

Taxpayers' Bill of Rights
ANNUAL REPORT TO THE LEGISLATURE

Franchise Tax Board

October 1, 2005

We prepared this report in response to the Taxpayers' Bill of Rights (Stats. 1988, Ch. 1573), Sections 21006 and 21009 of the California Revenue and Taxation Code. We divided the report into five parts.

Executive Summary

- I. Sample Data from the Audit Process
- II. Taxpayer Filing Errors
- III. Taxpayers' Bill of Rights Hearing
- IV. Compliance
 - Statutes or Board Regulations
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 - Taxpayer Communication/Education
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- V. Evaluating Franchise Tax Board Employees

You can direct any questions regarding this report to Debbie Newcomb, Taxpayer Advocate, at (916) 845-4300. If you would like a transcript of the Taxpayers' Bill of Rights hearing, please call (916) 845-5249.

Will Bush
Interim Executive Officer

EXECUTIVE SUMMARY

Revenue and Taxation Code Section 21006 requires the Franchise Tax Board to report to the Legislature on October 1 of each year its findings with respect to recurrent taxpayer noncompliance. To satisfy the provision's requirements, we conducted a study using a sample of both corporation and personal income tax *Notices of Proposed Assessment*. These proposed assessments are the result of Franchise Tax Board audits. Our staff also compiled information on taxpayers' filing errors detected during return processing.

Our audit results show where we direct our resources. We focus our audit programs primarily on those areas that are the most cost efficient.

We found that:

- For corporation taxes, during 2004 the largest cumulative dollar amount in proposed assessments from one primary issue resulted from allocation and apportionment audits.
- For personal income taxes, during 2004 the largest cumulative dollar amount in assessments resulted from filing enforcement assessments.
- Tax practitioners prepared nearly 69 percent of personal income tax returns. The percentage of taxpayers preparing their own returns was slightly more than 31 percent.
- Taxpayer errors detected during return processing amounted to a taxpayer error rate of approximately three percent. This is slightly lower than the error rate for this time period last year.

We continue improving our communications and services to taxpayers and tax practitioners. This year our efforts included educating taxpayers and practitioners on the tax gap, promoting amnesty from additional penalties for taxpayers who pay their past due tax obligations, and introducing ReadyReturn, a pilot program to provide taxpayers with an easier way to file their tax returns. Our ongoing efforts include:

- Providing well-written materials for accurate filing.
- Distributing tax products using methods that are convenient for taxpayers and tax practitioners.
- Participating with other tax agencies and state departments to develop cooperative communication efforts.
- Providing information on our department's Website.
- Issuing statewide press releases to inform taxpayers of tax law changes and using *Tax News* to inform tax practitioners of the same.
- Maintaining and enhancing an Interactive Voice Response system that provides automated telephone service for general state tax information.
- Improving products and services to persons with disabilities.
- Providing information and assistance to taxpayers and tax practitioners in languages other than English.
- Marketing e-programs including CalFile.
- Continuing to gather input from our stakeholders.
- Providing outreach through our Collections Program to help taxpayers and tax professionals understand and comply with tax laws.

PART I
SAMPLE DATA FROM THE AUDIT PROCESS

We used a statistically valid sample of corporation *Notices of Proposed Assessment* for this study. For individuals, we collected assessment information from the personal income tax NPA display file for assessments that became final in 2004. The volumes and dollar amounts shown represent the sample study numbers projected to the total universe of assessments. The results of the study are as follows.

Revenue and Taxation Code Section 21006(b)(1)(A) – “The statute or regulation violated by the taxpayer” and **Section 21006(b)(1)(B)** – “The amount of tax involved.”

The following table shows the distribution of NPAs by issue and tax assessed. In those cases where multiple issues are included in a single notice, we have categorized the notice under the issue that provides the majority of the tax change. Where there is no distinct primary issue, we have categorized the NPA as *Other*.

TABLE 1A
CORPORATION TAX LAW
NPAs Finalized in 2004 Categorized by Primary Statute (Issue)

Issue	Number of NPAs		Tax Assessed (Millions)		Average Assessment Per NPA
		%		%	
Allocation/Apportionment	1,015	37.2	\$ 294.1	66.8	\$ 289,784
Assess Minimum Tax	253	9.3	0.2	0.0	796
Revenue Agent Reports	713	26.1	54.9	12.5	76,950
State Adjustments	495	18.1	13.5	3.0	27,319
Other	253	9.3	77.8	17.7	307,585
Totals/Average	2,729	100	\$ 440.5	100	\$ 161,429

NOTE: All tables in PART I of this report reflect tax increase assessments only. The assessments became final in 2004. We may have issued the assessments in prior years, however, due to cases in protest status, we did not resolve them until 2004. The totals in PART I reflect rounded figures and may not compute exactly.

- *Allocation/Apportionment* involves corporations doing business within and outside of California.
- *Revenue Agent Reports* are copies of Internal Revenue Service tax change notices. These typically result when California conforms to federal law, and a change to a taxpayer's federal tax return also applies to the taxpayer's California tax return.
- *State Adjustments* reflect the differences between the Internal Revenue Code and the California Revenue and Taxation Code.

TABLE 1B
PERSONAL INCOME TAX LAW
NPAs Finalized in 2004 Categorized by Primary Statute (Issue)

Issue	Number of NPAs		Tax Assessed (Thousands)		Average Assessment Per NPA
		%		%	
CP2000	79,703	13.2	\$ 37,449	2.6	\$ 470
Filing Enforcement	414,729	68.5	1,196,936	82.2	2,886
Filing Status	20,134	3.3	19,629	1.3	975
Revenue Agent Reports	10,579	1.7	29,487	2.0	2,787
Other	80,348	13.3	173,439	11.9	2,159
Totals/Average	605,493	100	\$ 1,456,939	100	\$ 2,406

- The *CP2000* category results from the IRS comparing information documents that report income paid to individuals by third parties against income reported on their tax returns.
- *Filing Enforcement* refers to assessments issued to individuals who have not filed a state income tax return after we notified them of their filing requirement.
- *Filing Status* primarily reflects notices issued due to head of household adjustments.

RTC Section 21006(b)(1)(C) – "The industry or business engaged in by the taxpayer."

The following table categorizes the distribution and amount of NPAs according to the industry in which the taxpayer is engaged.

TABLE 2
CORPORATION TAX LAW
Corporations by Industry with NPAs Finalized in 2004

Industry	All Corporations 2003 Tax Year		Corporations with NPAs		Tax Assessed (Millions)	
		%		%		%
F.I.R.E.*	97,508	16.6	191	12.4	\$ 142.6	32.4
Manufacturing	48,610	8.2	262	17.0	93.7	21.3
Services	236,915	40.2	150	9.7	18.4	4.1
Trade	67,172	11.4	87	5.6	20.5	4.7
Other **	139,105	23.6	852	55.3	165.3	37.5
Totals	589,310	100	1,542	100	\$ 440.5	100

* Finance, insurance, real estate, and holding companies

** Includes agriculture, construction, utilities, and other industries not classified in the sample

For corporations not filing via a combined report, we base the industry designation on the corporation's primary business activity in California. In the case of combined reports, we base the industry designation on the primary occupation of the group, not necessarily on the industry of the parent. If the parent is a holding company of a diverse group of subsidiary corporations, then we group it with finance, insurance, real estate, and holding companies.

RTC Section 21006(b)(1)(D) – "The number of years covered by the audit period."

This section applies to either the taxable years for which we issued NPAs or the number of years for which a taxpayer receives notices of proposed assessment because of multiple taxable year audits during the same audit cycle. We issued a separate NPA to the taxpayer for each year included in an audit adjustment.

For corporations, we show the notices issued by taxable year in Table 3A. We show the frequency of multiple NPAs issued at the same time to a single corporation in Table 3B. In Table 4, we show this data with respect to individual taxpayers.

**TABLE 3A
CORPORATION TAX LAW
NPAs Finalized in 2004 Issued by Taxable Year**

Average Taxable Year	Number of NPAs		Tax Assessed (Millions)		Average Assessment per NPA
		%		%	
1997 and prior	1,008	37.0	\$ 281.4	63.9	\$ 279,199
1998	274	10.0	27.8	6.3	101,448
1999	453	16.6	97.7	22.2	215,776
2000	430	15.8	20.6	4.7	48,003
2001	334	12.2	10.8	2.5	32,385
2002	208	7.6	2.0	0.4	9,761
2003	22	0.8	0.0	0.0	3,421
Totals/Average	2,729	100	\$ 440.5	100	\$ 161,429

The earlier years, in which the statute of limitations for assessing additional tax has passed, reflect final figures for those years.

**TABLE 3B
CORPORATION TAX LAW
Multiple NPAs Finalized in 2004 for the Same Taxpayer**

Corporations with...	Number of Taxpayers	Tax Assessed (Millions)	Average Assessment per Taxpayer
One NPA	822	\$ 117.5	\$ 142,900
Two NPAs	443	91.8	207,342
Three NPAs	186	75.0	403,408
Four or more NPAs	91	156.2	1,716,368
Totals/Average	1,542	\$ 440.5	\$ 285,694

TABLE 4
PERSONAL INCOME TAX LAW
NPA's Finalized in 2004 Issued by Taxable Year

Taxable Year	Number of NPA's		Assessment Amount (Thousands)		Average Assessment Amount
		%		%	
1998 & prior	2,754	0.4	\$ 27,769	1.2	\$ 10,083
1999	13,404	2.2	51,197	0.8	3,819
2000	46,979	7.8	203,181	4.3	4,325
2001	128,717	21.3	130,414	15.3	1,013
2002	413,331	68.3	1,042,905	4.2	2,523
2003 & later	308	0.0	1,473	74.2	4,783
Totals/Avg.	605,493	100	\$ 1,456,939	100	\$ 2,406

Individuals typically have audit changes for just one year. More than 96 percent of the individuals who received NPAs during 2004 had audit changes for a single year.

RTC Section 21006(b)(1)(E) – "Whether professional tax preparation assistance was utilized by the taxpayer."

An in-house accounting department or an accounting or legal firm prepares virtually all corporation returns. We consider corporation tax returns as prepared by professionals.

We consider that taxpayers prepared their individual tax returns in the absence of a paid preparer's signature.

TABLE 5
PERSONAL INCOME TAX LAW
Resident Tax Return Preparation, 2003 & 2004 Process Years

Preparer	2003 Returns Processed		2004 Returns Processed		% Change
	(Thousands)	%	(Thousands)	%	
Professional	9,198	67.8	9,370	68.8	1.0
Taxpayer	4,360	32.1	4,248	31.2	-0.9
VITA*	17	0.1	6	0.0	-0.1
Totals	13,575	100	13,624	100	

* Volunteer Income Tax Assistance is a program that provides tax return preparation assistance for the elderly, disabled, non-English speaking, and those with low incomes.

TABLE 6
ELECTRONIC FILING AND PAYMENT STATISTICS

Activities	July 31, 2004	July 31, 2005	% Change
Credit Card Payments (Average payment is \$912)	65,000	80,000	23
Direct Debit of Balance Due (Electronic Funds Withdrawal)	173,000	213,000	23
Direct Deposit of Refund	3,013,000	3,461,000	15
e-file	6,930,000	8,132,000	17
* CalFile	109,000	158,000	45
* Online Filing	1,019,000	1,366,000	34

* We include these volumes in the e-file volume.

Note: TeleFile was discontinued for tax year 2004.

Electronically filed returns represent 57 percent of the total current year returns. Electronically filed self-prepared returns increased by 34 percent this year. With our pilot program, taxpayers electronically filed 5,608 Ready Returns to date.

RTC Section 21006(b)(1)(F) – "Whether income tax or bank and corporation tax returns were filed by the taxpayer."

**TABLE 7A
CORPORATION TAX LAW
Nonfilers Detected through the Automated Nonfiler System**

Tax Year	NPAs	Returns Filed	Total Assessments (Millions) ¹
1994	12,671	7,708 ²	273.5
1995	15,601	3,772 ²	379.5
1996	16,790	5,014 ²	592.0
1997	16,019	8,170 ³	432.4
1998	12,473	8,516 ⁴	387.2
1999	11,847	N/A	383.9

1. These amounts represent tax, penalties, and interest.
2. We extrapolate these results from a sample test performed in August of 1999.
3. This result is a cumulative total as of July 1, 2000.
4. This result is a cumulative total as of August 1, 2001.

NOTE: Due to resource constraints and limited benefits, this effort has been on hold. We anticipate sending notices for this program in April 2006.

**TABLE 7B
PERSONAL INCOME TAX LAW
Nonfilers Detected through the Automated Nonfiler System**

Fiscal Year	NPAs Issued ¹	Returns Filed ²	Total Assessments (Millions) ³
2000/2001	87,647 ⁴	99,376 ⁴	\$ 261 ⁴
2001/2002	294,216 ⁴	151,102 ⁴	\$ 1,669
2002/2003 ⁵	594,212	258,629	\$ 4,122
2003/2004	499,602	265,534	\$ 2,986
2004/2005	528,856	248,766	\$ 2,115

1. The total number of *Notices of Proposed Assessment* mailed by the Personal Income Tax Nonfiler Program during the fiscal year.
2. The Compliance Automated Tracking System determines the "returns filed" volumes. The system tracks nonfiler accounts from the issuance of the demand for a return until account resolution.
3. The total includes tax, penalties, and interest assessed.
4. The totals are lower than normal due to the delay in implementation of the new automated nonfiler system and a subsequent delay in mailing nonfiler notices.
5. Fiscal year 2002/2003 numbers are higher than normal primarily because we worked multiple years at the same time.

PART II

TAXPAYER FILING ERRORS

The tables below reflect errors taxpayers made on 2004 original tax returns processed between January 1, 2005, and July 28, 2005. We issued *Return Information Notices* to taxpayers who filed returns with errors that resulted in a change of tax liability. We explained the errors in adjustment paragraphs within the notices. The total number of adjustment paragraphs we issued does not equal the total number of *Return Information Notices* we sent, because many returns contain multiple errors, each error requiring an explanation.

TABLE 8A
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2005 PROCESS YEAR SUMMARY
Number of Adjustment Paragraphs Issued by Return Type

Adjustment Type	540	540 2EZ	540A	540NR	*N/A	Grand Total	% of Total
AGI	393	211	182	1,378	1	2,165	0.45
CDC	12,899	0	1,870	1,226	0	15,995	3.36
Deductions	10,151	56	5,497	1,180	26	16,910	3.55
Estimate Payment	132,038	1,932	3,589	6,293	0	143,852	30.20
Exemptions	24,207	165	13,037	6,876	17	44,302	9.30
Filing Status	133	46	58	21	0	258	0.05
Nonresident	104	2	0	19,134	2	19,242	4.04
Renter's Credit	7,638	4,477	6,001	721	0	18,837	3.96
Special Credits	510	0	0	69	0	579	0.12
State Disability Ins.	21,089	2	1,329	907	0	23,327	4.90
Tax Computation	18,495	444	9,193	3,775	12	31,919	6.70
Total Tax	13,257	52,527	10,986	946	9	77,725	16.32
Use Tax	5	5	1	0	0	11	0.00
Withholding	31,404	2,945	2,029	5,072	7	41,457	8.70
Miscellaneous	25,715	6,466	5,732	1,765	7	39,685	8.33
TOTAL	298,038	69,278	59,504	49,363	81	476,264	100.00

* Return type is undetermined.

TABLE 8B
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2005 PROCESS YEAR SUMMARY
Number of Adjustment Paragraphs Issued by Filing Method

Adjustment Type	e-file	Internet	Paper	Grand Total	% of Total
AGI	56	1	2,108	2,165	0.45
CDC	5,768	39	10,188	15,995	3.36
Deductions	1,600	24	15,286	16,910	3.55
Estimate Payment	75,166	890	67,796	143,852	30.20
Exemptions	363	3	43,936	44,302	9.30
Filing Status	4	0	254	258	0.05
Nonresident	519	0	18,723	19,242	4.04
Renter's Credit	945	0	17,892	18,837	3.96
Special Credits	254	0	325	579	0.12
State Disability Ins.	12,877	38	10,412	23,327	4.90
Tax Computation	242	4	31,673	31,919	6.70
Total Tax	1,529	9	76,187	77,725	16.32
Use Tax	0	1	10	11	0.00
Withholding	15,012	210	26,235	41,457	8.70
Miscellaneous	8,976	43	30,666	39,685	8.33
TOTAL	123,311	1,262	351,691	476,264	100.00

Note: E-filed and paper filed ReadyReturns had a *Return Information Notice* rate of less than 0.5 percent.

We issued 438,046 *Return Information Notices* out of 13,578,667 current year original tax returns processed from January 1, 2005, through July 28, 2005. This is an adjustment rate of 3.2 percent. The adjustment rate is down from last year for this time period (553,292 *Return Information Notices* issued for 13,567,876 returns). In the preceding tables, we displayed the adjustments by return type and filing method. This year was the first year there was not a Telefile return type.

The following analysis provides information regarding each adjustment type and a description of what typically causes each type of adjustment.

Adjusted Gross Income and California Adjustments (0.45 percent of all adjustments) – This adjustment occurs when taxpayers erroneously calculate California adjusted gross income, usually by improperly applying the California additions and subtractions (Schedule CA) from the federal adjusted gross income amount.

Child and Dependent Care (3.36 percent of all adjustments) – This adjustment occurs when taxpayers incorrectly claim the Child and Dependent Care Expenses Credit. These errors include simple math errors, nonresident filers who did not maintain a California home for a qualified individual, and taxpayers filing as married filing a separate return.

Deductions (3.55 percent of all adjustments) – This adjustment occurs when taxpayers claim the incorrect standard deduction amount for their filing status, claim the incorrect filing status when another person can claim them as a dependent on their return, claim an itemized deduction amount lower than the standard deduction amount, or leave the deduction line blank.

Estimate Payment (30.20 percent of all adjustments) – This adjustment occurs when taxpayers claim estimate and extension payment amounts that do not match payment amounts contained on our accounting system. This category does not include erroneous calculations of estimate penalties.

Exemptions (9.30 percent of all adjustments) – This adjustment occurs when taxpayers do not claim an exemption amount, claim the incorrect personal, blind, or senior exemption amount, claim a number of dependents that does not match the number of dependent names, or calculate exemptions incorrectly.

Filing Status (0.05 percent of all adjustments) – This adjustment occurs for two primary reasons: either a taxpayer files a tax return jointly, yet the return contains only one name, social security number, and signature; or a taxpayer claims the head of household filing status, but does not include the name of the qualifying person. We adjust the return to reflect the single filing status, and recalculate the corresponding exemption, standard deduction, and tax amounts.

Nonresident (4.04 percent of all adjustments) – This adjustment occurs when taxpayers make errors involving proration calculations and Schedule CA transfers. In addition to these errors, each of the other error types can occur on a nonresident return.

Renter's Credit (3.96 percent of all adjustments) – This adjustment occurs when taxpayers do not qualify for this credit due to filing status or income limitations.

Special Credits (0.12 percent of all adjustments) – This adjustment occurs when taxpayers claim a credit for which they were not eligible, commonly due to income limitations, maximum credit amounts, or carryover limitations.

State Disability Insurance (4.90 percent of all adjustments) – This adjustment occurs when taxpayers claim more excess State Disability Insurance than allowable.

Tax Computation (6.70 percent of all adjustments) – This adjustment occurs when taxpayers select a tax amount from the incorrect row or column of the tax table, or calculate taxable income incorrectly.

Total Tax (16.32 percent of all adjustments) – This adjustment occurs when taxpayers make calculation errors after they compute tax, and before they apply prepaid credits (withheld tax, estimate payments, State Disability Insurance). The difference between this category and tax computation errors is the tax return line location where the error occurs.

Use Tax (0.00 percent of all adjustments) – This adjustment occurs when taxpayers incorrectly report their use tax. For taxable years beginning on or after January 1, 2003, taxpayers can report their California use tax on their personal income tax return.

Withholding (8.70 percent of all adjustments) – This adjustment occurs when taxpayers claim withholding amounts different from the allowable amount, which we determine from a variety of sources, including a database of Employment Development Department information.

Miscellaneous (8.33 percent of all adjustments) – This adjustment occurs when taxpayers make miscellaneous addition or subtraction errors. An example is when taxpayers make an error in subtracting an estimate credit transfer amount from their overpaid tax amount.

PART III TAXPAYERS' BILL OF RIGHTS HEARING

Revenue and Taxation Code Section 21006(b)(2) – “Conduct an annual hearing before the Board itself where industry representatives and individual taxpayers are allowed to present their proposals for changes to the Personal Income Tax Law or the Corporation Tax Law which may further facilitate achievement of the legislative findings.”

We held the annual Taxpayers' Bill of Rights hearing on Wednesday, December 1, 2004, at the State Board of Equalization, Sacramento, California. Five individuals presented proposals to the three-member Board. We also received one written proposal.

Roland Boucher, representing United Californians for Tax Reform

Mr. Boucher presented the Board with two proposals at the hearing and in writing.

California Senior Legislation Resolution Assembly Proposal 35

Mr. Boucher recommended implementing California Senior Legislature Resolution AP-35 to allow the use of a simplified tax form for seniors with income from capital gains and to limit tax rates to 2.5 percent for gross income of up to \$100,000 for single taxpayers and \$200,000 for married taxpayers.

Tax Simplification

He also recommended implementing a program of tax simplification, which would make filing a tax return each year unnecessary for most citizens by making withholding exactly match a taxpayer's liability.

Gerald Goldberg, Executive Officer at the time of the hearing, responded that the Franchise Tax Board tries to strike a balance between developing simpler forms while including the complex issues needed to meet the needs of more taxpayers. He said that seniors themselves are a diverse group and some have very complex returns.

Lillian Lea, representing California Society of Enrolled Agents

Ms. Lea provided the Board with six proposals in writing. She addressed the first three proposals at the hearing.

Conformity – Health Savings Accounts

The California Society of Enrolled Agents would like to see California legislation conform to the Health Savings Account federal legislation.

Senate Bill 173 originally provided for this conformity. Unfortunately, the language providing conformity for Health Savings Accounts was amended out of the bill.

Conformity – Number of Shareholders in S Corporations

The society would like to see California legislation conform to the federal American Jobs Creation Act of 2004.

Current law provides that a federal S corporation is an S corporation for California purposes. In addition, Assembly Bill 115 provides for explicit conformity to federal changes for S corporations. The bill is currently pending.

Real Estate Withholding

The California Society of Enrolled Agents support the Franchise Tax Board proposal to change the current real estate withholding amount to 9.3 percent of the net gain.

No legislation was authored to provide for this change to real estate withholding.

Independent Contractor Withholding (provided in writing)

The California Society of Enrolled Agents recommends not requiring withholding on payments to independent contractors.

Franchise Tax Board is doing further study on this issue.

Reporting of Wages Paid to Domestic Workers (provided in writing)

The California Society of Enrolled Agents encourages Franchise Tax Board to allow employers of domestic workers to report and pay payroll taxes on their individual income tax return.

Franchise Tax Board is not currently pursuing this issue.

Practitioner Hotline Use Fee (provided in writing)

The California Society of Enrolled Agents continues to oppose legislation to charge practitioners a fee for their use of the Franchise Tax Board's Practitioner Hotline.

Franchise Tax Board is not currently seeking legislation to charge for Practitioner Hotline services.

Lenny Goldberg, representing the California Tax Reform Association

Mr. Lenny Goldberg presented the Board with four comments at the hearing.

Free Online Filing

Mr. Lenny Goldberg encouraged Franchise Tax Board to continue to make it easier for taxpayers to file directly, free, and online by ensuring that virtually all schedules and returns can be filed using the Internet without any charge.

Franchise Tax Board will offer CalFile, our free direct e-file for California resident personal income tax returns for the 2006 filing season.

Proforma (ReadyReturn) Pilot

Mr. Lenny Goldberg commented on the positive aspects of the Proforma (ReadyReturn) pilot and suggested the program be permanent.

The Proforma Pilot now called ReadyReturn, will continue as a pilot for the 2006 filing season.

Conformity

Mr. Lenny Goldberg commented that the Board should be cautious when conforming to federal law. Conformity to specific provisions of federal law requires consideration of revenue and the specific policy underlying each provision.

Revenue is always a key consideration as Franchise Tax Board continues to seek legislation to conform California law to Federal law.

Administration of Tax

Mr. Lenny Goldberg said contrary to the recommendation of the California Performance Review, the Executive Branch of California should continue to participate in the administration of the income and franchise tax systems.

Richard E.V. Harris

Mr. Harris addressed the Board with two matters at the hearing.

Transparency

Mr. Harris indicated that in an effort to improve transparency, the Litigation Roster on Franchise Tax Board's Website should be more current. In addition, prior versions of the Litigation Roster should be accessible on the Website.

Chief Counsel John Davies indicated that steps would be taken to make prior versions of the Litigation Roster available on Franchise Tax Board's Internet site.

"Deemed Denial" Provision

Mr. Harris indicated that staff did not respond to his proposal concerning a "deemed denial" for a protest pending more than 24 months.

Chief Counsel John Davies provided information with respect to that proposal and other related initiatives.

Gina Rodriquez, representing Spidell Publishing

Ms. Rodriquez presented three new proposals and one previously addressed proposal to the Board.

Underpayment (Estimate) Penalty Relief

Ms. Rodriquez recommended providing blanket exception from the underpayment penalty for any underpayment attributable to any retroactive tax increase.

Senate Bill 14 provides for the estimate penalty relief in situations where a tax law is given a retroactive provision. This bill was chaptered into law on September 22, 2005.

Conformity – Health Savings Accounts (also submitted by the CSEA)

Ms. Rodriquez recommended conforming to recent federal changes with respect to Health Savings Accounts and S corporation rules.

Senate Bill 173 originally provided for this conformity. Unfortunately, the language providing conformity for Health Savings Accounts was amended out of the bill.

Amnesty Clean-Up Legislation

Ms. Rodriguez said there is a need for clean-up legislation with respect to the Amnesty program in the following areas: “due and payable”, net refunds, and installment agreements for business entities.

Assembly Bill 911, which provides for netting of tax year balances, is pending. Senate Bill 157, which provides for installment agreements for taxpayers and business entities, was chaptered into law on September 6, 2005.

At the September 7, 2005, meeting of the Franchise Tax Board, the Board decided to take no action on the “due and payable” definition in relation to the amnesty penalty computation.

Nanny/Elder Care Tax Simplification (previously submitted)

Ms. Rodriguez restated that there is a need to simplify the administrative burden for employers of domestic workers.

Franchise Tax Board is not currently pursuing this issue.

William E. Taggart, Jr., representing Law Offices of Taggart & Hawkins

Liability Relief for Individuals Filing Separate Returns; Modification of Income Tax Reporting Responsibilities

Mr. Taggart submitted a written request to address income tax reporting for married individuals who file as married filing separately and who have community income.

Mr. Taggart proposed the addition of a new section to the Revenue and Taxation Code to address this issue.

Assembly Bill 849 provides for an amendment to the definition of marriage and the impact the change in definition has on California tax law. This bill is pending.

PART IV COMPLIANCE

Revenue and Taxation Code Section 21006(c) - "The Board shall include in its report recommendations for improving taxpayer compliance and uniform administration, including, but not limited to, all of the following:

- (1) Changes in statute or board regulations.
- (2) Improvement of training of board personnel.
- (3) Improvement of taxpayer communication and education.
- (4) Increased enforcement capabilities."

STATUTES OR BOARD REGULATIONS

STATUTES

Each year we review areas of the law and propose legislation in order to carry out our responsibility of improving taxpayer compliance and enhancing administration. We identified several areas of the law during the review process for which we proposed legislation to facilitate administration of our duties.

Chapered Legislation

AB 780 (Chu, Chap. 188, Stats. 2005) – This act would, allow the three-member Franchise Tax Board to take final action at a meeting of the Board on any properly noticed agenda item without delaying a final action due to distribution of written materials from members of the public.

AB 911 (Chu, Ch. 398, Stats. 2005) – This act addresses unintended consequences of the income tax amnesty program administered by the department as follows:

- Allows underpayments for amnesty-eligible years to be offset by overpayments from other years for purposes of computing the amnesty penalty.
- Establishes a 20-year statute of limitations to collect income or franchise tax balances due from taxpayers, and thereafter extinguishes the liability to pay such balances by abating the tax.
- Allows certain inactive taxpayer debts to be extinguished.
- Repeals the requirement that taxpayers that participate in amnesty must pay any tax due for the 2005 and 2006 taxable years to avoid having the benefits of amnesty revoked and the amnesty penalty imposed.
- Makes technical clarifications of certain amnesty provisions.

AB 1767 (Assembly Revenue & Taxation Committee, Chap. 264, Stats. 2005) –

This act:

- Clarifies current state law by conforming more closely to federal law with regard to the claim of right deduction.
- Requires financial institutions, upon request, to liquidate a taxpayer's securities to satisfy the taxpayer's tax liability.

- Provides an exception to the underpayment of estimated tax penalty due to an erroneous action by FTB.
- Incorporates into the Revenue and Taxation Code a provision of the Penal Code that provides an exception to FTB's general disclosure law.
- Allows reimbursement to persons for third-party charges and fees caused by an erroneous action by FTB.

SB 14 (Campbell Chap. 242, Stats. 2005) – This act provides an exception to the estimated tax underpayment penalty that results when a law change retroactively increases a taxpayer's estimated tax payment. This exception applies to penalties imposed on and after January 1, 2005.

SB 157 (Ackerman, Chap. 211, Stats. 2005) – This act allows business entities to enter into installment agreements to satisfy a tax liability. This act also conforms to federal law by allowing all taxpayers to enter into partial payment installment agreements.

SB 555 (Machado, Chap. 264, Stats. 2005) – This act:

- Coordinates the tax payment and withholding requirements applicable to nonresident members of certain limited liability companies.
- Repeals an obsolete provision relating to savings and loans.

Vetoed Legislation

AB 853 (Jones) – This bill would have extended the timeframe under which a state tax lien is effective for purposes of the use of Earnings Withholding Orders for Taxes (EWOTs) only.

In his veto message, Governor Schwarzenegger stated that this bill would burden some employers by requiring them to maintain EWOTs indefinitely.

AB 1628 (Klehs) – This act would have changed the failure to withhold penalty to 10 percent of the amount required to be withheld or a minimum of \$500. The bill would also change the application of the penalty to permit the assessment of the penalty immediately after a failure to withhold occurs.

In his veto message, Governor Schwarzenegger stated that this bill would stiffen the penalties for failing to properly withhold taxes and eliminates the "hold harmless" provision so that, if taxes are paid in the correct tax year, an escrow agent would still face the penalty.

AB 1630 (Klehs) – This bill would have provided that taxpayers must report a federal adjustment that occurs after the normal four-year statute of limitations (SOL) for issuing a proposed assessment has expired.

In his veto message, Governor Schwarzenegger stated that this bill would change tax policy retroactively and it is inappropriate and unfair to taxpayers to change tax laws retroactively. In addition, this bill is specifically intended to address an issue that is pending before the California Supreme Court.

REGULATIONS

Regulation 17952 – Income from Intangible Personal Property

On April 29, 2003, staff received approval from the Board to proceed with draft proposed changes to Regulation section 17952. These proposed changes address the timing of the sourcing of gains from sales of intangible personal property. Staff identified a need to clarify when the sourcing of the gains from the sale of intangible property should be fixed for purposes of sourcing installment sales proceeds. Under the *mobilieria* doctrine, absent a business situs, intangible property is sourced to the state of residence of the owner. If a California resident sells intangible property, the gain is taxable under a residency theory. If a California nonresident sells intangible property, the gain would be sourced to the nonresident's state of residence and California would not tax the gain, unless the intangible property had acquired a California business situs.

However, if a resident sells intangible property under the installment method and subsequently moves away, there may be some ambiguity as to the source of the gain from the future installment sales proceeds as they are received. Arguably, the *mobilieria* doctrine already provides that the source of the gain is in California because that is where the taxpayer was when the property was sold. The source could not have moved with the taxpayer because he or she no longer owned the property.

This has not been an issue in the past because California would have applied Revenue and Taxation Code Section 17554 to assert that the gain had already accrued prior to the move. However, Revenue and Taxation Code Section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. Without Revenue and Taxation Code Section 17554, staff believes that a clarification would be prudent.

A symposium was scheduled on August 13, 2003, if public interest was expressed and/or written comments were received by July 8, 2003. No public interest was expressed and no written comments were received, so a notice of cancellation was published on Franchise Tax Board's Website on July 30, 2003. The proposed amendments will be submitted to State and Consumer Services Agency for approval in October 2005.

Regulation Sections 20501 – "Medically Incapacitated" Defined, 20502 – "Substantially Equivalent to Property Taxes" Defined, 20503 – Submission of Property Tax Bill, 20504 – Proof of Disability, and 20505 – Opportunity to Cure Deficiency

On April 29, 2003, staff received authorization from the Board to proceed with the formal rulemaking process for the above proposed regulations. The proposed regulations address certain definitions and criteria applicable to the Senior Citizen Homeowners and Renters Property Tax Assistance (HRA) law. This law generally establishes a program that provides assistance for the elderly and disabled individuals with the payment of property tax assessments on their places of residence.

Since staff's initial proposal to the Board for approval to proceed, there was mounting evidence that one provision of the proposed regulations, proposed regulation section 20504,

subdivision (a)(4), was the primary source of fraud within the HRA program. Under this section of the regulations, applicants can establish that they are disabled, thereby making them eligible for assistance, by submitting a statement from a doctor. However, the method of proof provided for in the proposed regulation was susceptible to abuse, as evidenced by the fact that claimants had misappropriated physicians' medical license numbers, falsified letters, and filed multiple claims by using self-created letters. Moreover, staff learned that claimants' requests for signed affidavits were placing physicians in the position of being forced to sign the affidavit for individuals who, although impaired, did not technically meet the definition of disabled as found in the Revenue and Taxation Code and the Social Security Act.

Disability claims make up the bulk of the fraud that staff has investigated in connection with the HRA program. In an HRA fraud case pursued by the Los Angeles District Attorney's office in 2003, which was adjudicated and closed in March of 2004, the claimant/defendant had filed multiple claims using multiple copies of a physician's signature and license number, as well as various social security numbers. The court sentenced the claimant/defendant, pursuant to the Penal Code violations involved, to 180 days in the county jail and placed him on three years formal probation. Further, he was ordered to make restitution in the amount of \$17,973.55 to the Franchise Tax Board.

In addition, the State Board of Equalization recently imposed a \$500 frivolous appeal penalty against a claimant for submitting fraudulent documents containing a doctor's forged signature. The SBE concluded that the appellant had submitted a fraudulent document and, moreover, committed perjury when preparing his HRA claim form.

Given the documented increase in fraudulent activity associated with the use of affidavits, staff recommended that the proposed regulation be amended to identify reliance on a local, state, or federal agency's determination to verify that a claimant is disabled. Reliance on a finding of disability by a governmental agency is consistent with the HRA statutory scheme because, as indicated above, the Legislature has adopted the federal definition of disability as the standard for the HRA program. Further, staff has the ability to verify a claimant's Social Security eligibility through an interagency agreement with the Department of Health Services with regard to the current year.

Using such documentation, as set forth in proposed regulation section 20504, subdivisions (a)(1-4), staff can verify that the claimant is eligible under the specified definition as well as verify the social security number of the individual for identification purposes.

At the August 25, 2004, Franchise Tax Board meeting, staff recommended and received approval for the revision of the proposed regulation section 20504, subdivision (a)(4), to reduce and potentially eliminate the bulk of the fraudulent claims received by the HRA program. Staff also received authorization to proceed with the formal regulatory process.

Staff then scheduled a formal regulatory hearing, as required under the Administrative Procedure Act, for January 5, 2005, in the event staff received any public interest or written comments by December 21, 2004. Receiving neither, staff then cancelled the formal public hearing, and the final regulations were submitted to the Office of Administrative Law for approval on February 5, 2005, and were approved and filed with the Secretary of State on April 15, 2005.

Regulation Sections 24411 and 25106.5-1 – Ordering of Dividends

On February 9, 2005, staff received authorization from the Franchise Tax Board to proceed with a symposium on the proposed amendments to Regulation sections 24411 and 25106.5-1. The proposed amendments to the regulations are in response to an appellate decision, *Fujitsu It Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal. App. 4th 459. Staff is proposing amendments to Regulation sections 24411(e) and 25106.5-1(f)(2), not to change their substance, but to definitively set forth the rule for the ordering of dividends that are paid from income that has been included in a unitary combined report and from income that has not been included in a unitary combined report.

Many commentators have complained that the proposed amendments will overrule the holding of the Court of Appeal in *Fujitsu* and that the Board does not have the power to do that or should not do that. Revenue and Taxation Code Section 25106.5, which the regulations implement, contains a direct legislative delegation of authority to regulate.

A second issue raised by several commentators was whether the proposed amendments should be prospective only. Revenue and Taxation Code Section 19503, the statute generally authorizing the Franchise Tax Board to adopt regulations, formerly provided the Board with the authority to determine the extent to which regulations would operate without retroactive effect. That statute was amended in 1997 to provide that, with limited enumerated exceptions, a regulation would not apply to any years before the Franchise Tax Board issued to the public a notice substantially describing the expected contents of any regulation. However, the statute also provided that it only related to statutory provisions enacted after January 1, 1998. Revenue and Taxation Code Sections 24411 and 25106.5-1(f)(2) were enacted prior to 1998, so that any clarifying changes made to the regulations under the authority of those statutes can be made retroactive.

A symposium to discuss the proposed amendments to the existing regulations was held on April 4, 2005. As a result of the symposium, no change was made to the language in staff's original discussion draft proposal. The proposed regulations were addressed at the September 7, 2005, meeting of the three-member Franchise Tax Board. Further action is pending.

Regulation Section 25106.5-11 – Election to File a Group Return

On June 10, 2004, staff received approval to proceed with a partial symposium and soon thereafter announced that a symposium would be tentatively scheduled.

As discussed in the proposed regulation, each taxpayer that is subject to the California Corporation Tax Law has an obligation to file a return. If taxpayers conduct business within and without California, they must attach a copy of a combined report to their return, which shows how their business income is apportioned amongst the various states. In many instances, multiple California corporate taxpayers are members of the same combined reporting group. This means that the same combined report relates to each of them. Therefore, each must file its own return, attaching a copy of the same combined report to each return. This creates administrative difficulties and burdens, both for taxpayers and Franchise Tax Board.

As a matter of administrative convenience, it has been Franchise Tax Board's practice to allow taxpayers who are members of the same combined reporting group to file a "single-group return," thereby satisfying each taxpayer's return-filing obligation. Taxpayers attach a copy of the combined report to this return, showing how the business income of the group is apportioned amongst the various states. To qualify for this treatment, one of the affiliated taxpayers had to agree to be designated as the "key corporation" for the combined reporting group. The key corporation agreed to act as agent and surety for the remaining taxpayers included in the combined report. Affiliated taxpayers could avoid the burden of filing duplicative combined reports, while allowing Franchise Tax Board to coordinate with only one taxpayer as opposed to many. When one of the taxpayer members files the Form 100, attaching a completed Schedule R and Schedule R-7, it effectuates the designation of the key corporation and identifies the remaining taxpayer members included in the single group return.

The taxpayer community has followed this existing practice, so staff did not anticipate that this discussion draft of the proposed regulation would be controversial. This new proposed regulation will simply formally codify in regulations the department's long-standing administrative practice described above.

Staff held a symposium on August 30, 2004. As a result of the symposium, a number of changes were made to the language in staff's original discussion draft proposal. On December 1, 2004, staff received permission to proceed with the formal public hearing process as required under the Administrative Procedure Act. A hearing was scheduled for June 27, 2005, in the event staff received public interest or written comments by June 12, 2005. Receiving neither, staff then cancelled the hearing. Staff is in the process of finalizing the regulation for submission to the Office of Administrative Law sometime in the fall of 2005.

Regulation Section 25110 – Water's-Edge Election Group

On June 10, 2004, staff received approval to proceed with a partial symposium and soon thereafter announced a tentative symposium date.

Under Revenue and Taxation Code Section 25110, subdivision (a)(4), a foreign corporation with less than 20 percent average U.S. factors, or a foreign bank, is included in a water's-edge combined report to the extent of its U.S. source income and factors. When regulations were first promulgated under this section, the Franchise Tax Board defined United States income to mean the income that is "effectively connected" with the conduct of a U.S. trade or business (so-called effectively-connected income, or "ECI") under the provisions of the internal Revenue Code. California Code of Regulations, title 18, section 25110, subsection (d)(2)(F)3, also provides that deductions attributable to United States income shall be determined using the allocation and apportionment rules set forth in Treasury Regulation sections 1.861-8 (other than interest expense) and 1.882-5 (interest expense).

Effective for taxable years beginning on or after January 1, 1992, the California regulations expanded the scope of United States income to include not only ECI, but also U.S. source business income that is not effectively connected with the conduct of a U.S. trade or business ("NECI"). However, the portion of the California regulations relating to the determination of deductions attributable to United States income, still remain unchanged.

Under Internal Revenue Code section 882(a), except to the extent provided by treaty, foreign corporations are subject to U.S. *net basis* taxation on ECI. Foreign corporations with ECI may also be subject to a branch profits tax. Under Internal Revenue Code section 881(a), foreign corporations' U.S. source NECI is subject to a *gross basis* tax at a flat tax rate of 30 percent, unless reduced or eliminated by treaty. Therefore, there are no federal rules to determine deductions for NECI. Consequently, for federal purposes Treasury Regulation sections 1.861-8 and 1.882-5 specifically do not apply in the determination of deductions for U.S. source NECI, which is taxed at gross.

An amendment to California Code of Regulations, title 18, section 25110, subsection (d)(2)(F)3, is necessary to provide guidance in determining deductions attributable to non-effectively connected income of a foreign corporation that is included in a water's-edge combined report. The discussion draft of the proposed amendment to the existing regulation would set forth the rule that the allowable deductions against the non-effectively connected income shall be determined in accordance with California Code of Regulations, title 18, section 25120, subsection (d).

A symposium was held on February 10, 2005. As a result of the symposium, no change was made to the language in staff's original discussion draft proposal. However, at its public meeting held on Tuesday, March 29, 2005, the three-member Franchise Tax Board directed staff to work with the public to provide example(s) under the proposed amendments to Regulation section 25110(d)(2)(F)3. A second symposium was held on May 23, 2005. In response to comments received during the second symposium, staff has revised its original discussion draft proposal to include examples in the regulation and to incorporate other changes. Staff is continuing to work on the development of appropriate examples and will probably schedule an additional meeting with interested parties.

Staff anticipates holding a public hearing under the Administrative Procedure Act sometime during the spring of 2006.

Regulation Sections 25130 – Property Valuation, and 25137(b) – Other Apportionment Methods

On October 18, 2002, staff issued FTB Notice 2002-4, which announced a symposium to solicit public comments on proposed amendments to California Code of Regulations, title 18, section 25137, subsection (b), and conforming amendments to California Code of Regulations, title 18, section 25130. The proposed amendments would add language to the two regulations designed to address how to calculate the net annual rental rate for property factor purposes for the use of the property of someone other than the taxpayer from which natural resources such as timber, oil, gas, or hard minerals are extracted.

Staff received written comments by the December 31, 2002, deadline stated in FTB Notice 2002-4. On January 29, 2003, staff held a symposium, during which additional public comments were orally presented. On April 29, 2003, staff received permission from the Board to proceed with the formal regulatory process.

Staff worked with interested members of the public to make certain technical changes to the proposed regulatory amendments. Staff then submitted the proposed amendments to the State and Consumer Services Agency for review and approval on June 8, 2004.

A hearing was scheduled for November 8, 2004, in the event staff received public interest or written comments by October 23, 2004. Receiving neither, staff cancelled the formal public hearing. The regulations were submitted to the Office of Administrative Law for approval on December 16, 2004, and filed with the Secretary of State on February 28, 2005.

TRAINING

We strive to assure quality service to the public by developing the skills and abilities of our employees through ongoing training programs.

Filing Services

We provide basic training on our Taxpayer Information computer system to new employees in the Filing Services Bureau. We use these training classes to introduce our Filing Services Bureau employees to Taxpayer Information account processing, to model effective use of the Taxpayer Information computer system manual, and to practice basic account transactions. In addition, we offer advanced Taxpayer Information computer system training to employees responsible for more complex and specialized account analysis and resolution.

We provide basic training on our Business Entity Tax System to employees assigned to work with business entity accounts. We use these training classes to introduce Filing Service Bureau employees to Business Entity Tax System account processing, to model effective use of the system manual, and to practice basic account transactions. We offer advanced Business Entity Tax System training to employees responsible for more complex and specialized account analysis and resolution.

We provide basic training on the Accounts Receivable Collection System and the Integrated Nonfiler Compliance system to all Filing Services Bureau employees assigned to handle collection accounts. These training classes introduce employees to billing cycles and account analysis. We offer advanced Accounts Receivable Collection system training to employees responsible for more complex and specialized account analysis, resolution, and quality review.

We provide extensive training on tax laws, provisions of the Taxpayers' Bill of Rights, account analysis and resolution, security and disclosure, and telephone techniques to new public service staff in the Filing Services Bureau. Because our public service staff are often the public's only contact with government, we include a discussion of our goals, such as providing excellent service and resolution of each caller's issue with only one contact whenever possible. We provide on-going training on changes to tax laws, information systems, and procedures to all public service staff.

Collection

We provide training for all compliance representatives and tax technicians in the Collection Program through our Accounts Receivable Management Division Career Center. Employees in the Collection Program must complete a comprehensive six-week training program to ensure they have the required skills and abilities to administer the tax laws.

The training program consists of core compliance courses, including:

- Security and Disclosure
- System Training
- Account Resolution
- Customer Service
- Penalties and Interest
- Filing Requirements
- Installment Agreements
- Tax Assessments
- Taxpayer Bill of Rights
- Power of Attorney

In addition to specific compliance-related training, employees in the Collection Program receive mandatory training on information security and the Tax Amnesty Program.

Career Center staff and management work as a team to provide classroom instruction to new collectors, and skills enhancement for experienced employees. To minimize the cost of training, the Career Center partners with journey-level staff directly involved in the collection process to assist in training workshops. Computer-based training also provides low-cost, individual instruction to employees. Accounts Receivable Management Division employees are strongly encouraged to continue the learning process throughout their careers by enrolling in classes to refresh their existing skills or knowledge.

Audit

The Audit Division provides professional training to our auditors from the moment they begin their work at the Franchise Tax Board. Most new auditors complete a six-week basic professional auditor training series to establish a baseline expertise in the following areas:

- Organizational mission and values, and the principles of tax administration
- Customer service, and the Taxpayers' Bill of Rights
- Audit process, case management protocols, and policies and procedures
- Security and disclosure
- Information security, technologies, and work systems
- Tax law and research methodologies

New auditors receive ongoing support for their skills development throughout their careers with an emphasis on just-in-time technical law training. They also receive broad based development to optimize their knowledge of the latest electronic technologies, evolving business practices, specialized financial transaction tracing, and sophisticated auditing techniques.

We support our auditors who seek certified public accountant status. Under the Board of Accountancy guidelines, we provide certified public accountants with the opportunity to receive continuing education credits for courses we develop and administer.

TAXPAYER COMMUNICATION/EDUCATION

Our goal is to provide taxpayers and tax practitioners with the information they need to file their state tax returns completely, accurately, and timely. This year our communication efforts included educating taxpayers and practitioners on the tax gap, promoting amnesty from additional penalties for taxpayers who pay their past due tax obligations, and introducing ReadyReturn, a pilot program to provide taxpayers with an easier way to file their tax returns.

Tax Gap

The tax gap is defined as the difference between what taxpayers owe and what they voluntarily pay. The tax gap is estimated at \$6.5 billion each year. The greatest source of the tax gap is underreported income. Many taxpayers purposely or unwittingly are part of the underground economy, which is comprised of many components ranging from contractors who make cash payments to their employees, families who pay household employees in cash, unlicensed contractors who work for cash, waitresses and waiters who conceal their tips, professionals who trade or barter services with one another, and participants in swap meets.

Education and outreach is a central theme in our activities. We work with other state agencies to educate individuals and businesses about their income tax filing responsibilities. We work with tax practitioners, providing them with updates and resources to provide answers to questions they have in preparing returns and representing their clients.

This year we held the second tax gap symposium to provide attendees with information about the extent of the income tax gap at both the national and California level. The goal of the symposium was to provide a forum to discuss the methodology used to calculate the revenue loss attributable to the tax gap, and to shed light on potential strategies and measures that can be adopted to combat tax noncompliance.

Tax Amnesty

Senate Bill 1100 was signed into law on August 16, 2004. This bill was created to design a tax amnesty program to increase revenue, encourage compliance with the California tax laws, and lessen the tax gap.

Tax Amnesty was a limited time chance for individuals and businesses to pay past due personal or business income tax liabilities and file returns for years 2002 and prior without the fear of prosecution and free of most penalties and fees.

We developed a comprehensive public outreach program to publicize the tax amnesty program. To maximize public awareness, the methods used to publicize amnesty included statewide and local news releases, public service announcements, commercials on television and radio, billboards, movie theater ads, a tax amnesty Website, and a direct mail invitation to participate. We also held news conferences and interviews, provided information to practitioners, and directed taxpayers to our Web portal.

ReadyReturn

This past tax season, we offered a pilot program designed to ease the filing burden for taxpayers who filed the simplest returns. We invited about 50,000 taxpayers to participate in the ReadyReturn pilot program and mailed them a completed tax return using wage

information received from California employers. Taxpayers had the option to participate in the pilot. If taxpayers chose to participate, they verified the information, made any necessary changes, signed the returns, and submitted the information either on paper or electronically. Taxpayers filed a total of 11,517 ReadyReturns by paper and electronically this past tax season.

Along with our new programs, we continually strive to improve our communications and services to the public:

1. We provide well-written materials for accurate filing by:
 - Reviewing and revising our notices, forms, and publications to provide accurate information.
 - Ensuring our tax booklets contain forms and instructions that are clear and easy to understand.
 - Developing new forms to simplify the filing process.
2. We distribute tax products using methods that are convenient for taxpayers and tax practitioners. Our distributions efforts include:
 - Mailing tax booklets to taxpayers who used paper forms in the previous year.
 - Providing commonly used forms in banks, post offices, libraries, Franchise Tax Board field offices, and other government agencies throughout the state.
 - Providing tax forms and publications on the Internet through the California Home Page at www.ca.gov or directly through our Website at www.ftb.ca.gov.
 - Providing advance drafts of tax forms to software developers, and maintaining standards and an approval process for development of substitute forms and scannable forms generated by commercial software products.
3. We participate with other tax agencies and state departments to develop cooperative communication efforts by:
 - Providing easy access to a variety of tax information through hypertext links from one site to another on the California Home Page and individual agency Websites and through the California Tax Information Center Website at www.taxes.ca.gov.
 - Establishing joint field offices and providing service to taxpayers and tax practitioners through a single call, regardless of the tax agency called.
 - Participating in small business conferences with other state departments and agencies.
 - Developing and maintaining a joint e-file marketing program with the Internal Revenue Service to disseminate e-file-related information, participation requirements, and training to tax practitioners.
 - Educating specific groups in partnership with the Internal Revenue Service through the Volunteer Income Tax Assistance/Tax Counseling for the Elderly, VITA Military, and Homeowner and Renter Assistance volunteer programs.
4. We provide information on our Website such as regulations, frequently asked questions, and program-specific information, including personal income tax refund status, account balance, and payment information. Taxpayers and tax practitioners also can find information on the various e-programs.

5. We issue statewide press releases to inform taxpayers of changes to the tax law and publish Tax News to inform tax practitioners of legislative changes, e-file updates, new programs, etc. An ongoing media effort is a major component in our goal to reduce errors.
6. We maintain and regularly enhance an Interactive Voice Response system providing automated telephone service to a large number of callers at a low cost. The Interactive Voice Response system provides recorded responses to the most frequently asked questions regarding general state tax information. The system also allows callers to:
 - Check the status of their current year personal income tax refunds and homeowner and renter assistance claims.
 - Order state tax forms for the current year and prior two years.
 - Order homeowner and renter assistance claim forms for the current year.
 - Check personal income tax account balance information and verify various payments.
 - Transfer to a Franchise Tax Board representative when necessary.
7. We improve products and services to persons with disabilities by:
 - Providing the personal income tax booklet in a large-print version and on audiocassette.
 - Improving the overall readability of the Homeowner and Renter Assistance Booklet and providing it on audiocassette.
 - Using a diagnostic software tool that analyzes Web pages, helping to increase Internet accessibility.
8. We provide information and assistance to taxpayers and tax practitioners in Spanish and other languages by:
 - Partnering with agencies, organizations, and individuals to provide tax information and assistance in various languages to non-English speaking communities through Volunteer Income Tax Assistance and Homeowner and Renter Assistance volunteer sites.
 - Developing informational materials such as press releases, informational flyers, brochures, etc., in various languages.
 - Maintaining and enhancing an IVR system that provides automated telephone service to a large number of Spanish-speaking persons.
 - Providing information in Spanish on the Internet.
9. We market e-programs by:
 - Conducting direct mail efforts to inform tax professionals and taxpayers about e-programs.
 - Requesting hyperlinks to our Website from other strategic Websites.
 - Participating in various statewide tax professional organization events.
10. We continue to gather input from stakeholders. This helps us modify and enhance our programs based on what our stakeholders truly want and need.

11. We provide outreach through our Collections Program to help taxpayers and tax professionals understand and comply with tax laws by:
- Providing information online including the Collections Procedure Manual, answers to questions about bills and notices, what taxpayers can do if they are unable to pay (offer in compromise, installment agreement, and credit card payment), as well as phone numbers and addresses.
 - Maintaining a Collections Call Center staffed with collection experts to answer questions and assist taxpayers with collection problems.
 - Providing assistance directly to the tax professional community through the Tax Practitioner Liaison Unit. Collection experts are available to answer questions via telephone, a FAX help line, or our “911 – Request for Relief From Hardship” form.
 - Providing presentations on the offer in compromise program.
 - Maintaining an Innocent Spouse Unit to conduct outreach workshops in response to Taxpayers’ Bill of Rights legislation that changed Innocent Spouse Relief provisions. The unit developed and launched an interactive Web page dedicated to Innocent Spouse Relief on our Website.

ENFORCEMENT

Integrated Nonfiler Compliance Program

Our Integrated Nonfiler Compliance Program identifies and contacts individuals and business entities that have a requirement to file a California tax return yet have not done so.

Some of the taxpayers we contact are wage earners, self-employed individuals, individuals with unreported capital gains, nonresidents with California source income, and individuals who have partnership income.

Our Corporation Nonfiler Program uses information from other taxing agencies (the Internal Revenue Service, the State Board of Equalization, and the Employment Development Department) to identify potential nonfilers.

Audit

We complement federal, other state, and local agency enforcement and compliance efforts by identifying areas of noncompliance and optimally using our Audit resources. We apply our best audit practices as adopted in the Audit Procedures Regulations to establish a working partnership with taxpayers and practitioners during our audits. We use electronic technology to focus our audit efforts, reduce audit intrusiveness, and provide taxpayers with options for communicating through electronic, paper, or other medium of their choice.

Currently we are focused on:

- Resolving protective claims filed during tax amnesty.
To avoid the new amnesty penalty, taxpayers paid additional amounts by March 31, 2005, and filed protective claims. When taxpayers paid \$3.5 billion in protective claims in 2005, we gave top priority to auditing these claims within 12 months.
- Addressing tax gap initiatives that promulgate underreporting of tax.
The tax gap is the difference between the amount of taxes legally owed and voluntarily paid. We are increasing efforts to identify those who intentionally and continually underreport taxes and contribute to the tax gap. Our focus is to identify schemes used to evade reporting the correct amount of tax.
- Pursuing abusive tax shelter investors and promoters.
We continue to diligently pursue the examination of abusive tax shelter participants and promoters. Our partnership with other states, the Internal Revenue Service, and other federal agencies enhanced the sharing and exchanging of abusive tax shelter information, training, and leads information.

Collection

Our Collection Program collects tax and non-tax debts on behalf of the state of California. Tax debts are primarily unpaid audit and return assessments for individuals and corporations. Non-tax debts include vehicle registration fees, and various court-ordered and industrial

health and safety debts. Delinquent child support collection activity was transferred to the Department of Child Support Services as of July 1, 2005.

We use a variety of methods and tools to enforce the laws covering tax and non-tax debt.

- Liens and Levies:
We have authority to issue notices of liens and to levy wages and bank accounts. Individual collectors or our automated system can issue notices of liens and levies.
- Accounts Receivable Collection System (ARCS):
We use this automated system to process over one million individual and business accounts annually. We apply a customized approach to accounts, which greatly reduces the intrusion into taxpayer lives. By automating many key collection functions, we use ARCS to maximize efficiency and free collectors to answer questions, resolve problems, and help taxpayers find ways to pay their tax debts.
- Field Collections and Investigations:
Based out of field offices in various California locations, our field collectors make in-person contact with tax debtors who are persistently noncompliant. Our special investigators focus on the underground economy and bring felony criminal charges against the most egregious cases of tax evasion. Prosecuting these criminal activities results in many millions of dollars of tax revenue for the State of California.
- Contract Collection:
We use private collection agencies to collect debts in certain unfunded workloads.

Both the taxpayer and the state of California benefit by resolving tax debts. We seek the best way to resolve each individual account through a combination of automated actions, attention from experienced, highly trained professional staff, and a customer-centered collections approach. In keeping with this approach, we provide a variety of options to help taxpayers resolve their tax debts.

- Assistance and communications methods:
 1. We maintain a Collection call center staffed by collections experts, including several who are bilingual.
 2. We also maintain a tax practitioner FAX hotline providing tax representatives and practitioners with fast and direct access to collection experts.
 3. We provide online access to collection information, procedures, and electronic forms on our Internet Website.
- Payment Methods:
 1. Installment Agreements – We provide taxpayers who are unable to pay the full amount they owe in one payment the option of making their payments in installments.
 2. Offer in Compromise – We provide taxpayers who do not have, and will not have in the foreseeable future, the money, assets, or means to pay their tax liability the option to offer a lesser amount for payment of an undisputed final tax liability.

- Expanded Access to Innocent Spouse Status:
By conforming to the Innocent Spouse portion of the “Taxpayer Bill of Rights III” in the Internal Revenue Service Restructuring and Reform Act of 1998, we further expanded access to the innocent spouse status for taxpayers.
- Quality Assurance Practices:
We follow quality assurance practices to validate that we meet targets and deadlines, follow due process, and take correct actions.

Legal

Legal Department staff supports the enforcement effort by providing consultation and litigation support for positions developed in cooperation with the other enforcement programs. Support activities include representation in protests, appeal proceedings before the Board of Equalization, attorney general staff support in tax litigation proceedings in California and federal judicial proceedings, and representation in out-of-state bankruptcy proceedings.

PART V EVALUATING FRANCHISE TAX BOARD EMPLOYEES

Revenue and Taxation Code Section 21009 – “(a) The board shall develop and implement a program which will evaluate an individual employee’s or officer’s performance with respect to his or her contact with taxpayers. The development and implementation of the program shall be coordinated with the Taxpayers’ Rights Advocate. (b) The board shall report to the Legislature on the implementation of this program in its annual report.”

We completely revised the employee performance evaluation and probationary reports after the adoption of the Taxpayers’ Bill of Rights in 1989. Since that time, these forms continue to evolve. The term “Customer Service” is a performance dimension in the evaluations for supervisors and employees. We evaluate employees on how well they provide “quality customer service, while striving to exceed customers’ expectations,” their treatment of taxpayers, and providing “accurate, timely, and complete assistance.”

We also developed mission and value statements that emphasize the commitment of management and employees to a job well done, continuously improving service to customers, and courteous, fair treatment of everyone. We created the Mission and Values Team to promote an awareness of these concepts and to foster and encourage the achievement of a work environment reflecting them. The team consists of managers, supervisors, and staff at all levels throughout the department. We continue to revisit our values to ensure they meet the needs of our organization and customers.