

ANALYSIS OF AMENDED BILL

Author: Fuller Analyst: Davi Milam Bill Number: SB 526
 See Legislative
 Related Bills: History Telephone: 845-2551 Amended Date: April 14, 2015
 Attorney: Bruce Langston Sponsor _____

SUBJECT:	Innocent Spouse Relief / Joint Returns
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SUMMARY

Under the Administration Franchise and Income Tax Law (AFITL), this bill modifies the Innocent Spouse equitable relief provision.

RECOMMENDATION

No position.

Summary of Amendments

The April 14, 2015, amendments eliminated the bill’s prior legislative intent language and added the provisions discussed in this analysis. This is the department’s first analysis of this bill.

REASON FOR THE BILL

The reason for this bill is to provide greater discretion in resolving requests for equitable relief of joint and several liability.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2016, and specifically operative for requests for relief received on or after January 1, 2016.

FEDERAL/STATE LAW

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, or whether the correct amount of the tax is reported on the original return or whether the taxing authority subsequently assesses additional tax for the tax year in question. 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. Generally, the requesting spouse may not be relieved of tax liability on income that the requesting spouse earned or controlled.

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Existing federal and state “Innocent Spouse” laws¹ may generally be categorized as follows:

- Traditional Innocent Spouse Relief from Understatement of Tax;²
- Relief by Separate Allocation of Tax Liability;³ and
- Equitable Relief.⁴

Equitable relief may be granted, if taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency, and relief is not available under the two other innocent spouse provisions. However, even under equitable relief, the income tax liability from which the requesting spouse seeks relief generally must be attributable to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse’s income. However, the IRS will consider granting equitable relief even though the deficiency or underpayment may be attributable in part or in full to an item of the requesting spouse in the case of abuse prior to the time the return was filed or where funds that would have been used to pay the tax or deficiency were misappropriated by the nonrequesting spouse.

The Internal Revenue Service (IRS) has issued guidance for taxpayers seeking equitable relief from joint income tax liability.⁵ In general, a nonexclusive list of factors (no one factor controls the determination) is applied in determining whether relief should be granted because it would be inequitable to hold a requesting spouse liable.

Among the factors considered is the existence of a “legal obligation” arising from a divorce decree or other legally binding agreement.⁶ This factor will weigh in favor of relief if the nonrequesting spouse has the sole obligation to pay the outstanding income tax liability pursuant to a divorce decree or agreement. This factor will be “neutral, if the requesting spouse knew or had reason to know, when entering into the divorce decree or agreement, that the nonrequesting spouse would not pay the income tax liability.”

State law, in addition to the Innocent Spouse provisions discussed above, also provides for relief when the liability has been revised by court order in a proceeding for dissolution of marriage, provided the order meets specified conditions.⁷

¹ Internal Revenue Code section 6015 and Revenue and Taxation Code (R&TC) section 18533.

State law, under R&TC section 18533(i), also provides for relief based on IRS determination if applicable facts and circumstances are the same for federal and state income tax liabilities.

² R&TC section 18533(b).

³ R&TC section 18533(c).

⁴ R&TC section 18533(f).

⁵ Rev. Proc. 2013-34. <http://www.irs.gov/pub/irs-drop/rp-13-34.pdf>.

⁶ Rev. Proc. 2013-34, section 4.03(2)(d).

⁷ R&TC section 19006(b).

Unlike the “Innocent Spouse” provision that considers a legal obligation under dissolution of marriage as one of many factors; state law specifically provides that the liability may be revised by a court in a proceeding for dissolution of the marriage. The Franchise Tax Board (FTB) will grant relief to the requesting spouse provided the order does not relieve the requesting spouse of tax liability on income earned by or subject to the exclusive management and control of that spouse. The order is effective when the FTB is served with or acknowledges receipt of the order and provided the order:

- Separately states the income tax liabilities for the taxable years for which revision of tax liability is granted.
- Does not revise a tax liability that has been fully paid prior to the effective date of the order.

Additionally, the requesting spouse also must obtain from the FTB and file with the divorce court a tax revision clearance certificate if:

- Gross income reportable on the return exceeds one hundred and fifty thousand dollars (\$150,000), or
- The amount of tax liability the spouse is relieved of exceeds seven thousand five hundred dollars (\$7,500).

THIS BILL

This bill would provide that notwithstanding any other law, when taking into account facts and circumstances for equitable relief,⁸ the fact that the individual’s liability for any unpaid tax or deficiency has been revised under a judgment of dissolution of marriage may be a factor weighing in favor of relief from tax liability on income earned by or subject to the exclusive management and control of the individual, whether or not the individual was a victim of abuse at the time the return was filed or whether or not funds that would have been used to pay the tax or deficiency were misappropriated by the nonrequesting spouse.

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.

This bill would permit the FTB to relieve an individual of liability on the individual’s income pursuant to a judgment of dissolution of marriage. However, it is unclear how the order would be applied. For example:

- What date would the order be effective?
- To what taxable years would the order apply?

⁸ Under paragraph (1) of subdivision (f) of R&TC section 18533.

- Would the order apply only to liabilities due prior to the effective date of the order?
- Would the nonrequesting spouse be notified of the request for relief of liability?

It is recommended that the bill be amended to provide clarity on these issues and ensure consistency with the author's intent.

The bill includes the broad, sweeping language "Notwithstanding any other law" (at the beginning the amendment), which could be incompatible with other innocent spouse provisions. For example:

- This bill fails to limit relief to cases where a joint return was filed. Thus, the court order could require one spouse to be responsible for all state income tax debts even though separate state income tax returns were filed.
- Relief provided by this bill could be incompatible with an IRS determination providing innocent spouse relief to one or both parties. Consequently, the department could be required to extinguish any effort to collect from either party.
- The nonrequesting spouse could later claim relief under one of the other innocent spouse provisions.

LEGISLATIVE HISTORY

SB 1065 (Walters, Chapter 318, Statutes of 2010) required the FTB to grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances.

AB 1748 (Assembly Revenue and Taxation Committee, Chapter 342, Statutes of 2007) made changes to more closely conform California law to federal "innocent spouse" provisions and to provide the FTB the authority to issue guidelines and rules.

SB 285 (Speier, Chapter 370, Statutes of 2003) required the FTB to 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, Chapter 374, Statutes of 2002) 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.

PROGRAM BACKGROUND

The FTB has taken a number of steps to enhance awareness of the various provisions related to innocent spouse joint filer relief and relief of joint return liability by court order.

- The FTB has an Innocent Spouse Unit dedicated to resolving requests for innocent spouse relief. The unit has created an Innocent Spouse webpage⁹ that allows taxpayers and practitioners to learn about the types of relief available, including relief by court order and the types of documents required.
- Taxpayers submit Form FTB 705 *Request for Innocent Joint Filer Relief* to request relief from liability pursuant to several R&TC provisions.¹⁰ This form advises taxpayers who are in the process of getting a divorce to contact the FTB so that the department can provide information about court-ordered relief.
<https://www.ftb.ca.gov/forms/misc/705.pdf>
- The FTB has published a new brochure, FTB 714 (New 10-2014) *Innocent Joint Filer Relief: Relief from Paying California Income Taxes*. The brochure lists the items that must be included in a court order to enable the FTB to grant relief. The brochure is available on the FTB's website and provides information on how to request assistance.
<https://www.ftb.ca.gov/forms/misc/714.pdf>
- FTB has conducted education and outreach to increase practitioners' awareness of the items that must be included in the divorce order. For example, the webpage for the Superior Courts of California now provides a link to the FTB's brochure (FTB 714).¹¹ In addition, the FTB staff gave an educational presentation, *Taxation: Innocent Spouse and Equitable Relief*, at the State Bar's 2014 Annual Meeting in San Diego, California and distributed copies of the brochure.

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.

Illinois, Massachusetts, Michigan, Minnesota, and New York all provide innocent spouse relief; however, it is unclear whether the states provide comparable discretionary relief that would be provided by this bill.

Florida does not have a personal income tax.

⁹ <https://www.ftb.ca.gov/individuals/fag/innocentSpouseFAQ.shtml>.

¹⁰ R&TC sections 18533(b), 18533(c), 18533(f), 18533(i), 19006(b), and 19006(c).

¹¹ <http://www.courts.ca.gov/24649.htm>.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in a revenue impact to the general fund, but the amount is unknown.

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

Revenue Discussion

According to calculations, for every \$1 million in relief granted, the revenue loss would be \$60,000. This bill would allow, at the discretion of the FTB, subject to appeal to the Board of Equalization, the requesting spouse's tax liability to be shifted to the non-requesting spouse or allow instances where neither spouse would be legally obligated to pay the tax liability.

Estimating cases of discretionary relief made by the FTB, subject to appeal to the Board of Equalization for revisions of tax deficiencies, as part of the judgment for dissolution of marriage, cannot be predicted. To determine the magnitude of relief, both the frequency and the dollar amount of these judgments must be known. Because it is difficult to predict the frequency and the value of future discretionary actions, the revenue impact is unknown.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say this bill would assist taxpayers by providing greater discretions to FTB in resolving requests for equitable relief.

Opponents: Some may argue that this bill is too broad and would be inconsistent with long standing tax policy.

POLICY CONCERNS

State law generally conforms to the federal innocent spouse provisions. This bill would create a difference between federal and state law in the application of these provisions by allowing an individual to be relieved of liability on their own income even if the individual was not a victim of abuse or the funds were not misappropriated by the nonrequesting spouse.

Taxpayers who file a joint return are jointly and severally liable for the full tax liability for the tax year(s) in which they filed jointly. Under state law that liability may be revised by a divorce court, provided the order does not relieve the requesting spouse of tax liability on "income earned by or subject to the exclusive management and control of the requesting spouse." This condition reflects the longstanding tax policy of "proportional liability" (requesting spouse's pro rata share of tax liability on the requesting spouse's income). Applying a divorce order in all situations without regard to the concept of proportional liability would be contrary to this longstanding policy.

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