

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Assembly Revenue & Taxation Committee Analyst: Nicole Kwon Bill Number: AB 3078
Related Bills: See Legislative History Telephone: 845-7800 Introduced Date: March 13, 2008
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT:	Give Taxpayer Advocate Narrow Equitable-Type Powers to Relieve Penalties Due to FTB Action / Modify the Group Return Provisions / Real Estate Withholding for Certain Non-California Business Entities / Period of Limitations for Other State Tax Credit Claims for Credit or Refund
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SUMMARY

This bill would do the following:

- Allow entities to file a tax return on behalf of certain nonresidents.
- Close loopholes in current tax withholding on the payments nonresident individuals and non-California businesses receive from the sale of California real property.
- Extend the statute of limitations for claiming the credit for taxes paid to another state.
- Give discretionary authority to the Taxpayers' Rights Advocate to grant relief from penalties, fees, or interest imposed on a taxpayer because of erroneous actions of the department.

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board sponsored bill is to do the following:

- Make filing state returns more convenient for nonresidents,
- Ensure that tax is collected on payments to certain nonresident individuals and businesses from the sale of California real property,
- Provide parity in treatment of the Other State Tax Credit (OSTC), and
- Give taxpayers monetary relief from certain Franchise Tax Board (FTB) staff errors.

EFFECTIVE/OPERATIVE DATE

If enacted in 2008, this bill would be effective January 1, 2009. The operative dates of these changes vary and will be addressed separately for each provision.

POSITION

Support.

On November 28, 2007, the three-member FTB voted 2-0, with the member from the Department of Finance abstaining, to sponsor the language included in this bill.

Board Position:	Department Director	Date
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	Lynette Iwafuchi for Selvi Stanislaus	4/15/08

MODIFY THE GROUP RETURN PROVISIONS

EFFECTIVE/OPERATIVE DATE OF SOLUTION

If enacted in the 2008 legislative session, this provision of the bill would be effective on January 1, 2009, and specifically operative for taxable years beginning on or after January 1, 2009, and for returns filed on or after January 1, 2010.

ANALYSIS

STATE LAW

Existing state law imposes tax on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

California statutes do not explicitly establish rules to source income. Instead, a body of case law has prescribed source rules and the relevant California statute delegates to the FTB authority to prescribe sourcing rules by regulation.

These legislative regulations provide that income from services is sourced to California to the extent the services are performed in this state. When nonresidents perform services in California and other states, compensation for these services is sourced to California by using various apportionment methods that reasonably reflect the value of the California services as compared to the total services performed. These regulations are consistent with existing law and federal statutes that limit or preempt California's ability to tax the California source income of nonresidents.

California allows certain nonresidents who receive a distributive or pro rata share of income from a pass-through entity (partnerships¹ or S corporations) that derives income from California sources or is doing business in California to elect to have the pass-through entity file a group nonresident return on their behalf.² In addition, California allows filing of a group nonresident return for electing nonresident directors of a corporation. Electing nonresident directors would be those individuals that receive California source wages, salaries, fees, or other compensation from that corporation for director services, including attendance at board of directors' meetings that take place in this state.

Existing state law imposes tax on individuals, corporations, and certain business entities, and each is treated as a distinct entity for tax purposes.

¹ This includes limited liability companies classified as partnerships, registered limited liability partnerships, and foreign limited liability partnerships.

² Revenue & Taxation Code section 18535.

Under existing state law and instructions specifically prescribed by FTB, all of the following conditions must be met to be eligible for inclusion in a group nonresident return:

- 1) The partner/member/shareholder/director must be an individual. Estates, trusts, partnerships, LLCs, C corporations, S corporations, or other business entities cannot be included in the group nonresident return.
- 2) The individual must be a full-year nonresident of California.
- 3) The individual must not have California taxable income in excess of \$1,000,000.

Assuming these requirements are satisfied, the business entity files the group nonresident return and pays the tax on behalf of the electing nonresidents. The return must be for a calendar year and, except in the case of an S corporation shareholder, must include at least two electing nonresidents. An S corporation may file a group nonresident return on behalf of one shareholder. The business entity must use Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, for the group nonresident return. A nonresident individual can be included on more than one group nonresident return.

Nonresidents subject to the mental health tax (taxable income in excess of \$1,000,000) are ineligible to be included in a group nonresident return.

THIS PROVISION

This provision would amend current law to allow the following to be included in a group nonresident return:

- Entities with less than two electing nonresident individuals, and
- Individuals with more than \$1,000,000 in California taxable income.

IMPLEMENTATION CONSIDERATION

Implementing this provision would have a moderate impact on the department as discussed below under Fiscal Impact. Department staff anticipates implementing the provision during the normal updates that would apply to returns filed beginning January 1, 2010.

LEGISLATIVE HISTORY

AB 970 (Torrico, Stat. 2006, Ch. 343) authorized nonresident directors that receive California source wages, salaries, fees, or other compensation from that corporation for director services to file a group nonresident return.

SB 219 (Scott, Stat. 2002, Ch. 807) authorized a single shareholder of an S corporation to file a group return.

SB 298 (Campbell, Stat. 1995, Ch. 475) exempted from withholding income that is paid by a corporation for services performed in California to a nonresident corporate director for services.

AB 129 (Jones, Stat. 1987, Ch. 918) authorized nonresident individuals that receive a distributive share of income from a pass-through entity to file a group nonresident return.

PROGRAM HISTORY/BACKGROUND

Currently, electing individuals included in group nonresident returns are taxed at the highest marginal rate (9.3%) without deductions. Individuals with more than \$1,000,000 in California taxable income are ineligible to be included in a group nonresident return because their taxable income in excess of \$1,000,000 would need to be taxed at the highest marginal rate plus the additional 1% (mental health tax) rate, for a total of 10.3%.

For tax year 2005, the department received approximately 3,300 group nonresident returns on behalf of an estimated 68,000 nonresidents. Currently, per instructions specifically prescribed by FTB, group nonresident returns are not allowed to be filed electronically. After processing group nonresident returns, the department sends these returns to the Filing Enforcement Unit where the member and income information is manually keyed.

OTHER STATES' INFORMATION

Of the 40 states with a personal income tax, 39 states (Nebraska is the one exception) allow either the filing of group returns or impose an entity level tax similar to the group return concept. Specifically, *New York, Delaware, Pennsylvania, and Connecticut* allow group nonresident returns to be filed by pass-through entities, and they all require the electing partners to be individuals (the same as current California law). Requirements and criteria such as what entities can file, allowable deductions, exemptions, and tax rates vary widely for each state.

FISCAL IMPACT

Implementing this provision would require changes to existing tax forms and instructions (Form 540NR, California Part-Year Resident or Nonresident Income Tax Return and Publication 1067, Guidelines for Filing a Group Form 540NR), manually validating filed group returns, programming changes to computer systems, and electronic applications. The department would incur one-time costs for these items of approximately \$101,000, with absorbable annual ongoing costs.

ECONOMIC IMPACT

Revenue Estimate:

Based on data and assumptions discussed below, this provision would result in the following revenue gains.

The Revenue Estimate for AB 3078 Effective for Tax Years BOA 1/1/2009 Assumed Enactment Date After 6/30/2008 (\$ in Millions)			
	2008-09	2009-10	2010-11
General Fund Revenue	+\$2	+\$6	+\$6
Mental Health Services Fund Revenue	+\$3	+\$7	+\$8

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

Revenue Discussion:

The revenue impact of this provision would depend on the following:

- The extent compliance increases among nonresident non-filers that would generate new revenue.
- The extent taxpayers switch their method of filing, from filing individual nonresident returns to filing as part of a group return.
- The extent that taxpayers with income in excess of \$1,000,000 no longer erroneously file as part of a group return.

1. Increase in Compliance

To the extent this provision eases the filing process, some non-filing nonresident taxpayers may become compliant. The number of noncompliant nonresident taxpayers and their tax liabilities are unknown.

An estimate of the expected increase in compliance can be made with the amount of tax currently paid by nonresident taxpayers that report partnership income. For taxable year 2005, the amount of tax paid by nonresidents who only report partnership income is estimated to total \$280 million. This includes nonresidents who file a single nonresident return, as well as those who file as part of a group nonresident return. Assuming that nonresident partners are on average 90% compliant regarding the reporting of partnership income to California, approximately \$30 million $[(\$280 \text{ million} \div 90\%) - \$280 \text{ million}]$ in taxes currently go unreported.

This provision is not anticipated to substantially entice taxpayers to fulfill their filing or reporting requirements. Assuming that unreported tax would be reduced by 1%, this would result in a minor revenue gain of \$300,000 $(\$30 \text{ million} \times 1\%)$.

2. Change in Method of Filing

This provision would expand group return eligibility rules to include:

- Group 1: Single nonresident members of partnerships, LLCs, or corporations, and
- Group 2: Nonresident members of flow-through entities with taxable income in excess of \$1 million.

This change is anticipated to ease the filing process and entice nonresidents that file single returns to start filing as part of a group return. Based on a review of nonresident data, taxpayers from Group 1 that would be enticed to switch are estimated to currently report \$15 million in adjusted gross income (AGI). Tax liabilities for Group 1 taxpayers would increase because they would be assessed at a higher tax rate and not be allowed to use any exemptions, deductions, or credits. A comparison of data on reported AGI and tax liabilities implies that, on average, taxpayers would be assessed an additional 2.3% that would result in approximately \$350,000 $(\$15 \text{ million} \times 2.3\%)$ positive revenue impact.

For Group 2, based on a review of tax return data for nonresident taxpayers currently subject to the mental health tax, it is estimated that 305 taxpayers would switch and file as part of a group return.

Taxpayers with more than \$1 million in taxable income are currently assessed an effective tax rate of 9.4%, of which 8.9% represents revenue attributed to the General Fund and 0.5% represents revenue attributed to the Mental Health Fund. By filing a group return, these taxpayers would not be allowed to use any exemptions, deductions, or credits. Essentially, this provision would assess these taxpayers at a new effective tax rate of 10.3%, of which 9.3% would be attributed to the General Fund and 1% to the Mental Health Fund. It is estimated that AGI currently reported by these taxpayers approximates \$975 million. The difference in tax rates within each fund would generate approximately \$4 million increase in revenue for the General Fund $[(\$975 \text{ million} \times 9.3\%) - (\$975 \text{ million} \times 8.9\%)]$ and approximately \$5 million increase in revenue for the Mental Health Fund $[(\$975 \text{ million} \times 1\%) - (\$975 \text{ million} \times 0.5\%)]$.

3. Group Returns that Currently Erroneously Include Taxpayers Subject to the Mental Health Tax

Currently, some group returns erroneously include taxpayers subject to the mental health tax. The taxpayers erroneously filing group returns will be issued a filing enforcement notice and be required to pay the tax calculated on an individual basis, for which the actual tax rate on AGI will likely be between 9.3% and 10.3%.

Assuming the combined tax rate calculated on an individual nonresident return for a particular taxpayer's income is 9.7%, General Fund revenue under current law would be composed of two parts: (1) 9.3% of income would be received by the return filing date, and (2) an additional 0.4% of income would be received after the taxpayer is served with a filing enforcement notice and subsequently files an individual return. For this same taxpayer, under this provision, the amount of revenue would be 10.3% of income, and it would be received by the return due date. This provision would, essentially, lead to a trade off; the 0.4% of income that is received into the General Fund with a lag of one to two years after the return due date would be lost, in exchange for a gain of 1% of income for the Mental Health Fund. This revenue would be received by the return filing date.

The revenues generated by allowing these taxpayers to file as part of group returns, rather than file erroneously as part of a group return and then be subject to filing enforcement activity, is estimated to result in an increase in mental health tax revenues of approximately \$1 million. It is also expected to reduce General Fund revenue by an insignificant amount with a year lag.

Summary

Based on taxable year 2005 data, General Fund revenues would increase by approximately \$5 million (\$300,000 for Group 1 additional compliance + \$350,000 for Group 2, the single nonresident member for partnership, LLC, or corporation + \$4 million for Group 2 taxpayers with more than \$1,000,000 in taxable income) and the Mental Health Fund would increase by approximately \$6 million (\$5 million for Group 2 + \$1 million for Group 3). The revenue estimate in the chart above includes adjustments for projected growth in taxable income and reflects a fiscal year cash flow basis.

CLOSING LOOPHOLES IN REAL ESTATE WITHHOLDING FOR CERTAIN NON-CALIFORNIA TAXPAYERS

EFFECTIVE/OPERATIVE DATE OF PROVISION

If enacted in the 2008 legislative session, this provision would be effective on January 1, 2009, and would apply to real property sales that occur on or after that date.

ANALYSIS

STATE LAW

Revenue and Taxation Code (R&TC) section 18662 requires withholding at source from payments to nonresident individuals and business entities with no permanent place of business in California.

Real Estate Withholding – Partnerships and S Corporations

Current law generally requires withholding at source at the rates shown in the table that follows. Generally, payments of California source income to nonresident individuals and non-California business entities are subject to withholding at source. Sales of California real property by both resident and nonresident individuals and corporations without permanent place of business following the sale are subject to withholding. Sales of California real property by partnerships, regardless of whether they are California or non-California partnerships, are not subject to withholding. Under the FTB's general withholding authority, non-California partnerships are subject to 7% withholding on California source payments received; however, in the case of a payment to a non-California partnership from a real estate sale, no withholding is required.

For S corporation sellers of California real property, California taxes the gain from that sale twice. First, the gain is taxed under the corporate franchise tax at the S corporation entity-level rate. Second, the income from the sale that is passed through to the shareholders as their pro-rata share is taxed to the shareholder at the personal income tax rate. However, as noted in the table, for S corporations that elect the alternative withholding amount based on gain, the applicable withholding rate is limited to the entity-level tax rate.

Transaction	Resident Individuals Tax rate: 9.3%	Nonresident Individuals Tax rate: 9.3%	Non-CA Partnerships Tax rate depends on partner entity type	Non-CA C Corps Tax rate: 8.84% or 10.84%	Non-CA S Corps	
					Entity-level tax rate—1.5% or 3.5%	Shareholder tax rate—9.3% of pro rata share
Payments of CA source income to nonresidents	Not applicable	7% of income	7% of income and 7% of distribution to partners	7% of income	7% of income	7% of distribution
Sale of CA real property <ul style="list-style-type: none"> • Default withholding based on sale proceeds • Taxpayer elects withholding based on gain 	3 1/3%	3 1/3%	Not applicable	3 1/3%	3 1/3%	
	9.3%	9.3%	Not applicable	8.84% or 10.84% for financial corps	1.5% or 3.5% for financial corps	

Real Estate Withholding—Installment Sales

In the case of a sale of real property that qualifies as an “installment sale” under the Internal Revenue Code (IRC), current law allows the buyer to elect to withhold on each of the installment payments over the life of the installment contract, rather than withholding and remitting the entire withholding amount at the time of sale.

Withholding Administration

R&TC section 18668 provides additional withholding requirements and administrative procedures, including penalties and interest for failing to withhold or to remit withholding.³

THIS PROVISION

This provision would do the following:

1. Require non-California partnerships to be subject to withholding on California real property sales at a rate of 3 1/3% of sales proceeds or 9.3% of gain.
2. For S corporations, specify that the entity-level and pass-through withholding rates be combined to determine the alternative withholding rate to be applied to the gain on the sale. Stated simply, the withholding rate would equal the sum of the S corporation rate and the maximum individual rate (1.5% + 9.3% = 10.8%).

³Because the withholding statutes were modified over a period of decades, sometimes conforming to federal provisions in piecemeal fashion, a few procedural provisions regarding the assessment and collection of amounts required to be withheld are duplicative, internally inconsistent, and contradictory.

3. Require the buyer to withhold on each installment sale payment if the sale is structured as an installment sale.
4. Clarify that withholding amounts can be collected from the withholding agent if the agent fails to withhold or fails to remit the withheld amounts to the FTB, and provide a clear method for assessment and collection of unremitted withholding.

IMPLEMENTATION

This provision would not significantly impact the department’s programs or operations. Systems, forms, and instructions would be modified to administer the proposed withholding. In addition, education and outreach efforts would be conducted to inform withholding agents of the new requirements.

FISCAL IMPACT

Departmental costs associated with this provision are anticipated to be minor and would be implemented during normal annual forms and systems updates.

ECONOMIC IMPACT

Revenue Estimate:

The revenue impact of this provision is estimated to be as shown in the following table:

Estimated Revenue Impact Effective 1/1/2009 Enacted by 6/1/2008 (\$ in Millions)				
	2008-09	2009-10	2010-11	2011-12
Non-California S Corporations	+ \$1	+ \$1	a/	a/
Non-California Partnerships	+ \$7	+ \$2	+ \$2	+ \$2
Installment Sales	b/	c/	a/	a/
Total	+ \$8	+ \$3	+ \$2	+ \$2

a/ Minor gains of less than \$500,000.

b/ Minor loss of less than \$500,000.

c/ Insignificant gains of less than \$150,000.

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

Revenue Discussion:

The revenue impact of this provision was estimated separately for each of the three real property withholding provisions. Revenue impact was generally estimated as the difference between the cash flow under current law and the cash flow under proposed law. Cash flow includes withheld amounts, both with regard to the time of sales and the time of S corporation and partnership distributions, tax amounts paid subsequent to sales or distributions, and refunds. The general approach was to determine—under both current law and proposed law—how much tax would actually be paid and in what form: withholding, estimated payments, final payments, or refund. Then, the approximate timing in which the payments would be received was assigned to those payments.

For non-California S corporations, the withheld amounts at the time of sale under current law were based on actual amounts reported to the FTB. The amount of tax paid on shareholders' pass-through income under current law was approximated as the estimated gain from the above withholding times an assumed average tax rate of 7%. The amount of withholding and refunds under proposed law were computed based on the above estimated gains times the proposed withholding rate of 10.8% (1.5% + 9.3%). The net impact was extrapolated to later tax years. For extrapolation purposes, it was assumed that real estate sales would decline by 10% a year from 2007 to 2009 and would remain flat in 2010 and 2011. The extrapolated results on a tax-year basis were then converted to fiscal-year basis.

Total real estate sales by non-California S corporations are estimated to be \$887 million in 2009. The alternative withholding rate would be elected for only \$115 million of these sales, the gain on which was estimated to be \$38 million. After applying the methodology described in the paragraph above, this provision would result in revenue increases of \$1 million in the 2008-09 and 2009-10 fiscal years, and minor revenue increases of less than \$500,000 in the 2010-11 and 2011-12 fiscal years.

For non-California partnerships, real estate withholding is not currently required. The amount of tax paid on partners' pass-through income under current law and the withholding and refund amounts under proposed law were estimated as the product of the estimated real estate gains or sales by non-California partnerships and the applicable tax rates (the assumed tax rate on pass-through income is 7%). The real estate gain of non-California partnerships was assumed to be approximately 63% of real estate gain of non-California S corporations, estimated above. This assumption was based on the ratio of the reported number of partnerships in finance, insurance, and real estate industries in 2004 over the same number for S corporations. Real estate sales of non-California partnerships were then derived from the estimated gain and an assumed profit margin of 33%, resulting in \$557 million in 2009. The net impact was extrapolated to later tax years and converted to fiscal-year basis. After applying the methodology described in the first paragraph above, it was estimated this provision would result in revenue increases of \$7 million for the 2008/09 fiscal year and \$2 million for each of the later fiscal years. The revenue drop after the first year was due to the offset of tax refunds against withholding in the later years that would not occur in the first year.

The total amount of real estate installment sales was estimated from reported real estate withholding data on installment sales. Installment sales without buyer agreement to withhold on each installment payment were assumed to be equal to 25% of all real estate installment sales.

From the above data, the amounts of new withholding, refunds, and taxes under proposed and current law were derived. The net impact was then extrapolated to later tax years and converted to fiscal-year basis. Real estate installment sales without buyer agreement were estimated to be \$25 million in 2009. After applying the methodology described above, it was estimated this provision would result in minor revenue losses for the 2008/09 fiscal year and insignificant or minor revenue increases in later fiscal years. The revenue loss in the 2008/09 fiscal year was caused by applying the 3 1/3% withholding rate to each installment payment under proposed law, rather than the total sales prices as required under current law. That is, under the provision, the withholding shifts from year of sale to later years as installment payments are received.

There is no revenue impact resulting from the technical correction included in this provision.

PERIOD OF LIMITATIONS FOR OTHER STATE TAX CREDIT (OSTC) CLAIMS FOR CREDIT OR REFUND

EFFECTIVE/OPERATIVE DATE OF PROVISION

If enacted during the 2008 legislative session, this provision would be effective on or after January 1, 2009, and would specifically apply to taxes paid to another state on or after that date.

ANALYSIS

FEDERAL LAW

There is no comparable federal credit for taxes paid at the state level. State income taxes paid by individuals are generally deductible as an itemized deduction. Federal law provides a credit for taxes paid to foreign countries, and the statute of limitations (SOL) for claiming that credit is ten years from the date for filing the return for the year in which the foreign taxes were actually paid or accrued.⁴

STATE LAW

SOL

In General – California Revenue & Taxation Code (R&TC) section 19306 states that no credit or refund shall be allowed after four years from the original due date of the return, four years from the date the return was filed (if filed within the extension period), or one year from the date of the overpayment, whichever is later, unless before the expiration of that period a claim for refund is filed by the taxpayer.

Special Statutes - Other provisions of the R&TC extend the SOL for filing a claim for refund for specific circumstances, including claims based on federal changes, overpaid partnership items, bad debts or worthless securities, and financially disabled taxpayers.

⁴ The federal foreign tax credit rules are found in IRC § 901-908, while the applicable statute of limitations is found in IRC section 6511(d)(3).

OSTC

General OSTC Provisions - Subject to certain conditions and limitations:

- A California resident may claim a credit for income taxes paid to another state on income that has a source within the other state and is income that is taxable by California,
- An estate or trust treated as a resident of California and also a resident of another state may claim a credit for income taxes paid to another state on income that is taxable by California,
- A California resident beneficiary of an estate or trust may claim a credit for income taxes paid to another state on income that is taxable by California,
- Partners (including members of a limited liability company classified as a partnership) and S corporation shareholders may claim a credit for their share of income taxes paid by the respective entity to another state on income that is taxable by California,
- Nonresidents may claim the credit for net income taxes paid to another state if the income being taxed by the other state is also taxable by California, and the state of residence does either of the following:
 1. Does not tax the income of California residents that is derived from sources within that state, or
 2. Allows California residents to claim a credit for taxes paid to California on income that is also being taxed by that state.

Period Credit May be Claimed and Other Provisions

- Regulation section 18001-1, subsection (b), provides that the credit may be taken either at the time of filing returns or "subsequently." A taxpayer claiming the credit must provide a receipt showing proof of payment of taxes to the other state. A taxpayer must also provide a certified copy of the other state return or a certified copy of the notice assessing or proposing to assess the additional tax.
- Regulation section 18001-1, subsection (c), generally provides that if the net tax has been paid before a credit is claimed, a taxpayer must file a refund claim within four years from the date the return was filed, four years from the date the return was due (without regard to extensions), or one year from the date of the overpayment, whichever expires later.
- R&TC section 18007 provides that if a taxpayer has paid taxes to another state, received a California OSTC based on those taxes, and the other state at any time refunds or credits any of the tax back to the taxpayer, the taxpayer shall immediately report that fact to the FTB. R&TC section 18008 provides that a tax equal to the credit allowed for the taxes credited or refunded by the other state is due and payable upon notice and demand from the FTB.

THIS PROVISION

This provision would revise the SOL period for claiming an OSTC to be the *later* of the normal SOL period or one year after the taxpayer pays tax to the other state.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

FISCAL IMPACT

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

ECONOMIC IMPACT

The revenue impact of this provision would depend on the amount of tax paid to California on income that is subsequently taxed by another state after the expiration of the California SOL.

The revenue impact of this provision is indeterminable because the FTB does not track this issue. That is because either the taxpayer is aware of the expired SOL and does not submit a claim for refund or the taxpayer files a claim for refund after the expiration of the SOL and the claim is denied as barred by the SOL. The only instances that can be tracked are cases with this issue that are appealed to the BOE. Two cases, one totaling \$2,300 and the other \$900,000, were denied by the BOE during 2006 and 2007, respectively. In any given year, the potential exists for a taxpayer to file a claim with a very large amount at issue, which would result in a significant revenue impact under this provision. Based on the limited information available, the annual revenue loss from this provision is expected to be less than \$1 million.

TAXPAYER ADVOCATE EQUITY RELIEF

EFFECTIVE/OPERATIVE DATE OF PROVISION

As prescribed by the bill, these provisions would be effective January 1, 2009, and be specifically operative to requests for Taxpayers' Rights Advocate (Advocate) consideration that are received by the Advocate on or after January 1, 2009, irrespective of the tax year involved.

ANALYSIS

FEDERAL LAW

The IRS has authority to abate any unpaid portion of tax or any liability related to tax assessed erroneously. The IRS also has discretion to abate any interest assessed that is attributable to any unreasonable error or delay by the IRS when performing a managerial or ministerial act, but only if no significant aspect of the error or delay can be attributed to the taxpayer involved. The term "managerial act" means an administrative act that occurs during the processing of a taxpayer's case involving the temporary or permanent loss of records or the exercise of judgment or discretion relating to management of personnel. The term "ministerial act" means a procedural or mechanical act that does not involve the exercise of judgment or discretion and that occurs during the processing of a taxpayer's case after all prerequisites of the act, such as conferences and review by supervisors, have taken place. The error or delay must have occurred before the taxpayer was contacted in writing about the deficiency or payment.

A taxpayer can obtain written advice from the IRS on tax issues by providing a written request with accurate information regarding the tax issue. In response to such requests, the IRS issues Private Letter Rulings, Technical Advice Memorandums, and other forms of written advice which are taxpayer-specific. If a taxpayer relies on certain forms of written advice obtained from the IRS and it is later found that the tax reported on their return is incorrect because the IRS advice was incorrect, the IRS can abate any portion of any penalty or addition to tax assessed that is attributable to the erroneous written advice furnished to a taxpayer. The taxpayer must have reasonably relied on the advice, and the portion of the penalty or addition to tax must not have resulted from the taxpayer's failure to provide adequate or accurate information.

Subject to exceptions, the IRS is required to suspend interest on any amounts owed if the IRS fails to provide a notice to the taxpayer stating the amount owed and the basis of the amount owed within 18 months from when the return was filed, or if later, the date it is due without regard to extension. Beginning with notices issued after November 25, 2007, the IRS is required to issue notices stating the amount owed and basis of the amount owed within 36 months from when the return was filed, or if later, the date it is due without regard to extension.

The Treasury Secretary, in consultation with the IRS Oversight Board and the IRS Commissioner, appoints the National Taxpayer Advocate. The National Advocate reports directly to the Commissioner. The National Advocate's functions are as follows:

- Assist taxpayers in resolving problems with the IRS,
- Identify areas where taxpayers have problems dealing with the IRS,
- Propose changes to IRS administrative practices to mitigate identified problems, and
- Identify potential legislative changes to mitigate identified problems.

The National Advocate can issue Taxpayer Assistance Orders (TAOs) if it determines that the taxpayer will suffer a significant hardship because of IRS administration of the tax laws or regulations. A TAO can require the IRS to do the following:

- Release levied property of the taxpayer,
- Cease specified action with respect to the taxpayer, and
- Suspend an applicable statute of limitations while the taxpayer's case is under review by the National Advocate.

Although the National Advocate can make recommendations to the IRS to assist resolving the taxpayer's issue, the National Advocate is unable to adjust a taxpayer's account.

STATE LAW

Current law allows FTB staff to abate penalties, fees, additions to tax, or interest in the following narrow circumstances:

- Where interest is attributable to an unreasonable delay by the FTB in performing a ministerial or managerial act. Interest abatement is limited to interest that accrues after the FTB's first contact with the taxpayer regarding the tax year.

- Where the FTB issues an assessment based on an IRS assessment and the IRS abates interest due to an IRS delay.
- Where a taxpayer is experiencing an extreme financial hardship caused by a significant disability or catastrophic circumstance, the FTB can abate interest.
- Where a taxpayer reasonably relied on the written advice of a legal ruling by the Chief Counsel.
- Where penalties carry reasonable cause exceptions. Reasonable cause means generally that despite ordinary business care and prudence, the action that caused the penalty or addition to tax occurred. Not all penalties carry a reasonable cause exception.
- Where the FTB fails to provide a notice to the taxpayer stating the amount owed and the basis of the amount owed within 18 months from when the return was filed, or if later, the date it is due without regard to extension.
- Where the Chief Counsel rescinds the application of tax shelter penalties or fees as authorized.

State law authorizes the FTB to reimburse taxpayers for bank charges and fees that result from the issuance of an erroneous levy. Reimbursement includes fees and overdraft charges incurred because of the erroneous levy.

Taxpayers can appeal an action of the FTB to the State Board of Equalization (BOE). If a taxpayer loses the appeal at BOE and has paid the tax, the taxpayer can either file a lawsuit for refund of taxes or file a claim with the Victim Compensation and Government Claims Board (VCGCB). Taxpayers can file claims with VCGCB for refund of tax or losses caused by the action or inaction of a state agency. The claimant is required to submit a \$25 processing fee with the claim form, and if awarded the claim, the responsible state agency is liable for the claim plus an additional 15% surcharge.

Under state law, the Advocate reports directly to the Executive Officer of the FTB and is responsible for coordinating the resolution of taxpayer complaints and problems. The Advocate is empowered to review actions taken on a taxpayer's account and take prompt action including placing a hold on actions where a taxpayer has suffered or will suffer irreparable loss from the board action.

THIS PROVISION

This provision would expand the responsibility of the Advocate to include resolution of taxpayer issues identified by FTB employees. This bill would also authorize the Advocate to waive (grant relief from) penalties or additions to tax, fees, and interest that are attributable to any of the following:

- Erroneous action or erroneous inaction by the FTB in processing documents filed or payments made by a taxpayer,
- Unreasonable delay caused by the FTB, or
- Erroneous written advice that did not qualify for relief under Chief Counsel authority.

Relief may be granted only in situations where no part of the error is attributable to the taxpayer and relief is not available under any other statute or regulation.

The Chief Counsel of the FTB must concur with the decision to grant relief when the total reduction in penalties, fees, additions to tax, or interest exceeds \$500. If the total relief granted exceeds \$7,500, the Chief Counsel must notify the three member Franchise Tax Board itself. The threshold amounts are to be adjusted annually by the percentage change in the California Consumer Price Index. Relief at any level requires a public record to be placed in the office of the Executive Officer of the FTB that includes the following information:

- The taxpayer's name,
- The total amount involved,
- The amount payable or refundable due to the error or delay, and
- A summary of why the relief is warranted.

A refund may be paid as a result of the relief granted only if the written claim for refund is received by the Advocate within the applicable statute of limitations. Any decision for relief is not subject to review in any administrative or judicial proceeding and no other entity may participate in the grant or denial of relief.

This provision would require the Advocate to include in its annual report to the Legislature a summary of the instances where relief was granted, the nature of the error or delay, and the steps taken by the department to remedy systemic issues that required relief.

The provision would specify that the provisions granting relief shall apply to requests for Advocate consideration that are received by the Advocate on or after January 1, 2009, irrespective of the taxable year involved.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

PROGRAM BACKGROUND

The occurrences of errors by the FTB that this provision would address are believed to be infrequent—the Advocate estimates less than ten occurrences per year. If a system error were to occur, significant numbers of taxpayers could be affected by the error.

The following situations have been identified as the specific instances where the FTB lacks affirmative statutory authority to resolve the consequences of the error.

- The FTB lacks the ability to waive interest assessed due to a delay in processing. For example: A taxpayer files an amended return reporting additional income and tax, having paid the amount of tax originally reported on the return. The amended return is misplaced within the department and fails to be processed for several years. When the amended return is discovered and finally processed, it is determined that the taxpayer in fact does owe additional tax.

The FTB issues a bill to the taxpayer for the unpaid tax and the accrued interest from the original due date of the original return to the date of the billing, including the period during which the amended return was not processed. Because the department lacks authority to waive interest accrued prior to the first billing, the taxpayer is responsible for that interest.

- A taxpayer follows directions provided in FTB forms or publications to prepare his/her return. Upon audit, it is determined that the taxpayer owes additional tax, penalty or addition to tax, and interest despite following the directions provided by the FTB. Despite the FTB error, the taxpayer is responsible for payment of the penalty or addition to tax and interest.
- System limitations or workload constraints prevent the FTB from providing timely billing to a taxpayer, resulting in the accrual of additional interest to the taxpayer. Several years ago, the FTB implemented a new accounting system for business entities returns. In the process of transitioning from the old system to the new system, numerous accounts remained on the old system, with balances due, but no billing issued. Approximately ten months later, those accounts were incorporated into the new system, and bills were issued for balances due that included the accrued interest. The delayed billings prevented taxpayers from resolving their accounts without accruing interest.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. These states have interest waiver and reasonable cause exceptions to certain penalty provisions that are similar to the existing federal and California provisions. Statutes granting administrative relief at the tax agency level were not found in the laws of the comparison states.

FISCAL IMPACT

Although FTB is unable to quantify actual case volumes, it is expected that this provision would ultimately save minor litigation and appeal costs incurred for the issues that the department is unable to resolve under current statutory authority. It is estimated that any workload increases to the Advocate staff created by this provision would be absorbable.

ECONOMIC IMPACT

Based on data and assumptions discussed below, the provisions of the bill authorizing the Advocate to grant relief in limited circumstances would result in the following annual revenue losses:

Estimated Revenue Impact of AB 3078 Taxpayer Advocate Equity Relief Provisions Effective After January 1, 2009		
2007-08	2008-09	2009-10
-\$150,000	-\$150,000	-\$150,000

Revenue Discussion:

The revenue impact of this provision would depend on the amount of relief granted to taxpayers that would otherwise be collected. An estimated volume of less than ten cases per year would result in an insignificant impact on state income tax revenues. If a system error were to occur that affected numerous taxpayers, the loss could be substantial; however, the magnitude of the impact of a system error cannot be quantified. The above estimate is accrued back one year for relief granted for prior year liabilities.

ARGUMENTS/POLICY CONCERNS

This provision would relieve taxpayers from paying increased penalties or additions to tax, interest, or fees based on an FTB error. This provision would reduce the burden for taxpayers seeking relief from certain FTB errors by eliminating the need for the taxpayer to appeal to the BOE or the VCGCB as the only method to obtain relief. By granting discretionary authority to the Advocate to resolve these cases at the lowest level possible, it would avoid unnecessary expense to both the taxpayer and the department. The FTB would be able to correct its own errors and hold taxpayers harmless.

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