Taxpayers' Bill of Rights

ANNUAL REPORT TO THE LEGISLATURE

Franchise Tax Board

October 1, 2006

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.

You can direct any questions regarding this report to Debbie Newcomb, Taxpayer Advocate, at (916) 845-4300. For information about obtaining a transcript of the Taxpayers' Bill of Rights Hearing, call (916) 845-5249.

Selvi Stanislaus
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.

We focus our audit programs primarily on the most cost efficient areas. For 2005, we found that:

- For corporation taxes, the largest cumulative dollar amount in proposed assessments from one primary issue resulted from allocation and apportionment audits.
- For personal income taxes, the largest cumulative dollar amount in proposed assessments resulted from filing enforcement assessments.
- Based on the primary business activity in California, the largest dollar amount was assessed for corporations under the industry designated as Services.
- Almost 70 percent of all tax returns are prepared by tax professionals. The percentage of taxpayers preparing their own returns is slightly over 30 percent.

We compiled information on taxpayers' filing errors detected during return processing. *Return Information Notices* were issued to taxpayers who filed returns with errors that resulted in a change of tax liability. We detected an error rate of approximately 3.5 percent during return processing. We made the largest number of adjustments for estimate payment credit errors. We made this adjustment when taxpayers claimed estimate and extension payment amounts that did not match payment amounts contained in our system. We did not include erroneous calculations of estimate penalties in this category.

We held our annual Taxpayers' Bill of Rights hearing on December 7, 2005. At this year's hearing, we heard several taxpayers' proposals, which include the following:

- Audit of professionally prepared returns
- Conformity
- Deemed denial provision
- Online forms
- Fairness issues for taxpayers
- Tax simplification
- Relief from liability

In an effort to improve compliance, we continue to:

- Review the law and propose legislation to facilitate the administration of our duties.
- Develop employee skills and abilities to assure quality service to all taxpayers.
- Educate taxpayers and tax practitioners so they file accurate and timely returns.
- Provide taxpayers with options to resolve their debts.

We evaluate our employees based on their treatment of taxpayers and their ability to provide complete assistance.

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 2005. The volumes and dollar amounts represent the sample study numbers projected to the total universe of assessments.

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. If a single notice includes multiple issues, we categorized the notice under the issue that provides the majority of the tax change. We categorized the NPA as *Other* where there is no distinct primary issue.

TABLE 1A
CORPORATION TAX LAW
NPAs Finalized in 2005 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment Per NPA
Allocation/Apportionment	793	36.5	$ 463.6	88.6	$ 584,672
Assess Minimum Tax	280	12.9	0.2	0.0	798
Revenue Agent Reports	444	20.5	27.7	5.3	62,467
State Adjustments	469	21.6	10.9	2.0	23,166
Other	184	8.5	20.8	3.9	113,057
Totals/Average	2,170	100	$ 523.3	100	$ 241,139

NOTE: In PART I, all tables reflect tax increase assessments only. The assessments became final in 2005. We may have issued the assessments in prior years, however, due to cases in protest status, we did not resolve them until 2005. 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* typically result when California conforms to federal law, and a change to a taxpayer's federal tax return 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 2005 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Thousands)	%	Average Assessment Per NPA
CP2000	77,604	15.4	$ 54,911	4.2	$ 708
Filing Enforcement	353,104	69.9	1,023,506	79.1	2,899
Filing Status	30,137	6.0	27,437	2.1	910
Revenue Agent Reports	12,248	2.4	44,233	3.4	3,611
Other	31,899	6.3	143,258	11.1	4,491
Totals/Average	504,992	100	$ 1,293,345	100	$ 2,561

- 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 2005

Industry	All Corporations 2004 Tax Year	%	Corporations with NPAs	%	Tax Assessed (Millions)	%
F.I.R.E.*	102,644	16.6	171	13.7	$ 52.6	10.0
Manufacturing	40,733	6.6	196	15.7	58.0	11.0
Services	251,407	40.8	164	13.1	68.2	13.0
Trade	117,725	19.1	128	10.2	18.1	3.4
Other **	104,296	16.9	589	47.1	326.3	62.3
Totals	616,805	100	1,248	100	$ 523.3	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.

TABLE 3A
CORPORATION TAX LAW
NPAs Finalized in 2005 Issued by Taxable Year

Average Taxable Year	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment per NPA
1998 and prior	720	33.1	$ 407.8	77.9	$ 566,411
1999	285	13.1	43.1	8.2	151,400
2000	441	20.3	47.8	9.1	108,371
2001	337	15.5	19.4	3.7	57,419
2002	223	10.2	3.1	0.6	13,876
2003	127	5.8	2.0	0.4	15,597
2004	37	1.7	0.0	0.0	2,409
Totals/Average	2,170	100	$ 523.3	100	$ 241,139

Because the statute of limitations for assessing additional tax has passed, the earlier years reflect final figures.

TABLE 3B
CORPORATION TAX LAW
Multiple NPAs Finalized in 2005 for the Same Taxpayer

Corporations with…	Number of Taxpayers	Tax Assessed (Millions)	Average Assessment per Taxpayer
One NPA	703	$ 65.8	$ 93,635
Two NPAs	326	103.8	318,334
Three NPAs	135	63.6	471,139
Four or more NPAs	84	290.1	3,453,150
Totals/Average	1,248	$ 523.3	$ 419,288

For individuals, the following table shows notices issued by taxable year.

TABLE 4
PERSONAL INCOME TAX LAW
NPAs Finalized in 2005 Issued by Taxable Year

Taxable Year	Number of NPAs	%	Assessment Amount (Thousands)	%	Average Assessment Amount
1999 & prior	1,972	0.4	$ 60,090	4.6	$ 30,472
2000	3,181	0.6	57,130	4.4	17,960
2001	19,648	3.9	45,673	3.5	2,325
2002	87,925	17.4	74,496	5.8	847
2003	386,688	76.6	1,050,054	81.2	2,716
2004 & later	5,578	1.1	5,902	0.5	1,058
Totals/Average	504,992	100	$ 1,293,345	100	$ 2,561

Individuals typically have audit changes for just one year. More than 98 percent of the individuals who received NPAs during 2005 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 professionally prepared.

In the absence of a paid preparer's signature, we consider that taxpayers prepared their personal income tax returns.

TABLE 5
PERSONAL INCOME TAX LAW
Resident Tax Return Preparation, 2004 & 2005 Process Years

Preparer	2004 Returns Processed (Thousands)	%	2005 Returns Processed (Thousands)	%	% Change
Professional	9,370	68.8	9,623	69.6	0.8
Taxpayer	4,248	31.2	4,202	30.4	-0.8
VITA*	6	0.0	8	0.0	0.0
Totals	13,624	100	13,833	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, 2005	July 31, 2006	% Change
Credit Card Payments (Average payment is $964)	80,000	92,000	15
Direct Debit of Balance Due (Electronic Funds Withdrawal)	213,000	254,000	19
Direct Deposit of Refund	3,461,000	3,869,000	12
e-file	8,132,000	8,878,000	9
* CalFile	158,000	112,000	-29
* Online Filing	1,366,000	1,467,000	7

* We include these volumes in the e-file volume.
Note: e-file volume includes Business Entity returns.

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]
1999	12,573	N/A	383.9
2002	15,064	N/A	N/A
2004	10,000[2]	N/A	N/A

1. Total assessments include tax, penalties, fees, and interest.
2. Volume estimated based on the standard ratio of NPAs issued to demands issued.

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

Fiscal Year	NPAs Issued	Returns Filed	Total Assessments (Millions)[1]
2003/2004	499,602	252,103	$ 2,986
2004/2005	528,856	248,766	$ 2,115
2005/2006	509,066	195,034	$ 4,140

1. Total assessments include tax, penalties, fees, and interest.

PART II
TAXPAYER FILING ERRORS

Tables 8A and 8B reflect taxpayers' errors on 2005 original tax returns we processed between January 1, 2006, and August 22, 2006. 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. Total adjustment paragraph numbers do not equal return information paragraph notices we sent, because many returns contain multiple errors, each error requiring an explanation.

TABLE 8A
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2006 PROCESS YEAR SUMMARY
Number of Adjustment Paragraphs Issued by Return Type

Adjustment Type	540	540A	540NR	N/A*	540 2EZ	Grand Total	% Of Total
AGI	470	184	1,396	1	2,437	4,568	0.95
CDC	9,592	1,692	661	43	0	12,442	2.58
Deductions	9,330	5,276	1,137	17	86	15,971	3.32
Estimate Payment	136,387	3,351	8,077	738	2,164	150,781	31.32
Exemptions	21,984	12,600	7,314	323	261	42,651	8.86
Filing Status	119	51	54	3	48	277	0.06
Mental Health Tax	723	524	112	0	0	1,362	0.28
Nonresident	36	0	16,634	0	0	16,747	3.48
Renter’s Credit	6,547	5,426	669	0	4,142	16,791	3.49
SDI	14,196	1,147	709	286	1	16,502	3.43
Special Credits	347	0	54	0	0	401	0.08
Tax Computation	18,318	8,655	3,214	9	736	32,271	6.70
Total Tax	16,094	12,872	796	205	54,987	85,375	17.73
Use Tax	23	1	0	0	3	73	0.02
Withholding	27,947	1,620	5,359	2,468	2,782	40,815	8.48
Miscellaneous	28,158	5,425	2,014	340	7,209	44,448	9.23
Totals	290,271	58,824	48,200	4,433	74,856	481,475	100.00

* Return type is undetermined.

TABLE 8B
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2006 PROCESS YEAR SUMMARY
Number of Adjustment Paragraphs Issued by Filing Method

Adjustment Type	E-file	Internet	Paper	Grand Total	% Of Total
AGI	219	1	4,348	4,568	0.95
CDC	3,420	34	8,988	12,442	2.58
Deductions	1,580	23	14,368	15,971	3.32
Estimate Payment	77,284	500	72,997	150,781	31.32
Exemptions	518	2	42,131	42,651	8.86
Filing Status	2	0	275	277	0.06
Mental Health	71	0	1,291	1,362	0.28
Nonresident	650	0	16,097	16,747	3.48
Renter's Credit	650	2	16,139	16,791	3.49
SDI	7,488	41	8,973	16,502	3.43
Special Credits	70	0	331	401	0.08
Tax Computation	351	3	31,917	32,271	6.70
Total Tax	1,251	6	84,118	85,375	17.73
Use Tax	0	0	73	73	0.02
Withholding	14,406	108	26,301	40,815	8.48
Miscellaneous	9,387	10	35,051	44,448	9.23
Totals	117,347	730	363,398	481,475	100.00

We issued 481,475 *Return Information Notices* out of 13,634,399 current year original tax returns processed from January 1, 2006, through June 30, 2006. We had an adjustment rate of 3.5 percent. This rate has gone up by 0.02 percent from last year for this period (438,046 *Return Information Notices* issued for 13,578,667 returns). In the preceding tables, we displayed the adjustments by return type and filing method.

We provided a description of what typically caused each adjustment:

Adjusted Gross Income and California – Taxpayers erroneously calculated 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 Expenses Credit – Taxpayers incorrectly claimed the Child and Dependent Care Expenses Credit. These adjustments continue to decrease as modifications to the form clarify eligibility rules and taxpayers and practitioners increase their knowledge about the credit.

Deductions – Taxpayers claimed the incorrect standard deduction amount for their filing status, claimed the incorrect filing status when another person claimed them as a dependent on their return, claimed an itemized deduction amount lower than the standard deduction amount, or left the deduction line blank.

Estimate Payment Credit – Taxpayers claimed estimate and extension payment amounts that did not match payment amounts contained on our accounting system. This category does not include erroneous calculations of estimate penalties.

Exemptions – Taxpayers did not claim an exemption amount, claimed the incorrect personal, blind, or senior exemption amount, claimed a number of dependents that did not match the number of dependent names, or calculated exemptions incorrectly.

Filing Status – Taxpayers filed a tax return jointly, yet the return contained only one name, social security number, and signature; or taxpayers claimed the head of household filing status, but did not include the name of the qualifying person. We adjusted the returns to reflect a single filing status, and recalculated the corresponding exemptions, standard deductions, and tax amounts. We issued *Return Information Notices* advising that we needed additional information to allow the filing status the taxpayers claimed.

Mental Health Tax – Taxpayers failed to claim the tax or claimed an incorrect amount for the new Mental Health Tax derived from the Mental Health Services Act.

Nonresident Only – Taxpayers made errors involving proration calculations and Schedule CA transfers. In addition to Nonresident Only errors, each of the other error types can occur on a nonresident return.

Renter's Credit – Taxpayers did not qualify for this credit due to filing status or income limitations.

Special Credits – Taxpayers claimed a credit for which they were not eligible, commonly due to income limitations, maximum credit amounts, or carryover limitations.

State Disability Insurance – Taxpayers claimed more excess State Disability Insurance than allowable.

Tax Computation – Taxpayers selected a tax amount from the incorrect row or column of the tax table, or calculated taxable income incorrectly.

Total Tax Liability – Taxpayers made calculation errors after they computed tax, and before they applied 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 – Taxpayers incorrectly reported their use tax.

Withheld Tax – Taxpayers claimed withholding amounts different from the allowable amount, which we determined from a variety of sources, including a database of Employment Development Department information.

Miscellaneous Computation – Taxpayers made miscellaneous addition or subtraction errors. For example, taxpayers made errors subtracting estimate credit transfer amounts from their overpaid tax amounts.

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."

Taxpayers presented proposals to the three-member Board at the annual Taxpayers' Bill of Rights hearing on Wednesday, December 7, 2005. The meeting took place at the State Board of Equalization in Sacramento, California.

William A. Lowell

Audit of Professionally Prepared Returns
Mr. Lowell, an FTB employee in 1962, stated FTB does not audit tax returns prepared by professional tax preparers. He suggested hiring, training, and providing office space for adequate auditors.

Will Bush, FTB's interim executive officer at the time of the hearing, stated that over two-thirds of all personal income tax returns are professionally prepared, even more on the corporate side. He assured Mr. Lowell that FTB audits returns prepared by professional preparers. Mr. Bush indicated that staff would be happy to talk to him about his concerns.

Gina Rodriquez, representing Spidell Publishing

On behalf of the editors at Spidell Publishing, Ms. Rodriquez thanked several FTB employees for their outstanding civil service during 2005. She presented the following issues to the Board.

Conformity
Ms. Rodriquez recommended sponsoring legislation to provide conformity to federal Health Savings Accounts and other federal provisions.

Assembly Bill 2010 and Senate Bills 1584 and 1787 were unsuccessful.

50% Interest Penalty
Ms. Rodriquez recommended sponsoring clean-up legislation to eliminate the unintended effects of the 50% interest penalty.

Assembly Bill 2326 was unsuccessful.

Household Employer Simplification
Ms. Rodriguez suggested sponsoring legislation to conform California's household employment tax procedures to the federal procedures by simplifying the reporting and payment process.

Assembly Bill 2786 was unsuccessful.

Gina Rodriquez, representing Spidell Publishing (cont.)

Mandatory Real Estate Withholding
Ms. Rodriquez suggested sponsoring legislation to:

- Align real estate withholding with the amount of taxable gain.
- Allow taxpayers to use their suspended passive losses from all investment property, not just the property with the disposition, when determining real estate withholding.
- Allow the FTB to provide a de minimis rule for small gains.

Assembly Bill 2962 was signed into law on September 22, 2006.

Late-Payment Penalty
Ms. Rodriquez recommended the following:

- Have FTB staff implement procedures to waive the late-payment penalty for taxpayers who meet the regulatory reasonable cause exception.
- Follow the IRS by providing information about the regulatory reasonable cause exception in the Form 3519 instructions.
- Change the name of the penalty on RINS to late-payment penalty.

FTB staff is researching potential system and/or procedural changes to prevent future erroneous late penalty assessments.

LLC Total Income Fee
Ms. Rodriquez recommended sponsoring legislation or directing staff to write ruling that clarifies expense reimbursements are not included in total income for purposes of the LLC fee.

FTB Legal staff does not agree with this proposal. We feel that the statute is clear and our interpretation of this law is correct.

Voluntary Disclosure Program Expansion
Ms. Rodriquez recommended amending Revenue and Taxation Code Section 19192 to encourage trusts that have an obligation to file California trust tax returns to come into compliance.

Assembly Bill 2344 was unsuccessful.

Richard E.V. Harris, representing Richard E. Harris Law Office

Mr. Harris addressed the Board with the following proposals.

"Deemed Denial" Provision
Mr. Harris mentioned his proposal from the previous meeting concerning a "deemed denial" for a protest pending more than 24 months. Although staff responded to his proposal, Mr. Harris would like legislation for a deemed denial provision.

FTB Legal staff is reengineering the docketed protest process to reduce the time necessary to process cases in our Legal Department.

Richard E.V. Harris, representing Richard E. Harris Law Office (cont.)

Transparency
Mr. Harris suggested more ways to improve transparency. He requested more information on the Website.

We have added a significant amount of information to our Website in the past year including new information under the categories shown below:

- ***FAQs***
- ***Increased legal information***
- ***Administrative structure and contact information***
- ***High profile tax-related topics***
- ***Tax season-related or special situations***
- ***Collections-related content***
- ***Information from or about other government agencies***

Lenny Goldberg, representing the California Tax Reform Association

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

More Forms Online
Mr. Goldberg said the number of forms online should continue to expand. He said taxpayers should be able to fill out their own taxes directly online. He said taxpayers should know what information the state has about them.

We are rewriting our forms instructions using the Van Write editing software, which will improve the readability of our tax form instructions. We applied Adobe extensions to the following forms:

1. ***2006 540***
2. ***2006 540 2EZ***
3. ***2006 540A***
4. ***2006 540 Schedule CA***
5. ***2006 540NR Short Form***
6. ***2006 540NR Long Form***
7. ***2006 3519***
8. ***2007 540-ES***
9. ***2006 540NR Schedule CA***
10. ***2006 Schedule W-2***

These forms will be available online December 15, 2006, and taxpayers will be able to save the forms. Each year, we will apply the extensions to our top 10 forms.

We are using the FTB Internet Website to post information on Fed/State conformity issues, which allows taxpayers to get an in-depth understanding of the differences in law and where they need to make changes to state forms.

Teresa Casazza, California Taxpayers' Association

Teresa addressed fairness issues for taxpayers.

Fairness Issues for Taxpayers
Ms. Casazza asked FTB to do the following:

- Establish policy for treatment of disaster victims.
- Establish policy for treatment of disabled individuals.
- Change statute of limitations
- Keep records as long as the statute of limitations is open.
- Follow BOE decisions
- Schedule Bill of Right's hearing earlier.

To address Ms. Casazza's issues:

- ***We already have a policy in place for disaster victims.***
- ***We follow the IRS for the treatment of disabled individuals for tax purposes.***
- ***Effective July 1, 2006, the statute of limitations on the collection of income or franchise from individuals and business entities was limited to 20 years.***
- ***We keep our records for the period of time the statute is open.***
- ***We follow final BOE decisions.***
- ***The Bill of Right's hearing date is decided based on the Franchise Tax Board members' schedules.***

Roland Boucher, representing United Californians for Tax Reform

Tax Simplification
Mr. Boucher provided written proposals for tax simplification to the Board.

Assembly Bill 249 introduced February 8, 2005, would have allowed taxpayers with capital gains to use Form 540 2EZ. This bill was unsuccessful.

Legislative Analyst's Office and Franchise Tax Board will conduct a study on the impact of the revised 540 2EZ and report to the legislature, no later than January 1, 2008 – the following:

- ***The number of filers using the revised Form 540 2EZ.***
- ***The effectiveness of the revised Form 540 2EZ in the simplification of tax preparation for taxpayers eligible to use that form.***
- ***The impact the revised Form 540 2EZ has on FTB's administration of Personal Income Tax law.***

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

Relief from Liability for Income Taxes Attributable to Community Income for Individuals Filing Separate Returns

Mr. Taggart resubmitted 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.

Senate Bill 1827 was signed into law on September 30, 2006.

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.

Chaptered Legislation –
<u>AB 2341 (Villines, Chap. 773, Stats. 2006)</u>
This act eliminates the requirements to obtain a tax clearance and, if certain requirements are met, suspend further liability for the annual or minimum franchise tax.

<u>AB 2962 (Benoit, Chap. 428, Stats. 2006)</u>
This act allows sellers of California real estate to choose between rates of withholding.

<u>SB 663 (Migden, Chap. 22, Stats. 2006)</u>
This act clarifies specific provisions of the franchise tax law relating to water's-edge taxpayers.

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 *mobilia* 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 *mobilia* 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.

A formal regulatory hearing was held on July 17, 2006, where five public comments were received. Staff is preparing written responses to the comments. Staff plans to present the proposed amendments to the existing regulation and the responses to the public comments near the end of 2006.

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 revised 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 applied retroactively.

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.

Staff waits for approval from the Franchise Tax Board to proceed with the formal regulatory process.

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 source 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 source income remains 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 2007.

Regulation Section 25137-14 – Taxation of Mutual Fund Companies –

The need for an alternative apportionment methodology for mutual fund service providers has led to the issuance of regulations and statutory amendments in many of the states that have a significant mutual fund service provider presence. California, while being home to many such companies, has not addressed this issue. Staff has received Revenue and Taxation Code Section 25137 petitions from members of the industry over the last several years and, with either action by, or the knowledge of, the Board, has granted relief to the practitioners. Staff believes that it is appropriate to formally recognize the need for a variance from the standard Uniform Division of Income for Tax Purposes Act (UDITPA) provisions so that it will no longer have to deal with these requests on a piecemeal basis. This regulation project is intended to provide much needed guidance in this area.

The normal apportionment provisions set forth in Revenue and Taxation Section 25136 assign receipts to the location where the income producing activity occurs. For mutual funds service providers, this usually results in most, if not all, of their receipts for services being assigned to one location. This is at odds with the purpose of the sales factor, which is to reflect the market for a taxpayer’s goods and services. This problem has been remedied in most states by overriding the normal UDITPA rules and assigning receipts to the numerator of the sales factor based upon the location of the underlying shareholders of the mutual funds. This location is usually deemed the mailing address on file with the fund. Such a methodology would appear to be appropriate for use in California as well.

On September 7, 2005, staff received authorization from the board to proceed with a symposium to obtain industry input regarding a proposed regulation. This enabled staff to have discussions with interested parties regarding what other states have adopted and what language would be incorporated into a proposed draft regulation. The symposium was successful in this regard and led to the creation of the draft regulation language. On June 19, 2006, staff received authorization from the Board to proceed with the formal regulatory process. Staff anticipates holding a public hearing sometime in the fall of 2006.

TRAINING

We develop employee’s skills and abilities to improve our service to the public.

Filing Services

We provide comprehensive technical training to new employees in the Filing Services Bureau on Taxpayer Information System account processing and account transactions. We provide Taxpayer Information System refresher training to veteran staff and advanced training to employees responsible for more complex and specialized account analysis and resolution.

We also provide basic and advanced technical training on our Business Entity Tax System to employees assigned to work with business entity accounts. We introduce Filing Service Bureau employees to Business Entity Tax System account processing and account transactions. We provide advanced training to employees responsible for more complex and specialized account analysis and resolution.

We provide basic and advanced technical training on the Accounts Receivable Collection System and the Integrated Nonfiler Compliance system to all Filing Services Bureau employees assigned to handle collection accounts. We introduce employees to the 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, customer service, and telephone techniques to new public service staff in the Filing Services Bureau. We emphasize customer service and train on topics such as excellent customer service and resolution of each caller’s issue with only one contact whenever possible. We provide year-round training on changes to tax laws, information systems, and procedures to all public service staff.

In addition to technical training, we train our employees on workplace diversity, sexual harassment prevention, career development and upward mobility, and other administrative courses. We also provide technical training throughout the department. We invite subject matter experts to serve as mentors and coaches, training consultants, or guest instructors to provide new or updated training. We encourage employees to further their education through computer based training and college courses.

Collection

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

We train our employees on core compliance courses:

- 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, we provide 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. We also provide individual instruction to employees at a low cost through computer-based training. We strongly encourage Accounts Receivable Management Division employees to continue the learning process throughout their careers by enrolling in classes to refresh their existing skills or knowledge.

Audit

We provide professional training to our auditors from the moment they begin their work at the Franchise Tax Board. We provide a six-week basic professional auditor training series to establish an auditor’s baseline expertise in the following areas:

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

We offer ongoing support for new auditors to develop their skills throughout their careers with an emphasis on just-in-time technical law training. We also provide 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

We strive to provide taxpayers and tax practitioners with the information they need to file their state tax returns completely, accurately, and timely.

This year, in an effort to reach more taxpayers, we translated some of our publications into Chinese, Vietnamese, and Korean. We had employees available to answer questions in these languages.

We continue to expand our education and outreach in Spanish. Through our Spanish Web Portal, we provide Spanish-speaking taxpayers and tax professionals with information, how to contact us, and available e-services. We also maintain and enhance our Interactive Voice Response system for Spanish-speaking taxpayers.

For persons with disabilities, we provide access to our programs, services, and facilities in accordance with Title II of the Americans with Disabilities Act of 1990. At the taxpayers' request, we provide reasonable accommodations in alternative format including the personal income tax booklets in large-print version and on audiocassette.

We continue the following education and outreach efforts:

1. We develop new notices, forms, and publications, as well as review and revise our current notices, forms, and publications, to ensure they are accurate, up-to-date, and easy to understand.

2. We distribute tax products using methods convenient for taxpayers and tax practitioners including providing tax forms and publications on the Internet through the California Home Page or through our Website.

3. We provide information on our Website such as regulations, frequently asked questions, and program-specific information, including personal income tax refund status, account balance, payment information, and e-programs.

4. We maintain and regularly enhance an Interactive Voice Response system providing recorded responses to the most frequently asked questions regarding general state tax information.

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 participate with other tax agencies to establish joint field offices to provide service to taxpayers and tax practitioners through a single call. We also provide easy access to a variety of tax information through hypertext links from one Website to another on the California Home Page and individual agency Websites through the California Tax Information Center at www.taxes.ca.gov.

7. We facilitate a statewide Volunteer Income Tax Assistance and Tax Counseling for the Elderly Program. Through this program, we provide:
   - Free tax return preparation for low income, non-English speaking, and elderly taxpayers.
   - Easily accessible sites for taxpayers to receive forms, booklets, free of charge form preparation, and electronic filing options.
   - One stop shopping for taxpayers to receive federal and state tax assistance.

8. We jointly administer the School Volunteer Income Tax Assistance program with the Internal Revenue Service. Through this program, we provide students with opportunities to develop job skills and learn about volunteerism as they help non-English speaking, disabled, elderly, and low-income members of the community prepare basic state and federal income tax forms.

9. We participate in small business conferences with other state departments and agencies. We also provide speakers to help non-profit organizations, community groups, and government-funded educational institutions learn more about tax-related issues.

10. We continue to gather input from stakeholders to help us modify and enhance our programs based on what our stakeholders truly want and need.

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.

We contact 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 the Internal Revenue Service, the State Board of Equalization, and the Employment Development Department to identify potential nonfilers.

Audit

We identify areas of noncompliance and optimally use our Audit resources to complement federal, other state, and local agency enforcement and compliance efforts. 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 focus on the following:

Resolving protective claims filed during tax amnesty –
Taxpayers paid $3.6 billion in protective claims in 2005 because of tax amnesty. During the past year, we completed audits on over $1.4 billion in protective claims. Of that amount, we resolved $725 million in protective claims with no further protest or appeal rights and we retained $618 million. Of the remaining $107 million in overpayments, we either refunded the money or kept the money at the taxpayer's request as a cash deposit for future use. Protective claims cases that remain outstanding as of July 30, 2006, include cases in the following categories:

Open audits	$782 million
Pending federal	$521 million
Protest	$922 million
Appeal	$ 33 million
Settlement	$184 million

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 increased efforts to identify those who intentionally and continually underreport taxes and contribute to the tax gap. We focus our efforts to identify schemes used to evade reporting the correct amount of tax. We dedicated specialized auditors to evaluate non-traditional sources to identify taxpayers who may not have fully self-assessed and paid the correct amount of tax. Additionally, we initiated a tax preparer audit program. This program penalizes tax preparers who claimed deductions or credits erroneously.

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. We focused and dedicated audit resources to identify and evaluate investor leads, promoters, and to carryout FTB Notice 2006-1, California Tax Shelter Resolution Initiative.

- Investor Leads – In addition to conducting audits, we contact taxpayers suspected of participating in tax shelters and offer them an opportunity to self-correct their tax return.
- Promoters – We created a database of potential promoters and began assessing Abusive Tax Avoidance Transaction promoter penalties.
- California Tax Shelter Resolution Initiative – With this initiative, we generated 283 applications to participate in the initiative involving 817 tax years.

Streamlining the audit process and staying current with our audits –
By focusing on adherence to Regulation 19032, we streamlined our audit process, which allowed us to stay current with our Audit workloads. The following is a list of tools we have used to achieve our goals:

- Engage taxpayers or representatives as to the scope of the audit at the start.
- Follow-up timely, 30 days.
- Complete audit within two years of initial audit contact.
- Emphasize materiality; however take into account compliance issues as well.
- Eliminate redundant processes, such as certain review processes.
- Minimize intrusiveness and maintain efficiencies.

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 –
We use this automated system to process and maintain approximately 1.7 million individual and 600,000 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 the system 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 persistently noncompliant tax debtors. 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 near 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.