

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Cohn Analyst: Gloria McConnell Bill Number: AB 2781

Related Bills: See Legislative History Telephone: 845-4336 Amended Date: 04/25/02

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Franchise Tax Board Electronic Filing

SUMMARY

This bill would:

- express Legislative intent for expanding electronic filing in the future;
- specify the method the Franchise Tax Board (FTB) would use when expanding electronic filing for taxpayers for California Form 540 2EZ; and
- require FTB to explore the feasibility of creating a clearinghouse to route California 540 2EZ filers to commercial sector and other web sites.

SUMMARY OF AMENDMENTS

The April 25, 2002, amendments would remove the language that would have required FTB to **either** 1) outline the method FTB would use when expanding e-filing; **or** 2) create a clearinghouse for e-filing. Instead, the April 25 amendments would require FTB to implement 1, above, and explore the feasibility of creating 2. The April 16, 2002, amendments removed the bill's provision that would have restricted FTB's use of electronic technology and replaced it with the provisions discussed in this analysis.

PURPOSE OF THE BILL

According to testimony of the author's staff at the March 25, 2002, FTB meeting, the purpose of this bill is to codify a Memorandum of Understanding (MOU) discussed below under "Program Background."

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2003.

POSITION

Pending.

Board Position:

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

Department Director

Date

Alan Hunter for GHG

5/20/02

ANALYSIS

FEDERAL/STATE LAW

Under federal law, income tax returns are in a form prescribed by the Secretary of the Treasury.

Federal income tax law has several provisions relating to filing returns electronically with the Internal Revenue Service (IRS). Under these provisions, the Secretary is:

- authorized to promote the benefits and encourage the use of electronic tax administration programs;
- required to develop procedures for the acceptance of signatures in digital and other electronic signatures; and
- authorized to provide regulations for the delivery and postmark date for electronic filing.

Under current state income tax law¹ relating to electronic filing:

- income tax returns must be in a form prescribed; and
- taxpayers must sign written declarations under penalty of perjury.

Under current state income tax law, FTB is required to examine returns and determine the correct amount of tax. This requires FTB to determine whether the taxpayer has self-assessed the correct amount of tax imposed under the law. For tax returns filed with FTB, the law provides that, for such determinations, the tax return or electronic-stored return data must be examined and in no case may the determination be arbitrary or without foundation. For the purpose of this examination, electronic-stored return data is defined as electronic records of line items from an original or amended return. If FTB determines the taxpayer under-assessed the tax, a notice of proposed deficiency assessment (NPA) is issued. Taxpayers may protest an NPA and subsequently appeal FTB's action on the protest of the NPA, if the taxpayer so desires.

See Appendix A for additional information about FTB practices and services.

THIS BILL

This bill contains language that expresses legislative intent as follows:

- FTB would be directed to make every effort to assure the privacy of California taxpayers that choose to file tax returns electronically. This would include the assurance that the preparation of tax returns, the entry of data on tax forms, and the answering of questions does not allow FTB to store, review, or monitor drafts of taxpayer returns.
- The form used to implement the expansion of electronic filing would include safeguards and principles as outlined.
 - A convenient electronic method for filers to transmit tax data to FTB.
 - Arithmetic calculations and automated tax amount look up would be prohibited.
 - No cost to taxpayers.

¹ For purposes of this analysis, "income tax law" refers to the Personal Income Tax Law, the Corporation Tax Law and the Administration of Franchise and Income Tax Laws. Unless specified otherwise, reference to "taxpayers" means taxpayers subject to these laws.

- An appropriate level of privacy that would minimize the risk of data disclosure to third parties.
- Disclosure to electronic filers, prior to use, of the risks in using electronic forms and processes.
- Procedurally prevent government monitoring or copying of draft tax returns or key strokes entered during the creation of a tax return.
- Secure transmission of data using 128-bit secure socket layer encryption.
- Acknowledgment of successful transmission and receipt of complete data by FTB.
- FTB would be required to report to the Legislature any plans to implement any expansion of electronic filing and any subsequent expansion of these plans, including steps taken or planned to protect taxpayer privacy.

In addition, this bill would require FTB to implement method one and explore the feasibility of implementing method two for any expansion of electronic filing for taxpayers using the 540 2EZ.

1. A system that only allows the downloading of the 540 2EZ for preparation offline and a subsequent transmission to FTB. The system must contain the following operational safeguards or characteristics.
 - A taxpayer who electronically files must be allowed to obtain a copy of the 540 2EZ that can be filed electronically from the FTB website or other third party web sites.
 - The form must be downloaded using free software and then the taxpayer completes it offline on their own computer or a public computer with Internet access.
 - The taxpayer would initiate a process specific to the downloaded form that transforms the taxpayer-entered data into a format that would be transmitted directly and securely to FTB's direct filing portal using the taxpayer's Internet connection and 128-bit secure socket layer encryption.
 - FTB must provide the taxpayer an acknowledgement of filing.
 - The taxpayer must have the option to print a copy of their return during any point in the process.
 - The system must reflect and implement the intent of the Legislature as described above.
2. The creation of a clearinghouse to route any 540 2EZ filers to various commercial, philanthropic, or private web sites that would help the taxpayer use electronic filing. FTB must assure that any web site included in the clearinghouse send the taxpayer information to FTB timely and in a format compatible with FTB systems.

IMPLEMENTATION CONSIDERATIONS

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

Several portions of the legislative intent language are unclear:

1. The phrase "expansion of e-filing."
 - If FTB were to expand the criteria for its current Telefile system and thereby increase the number of Telefilers, it appears this would be considered an expansion of electronic filing. Hence, because the Telefile system monitors the creation of the return, captures telephone keypad keystroke information, identifies math errors and looks up the amount of tax from the tax table, such an expansion of Telefile would be prohibited under this bill.

- The Governor's budget proposes a requirement for certain tax preparers to electronically file, which would significantly expand the number of returns filed electronically. FTB anticipates this electronic filing requirement would be incorporated into its current electronic filing system and processes with tax preparers and software providers, which would result in significant departmental cost savings. However, if this requirement were considered an "expansion of e-file," it would be prohibited under this bill. FTB's existing electronic filing system checks the return by computer to validate data that is necessary to the processing of the return, such as two names and social security numbers for a joint return, and identifies arithmetic errors for correction before accepting the return. Under this bill, FTB would be prohibited from validating the information and identifying math errors on those returns that are required to be filed electronically.
 - Electronic filing could not be expanded to include amended or prior year returns, even though FTB anticipates it would use the same electronic system and processes currently used for tax preparers or tax preparation software providers.
 - The current electronic system and processes allows taxpayers that electronically file to take advantage of several benefits that are not available to taxpayers that file via paper. When filing electronically, taxpayers can: file early but electronically pay later, on the due date; make installment payment arrangements; and submit a head of household questionnaire to prevent subsequent inquiries by FTB. If FTB were to expand the electronic-filing benefits, thereby encouraging more taxpayers to file electronically, it is unclear whether that would be considered an "expansion of e-filing" and would be prohibited by this bill.
2. The purpose of providing the report to the Legislature is unclear. It is uncertain what would occur after the report is prepared. It is anticipated FTB would continue to implement the plan unless the Legislature introduces legislation to alter or stop the plan. Also, it is unclear what is anticipated by the author if FTB were to develop the plan for the following filing season, but late in the legislative year or when the Legislature is out of session. It is unclear if FTB is expected to put the plan on hold waiting for the Legislature to respond to the plan or proceed with the plan with the expectation to implement the plan for that following filing season.

The language affecting the electronic filing of the Form 540 2EZ may be problematic to implement because of the following differences between the language in the bill and the MOU, which may lead to confusion.

- It is staff's understanding that the intent of the MOU was to require implementation of the downloadable 540 2EZ and explore the feasibility of creating the clearinghouse, which is consistent with the language in this bill. However, at the FTB meeting of March 25, 2002, it was expressed that the intent of the MOU was to provide two implement methods for filing the 540 2EZ electronically. It appears that the intent was not to provide an either/or alternative. Consequently, it is unclear if this bill is consistent with the intent of the MOU .
- This bill, like the MOU, addresses the creation of a "clearinghouse" but there is no definition or criteria set forth for that clearinghouse. The MOU states "the parties agree that a variety of viewpoints from the commercial electronic filing industry exist with regard to the terms and conditions that would apply to the hosting and operation of a clearinghouse." This bill does not provide for terms and conditions.

- This bill requires FTB to assure that any clearinghouse web sites forward the information to FTB on a timely basis and present the data in a format compatible with FTB's system. This requirement goes beyond the requirement set forth in the MOU. Under the MOU, the responsibility for forwarding the information on a timely basis and in a compatible format is on the overall system that is developed, not solely the FTB. In the clearinghouse environment, FTB would not be able to assure that the clearinghouse participants file the information timely. FTB may be able to set criteria that would require a clearinghouse participant to forward information on a timely basis and in a compatible, acceptable form. However, the clearinghouse participant ultimately would be responsible for the programming necessary to be in compliance with the criteria. In addition, under the MOU, "timely basis" specifically is noted as "yet to be defined." This bill, likewise, does not provide a definition, nor does it note that it is yet to be defined.

LEGISLATIVE HISTORY

SB 415 (Dunn; 2001-02) would have required FTB to provide individuals, free of charge, tax return forms that could be filed electronically directly with FTB. This bill was held in Assembly Appropriations Committee.

AB 1936 (Horton; 2002) would allow taxpayers that are subject to the special tax laws administered by the Board of Equalization (BOE) to electronically file their required tax returns in a form prescribed by the BOE.

PROGRAM BACKGROUND

FTB designed a functional electronic 540 2EZ that would have the ability to do basic arithmetic functions and look up the taxpayer's tax using a tax table. In response to industry concerns, the department redesigned the electronic 540 2EZ by removing the arithmetic and tax look up functions, leaving FTB a tax form that the taxpayer could download from the FTB website, complete offline, and submit electronically directly to FTB's website. In further response to industry concerns regarding this redesign, the redesign was set aside while FTB and affected industry representatives met and agreed upon an MOU (a facsimile is provided as Appendix D).

OTHER STATES' INFORMATION

Electronic technology that is offered in other states vary. A chart that displays the variations is provided at the Federation of Tax Administrators (FTA) website² (www.taxadmin.org/fta/edi/trend.ssi). According to other FTA documents,³ electronic programs offered by the various states are free and perform basic arithmetic and tax calculation functions. Some of the more advanced state-direct online filing feature customized online forms designed to request only the relevant information needed from a specific filer.

For additional information, Appendix B provides a chart prepared by FTB staff of the 17 states that offer taxpayers direct online electronic tax preparation and electronic filing without the use of a third party intermediary. Appendix C provides a chart that reflects the length of time that taxpayer return data may be retained by those state taxing agencies from which FTB was able to readily obtain information. Additionally, TaxExPRESS, a weekly electronic newsletter for state tax agencies, reports that Missouri has enhanced its paper-based Internet income tax form to add full math calculations and to calculate the tax due.

² "Status of State Electronic Filing Programs for Individual Income Tax"

³ "State Electronic Tax Administration, Briefing Paper, May 2001"

FISCAL IMPACT

Departmental Costs

This bill should not affect departmental costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would not affect the state's tax revenue.

ARGUMENTS/POLICY CONCERNS

FTB currently has the authority to prescribe the forms and processes for filing tax returns. The legislative intent language could be viewed as a restriction of one area of FTB's administrative authority regarding forms and electronic filing.

Current state law requires FTB to design forms that ease taxpayer compliance. Further, the Franchise Tax Board is committed to simplifying the ways Californians file and pay their taxes. The FTB has an ongoing history of attempting to ease the administrative filing burdens on taxpayers and helping individuals file their tax returns faster and better. The department is constantly improving the filing systems. For example, adding programs like Telefile, electronic filing, offering simpler paper returns like the Form 540 2EZ and Form 540A Senior, and providing a variety of scanning options. This bill would reduce this flexibility and establish restrictions and limitations for returns filed electronically that do not exist for paper returns.

Under this bill, FTB may not experience future budgetary savings that it otherwise could if e-filing capabilities were sufficiently expanded.

Each section of this bill could be viewed as going beyond the intent of the MOU signed by affected industry and the FTB:

Section 1 -- This bill's legislative intent language sets forth criteria and restrictions for all electronic filing. Additionally, this bill is contrary to the spirit of the board members' discussion during in the FTB meeting of March 25, 2002, which is to look at electronic filing enhancements for California taxpayers in light of other states inroads to electronic filing functionality, expressly Missouri's example. This bill precludes the prospect of future electronic filing enhancements.

Section 2 --The MOU set forth criteria and restrictions specifically for the electronic 540 2EZ project. However, staff understands the MOU was intended simply to be a framework for further development and participation between industry and the FTB in implementing a direct file electronic 540 2EZ tax form. The MOU set forth a conceptual approach that was acceptable to industry, leaving certain aspect to be determined through an interactive process. The MOU was for a limited purpose and was to have limited effect; it was not contemplated as the springboard for legislative restrictions on the future development of the FTB's role in e-government.

The MOU was an agreement between affected industry and FTB. However, industry would not be bound by this bill. All requirements and restrictions would apply to FTB, including the requirement that the cost be free to the taxpayers. Industry would not be required to make their electronic-filing products or services or the electronic forms obtained from their web sites free of charge.

The saving in departmental costs anticipated in the Governor's Budget from the requirement for certain tax practitioners to electronically file would be at risk under this bill.

Employment Development Department (EDD) and BOE have each developed and have made available online tax forms, publications, and other information that in some way determine or calculate a taxpayer's tax liability. Some of these electronic services may be used online. Also, EDD has available for household employers an online electronic service for reporting, filing, and paying their employment taxes. This electronic service determines or calculates the employer's tax liability and is submitted by the taxpayer directly to EDD.

FTA's "Electronic Commerce Best Practices" publication on its website indicates that the Internet offers an incredible flexibility for taxing agencies. This bill would exclude California taxpayers from the flexibility that the Internet offers and that at least 17 other states offer their taxpayers.

LEGISLATIVE STAFF CONTACT

Gloria McConnell
Franchise Tax Board
845-4336

Brian Putler
Franchise Tax Board
845-6333

Appendix A

Current Practice

From FTB's mission statement: The purpose of FTB is to collect the correct amount of tax revenue and operate other programs entrusted to us; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

FTB electronic services that determine or calculate tax liability

FTB's mainframe computer systems and other electronic systems were developed or made available to determine or calculate a taxpayer's income tax liability. This is a routine part of the processing of the tax return and determining whether the correct tax liability is shown on the tax return.

In addition, online electronic services are used by taxpayers and the general public. These tax forms are published online for taxpayers to download, prepare, and mail, or to just view and use for purposes of completing their paper or electronic forms, including tax returns. Tax publications, legal rulings, regulations, and other publications or documents also are made available online with the purpose in some way to determine a taxpayer's income tax liability. Also available online is a calculator that taxpayers can use instead of the tax tables or tax rate schedules to complete their tax returns.

Further, the Telefile system allows taxpayers to enter data through the telephone keys. The electronic system determines the tax based on that data and the data is submitted, which becomes the tax return.

FTB electronic tax forms

For taxpayers to prepare tax returns, the FTB provides online a variety of electronic tax forms, which includes tax returns, schedules, instructions, special publications, and tax booklets. To allow taxpayers to electronically prepare the required returns, all of the forms and many of the simpler schedules can be downloaded to taxpayers' personal computers. In electronically preparing the returns, taxpayers do all math functionality, seek tax advice through the tax form booklets offered by FTB, or elsewhere. Taxpayers must then print the completed tax returns and mail them to FTB.

Electronic preparation and electronic filing partnership between business and FTB

With the growth of technology, there are three ways to electronically prepare an income tax return through the following businesses: (1) tax professionals that utilize tax preparation software to complete the tax return, (2) tax preparation software purchased by taxpayers to install on their personal computer, and (3) tax preparation programs that taxpayers can access with their personal computer via the Internet. All these services do basic arithmetic functions (mathematical addition and subtraction), mathematical calculations (multiplication, adjustments, populating fields, etc.), offer some form of tax advice, and determine or calculate the tax liability for taxpayers.

Taxpayers can electronically file tax returns through businesses in three ways: (1) tax practitioners that generally transmit the tax returns from their computer system (on which the return resides) to a third party transmitter and then to FTB's computer system, (2) tax preparation software purchased by taxpayers or on-line tax preparation programs of service providers that transmits the taxpayer's tax return electronically to FTB's computer system using the service providers computer system (on which the return resided), and (3) the direct filing portal which was developed to allow taxpayers the opportunity to use their own Internet service provider to file directly with FTB. However, the only businesses that offer the direct portal filing opportunity requires taxpayers to use the businesses' Internet service provider. The taxpayer's return resides on those businesses' computer system.

The cost for taxpayers to use these electronic services vary. Tax practitioners generally charge a fee for electronic tax preparation and the associated electronic filing. However, several of these businesses offer free electronic tax preparation and filing services if the individual's adjusted gross income is below a specified amount or if the individual is filing a simple Form 540 2EZ. Such free services are not required by law and, therefore, are subject to change by the business and could be withdrawn at will at any time. The cost for using tax preparation software/programs often includes the electronic filing services.

A significant advantage of using business to complete tax returns, including software/programs, is that business prepares both state and federal income tax returns.

Appendix B

The following States (17 total) offer direct Internet filing of Personal Income Tax returns. 16 states host the application on their web site, one state (Oklahoma) links citizens to a customized version of TurboTax for the Web which is not hosted on the state web site.

	Fillable form format	Does Calculations	Q & A format	Built in-house	Vendor built	Transmit via 3 rd Party	Transmit via modem or Internet	Application determines form type, or T/P chooses
Arkansas	Yes	Yes		Yes		Direct	Internet	1 tax form, same as TeleFile.
Colorado	Yes	Yes & edits		Yes		Direct	Internet	Only 1 tax form
Delaware	Yes	Yes		Yes		Direct	Internet	TP chooses
Iowa	Yes	Yes			Yes	Direct	Internet	Only 1 tax form
Illinois		Yes	Yes		Yes	Direct	Internet	Only 1 tax form
Indiana	Yes	Yes		Other State agency		Direct	Internet	TP Chooses
Louisiana*		Yes	Yes	Yes		Direct	Internet	Only 1 tax form
Maine		Yes	Yes		Yes	Direct	Internet	
Maryland		Yes	Yes	Yes		Direct	Internet	App chooses
Massachusetts	Yes	Yes	Few		Yes	Direct	Internet	TP chooses, System Q & A to assist if T/P is unsure of form type.
Missouri		Yes	Yes	Yes		Direct	Internet	1 tax form, same as TeleFile.
New Mexico	Yes	Yes		Other state agency		Direct	Internet	Only 1 tax form
Oklahoma	Provides free electronic filing through TurboTax.							
Pennsylvania	Yes	Yes	Few		Yes	Direct	Internet	Only 1 tax form
So. Carolina	Yes	Yes			Yes			
Vermont*	Yes	Yes	Few		Yes	Direct	Internet	Only 1 tax form
Virginia*		Yes			Yes	Direct	Internet	Only 1 tax form

Notes:

*No response was received, information was obtained from their websites.

- Of the 13 respondents, 10 require Federal AGI prior to filing state return.
- Many of the states allow Tax Practitioners to use the state's system.
- Maine offers a demo at http://janus.state.me.us/revenue/netfile/1040demo/lfile_demo_welcome.htm

Appendix C

Data Retention of Internet Filed Returns Conducted by Selected States

State	Option to save draft or interim return?	How long is draft information saved?	What happens to data?	Who hosts the Internet application?
Arkansas	No		Not stored, unless return is completed.	State
Colorado	Yes	Through Oct. extension date	Stored, purged after Oct. extension date.	State
Illinois	No		Not stored, unless return is completed.	State
Indiana	Yes	2 weeks	Stored for 2 weeks then purged, unless return is completed.	State
Iowa	Yes	48 hours	Stored for 48 hours then purged, unless return is completed.	Vendor, GovConnect.
Louisiana	No		Not stored, unless return is completed.	State
Oklahoma	Yes	Through Oct. extension date	Stored indefinitely.	Vendor, Intuit.
Pennsylvania	No		Not stored, unless return is completed.	Vendor, GovConnect
So. Carolina	No		Not stored, unless return is completed.	State
Wisconsin	No		Not stored, unless return is completed.	State

Appendix D

MEMORANDUM OF UNDERSTANDING

Inasmuch as electronic tax filing benefits the State of California and taxpayers by providing convenience, efficiency and cost savings in the administration of tax laws; and the Franchise Tax Board is committed to maximizing the use of electronic filing; and in an effort to maximize the use of electronic filing, the California State Controller and Chair of the Franchise Tax Board, Kathleen Connell, facilitated a cooperative discussion between representatives of private industry and representatives of the Franchise Tax Board staff for the purpose of identifying a process that will maximize the use of electronic filing for taxpayers using California 540 2EZ form. The representatives participating in this March 12, 2002, discussion are signatories to the Memorandum of Understanding and by signing this Memorandum of Understanding agree to Implementation by the Franchise Tax Board and its staff, of the process described herein.

Now, therefore, in consideration of the Franchise Tax Board's issuing direction to its staff to implement this Memorandum of Understanding and for the purpose of agreeing to the deployment of an electronic version of the California 540 2EZ, the parties set forth below accept the following objectives for the form.

The form shall:

- Provide a convenient electronic method for filers to transmit tax data
- Not provide arithmetic calculations or tax table look-up features
- Be free to use
- Provide an appropriate level of privacy; minimize risk of disclosure of data to third parties, disclose to filers, prior to use, all risks inherent in the use of the electronic form and process; and procedurally preclude government monitoring of draft returns or key strokes
- Provide secure transmission of data using 128-bit secure socket layer encryption
- Provide for acknowledgment of successful transmission and receipt of complete data by the Franchise Tax Board

The parties further agree that [one of]⁴ the following solutions will be, subject to Franchise Tax Board approval, implemented to meet the objectives above;

- A) Download the California 540 2EZ form for offline preparation and subsequent transmission to the Franchise Tax Board. A prototype solution, involving the downloading of a graphic California 540 2EZ form using free Adobe (.pdf) form utility software, was demonstrated to interested parties on March 12, 2002. As demonstrated to the group in attendance, this approach would work as follows: A taxpayer would obtain a copy of the California 540 2EZ form from the Franchise Tax Board website or from other third party websites.

⁴ These words were deleted from the MOU at the Franchise Tax Board's meeting of March 25, 2002, prior to the board's unanimous vote to approve it.

The form would be downloaded using free Adobe software and then filled in offline on the taxpayer's computer, or a public access Internet terminal. Upon completion of the filled-in form, a taxpayer would initiate a process specific to the downloaded form that transforms the taxpayer-entered data into a format to be transmitted directly and securely to the Franchise Tax Board's Direct Filing Portal using the taxpayer's Internet connection and 128-bit secure socket layer encryption. The Franchise Tax Board would present the taxpayer with an acknowledgment of filing. At any point in the process, the taxpayer would have the option to print a copy for record-keeping purposes. While questions about the limitations of Adobe software were raised at the March 12 demonstration about the downloaded form approach, it was generally agreed that the issues could be resolved technically, or be otherwise remediated through property risk disclosures to filers.

- B) Create a clearinghouse to further the public interest by routing California 540 2EZ filers to commercial sector, philanthropic and other web sites. The parties agree that a variety of viewpoints from the commercial e-file industry exist with regard to the terms and conditions that would apply to the hosting and operation of a clearinghouse. The system developed to implement this process would forward the information provided by filers to the Franchise Tax Board on a timely basis (to be defined) and will present the data in a format compatible with the Franchise Tax Board's systems.

The parties agree that either alternative can be successfully deployed. This Memorandum of Understanding is for the sole purpose of memorializing the recommendations made by the parties present. This Memorandum of Understanding does not imply or constitute any contract for services or products or arrangement for payment or other consideration by the Franchise Tax Board to any of the private sector signatories to this agreement. This Memorandum is subject to ratification by vote of the three-member Franchise Tax Board.