent on both their interpretation and implementation, but likely would result in annual General Fund administrative costs in excess of $10 million.

Minor decreases in state welfare administrative costs, resulting from increased child support compliance, may partially offset these costs.

Summary of Fiscal Effects

The measure would have the following major state fiscal effects:

- Reductions in state revenue from the deductibility of child support payments and changed tax administration provisions in the range of the low hundreds of millions of dollars annually.
- Annual tax administration costs likely in excess of $10 million annually.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Michael C. Genest
Director of Finance