BILL ANALYSIS

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Department, Board, Or Commission	AUTHOR	Bill Number
Franchise Tax Board	**Assembly Revenue & Taxation Committee**	**AB 1748**

SUBJECT

Innocent Spouse/No Credit Or Refund Shall Be Allowed If Election For Relief Of Liability

SUMMARY

This bill would make changes to the statutory provisions for "innocent spouse" to more closely conform California law to federal law and to provide the Franchise Tax Board (FTB) the authority to issue guidelines and rules.

This bill would also amend some provisions of the Revenue and Taxation Code relating to the administration of tax programs administered by the Board of Equalization (BOE); however, those provisions do not apply to FTB. This analysis addresses only those provisions of the bill affecting FTB.

PURPOSE OF BILL

According to the author's office, the purpose of the bill is to conform California law to federal law to eliminate differences in the application of the innocent spouse relief provisions for certain taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2008, and would apply to requests for relief filed on or after that date.

ANALYSIS

<u>FEDERAL LAW</u>

Under federal and state income tax law, spouses who file a joint tax return are individually responsible for the accuracy of the return and for the full tax liability for that tax year. These obligations apply regardless of which spouse earns the income. The concept of obligating each spouse individually for all of the tax liability is called joint and several liability. However, joint and several liability can result in inequitable consequences to one spouse in certain circumstances. Consequently, both the federal government and California enacted "innocent spouse" legislation, which may allow a spouse to be relieved of some or all of the responsibility for a joint tax debt.

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The Internal Revenue Restructuring and Reform Act of 1998 (RRA 98) revised the circumstances under which relief is allowed for joint and several liabilities (JSL). RRA 98 allowed an innocent spouse to qualify for relief under one of the following provisions:

1. *Understatement/Apportionment.* This provision applies where a joint return has been filed and there is an understatement of tax on the return attributable to an erroneous item. To qualify for relief, the requesting taxpayer must show that the understatement was attributable to the non-requesting spouse, and that at the time the return was signed, he or she did not know and had no reason to know of the understatement of tax. The *understatement/apportionment* provision is also known as "complete/partial relief."

2. *Separate liability election.* A requesting spouse may elect to be taxed as though he or she filed a *married filing separate* tax return. An individual is eligible to make this election only if, at the time the election is filed, he or she is no longer married to, or is legally separated from, the spouse with whom the joint return was filed, or has lived apart from the spouse for 12 months prior to requesting relief. At the time the joint return was signed, the requesting spouse must have lacked actual knowledge of the item resulting in the tax deficiency. The *separate liability election* provision is also known as "separate allocation relief."

3. *Equitable relief.* Relief is available under this provision if the IRS determines from a review of all the facts and circumstances that the requesting taxpayer would not qualify for relief under either 1 or 2 above, and it would not be equitable to hold the requesting spouse liable for any unpaid tax or any deficiency.

Former federal law generally allowed refunds under the *understatement/apportionment* section for "complete/partial relief," and under the *separate liability election* section for "separate allocation relief." In 2000, Congress amended the law to provide, among other things, that refunds for taxes paid under the *understatement/apportionment* section are limited by the claim for refund statute of limitations (3 years from the time the return is filed or 2 years from the time the tax is paid) and that no refunds for taxes paid are allowed under the *separate liability election* section.

If under all the facts and circumstances it is inequitable to hold a spouse liable for any portion of any unpaid tax or deficiency, IRS may relieve that spouse of liability for that unpaid tax or deficiency and in limited cases may issue a refund. According to the Frequently Asked Questions on the IRS website, the IRS would allow refunds under *equitable relief* in the following circumstances:

- Understatements – Refunds are allowed for installment agreement payments made after the request for relief is filed.

- Underpayments – Refunds are allowed for payments made after July 22, 1998 (the effective date of RRA 98), unless the payments were made jointly with the non-requesting spouse, payments were made with the tax return, or payments were made by the non-requesting spouse.

In each case, the requesting spouse must establish that he or she provided the funds used to make the payment for which he or she seeks a refund. In both circumstances, the federal statute of limitations for claiming a refund applies.

STATE LAW

In 1999, California conformed to portions of the RRA 98 by enacting the Taxpayer Bill of Rights Act of 1999 (TPBOR 99), which revised and expanded innocent spouse relief at the state level. California, however, has not conformed to the subsequent 2000 federal changes to limit refunds under the *complete/partial relief* election to those claims filed within the statute of limitations or to prohibit refunds under the *separate allocation relief* election.

Under current state innocent spouse law, there is no statute of limitations provision for making a claim for refund under the innocent spouse provision of *complete/partial relief*. California law also has no statute of limitations for a *separate allocation relief* election.

In addition, current state law provides two avenues for relief not available under federal law:

1. A taxpayer may seek a divorce court order relieving the taxpayer of JSL for income tax reported on a joint return or additional tax resulting from an audit. The order cannot relieve tax on any income that was earned by or derived from assets under the exclusive control and management of the taxpayer seeking relief.

2. A taxpayer may seek relief from FTB on any unpaid self-assessed tax liability on a joint return, including penalties and interest. The tax liability must not be attributable to income that was under the exclusive control and management of the requesting taxpayer.

In both instances, state law requires the taxpayer to demonstrate that he or she neither knew nor had reason to know of the nonpayment of tax at the time the return was filed.

The California Administrative Procedures Act requires all regulations to be promulgated according to specific procedures, which generally require a hearing and an opportunity for comment by the public. Unlike federal law, all rules of general application issued by a state agency are considered a regulation and subject to the procedures applicable to regulations, unless otherwise provided.

THIS BILL

This bill would amend existing law to more closely conform to federal law by applying the general statute of limitations for claims for refund to *complete/partial relief* and by disallowing any claims for refund for *separate allocation relief*. Thus, such claims for relief made after the statute of limitations would be disallowed for claims for refunds to *complete/partial relief*.

This bill would also provide FTB the authority to issue guidelines and rules comparable to the IRS without the necessity of going through the formal rulemaking process under the Administrative Procedures Act.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Implementing this bill would occur during the department's normal annual update.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>**:**

Based on data and assumptions discussed below, the Personal Income Tax revenue gain from this proposal would be as follows:

Estimated Revenue Impact Of AB 1748 Effective On Or After January 1, 2008 Enactment Assumed After January 1, 2008			
	2007-08	2008-09	2009-10
Innocent spouse	+ <$150,000	+ <$150,000	+ <$150,000

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

<u>Revenue Discussion</u>**:**

Departmental data shows that in the most recent fiscal year, from July, 2005, through July, 2006, approximately $125,000 in innocent spouse relief was granted. This bill could result in some claims for innocent spouse relief being rejected. This would produce a revenue gain, but the gain would be insignificant (less than $150,000).

VOTES

Assembly Floor-Yes: 73, Noes: 0.
Senate Floor-Yes: 39, Noes: 0.
Concurrence-Yes: 76, Noes: 0.

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