ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Walters	Analyst:	Jahna Alvarado	Bill Number:	SB 1065
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 17, 2010
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Innocent Spouse Law Conformity

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would make changes to the statutory provisions for “innocent spouse relief” to more closely conform California law to federal law.

PURPOSE OF THE BILL

The purpose of this FTB-sponsored bill is to reduce taxpayer burden and confusion by bringing California’s innocent spouse relief provisions into conformity with federal innocent spouse relief provisions.

EFFECTIVE/OPERATIVE DATE

If enacted by September 30, 2010, this bill would be effective January 1, 2011, and would specifically apply to 1) requests for state relief that are based on an IRS request for similar relief made on or after January 1, 2009; and 2) to requests for equitable relief received by the FTB on or after January 1, 2011.

POSITION

On December 3, 2009, the FTB voted 2-0, with Department of Finance abstaining, to sponsor the language included in this bill.

ANALYSIS

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. Joint and several liability can result in inequitable consequences to one spouse in certain circumstances. Consequently, the federal government and California enacted “innocent spouse” legislation, which may allow a spouse to be relieved of some or all of the responsibility of a joint tax debt.

Board Position:			Department Director	Date
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N	OUA	PENDING		

FEDERAL LAW

The federal Internal Revenue Restructuring and Reform Act of 1998 (the "1998 Act") made innocent spouse relief easier to obtain. The 1998 Act allows an innocent spouse to qualify for relief under one of the following three provisions:

1. *Understatement/Apportionment.* A spouse may request to be relieved of a tax liability for a taxable year to the extent the liability is attributed to an assessment of tax exceeding the amount reported on the return (also called “understatement of tax”). Generally, the requesting spouse must show that the understatement of tax is a result of an erroneous item, such as an omission of income or an overstatement of deductible expenses, which results in an understatement of tax. In addition, the taxpayer must show that at the time the return was signed he or she did not know and had no reason to know of the erroneous item that lead to the understatement of tax.

   If the taxpayer can show lack of knowledge, as described above, with respect to *a portion of the understatement,* the taxpayer may be relieved of liability for the tax that is attributable to that portion of the understatement.

2. *Separate liability election.* A requesting spouse may elect to be taxed as though he or she filed a *married filing separate* tax return. Any tax liability for any deficiency that is assessed on the return, interest, and penalties will be limited to the amount attributable to the income the individual spouse actually earned. This relief is available to taxpayers who are no longer married, are legally separated, or have lived apart from their 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.

3. *Equitable relief.* 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, the IRS may determine that it would not be equitable to hold the requesting spouse liable for any unpaid tax or any deficiency.

In order for a taxpayer to qualify for relief under either 1 or 2 above, the taxpayer must request relief within two years of the date the Secretary has begun collection activities with respect to the taxpayer making the election.

The federal Tax Relief and Health Care Act of 2006 (the “2006 Act”) gave the Tax Court authority to review an IRS denial of equitable innocent spouse relief and suspends the running of the period of limitations while the appeal is pending. The changes made by the 2006 Act apply to requests for equitable relief with respect to liability for taxes arising or unpaid after December 20, 2006.

STATE LAW

In 1999, California conformed to portions of the 1998 Act by enacting the Taxpayers’ Bill of Rights Act of 1999, which revised and expanded state innocent spouse relief to be similar to the federal provisions outlined above.

In addition, California law provides two avenues for innocent spouse relief not available under federal law:

1. A taxpayer may seek a divorce court order relieving the taxpayer of joint and several liability 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 also seek relief from the 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.

During the period from January 1, 2004, through December 31, 2008, under changes made by SB 285 (Speier, Stats. 2003, Ch. 370), an individual who had been granted relief from specified joint and several liability provisions under Internal Revenue Code (IRC) section 6015 would also be granted relief under California law when the facts and circumstances supporting relief were the same. This provision was repealed by a sunset provision.

California has not conformed to the 2006 Act. As a result, FTB "equitable relief" determinations cannot be appealed.

THIS BILL

This bill would do all of the following:

- Reenact and make permanent the statutory requirement that the FTB grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances.
- Allow a taxpayer to appeal the FTB's determination on an "equitable relief" request for innocent spouse relief.
- Remove the obsolete transition rule that refers to a four year period for submitting a request for innocent spouse relief.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

SB 285 (Speier, Stats. 2003, Ch. 370), required that the FTB would grant innocent spouse relief to an individual who had received an IRS grant of innocent spouse relief when the underlying facts and circumstances were the same. SB 285 was repealed by its own provisions effective January 1, 2009.

AB 2979 (Assembly Revenue and Taxation Committee, Stats. 2002, Ch. 374) increased the gross income and tax liability thresholds to qualify for relief under a divorce court order to reflect inflation from 1977 to 2001, so that the amounts became $150,000 for the gross income threshold and $7,500 for the state income tax liability threshold.

OTHER STATES' INFORMATION

The states surveyed include *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.

Illinois law provides that a federal request for innocent spouse relief constitutes a request for *Illinois* state tax relief. Under *Illinois* law, innocent spouse relief from a tax liability arising and paid prior to August 13, 1999 is granted based on proof of IRS relief for the same tax years.

Massachusetts law provides for innocent spouse relief to the extent that a tax liability is attributable to a substantial understatement of tax attributable to grossly erroneous items of the taxpayer's spouse. *Massachusetts* innocent spouse relief provisions do not refer to or conform to IRC section 6015.

Michigan law provides for innocent spouse relief similar to federal relief and adheres to IRS interpretation in matters regarding relief from joint and several liability.

Minnesota grants innocent spouse relief to the extent a liability is due to an understatement. Federal standards as set forth in IRC section 6015(b) determine qualifications. Final denials or grants of relief may be appealed to the Minnesota Tax Court.

New York adopted the federal innocent spouse provisions for tax years beginning on or after January 1, 2009.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue loss from this bill would be:

Estimated Revenue Impact of SB 1065, As Introduced February 17, 2010 Effective January 1, 2011 and Operative for Requests Made On or After January 1, 2009 Enactment Assumed September 30, 2010			
2009/10	**2010/11**	**2011/12**	**2012/13**
-$90,000	-$200,000	-$200,000	-$200,000

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

ARGUMENTS/POLICY CONCERNS

This bill would eliminate several differences between state and federal innocent spouse relief provisions, which is in accord with the general policy of state and federal conformity.

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