State of California
Franchise Tax Board

Taxpayers' Bill of Rights

ANNUAL REPORT TO THE LEGISLATURE

Franchise Tax Board
October 1, 2007

EXECUTIVE SUMMARY

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.

To satisfy the provision's requirements, we conducted a study using a sample of both corporation and personal income tax *Notices of Proposed Assessments.* These proposed assessments are the result of Franchise Tax Board audits.

- 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 from one activity resulted under the industry designated as Manufacturing.

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 in tax liability. We detected an error rate of approximately 3.9 percent during return processing. We used this data to identify and address some of the most common taxpayer issues.

The report includes Taxpayer Advocate Bureau responsibilities and contacts. The Taxpayer Advocate received 13,667 contacts from January through July 2007. In addition to assisting taxpayers, the Taxpayer Advocate is responsible for:

- Explanation of taxpayers' rights.
- Taxpayer and tax practitioner education.
- Taxpayers' Bill of Rights Hearing.

We continue to examine and address common taxpayer issues in our efforts to reduce the number of notices we issue and make it easier for taxpayers to meet their obligations. We also provide information and assistance to taxpayers and tax practitioners as issues arise.

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Executive Officer

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TAXPAYERS' RIGHTS ADVOCATE

Mission of the Taxpayer Advocate Bureau

We ensure that taxpayers' rights are protected. We identify problems and find solutions in a cooperative effort while recognizing the goals of the audit, collection, and filing programs. We promote integrity and responsibility so that our customers can rely on quality information and efficient service.

Taxpayers' Bill of Rights Legislation

In 1988, the California Legislature enacted the Taxpayers' Bill of Rights. For the first time legislation spelled out California taxpayers' rights and our obligations. This law codified many existing department procedures and established a Taxpayer Advocate.

On July 30, 1996, the federal Taxpayer Bill of Rights 2 passed, followed a few months later by California Taxpayers' Rights Conformity Legislation.

California lawmakers enacted the Taxpayers' Bill of Rights Act of 1999 to further guarantee taxpayers' rights.

Responsibilities of the Taxpayer Advocate

The Taxpayer Advocate reports directly to the Executive Officer of the Franchise Tax Board. By legislation, our responsibilities include:

- Coordinate resolution of taxpayer complaints and problems including complaints regarding unsatisfactory treatment by FTB employees.
- Develop and implement a taxpayer education and information program.
- Identify areas of recurrent taxpayer noncompliance.
- Conduct an annual hearing where individual taxpayers and industry representatives may present proposals to clarify the California Revenue and Taxation Code.
- Make recommendations to improve taxpayer compliance and uniform tax administration.
- Inform taxpayers, in simple, non-technical language, of procedures and remedies and rights during audit, appeal, and collection proceedings.
- Evaluate employees on performance based on taxpayer contact and not on the revenue produced.

The Taxpayer Advocate Bureau coordinates outreach efforts, such as practitioner and Advisory Board meetings. We provide filing season updates and information to legislative offices. We also conduct independent administrative reviews and administer Interest Abatement and Third Party Fee Programs.

Explanation of your Rights in Publications

We develop, review, and revise our notices, forms, and publications to ensure our publications are clear, accurate, and timely. Staff is trained to follow department standards and writing guidelines to meet readability requirements as well as technical accuracy.

Our tax booklets and notices include information about taxpayers' rights. Our goal is to inform taxpayers in simple, non-technical language, of procedures and their remedies and rights during audit, appeal, and collection proceedings.

We provide detailed information on Taxpayers' Bill of Rights legislation in our Taxpayer Advocate publications:

California Taxpayers' Bill of Rights (FTB 4058) – This brochure gives you a basic description of your rights during the audit process. It also tells you how to protest and appeal.

California Taxpayers' Bill of Rights 2 (FTB 4063) – In response to further federal legislation, the California Legislature enacted the Taxpayers' Bill of Rights 2. This brochure provides information about additional protection of your rights under this California legislation.

California Taxpayer Bill of Rights Act of 1999 (FTB 4064) – To further guarantee your rights as California taxpayers, California's lawmakers enacted the Taxpayers' Bill of Rights Act of 1999. This brochure provides the major highlights of this legislation.

California Taxpayers' Bill of Rights – A Comprehensive Guide (FTB 4058C) – This publication describes provisions of the California Taxpayers' Bill of Rights and tells how we implemented these provisions. This publication is also available in Chinese, Korean, Spanish, and Vietnamese.

The Advocate also reviews external publications and communications for compliance with the Taxpayers' Bill of Rights legislation.

Advisory Board

The Taxpayer Advocate coordinates annual Advisory Board Meetings with representatives from industry, state and federal government, and the FTB to discuss issues relating to California income tax. They meet to provide our executive officer with insight and contributions on the various projects and programs we administer.

The topics from our latest meeting ranged from ways to increase the public's use of our e-pay programs to questioning senior management on topics as varied as HRA, processing timeframes, and registered domestic partners.

Annual Meetings with Tax Practitioners

The Taxpayer Advocate coordinates liaison meetings with the California Society of Enrolled Agents and the California Society of Certified Public Accountants. At the meetings, we present Franchise Tax Board's upcoming projects and issues. We also respond to questions from the tax practitioners.

Legislative Information Folder

In addition to assisting legislative staff with their constituents' tax issues, the Taxpayer Advocate provides legislative staff with annual filing season updates and an information folder that includes forms, instructions, and services available.

For the 2007 filing season, we included Chinese, Korean, Spanish, and Vietnamese language versions of our innocent spouse and glossary of terms publications in the information folder.

Interest Abatement

The Taxpayer Advocate administers the Interest Abatement Program. Franchise Tax Board may cancel interest taxpayers owe if they can show that an unnecessary delay in our processing caused the interest or delay in their payments. We may also cancel interest if taxpayers can show the interest accrued because we made an unreasonable error in performing certain kinds of acts. If we deny a taxpayer's request, they have the right to appeal our action.

Third Party Fees

The Taxpayer Advocate administers the Third-Party Fee Program. Taxpayers may file a claim for refund for reimbursement of charges imposed by an unrelated third party as the direct result of an erroneous processing or collection action by the Franchise Tax Board. Charges that may be reimbursed include, but are not limited to, usual and customary charges for complying with levy instructions and reasonable charges for overdrafts that are a direct result of our erroneous action.

Advocate Contacts

The Advocate is contacted when taxpayers are unable to resolve their issues through regular channels. We assist taxpayers with their issues by reviewing their unresolved tax problems and ensuring they are handled promptly and fairly. We also interact with other state and federal agencies, and assist in identifying and resolving departmental problems.

The Governor's office, Board members, our employees, Legislators, state and federal agencies, and taxpayers or their representatives contact us. We are contacted by mail, fax, phone, and email. We received 13,677 contacts from January through July 2007. The majority of taxpayers contacted us by telephone and represented 8,278 contacts.

We received 1,449 contacts by email from January through July 2007. We expect to see the number of emails continue to increase, as taxpayers become more acquainted with our Website. Taxpayers also contacted the Advocate by email when they could not contact the department by phone or when the phone wait time was too lengthy.

We also provide a public number for taxpayers to contact our Advocate Support Unit at (800) 883-5910.

The top five reasons taxpayers contacted our office from January to July 2007 include:

- Filing Enforcement
- Earnings Withholding Order for Taxes
- Refund
- Balance Due
- Lien

Some examples of how we assisted taxpayers with these issues include:

<u>Filing Enforcement</u>
We explained assessments and provided information to assist taxpayers in completing their returns. In some cases, we canceled assessments or addressed hardship issues.
<u>Earnings Withholding Order for Taxes</u>
We modified or released these assessments based on additional information.
<u>Refund</u>
We assisted taxpayers by checking the status of their refunds or reissuing refunds.
<u>Balance Due</u>
We mailed tax computations, sent Offer in Compromise packages, reevaluated assessments, and encouraged taxpayers to send payments.
<u>Lien</u>
We assisted taxpayers who needed assistance with liens showing up on their credit reports.

DEPARTMENT PROJECTS AND INITIATIVES

Projects

Scan and Shred Project

This year we implemented a Scan & Shred Project, a scalable solution for scanning, storing, and viewing all Business Entity returns, forms, schedules, and attachments submitted on paper. Staff can now view an image of the return at their personal computer and multiple users can view the same return at the same time. This process allows us to shred the paper forms, eliminating the costs of the physical storage space and the personnel hours expended filing and retrieving the paper returns.

ReadyReturn

ReadyReturn is on track to be deployed in January 2008. The three-member Franchise Tax Board approved ReadyReturn in December 2006. ReadyReturn is a tax-filing method where we use wage and withholding information to complete tax returns for taxpayers with simple filing circumstances. ReadyReturn is a voluntary program where taxpayers have the option of viewing, making changes, and e-filing their ReadyReturn via an online Web application.

Eligible taxpayers have the option of using our Interactive Voice Response system or Taxpayer Services Center to request that we mail them a paper copy of their ReadyReturn.

Tax Systems Modernization

The IT Strategic Plan is being developed through the Tax Systems Modernization Project. We are taking a structured and comprehensive look at our current business and supporting technologies across the enterprise. We are also engaging our stakeholders to envision how we can better serve them and give them peace of mind at the end of their tax filing experience. These efforts will assist us in identifying long-term business and customer service strategies, leading to a prioritized list of improvement projects.

Key Initiatives for 2007

Implement the Tax Gap Plan

The tax gap is a way to gauge taxpayers' compliance with their state tax obligations. This measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time. The current estimate of the tax gap in California is $6.5 billion. We developed a tax gap plan and want to spend time to implement the strategies laid out in the plan.

IRS/FTB Meetings
We are working with the IRS on the State Reverse Filer Match Initiative. The IRS will match non-filer data provided by the states against their system to determine if they have similar compliance issues.

Tax Gap Forum
We are invited to participate in the "Tax Compliance: Options for Improvement and Their Budgetary Potential." The forum is sponsored by the Government Accounting Office, Congressional Budget Office, and Joint Committee on Taxation and is being held in Washington D.C.

Media Plan
We plan to release a Request for Proposal to solicit detailed information from a prospective full-service ad agency, marketing, public relations, or communications firm for developing a comprehensive strategic plan for using a social marketing approach to tackle the tax gap.

Increase Transparency

We strive to make our organizational goals and operations more transparent and accountable to the public to strengthen our relationship.

"Transparency" is a process that allows citizens to openly see the activities of their government. This means making our information and processes more accessible and understandable to taxpayers. Transparency will help us improve our services and increase compliance with the tax laws.

Increase Employee Engagement

"Employee engagement" is present when employees come to work and put their heart into their day-to-day work. The corporate culture is one where everyone is treated with dignity and respect and can connect their work to the organization's mission and key strategies. The work environment is one where inclusion is fostered and each employee believes they make a difference in our business. All employees have the tools they need to do their job, are achieving their career objectives, and have confidence in our leadership.

Increase the Speed of Our Actions

A key component of customer satisfaction is speed. Our values of quality work or spending wisely still are important, but in the coming year, we want to focus on the speed of our actions. We want to look at speed of internal actions as well as service provided to taxpayers. The Ken Miller reengineering effort is one methodology to determine ways of gaining speed.

Work to Reduce the Top 10 Customer Service Contacts

Saving taxpayer time is a key factor in taxpayer satisfaction. And, the best customer service is when the taxpayer never needs to call us, followed by resolving the taxpayer's call in a short amount of time. We believe we should identify the top 10 reasons why people call us. With this list, we need time to figure out why they need to call us. What can we change, or modify so the taxpayer does not need to call us at all.

TAXPAYER EDUCATION AND OUTREACH

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

One of our service goals is to improve our communications to better serve the growing communities of taxpayers who speak English as a second language.

We have a task force to coordinate the translation of forms, publications, Web information, news releases, and other documents as needed. Based on these criteria, we identified various publications to translate into Spanish, Chinese, Korean, Russian, and Vietnamese. Other selected languages may be added in the future, as well as other publications, Web content, and other documents as needed.

Our Spanish Web Portal continues to expand. We provide Spanish-speaking taxpayers and tax professionals with information, how to contact us, and e-services.

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 taxpayer’s request, we provide reasonable accommodations in alternative format, including income tax booklets in large print and on audiocassette.

An ongoing media effort is a major component in our goal to reduce taxpayer errors. We give news interviews, prepare news releases, and make public service announcements to inform taxpayers of changes to the tax law, new programs, and current issues that might interest taxpayers.

Interactive Voice Response

We maintain and regularly enhance an Interactive Voice Response system providing recorded responses to the most frequently asked questions regarding general state tax information. We also maintain and enhance our Interactive Voice Response system for Spanish speaking taxpayers.

California Tax Information

In an effort to provide one stop service for California taxpayers, we participate with other state tax agencies to establish State Taxpayer Service Centers.

On the Web, the California Home Page **www.ca.gov** and California Tax Service Center **www.taxes.ca.gov** provide taxpayers with easy access to a variety of state and federal tax information through hypertext links from one Website to another.

Tax News

To inform tax professionals about state income tax laws, our regulations, policies, and procedures, and events that affect the tax professional community, we developed Tax News, our monthly online publication. Tax practitioners can subscribe to Tax News by email. To subscribe, search for Tax News on our Website. We also periodically release Tax News bulletins to quickly notify subscribers of urgent, time-sensitive information.

Small Business Outreach

We provide training at seminars and develop programs to help small businesses meet their state income tax filing requirements. In conjunction with the Internal Revenue Service, Employment Development Department, and Board of Equalization, we develop products that simplify the process of obtaining information on most business filing requirements.

We also provide speakers to help non-profit organizations, community groups, and government funded educational institutions learn more about tax-related issues.

Speakers' Bureau

Speakers' Bureau is available to help non-profit organizations, community groups, and government-funded educational institutions learn more about tax-related issues. FTB speakers typically make brief presentations to groups of 25 or more.

Interested Parties Meetings

We hold meetings to discuss or generate feedback from interested parties about specific topics such as implementation of new law or proposed initiatives, etc.

Free Filing Assistance

Along with the Internal Revenue Service, we jointly administer two volunteer programs: Volunteer Income Tax Assistance and Tax Counseling for the Elderly.
These volunteer programs help individuals with low income and/or over the age of 60 prepare their state and federal income tax returns.

VITA program helps taxpayers with basic tax returns. They specialize in assisting disabled taxpayers, those with low to limited income, and non-English speaking taxpayers.

TCE program provides free income tax assistance for middle or low-income taxpayers, giving special attention to those aged 60 or older.

Schools Partnership Program Volunteer Income Tax Assistance

We collaborate with the Internal Revenue Service to administer the School VITA Program at Cordova and Hiram Johnson High Schools. This program provides students with opportunities to develop job skills, earn school credit, and learn about the value of volunteerism as they help non-English speaking, disabled, elderly, and low-income members of the community prepare basic state and federal tax returns.

IDENTIFY AREAS OF NONCOMPLIANCE

Sample Data from the Audit Process

We compiled and analyzed sample data from the audit process to identify areas of recurrent taxpayer noncompliance. The sample data includes:

- The statute or regulation violated by the taxpayer.
- The amount of tax involved.
- The industry or business engaged in by the taxpayer.
- The number of years covered in the audit period.
- Whether the taxpayer used professional tax preparation assistance.
- Whether the taxpayer filed individual or corporate returns.

We collected assessment information from the personal income tax *Notice of Proposed Assessment* display file for assessments that became final in 2006. The volumes and dollar amounts represent the sample study numbers projected to the total universe of assessments. See tables in Appendix 1 for details.

We collected data for the distribution of *Notices of Proposed Assessment* 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 assessment as "*Other*" where there is no distinct primary issue.

For corporation taxes, the largest cumulative dollar amount in proposed assessments from one primary issue resulted from allocation and apportionment audits. Allocation and apportionment audits involve corporations doing business within and outside California.

Allocation is the assignment of non-business income to a particular state. Apportionment is the division of business income among states by the use of a three-factor apportionment formula. Within the apportionment formula, the sales factor is the most frequent audit issue for corporations. The higher rate of noncompliance associated with allocation and apportionment may be attributed to the complexity of the issues involved. In addition, noncompliance may occur due to varied interpretations of the tax laws.

For personal income taxes, the largest cumulative dollar amount in proposed assessments resulted from filing enforcement assessments. Filing enforcement assessments refers to individuals who have not filed their state income tax return after we notified them of their filing requirement. Most of the proposed assessments were issued to personal income taxpayers for failure to file a state income tax return.

Based on the primary business activity in California, the largest dollar amount was assessed from one activity resulted under the industry designated as Manufacturing.

We issued a separate *Notice of Proposed Assessment* to the taxpayer for each year included in an audit adjustment. Individuals typically have audit changes for just one year. More than 96 percent of the individuals who received *Notices of Proposed Assessment* during 2006 had audit changes for a single year.

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. Tax professionals file almost 70 percent of all personal income tax returns.

We also compiled statistics for electronic filing and payments. For these figures, see Appendix 1, Table 6. Electronic filing continues to increase with 9.5 million returns filed electronically. As of July 31, 2007, we received 24, 000 e-filed business entity returns.

We inform taxpayers about their California filing requirements throughout our Website, through our letters, and through our contacts of nonfilers. First time nonfilers who have complied in the previous four years will receive a *Request for Tax Return* notice. Repeat nonfilers will receive a *Demand for Tax Return* notice. Nonfilers who do not file the necessary tax returns after receiving a request or demand notice from us, will receive a *Notice of Proposed Assessment.* Our goal is to obtain tax returns from those who have a filing requirement without having to issue a *Notice of Proposed Assessment.*

To measure our progress in reaching this goal, we track the filing rate for the current and previous years. See Appendix 1, Tables 7A and 7B. Over one third of the taxpayers who received a Notice of Proposed Assessment filed a return.

Taxpayer Filing Errors

Revenue and Taxation Code requires the Advocate to identify the most common errors made by taxpayers when they filed their returns and how those errors may be avoided or corrected.

We compiled information on taxpayers' errors on 2006 tax returns we processed between January 1, 2007, and August 18, 2007. 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 number of adjustment paragraphs does not equal the number of notices, because many returns contained multiple errors. The actual number of *Return Information Notices* sent to taxpayers was 503,349.

Out of 14,403,712 current year tax returns processed from January 1, 2007, through August 18, 2007, we made 562,617 adjustments. We had an adjustment rate of 3.9 percent. This rate has gone up by 0.4 percent from last year for this period (*3.5 percent: 481,475 Return Information Notices issued for 13,634,399 returns through August 22, 2006*). Tables in Appendix 2 display the number of adjustments by return type and filing method. We included a definition of what typically caused each adjustment.

Paper filed returns represent the filing method type with the most adjustments representing over 73 percent. Internet and e-file continue to have the lowest adjustment rate representing about 27 percent of all adjustments. Our goal is to help reduce taxpayer burden and improve the timeliness and accuracy of tax returns. Each year, we increase the number of online taxpayer services available.

As reported earlier in this report under Projects, *ReadyReturn* is a tax filing method introduced as a pilot program in 2005 and 2006. The Board directed us to offer *ReadyReturn* as a service for all eligible taxpayers. This service will be available beginning January 2008, for tax year 2007.

Over one-third of all *Return Information Notices* were issued due to Estimate Payment Credit adjustments. Taxpayers either neglect to claim estimate payments submitted, claim a credit that differs than what was submitted, or claim credits that we have no record of receiving. For all filing methods, the most common taxpayer error was the estimate payment adjustment and occurred almost equally on e-filed and paper returns.

Estimate Payment Information Notice Pilot Project

In an effort to educate taxpayers and reduce the number of *Return Information Notices* generated, we created a pilot letter to provide taxpayers with the total estimate payment credit they paid for the 2005 tax year. We sent the letter in early February 2006, to taxpayers who had previously made estimate payments and claimed the incorrect amount on their return, which resulted in the generation of a *Return Information Notice* for two or more years. We provided the taxpayer with the opportunity to rectify their account before filing their return.

The results of the pilot indicate that those taxpayers who participated in the pilot project saw an 80 percent reduction in the number of estimate penalty generated *Return Information Notices*.

With the success of the pilot project, management requested an expansion to include the 2006 tax year. The expansion project encompassed taxpayers who received a *Return Information Notice* for their 2005 personal income tax return with the estimate payment error. A letter was sent to approximately 103,000 taxpayers.

As of July 7, 2007, the number of taxpayers who received the letter and filed their returns totaled 64,241 or 62 percent. Eighty-two percent of these taxpayers did not receive an estimate penalty generated notice.

The overall goal of this effort is to reduce the number of estimate payment reporting errors since this continues to be the most common error made by taxpayers filing current year tax returns.

TAXPAYERS BILL OF RIGHTS HEARING

Taxpayers presented proposals to the three-member Board at the annual Taxpayers' Bill of Rights hearing on December 4, 2006. The meeting took place at the State Board of Equalization in Sacramento, California. For copies of the responses, you can visit our Website at ftb.ca.gov and search for "hearing responses." The responses are in order of the presentations at the meeting.

Roland Boucher

Mr. Boucher, representing United Californians for Tax Reform, provided written material and oral comment to the Board on the following matters:

Reduce the number of complex tax returns by:

- Repealing the $87 personal exemption.
- Raising the standard deduction up to $6,500.

In her letter dated January 10, 2007, former Taxpayer Advocate Debbie Newcomb responded that legislative services staff will develop a legislative proposal to increase the standard deduction and eliminate the personal exemption. Staff developed a written proposal for the three-member Franchise Tax Board to consider with the legislative proposals.

Mr. Boucher suggested the Franchise Tax Board provide information on the Website for free tax filing.

Ms. Newcomb wrote that FTB staff would place information about free tax filing on the Website and in pre-filing press information. Taxpayers can find this information on our home page or by searching for CalFile.

William Lowell

Mr. Lowell provided oral comment to the Board on the following matters:

The state loses $6.5 billion per year because of insufficient audit staff. Mr. Lowell stated his concern about the offshore outsourcing and what effect it has on California's revenues – losing living wage jobs for people.

Ms. Newcomb addressed Mr. Lowell's concerns in a letter dated January 10, 2007.

The Franchise Tax Board and the Internal Revenue Service are looking into offshore outsourcing and auditing the movement of funds offshore at both the individual and corporate levels. On the corporate front, we have formed a team to look into the identification and audit of flagrant abuses of the existing law in this area.

Reducing the tax gap is a departmental effort. Hiring more auditors is a step towards reducing the tax gap. But a comprehensive approach is required. In this endeavor, the Franchise Tax Board developed a plan to comprehensively address the tax gap.

Mr. Lowell also indicated his concern on minimum wages versus living wages, corporations back-dating CEO benefits, dollar amounts provided to inmates upon release from prison as well as rehabilitation of inmates, and the southern border problem of California.

We issued FTB Notice 2007-1 (February 23, 2007) that established a California program parallel to the IRS effort under IRC Section 409A, for certain back-dated stock options.

Mr. Lowell's remaining issues were not under the jurisdiction of the Franchise Tax Board. In Ms. Newcomb's letter, she refers Mr. Lowell to the appropriate agencies for his concerns.

David Doerr

Mr. Doerr, representing the California Taxpayer's Association, expressed his desire to have Franchise Tax Board meeting times set at the end of each year for the upcoming year. This would give the public more time to plan accordingly.

Ms. Newcomb responded to David R. Doerr on January 10, 2007. She stated that FTB is very sensitive to the Bill of Right's Hearing dates.

Tentative dates for all Board meetings for calendar year 2007, including the meeting at which the Taxpayers' Bill of Rights Hearing normally occurs, were posted on our Website shortly after the year began.

Gina Rodriquez

Ms. Rodriquez, representing Spidell Publishing, presented written materials and provided oral comment to the Board on the following issues:

The 50% penalty – she addressed last year. This penalty does not meet the government's objectives of penalty imposition.

The amnesty bill is located in Assembly Bill 561, which is currently being held in the Senate Revenue and Taxation Committee.

Need for conformity with respect to a custodial parent and whether or not they can claim the dependency exemption.

Assembly Bill 1561, the conformity bill, is on the suspense file of the Senate Appropriations Committee.

Registered domestic partners – Senate Bill 1827. Ms. Rodriquez recommended that the AGI limitation rule established in that legislation be amended and thanked staff for holding an interested parties meeting on this topic.

We held interested parties meetings on November 30, 2006, and January 30, 2007. Technical clean up of the registered domestic partner issue is addressed in Senate Bill 105, which is enrolled and may be approved by the Governor by the time this report is distributed.

In a follow-up issue, Ms. Rodriquez suggested providing the Advocate with the authority to administer some type of equity relief to taxpayers in certain situations.

Ms. Newcomb informed Ms. Rodriquez in a letter dated March 2, 2007, that we are looking into this issue and will provide her with information.

Richard Harris

Mr. Harris addressed the issue of the Spanish language aspects of the FTB Website. He applauded the Website and indicated he noticed a tremendous improvement from last year.

FTB has made significant progress in addressing the needs of our non-English speaking taxpayers. For instance, we:

- *Established a departmental task force to translate various publications to foreign languages.*
- *Provided Spanish language IVR telephone lines.*
- *Participated in small business seminars in Spanish and other languages.*
- *Developed a pool of qualified bilingual employees who are available to assist non-English speaking taxpayers.*
- *Continued to expand the Spanish version of the FTB Website.*

FTB indicates the litigation rosters are now archived and accessible on the Website. Mr. Harris stated after a quick attempt he was unsuccessful in locating the rosters.

The litigation roster is available online, search using the word litigation.

Mr. Harris indicated that staff responses to suggestions and comments made during a Taxpayer Bill of Rights hearing are not timely. Mr. Harris suggested that responses he received were non-responsive.

In her letter dated January 10, 2007, Debbie Newcomb indicated that we would update presenters on their issues as soon as resolutions are made available.

Mr. Harris reiterated a previous request to have manuals and reports available online.

In 2006, the department adopted a policy that all manuals that can be obtained through a Public Records Act request should be placed on the FTB Website. Many of these manuals have already been posted. The department is currently identifying all remaining manuals that should be reviewed for placement on the Website. This review is ongoing and subject to available department resources. The department will post individual manuals to the Website upon completion of the review process.

Mr. Harris requested that briefs filed by or on behalf of Franchise Tax Board be made available on our Website.

Copies of briefs filed by or on behalf of the Franchise Tax Board are available from the court where the brief was filed or from the State Board of Equalization. The Board of Equalization redacts certain information in copies provided to the public. Our current practice with respect to the publication of briefs on the Internet is identical with the practice of the Internal Revenue Service.

In addition, we think there are sound reasons to adhere to the practices of the Internal Revenue Service and not publish briefs filed by or on behalf of the Franchise Tax Board on our Website. As a technical and policy matter, disclosure in the form of publication on the Internet of a brief filed in a court of law by the Office of the Attorney General on behalf of the Franchise Tax Board is a matter within the purview of the court where the brief was filed. Similarly, the publication on the Internet of a brief filed by the Franchise Tax Board with the State Board of Equalization is a matter within the purview of the State Board of Equalization.

While we appreciate Mr. Harris's interest in enhancing transparency, we could not recommend favorable action with respect to his request.

Mr. Harris reiterated and elaborated on his previous request to allow a taxpayer to treat a protest as "deemed denied."

In Ms. Newcomb's letter dated November 22, 2006, she provided a copy of the Executive Summary for Franchise Tax Board's Re-Engineering The Docketed Protest Process. FTB Notice 2006-5 and FTB Notice 2006-6 provide additional information about these new procedures. We chose an administrative approach to improve the timeliness of concluding docketed protests. This administrative approach is currently in effect, for protests filed after July 1, 2006. We believe this administrative approach will go a long way to accomplish the goal of timely, efficient, and responsible resolution of tax disputes.

At this time, we will not pursue the deemed denial remedy Mr. Harris suggested.

Mr. Harris expressed support for Mr. Doerr's recommendation to provide the public with more notice of upcoming FTB meetings.

Your comments about scheduling the Taxpayers' Bill of Rights Hearing and providing notice in advance are well taken. As mentioned in the response to Mr. Doerr, the tentative dates for all Board meetings for calendar year 2007, including the meeting at which the Taxpayers' Bill of Rights Hearing normally occurs, were posted on our Website shortly after the year began.

Vicki Mulak

Ms. Mulak, representing the California Society of Enrolled Agents, submitted written materials and commented regarding nonconformity to federal law and the problems that result for taxpayers:

- California taxpayers believing that Congress has given them certain benefits only to find out it's only true at the federal level.
- California tax return schedule of differences that keep increasing with the passage of federal tax bills.
- California and federal basis differences that result when contribution levels and deduction levels do not match.
- Complex tax return preparation; formal definition of child and the differences in divorce decrees and who claims children.

FTB staff is the foundation of the conformity bill process each year. This year FTB convened a meeting of interested parties, with the active support and participation of legislative staff.

FTB staff provides extensive technical support each year to the Assembly committee staff on all provisions of California income tax law out of conformity with federal income tax law. The technical support provided includes a master list of nonconforming statutes, a technical explanation of each non-conforming provision, a revenue estimate for each nonconforming provision of the impact to conform, a summary of the impact to taxpayers and the department of not conforming, and any other pertinent information.

After the Assembly Revenue and Taxation Committee staff completes the process of gathering information and input, the committee chair determines whether to proceed with a conformity bill and what provisions shall be included in the bill.

As mentioned in an earlier response, Assembly Bill 1561, the conformity bill is on suspense in the Senate Appropriations Committee.

Lenny Goldberg

Mr. Goldberg, representing the California Tax Reform Association, congratulated the Board members for supporting the continuation of ReadyReturn, but asked that the CalFile system be strengthened. He also welcomed enhanced access of taxpayers' information, consistent with serious security issues.

In September 2006, the Board directed the Franchise Tax Board to study the feasibility of allowing taxpayers to import certain tax data into software products, including CalFile.

We conducted a survey with taxpayers and practitioners to determine the interest level in pre-populating commercial software products and CalFile. Taxpayers and practitioners showed interest in the "pre-filled" feature. They indicated the most interest in the areas of income (wages, withholding, 1099, unemployment) and estimate payment information. Taxpayers that used CalFile were interested in "pre-filling" their CalFile return with any information that FTB has available. The items of most interest were name, address, dependent information, wage and withholding amounts, and prior year refund amount.

Having these features in software products and CalFile would require a self-managed authentication process to protect the security of taxpayer information.

With respect to the tax gap, in terms of corporate tax sheltering, Mr. Goldberg asked staff to take a serious and more systematic look at the extent to which the M-3 forms are filed and to report on the value of that information.

Effective for tax years ending on or after December 31, 2004, the IRS required large and medium size corporations who have assets of $10 million or more to file a schedule M-3. The primary purpose of this form is to provide a complete reconciliation from financial accounting net income to taxable income.

For tax years ending on or after December 31, 2006, the filing requirement for this form was expanded to include limited liability companies, S-corporations, and partnerships. The objective of this form is to provide more transparent reporting of "book income to tax income." By so doing it will enable the Internal Revenue Service to identify potential non-compliance issues, especially in the area of potential abusive tax shelters.

In 2006, the California legislature considered legislation that would require similar M-3 reporting for state purposes, however this legislation was not adopted. As this form is new, the Internal Revenue Service has not had an opportunity to extensively measure its success in meeting the stated objectives. We intend to work closely with the IRS to determine the effectiveness of this form. This along with feedback from the taxpayer and tax professional community will assist in determining the course of action we will recommend for the future with regard to this issue.

Mr. Goldberg expressed support for legislation that would reduce the filing burden for reporting wages of domestic workers.

While the Franchise Tax Board and the Employment Development Department are generally amendable to changes that ease the burden of the taxpayer, we have not been able to find a resolution for this issue that does not create problems with preserving the rights of "domestic" employees.

Specifically, one of those rights is the timely payment of entitled benefits under the Unemployment Insurance and Disability Insurance Program. The Employment Development Department requires wage data on a quarterly basis in order to determine timely eligibility and benefit amounts. The federal government does not require this information quarterly because the administration of the Unemployment Insurance Program is delegated to the states. For state purposes, if employers reported and paid "domestic" employee taxes on the employer's individual personal income tax return, the Employment Development Department would not have the ability to provide timely benefits.

Mr. Goldberg suggested it would be extremely helpful to provide quicker information, or the legislative analysis regarding complex tax bills on the FTB Website.

As Brian Putler indicated at the Hearing, our Legislative Services staff analyze legislative bills and post the resulting analysis as expeditiously as possible.

William E. Taggart, Jr.

Mr. Taggart, representing the law offices of Taggart & Hawkins submitted a written comment for record at the hearing.

Ms. Newcomb responded in writing and her response can be found on our Website at www.ftb.ca.gov search for "hearing responses."

IMPROVE COMPLIANCE

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 -
AB 361 (Ma, Ch. 105, Stats. 2007)
This act requires an administrator or executor of a deceased's estate to provide notice of the administration of the estate to Franchise Tax Board no later than 90 days after the date letters are first issued to a general personal representative. The notice must be provided by any estate opened on or after July 1, 2008.

AB 1747 (Assembly Revenue & Taxation Committee, Ch. 341, Stats. 2007)
This act makes three changes to the Revenue and Taxation Code:

- Revise check casher reporting requirements to exclude government, payroll, and one-party checks, as defined.
- Define the term "last known address" for legal notices.
- Change the date that the annual Taxpayers' Bill of Rights Report is due to the Legislature from October 1 of each year to December 1 of each year.

SB 788 (Cogdill, Ch. 306, Stats. 2007)
This act allows Franchise Tax Board to apply discretion for deciding when to examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of all factors, including the relative levels of noncompliance and materiality.

SB 1043 (Senate Revenue & Taxation Committee, Ch. 309, Stats. 2007)
This act excludes evidence of settlement negotiations with Franchise Tax Board in administrative civil tax dispute forums in California.

SB 1044 (Senate Revenue & Taxation Committee, Ch. 156, Stats. 2007)
This act removes any ambiguity regarding the authority of Franchise Tax Board to disallow deductions for unreported payments made for personal services by eliminating obsolete cross references.

Regulations

The laws administered by the Franchise Tax Board broadly authorize the promulgation of rules and regulations necessary for their enforcement. Occasionally specific statutory provisions require the FTB to promulgate regulations. See Appendix 3 for a list of regulations.

Training

To improve our service to the public and encourage voluntary compliance, we develop employees' skills and abilities. We provide extensive training to our public service staff on customer service and telephone techniques. Our contact center represents the front line process. When properly staffed with employees trained to provide general information, tax law explanations, and forms, we can minimize the cost associated with collection and audit functions that result when returns are improperly filed.

We provide technical training to our employees on the following systems:

- Taxpayer Information System
- Business Entity Tax System
- Accounts Receivable Collection System
- Integrated Nonfiler Compliance System

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 the following basic training:

- Tax Law
- Taxpayers' Bill of Rights
- Account Analysis and Resolution
- Security and Disclosure

To ensure all compliance representatives and tax technicians in the Collection Program have the required skills and abilities to administer tax laws, we train our employees on core compliance courses which include:

- Penalties and Interest
- Filing Requirements
- Installment Agreements
- Tax Assessments
- Power of Attorney

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 by enrolling in classes, including computer based courses and college courses, to refresh or further their existing skills or knowledge.

Our auditors receive a six-week basic professional training series to establish an auditor's baseline expertise in the audit process.

New auditors receive ongoing support to develop their skills throughout their careers with an emphasis on technical law training. Mentors or leads are established for our new auditors so they can provide guidance, direction, and on-the-job training and support. 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.

Enforcement

Although we encourage voluntary compliance through taxpayer education by providing pre-filing assistance and information, we continue to identify ways to improve our enforcement capabilities.

Filing Enforcement Program

Our Filing Enforcement Program identifies and contacts individuals and business entities that have a requirement to file a California tax return yet have not filed.

We contact wage earners, self-employed individuals, individuals with unreported capital gains, nonresidents with California source income, and individuals who have partnership income. We will use several new income sources in the filing enforcement process. The new income sources are:

- Alcoholic Beverage Control identifies individuals who have requested a permit to sell alcohol in California.
- Board of Equalization motor fuel information identifies individuals who have requested a license to transport motor fuel on California highways.
- Check cashing businesses information identifies individuals with economic activity.
- City business tax information identifies individuals who hold a business license.
- Department of Social Services community care licensing information identifies potential nonfilers involved in providing care at a licensed facility.

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.

We continuously strive to improve our filing enforcement program, and the services that are available to both the taxpayer, and the tax preparer communities. Listening to the feedback we received from preparers and taxpayers, we implemented a Website with around-the-clock access.

- Taxpayers can request additional time to file a tax return. This service may assist those who are experiencing a life crisis, or who need more time to obtain records to file a return.
- Taxpayers can request payment arrangements.
- Taxpayers can respond to the *Request* or *Demand for Tax Return Letter*.

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:

<u>Resolving protective claims filed during tax amnesty</u>
Taxpayers paid $3.6 billion in protective claims in 2005 because of tax amnesty. As of July 30, 2007, Franchise Tax Board has finalized $1.207 billion in protective claims. Of that figure, $871 million was retained and the taxpayer overpaid $336 million. For the overpaid amount, $214 million of this amount has been refunded and taxpayers have requested $122 million be kept on account as a cash deposit for future use.

For the amounts listed in the above paragraph, during the past year, we completed audits on over $530 million in protective claims. Of that amount, we resolved $481 million in protective claims with no further protest or appeal rights and we retained $253 million. Of the remaining $228 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, 2007, include cases in the following categories:

Open audits	$ 252 million
Pending federal	$ 381 million
Protest	$1,169 million
Appeal	$ 78 million
Settlement	$ 357 million
Closed - Nonfinal	$ 156 million

Addressing tax gap initiatives that promulgate underreporting of tax

As mentioned earlier in the report, the tax gap is the difference between the amount of taxes legally owed and voluntarily paid. We continue to use our audit resources 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 dedicate 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, our tax preparer audit program penalizes tax preparers who claimed deductions or credits erroneously. To complement these efforts, we take strides in educating the citizens of California in common areas where noncompliance is prevalent.

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 focus and dedicate audit resources to identify and evaluate investor leads, promoters, and to assess disclosure and information return penalties.

- 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.
- Disclosure and Information Return Penalties – We are identifying investors and promoters who are required but who have failed to file disclosure statements or information returns. FTB Notice 2007-3 gives investors a 60-day grace period to file complete disclosure statements if they have failed to do so before issuance of this notice. Investors who do not comply will be assessed penalties.

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.

Collections

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

We maintain a Collection call center staffed by collections experts, including several who are bilingual. We also maintain an advocate support section to assist taxpayers, tax representatives, and practitioners with fast and direct access to collection experts. We provide online access to collection information, procedures, and electronic forms on our Website.

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 1.8 million individual and 450,000 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 investigative specialists 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 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.

Payment methods
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.
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. In addition, outreach events in 2000 and legislation in 2003 and 2004 increased opportunities for relief.

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.

EVALUATING FRANCHISE TAX BOARD EMPLOYEES

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.

APPENDICES

Appendix 1

All tables in Appendix 1 reflect tax increase assessments only. The assessments became final in 2006. We may have issued the assessments in prior years, however, due to cases in protest status, we did not resolve them until 2006. Appendix 1 totals reflect rounded figures and may not compute exactly.

Table 1A
CORPORATION TAX LAW
NPAs Finalized in 2006 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment Per NPA
Allocation/Apportionment	648	28.3	$ 426.8	75.3	$ 658,658
Assess Minimum Tax	613	26.7	0.5	0.0	818
Revenue Agent Reports	505	22.0	97.8	17.3	193,672
State Adjustments	293	12.8	20.3	3.6	69,186
Other	233	10.2	21.3	3.8	91,588
Totals/Average	2,292	100	$ 566.7	100	$ 247,263

- *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 2006 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Thousands)	%	Average Assessment Per NPA
CP2000	130,776	20.8	$ 77,432	4.9	$ 592
Filing Enforcement	416,595	66.4	1,282,184	81.8	3,078
Filing Status	25,501	4.1	23,654	1.5	928
Revenue Agent Reports	19,300	3.1	36,492	2.3	1,891
Other	35,663	5.6	147,179	9.5	4,127
Totals/Average	627,835	100	$ 1,566,941	100	$ 2,496

- 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.

Table 2
CORPORATION TAX LAW
Corporations by Industry with NPAs Finalized in 2006

Industry	All Corporations 2005 Tax Year	%	Corporations with NPAs	%	Tax Assessed (Millions)	%
F.I.R.E.*	112,959	17.4	134	10.3	$ 79.1	13.9
Manufacturing	48,333	7.4	167	12.9	119.3	21.1
Services	258,645	39.7	126	9.7	37.3	6.6
Trade	72,508	11.1	126	9.7	42.9	7.6
Other **	158,613	24.4	743	57.3	288.1	50.8
Totals	651,058	100	1,296	100	$ 566.7	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 corporations filing via 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.

Tables 3A, 3B, and 4, apply 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.

Table 3A
CORPORATION TAX LAW
NPAs Finalized in 2006 Issued by Taxable Year

Average Taxable Year	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment per NPA
1999 and prior	643	28.1	$ 339.2	59.9	$ 527,498
2000	221	9.6	109.8	19.4	496,705
2001	312	13.6	75.2	13.3	241,062
2002	407	17.8	28.0	4.9	68,903
2003	367	16.0	11.5	2.0	31,450
2004	273	11.9	2.7	0.5	9,852
2005	69	3.0	0.3	0.0	4,170
Totals/Average	2,292	100	$ 566.7	100	$ 247,263

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 2006 for the Same Taxpayer

Corporations With…	Number of Taxpayers	Tax Assessed (Millions)	Average Assessment per Taxpayer
One NPA	725	$ 61.4	$ 84,672
Two NPAs	338	81.7	241,651
Three NPAs	143	87.3	610,728
Four or more NPAs	90	336.3	3,736,983
Totals/Average	1,296	$ 566.7	$ 437,290

Table 4
PERSONAL INCOME TAX LAW
NPAs Finalized in 2006 Issued by Taxable Year

Taxable Year	Number of NPAs	%	Assessment Amount (Thousands)	%	Average Assessment Amount
2000 & prior	3,743	0.6	$ 80,323	5.1	$ 21,460
2001	12,212	1.9	52,827	3.4	4,326
2002	34,740	5.5	85,046	5.4	2,448
2003	178,153	28.4	167,445	10.7	940
2004	395,394	63.0	1,176,982	75.1	2,977
2005 & later	3,593	0.6	4,318	0.3	1,202
Totals/Average	627,835	100	$ 1,566,941	100	$ 2,496

Table 5
PERSONAL INCOME TAX LAW
Resident Tax Return Preparation, 2005 & 2006 Process Years

Preparer	2005 Returns Processed (Thousands)	%	2006 Returns Processed (Thousands)	%	% Change
Professional	9,466	68.4	9,844	69.9	1.5
Taxpayer	4,202	30.4	4,078	28.9	-1.5
VITA*	165	1.2	165	1.2	0.0
Totals	13,833	100	14,087	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, 2006	July 31, 2007	% Change
Credit Card Payments (Average payment is $1,008)	92,000	104,000	13
**Direct Debit of Balance Due (Electronic Funds Withdrawal)	254,000	283,000	11
**Direct Deposit of Refund	3,869,000	4,244,000	10
e-file	8,878,000	9,551,000	8
* CalFile	112,000	141,000	26
* Online Filing	1,467,000	1,716,000	17
* Business Entity	5,500	24,000	336

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

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	13,271	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	$ 3,140
2006/2007	546,614	181,027	$ 2,848

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

Appendix 2

TABLE 8A
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2007 PROCESS YEAR SUMMARY
Number of Adjustment Paragraphs Issued by Return Type

Adjustment Type	540 2EZ	540A	540	540NR	540X	N/A *	Total	% of Total
AGI	2,459	176	302	1,303	42	0	4,282	0.76%
Amended	1,097	434	6,862	636	14,665	23	23,717	4.22%
CDC	0	1,693	9,323	665	376	0	12,057	2.14%
Deductions	86	7,454	7,246	1,190	116	29	16,121	2.87%
Estimate Payment	2,266	4,773	175,052	14,408	58	1	196,558	34.94%
Exemptions	271	18,478	16,053	7,501	131	16	42,450	7.55%
Filing Status	42	52	104	55	1	0	254	0.05%
Mental Health Tax	0	937	479	182	18	0	1,616	0.29%
Miscellaneous	7,083	7,372	32,918	4,087	1,866	9	53,335	9.48%
Nonresident	0	1	2	17,678	73	2	17,756	3.16%
Renter's Credit	3,989	6,341	5,053	663	8	2	16,056	2.85%
SDI	1	1,164	14,522	781	132	0	16,600	2.95%
Special Credits	1	0	411	78	0	0	490	0.09%
Tax Computation	713	11,235	14,510	3,251	1,093	15	30,817	5.48%
Total Tax	54,135	16,634	11,797	867	363	12	83,808	14.90%
Use Tax	3	2	22	1	46	0	74	0.01%
Withholding	2,782	1,818	32,525	8,883	609	9	46,626	8.29%
Total	74,928	78,564	327,181	62,229	19,597	118	562,617	100%
% of Total	13.32%	13.96%	58.15%	11.06%	3.48%	0.02%		

* Return type is undetermined

TABLE 8B
INDIVIDUAL RETURN VALIDATION ADJUSTMENTS: 2007 PROCESS YEAR
SUMMARY
Number of Adjustment Paragraphs Issued by Filing Method

Adjustment Type	e-File	Internet	Paper	Total	% of Total
AGI	224	1	4,057	4,282	0.76%
Amended	503	34	23,180	23,717	4.22%
CDC	3,543	35	8,479	12,057	2.14%
Deductions	1,759	23	14,339	16,121	2.87%
Estimate Payment	99,885	513	96,160	196,558	34.94%
Exemptions	562	2	41,886	42,450	7.55%
Filing Status	2	0	252	254	0.05%
Mental Health Tax	84	0	1,532	1,616	0.29%
Nonresident	724	0	17,032	17,756	3.16%
Renter's Credit	664	2	15,390	16,056	2.85%
SDI	7,951	41	8,608	16,600	2.95%
Special Credits	73	0	417	490	0.09%
Tax Computation	359	3	30,455	30,817	5.48%
Total Tax	1,295	7	82,506	83,808	14.90%
Use Tax	1	0	73	74	0.01%
Withholding	17,513	108	29,005	46,626	8.29%
Miscellaneous	13,467	12	39,856	53,335	9.48%
Total % Of Total	148,609 26.41%	781 0.14%	413,227 73.45%	562,617	100%

Definitions:

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.

Amended – Taxpayers filed an amended return using amounts that did not match their original return. For example taxpayers might have reported a different amount of California withholding or refund received.

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 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.

Appendix 3

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 for 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 were submitted to the State and Consumer Services Agency for review and approval on March 28, 2006. A formal regulatory hearing, as required under the Administrative Procedure Act, was held on July 17, 2006. Four comments containing suggested revisions were received. Staff considered these suggestions and revised the proposed regulations where appropriate. Staff then published a fifteen-day notice incorporating the proposed revisions on January 26, 2007, and submitted the final version to the Office of Administrative Law on May 18, 2007, for approval and adoption.

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 expects to submit the proposed regulations to the State and Consumer Services Agency for review and approval in September of 2007 and to hold a public hearing, as required under the Administrative Procedure Act, toward the end of 2007.

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 revised its original discussion draft proposal to include examples in the regulation and to incorporate other changes.

The proposed amendments were submitted to the State and Consumer Services Agency for review and approval on September 29, 2006. A formal regulatory hearing, as required under the Administrative Procedure Act, was held on December 1, 2006. Three comments were received in support of the proposed amendments. The proposed regulations were submitted to the Office of Administrative Law on December 8, 2006, for review and filed with the Secretary of State on January 23, 2007.

Regulation Section 25137(c)(1)(D) – Special Rules/Sales Factor/Treasury Function

The new proposed regulation is intended to specify the proper sales factor treatment for gross receipts generated by a taxpayer's treasury function. A treasury function involves the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle. The proper amount to include in the sales factor from this activity has been the subject of numerous litigation cases involving taxpayers and the Franchise Tax Board. While these cases have consistently concluded that the inclusion of gross receipts from a treasury function results in a distortion of the sales factor, and may be remedied under the authority of section 25137 of the Revenue and Taxation Code, they have been decided based on the facts and circumstances of each case. This has led to uncertainty for taxpayers and the Franchise Tax Board, as each taxpayer must determine whether their facts are similar enough to the case law to apply the court's holding in the relevant cases to its particular circumstances. Taxpayers have requested a more uniform approach to this issue, which will provide certainty regarding the proper sales factor treatment for this activity, and this proposed regulation will provide such an uniform rule.

The staff of the Franchise Tax Board held several interested parties meetings to discuss two recent decisions by the California Supreme Court, Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750, and General Motors Corporation v. Franchise Tax Board (2006) 39 Cal 4th 773. Comments at those meetings supported the adoption of a regulation. The analysis by the California Supreme Court in Microsoft was based under the statute that authorizes this regulation, and statements made by the court in its decision support the use of a standardized approach. The staff of the Franchise Tax Board, in addition, relies upon (1) the two recent California Supreme Court cases cited above; (2) other pending cases in litigation, including two others which resulted in appellate decisions which were vacated by the California Supreme Court; (3) cases before the Board of Equalization, both decided and pending; (4) other cases pending in the administrative process that have raised this issue; (5) existing model regulations promulgated by the Multistate Tax Commission; and (6) actions taken by other states to address this issue.

Staff received approval to commence a formal regulatory project for the proposed regulation on April 4, 2007, from the three-member Franchise Tax Board. The proposed regulation was submitted to the State and Consumer Services Agency for review and approval on September 29, 2006. A formal regulatory hearing, as required under the Administrative Procedure Act, was held on August 17, 2007. Three comments were received with proposed changes. Staff is currently in the processing of receiving additional comments and addressing the comments already submitted.

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 three-member Franchise Tax 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. A public hearing, as required under the Administrative Procedure Act, was held on December 18, 2006. Sixteen comments were received regarding suggested changes to the proposed regulation. Staff considered these suggestions and revised the proposed regulations where appropriate. Staff published a fifteen-day notice incorporating the proposed revisions on February 21, 2007. The rulemaking file was submitted to the Office of Administrative Law for approval on May 2, 2007, and filed with the Secretary of State on June 20, 2007.