'08

# Taxpayers' Bill of Rights

# Annual Report to the Legislature

State of California
Franchise Tax Board

December 1, 2008

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## Executive Summary

In January 2008, Steve Sims was appointed as the new Taxpayers' Rights Advocate. He has worked for the Franchise Tax Board (FTB) for over 25 years, has a B.S. in Accounting, and is an Enrolled Agent with the Internal Revenue Service. I worked with Steve to redefine the role of the Advocate to be more independent and to take a more proactive approach in addressing taxpayers' issues. It is our goal that the Taxpayers' Rights Advocate be more visible throughout the tax practitioner community, large and small business community, and work to facilitate a more successful relationship with FTB.

The following report was prepared by the Taxpayers' Rights Advocate's Office in response to the Taxpayers' Bill of Rights (Stats. 1988, Ch. 1573), Sections 21006 and 21009 of the California Revenue and Taxation Code.

In this report you will find a new section, the Advocate's Address, which provides a brief discussion of significant issues, concerns, and challenges to both taxpayers and the department. In another section of the report, the Taxpayers' Rights Advocate identifies areas where FTB can make improvements to ease the burden on taxpayers and increase self-compliance.

The report includes the Taxpayers' Rights Advocate's responsibilities and contacts. From July 1, 2007, through June 30, 2008, the Taxpayers' Rights Advocate's Office responded to 20,264 contacts from taxpayers. In addition to assisting taxpayers, the Taxpayers' Rights Advocate also:

- Explains taxpayers' rights.
- Provides education services to taxpayers and tax practitioners.
- Conducts the Annual Taxpayers' Bill of Rights hearing.

To satisfy the Taxpayers' Bill of Rights requirements, we conducted a study using a sample of both corporation and personal income tax (PIT) *Notices of Proposed Assessments*. These proposed assessments are the result of FTB audits. Following are our primary findings:

- 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 a taxpayer error rate of approximately 4.4 percent during return processing. We examined this data to identify and address some of the most common taxpayer errors.

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

Selvi Stanislaus

**Selvi Stanislaus**
*Executive Officer*

## Advocate's Address

***Members of the California Legislature:***

I submit for your review the 2008 Taxpayers' Bill of Rights Annual Report to the Legislature. This year you will find a more independent Taxpayers' Rights Advocate perspective on the challenges taxpayers are facing. My responsibility as outlined in the Taxpayers' Bill of Rights legislation remains the same; however, the Advocate's role has been redefined by the Franchise Tax Board (FTB). As the Taxpayers' Rights Advocate, I am taking a more proactive approach in addressing taxpayers' issues, concerns, and challenges.

In this year's Annual Report, I am identifying areas where FTB can improve its operations and the services it provides to taxpayers, including systemic issues that are impacting the department.

As the new Taxpayers' Rights Advocate since January of 2008, I have been more pro-active, visible, and accessible to taxpayers. I maintain constant interaction with the tax practitioner community and with taxpayers. I have been involved in working with the tax practitioner community for over 15 years. In the last three years, I have personally made an average of 80 presentations per year to a variety of tax practitioner, community, and government groups throughout California. Meeting with these groups has allowed me to hear first hand what issues, concerns, and challenges taxpayers are facing and the impact that tax legislation has had on them. More importantly, I hear about the effects FTB's policies, processes, and procedures have on taxpayers.

My goal is to ensure that taxpayers' rights are protected. One of my responsibilities is to improve the communication and services that FTB provides. My staff is now working on the development of a web application where taxpayers and tax practitioners can provide comments on our processes, procedures, laws, and legislation that create a burden for taxpayers. This will allow me to track and identify systemic problems and recommend solutions.

This year, I have reached out to the National Taxpayer Advocate and other states' Tax Advocates. My goal is to build a communication network for the Advocates. This network will enable us to share information and address systemic issues that face tax agencies nationwide.

***Conformity***

In this year's report, I would like to address the issue of conformity to federal tax laws or, more precisely, the state's lack of conformity to the current federal Internal Revenue Code (IRC). Conformity has become one of the biggest areas of concern for California taxpayers.

The notion that taxes should be simpler is one of the very few concepts in tax policy that generates universal agreement. Simpler tax law is seen as having numerous benefits such as reducing taxpayers' costs of complying with the tax system in terms of time, money, and mental anguish. The basic problem with tax simplification is that, although everyone thinks taxes should be simpler, almost every year the adjustments needed to arrive at taxable income pursuant to California law becomes more complex, due to the growing disparity between the taxpayer's federal adjusted gross income and California adjusted gross income.

In the early 1980s, there was a drive for tax simplification. As a result, both the federal and state legislatures passed sweeping legislation that made significant changes in the way taxes are reported[1]. Our state legislature changed our Revenue and Taxation Code (R&TC) from one of a stand-alone system of legislation to one of conformity[2]. That is, we adopted a system where the California codes are no longer read alone, but instead begin with the federal IRC through adoption of various sections or chapters as of a specific date and then, if necessary, makes specified modifications. In 1987[3], California's federal conformity bill, which brought California's 1987 PIT law into conformity with most of the provisions of the federal Tax Reform Act of 1986,[4] repealed and replaced most of the R&TC sections with provisions that adopted federal law by specific reference to portions of the IRC, so that the R&TC now incorporates IRC sections by specific reference, making specified modifications, if necessary. These changes were enacted based on the belief that there would be annual conformity to any federal revisions. Along with this new system, R&TC Sections 19581 and 19582 (formerly 19310 and 19311) were added to our code directing us to revise our forms from a system that was a stand-alone method of determining taxable income to one that begins with the taxpayer's federal adjusted gross income where in theory only minor adjustments would be needed to arrive at taxable income pursuant to California law[5].

Determining the correct amount of a taxpayer's California income tax liability is becoming increasingly more complex because of the lack of conformity. California has not conformed to many of the federal law changes enacted after January 1, 2005 (see R&TC 17024.5 and 23051.5). Between January 1, 2005, and December 29, 2007, Congress enacted thirty public laws that amended the federal IRC. Conformity reduces the administrative burden for both taxpayers and the state.

Conformity to certain federal tax provisions can reduce complexity by allowing taxpayers to use the same calculations for both their federal and their state tax returns. It also reduces administrative costs by enabling California to rely on information exchanges with the Internal Revenue Service (IRS) to verify substantial portions of Californians' tax returns without developing more expensive independent audit capacity.

Complex rules or documentation procedures are a common source of tax complexity, and require more record keeping by the taxpayer and the government.

[1] The Tax Reform Act of 1986, for example, substantially simplified individual income taxes.

[2] The IRC provisions are incorporated into Part 10 (commencing with Section 17001) and Part 11 (commencing with Section 23001) of Division 2 of the Revenue and Taxation Code by specific reference to portions of the IRC.

[3] This 1987 legislation made further reforms to the original 1983 federal conformity legislation (AB 36).

[4] However, prior to 1987, California law, for the most part, was patterned after the federal IRC.

[5] The Legislature (in R&TC Section 19581) declared the California Personal Income Tax Fairness Simplification and Conformity Act of 1987 was enacted to greatly reduce the burden of preparing tax returns for most taxpayers by allowing the taxpayer to copy numbers from the federal return and make simple adjustments.

I believe the effect of not conforming California law to the subsequent federal changes has an effect beyond revenue increases or decreases[6]. The lack of conformity has:

- A direct effect on the taxpayer's ability to self-assess.
- Increased the unintentional taxpayer errors.
- Increased the burden of preparing tax returns for most taxpayers.
- Increased the cost for taxpayers to prepare their returns.
- Increased administrative costs to the state.

I believe if we were to conduct a study, looking back historically, we will see that there is a correlation to taxpayer self-compliance, the costs of administration and enforcement of the income tax laws, and the state's conformity to the federal IRC.

### *Late State/Federal Legislation*

Late legislation, whether at the state or federal level, creates a burden on taxpayers and their ability to be self-compliant. Taxpayers may not have the information they need to understand the changes; they may not have the most current forms; and, industry groups may not have time to update their tax preparation products with any changes resulting from legislation.

There is also a significant impact on FTB to conduct last minute education and outreach efforts to inform taxpayers and the professional tax preparation groups of the changes. In addition, we must update forms, systems, and our website to reflect the changes. When there is late federal legislation, we have the additional requirement to meet the state mandate of reporting to the Legislature within specified time frames. We have to allocate resources to provide training to our staff to implement the new legislative changes and to be able to respond to inquiries from taxpayers and the professional tax preparation groups. There is also a demand to provide timely input to the software developers and providers to update their tax preparation products.

If the last minute changes are not addressed promptly, it may lead to confusion and taxpayer errors. We need to have dedicated staff and resources available to follow and provide analysis on both late state and federal legislation.

### *Education and Outreach*

One of our goals is to provide taxpayers and tax practitioners with information to help them be self-compliant. We provide presentations and materials, including publications and information on our website, on a variety of topics. Last year, we focused a large part of our education and outreach effort on informing taxpayers and tax practitioners of the issues related to registered domestic partners and same sex married couples. Recently, we identified an increase in the demand for information on the tax implications related to foreclosures.



[6] Reliable estimates of the costs of compliance, administration, and enforcement are not available, due in part to inadequate data.

### *Registered Domestic Partner (RDP) / Same Sex Married Couples (SSMCs)*

As a result of recent legislation[7] regarding Registered Domestic Partnerships (RDPs) and the California Supreme Court's[8] recent ruling regarding Same Sex Married Couples (SSMCs), we are working diligently to inform the public of the state tax implications.

We added a discussion topic and created a presentation on RDPs and SSMCs. We conducted 35 presentations, issued news releases and announcements, posted public service bulletins, issued a notice, and created webpages, all of which related to RDPs and SSMCs.

FTB provides subscription services to allow individuals and tax professionals to sign up and receive updates on RDPs and SSMCs along with a variety of other topics.

### *Cancellation of Debt*

As a result of public demand, FTB has begun working to inform the public of the state tax ramifications of foreclosures, short sales, and other activities resulting in debt forgiveness.

We added a discussion topic on foreclosures to our public presentations, participated with the IRS in making joint presentations, and developed publications to be available soon in print and on our website.

The impact of the passage of new income tax legislation on the State of California's taxpayers is becoming increasingly more apparent. The lack of conformity, and the late passage of state and federal legislation, is increasing the complexity of preparing a California income tax return. This increased complexity appears to be generating increased costs of compliance for taxpayers, and increased administrative costs to the state. While I realize the importance of the passage of prudent and well-thought out legislation, it is important that we identify the negative unintended effects that are resulting from this process. As we move forward, it is important that we consider the effect our legislative process has on California taxpayers.

[7] Senate Bill 1827 (Stats. 2006, Ch. 802), effective January 1, 2007. Registered Domestic Partners (RDPs) are required to file their personal income tax returns as either married filing jointly or married filing separate.

[8] The California Supreme Court's ruling, In Re Marriage CASES (2008) 43 Cal.4th 757, allowed same-sex couples to begin marrying on June 16, 2008, at 5:00 p.m.

## Taxpayers’ Rights Advocate Contact Information

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You can order this publication from the Taxpayers’ Rights Advocate’s Office. Call 916.845.5249, write to the address above, or download from our website at **ftb.ca.gov**.

# Taxpayers’ Rights Advocate

## Mission of the Taxpayers’ Rights Advocate Office

The Taxpayers’ Rights Advocate’s Office works with Franchise Tax Board’s program areas to ensure taxpayers’ rights are protected. We identify systemic problems and find solutions in a cooperative effort while protecting taxpayers’ rights and recognizing the goals of our audit, collection, and filing programs. We also coordinate the resolution of taxpayer complaints and problems, including complaints regarding unsatisfactory treatment of taxpayers by employees. We promote integrity and responsibility so 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 FTB obligations. This law codified many existing department procedures and established a Taxpayers’ Rights 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.

Recent legislation (AB 3078 – amending R&TC 21004) now allows the Taxpayers’ Rights Advocate the discretionary authority to grant relief from penalties, fees, or interest imposed on a taxpayer because of erroneous actions or inactions of the department.

## Responsibilities of the Taxpayers’ Rights Advocate

The Taxpayers’ Rights Advocate has a direct reporting relationship to the Executive Officer of the Franchise Tax Board. As enacted by the Legislature in the Revenue and Taxation Code, the Taxpayers’ Rights Advocate:

- Coordinates the resolution of taxpayer complaints and problems including complaints regarding unsatisfactory treatment by FTB employees. Recent legislation allows the Taxpayers’ Rights Advocate the discretionary authority to grant relief from penalties, fees, or interests imposed on a taxpayer because of erroneous actions of the department.
- Develops and implements a taxpayer education and information program.
- Identifies areas of recurrent taxpayer noncompliance.
- Conducts an annual hearing where individual taxpayers and industry representatives may present proposals to clarify the California Revenue and Taxation Code.
- Makes recommendations to improve taxpayer compliance and uniform tax administration.
- Informs taxpayers, in simple, nontechnical language, of procedures, remedies, and rights during audit, appeal, and collection proceedings.
- Evaluates employees’ performance based on taxpayer contact and not on the revenue produced.

The Taxpayers' Rights Advocate's Office coordinates education and outreach efforts throughout California, such as practitioner and Advisory Board meetings. In addition, the Taxpayers' Rights Advocate and FTB staff participate in tax practitioner seminars, industry group workshops, and small business events. We provide filing season updates and information to legislative offices. The Taxpayers' Rights Advocate also conducts independent administrative review, and administers the Interest Abatement and Third Party Fee Programs.

### *Explanation of Taxpayer 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. We also include revision dates on all of our publications and offer many of them in other languages, including Spanish, Chinese, Korean, Russian, and Vietnamese.

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

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

- *California Taxpayers' Bill of Rights (FTB 4058)*
  This brochure gives a basic description of taxpayers' rights during the audit process. It also tells them 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 taxpayers' rights under this California legislation.
- *California Taxpayers' Bill of Rights Act of 1999 (FTB 4064)*
  To further guarantee taxpayers' 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 implement these provisions.

We also review external publications and communications for compliance with the Taxpayers' Bill of Rights legislation.

### *Advisory Board*

The Taxpayers' Rights Advocate's Office coordinates annual Advisory Board meetings with representatives from industry, state and federal government, and our department 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 our e-file options, such as ReadyReturn and CalFile, to discussions about tax gap activities, conformity legislation, and a limited liability company (LLC) update.

### *Annual Meetings with Tax Practitioners*

The Taxpayers' Rights Advocate's Office coordinates liaison meetings with the California Society of Enrolled Agents and the California Society of Certified Public Accountants. At the meetings, we provide legislative, filing, and audit updates. We present and discuss FTB's upcoming projects and issues. We also respond to questions from the tax practitioners.

### *Legislative Information Letter*

In addition to assisting legislative staff with their constituents' tax issues, the Taxpayers' Rights Advocate's Office provides legislative staff with annual filing season updates and information on services available to taxpayers. This year to promote our online services, we did not include the folder of tax forms and publications that formerly accompanied this memorandum. We provided information on the wide variety of online services available at our website, including filing a tax return, making payments, or finding an answer to a state tax question.

We continue to provide more state tax information in Spanish, Chinese, Korean, Russian, and Vietnamese on our website.

### *Interest Abatement*

FTB may cancel interest taxpayers owe if the taxpayer can show that an unnecessary delay in our processing caused the interest to accrue or delayed their payment. We may also cancel interest if the taxpayer 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*

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 us. 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.

## Taxpayers' Rights Advocate Contacts

Taxpayers contact the Taxpayers' Rights Advocate's Office when they are unable to resolve their issues through regular channels. We assist taxpayers by reviewing their unresolved tax problems, and ensuring their issues 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, Franchise Tax 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 20,264 contacts from July 1, 2007, through June 30, 2008. The majority of taxpayers contacted us by telephone, 14,566 contacts. We provide a public number for taxpayers to contact our Advocate Hotline at 800.883.5910.

We received 2,308 contacts by email during this reporting period. We expect to see the number of emails continue to increase, as taxpayers become more acquainted with our website. Taxpayers also chose to email the Taxpayers' Rights Advocate's Office when they could not contact the department by phone or when the phone wait time was too lengthy.

The top five reasons taxpayers contacted the Taxpayers' Rights Advocate's Office from July 1, 2007, through June 30, 2008 include:

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

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

### Filing Enforcement

We explained assessments and provided information to assist taxpayers in completing their returns. In some cases, we canceled assessments or addressed hardship issues.

### Balance Due

We mailed tax computations, sent Offer in Compromise packages, reevaluated assessments, and encouraged taxpayers to send payments.

### Refund

We assisted taxpayers by checking the status of their refunds or reissuing refunds.

### Earnings Withholding Order for Taxes

We modified or released these orders based on additional information.

### Lien

We assisted taxpayers who had liens showing on their credit reports.

## Identify Areas of Noncompliance

### Sample Data from the Audit Process

We compiled and analyzed data from the audit process to identify areas of recurrent taxpayer noncompliance. The data, some of which is derived from statistical samples, includes:

- The statute or regulation violated by the taxpayer.
- The amount of tax involved.
- The industry or business engaged in by the taxpayer. (Sample data)
- The number of years covered in the audit period.
- Whether the taxpayer used professional tax preparation assistance. (Sample data)
- 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 the 2007/2008 fiscal year. When sample data was used, 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 included multiple issues, we categorized the notice under the issue that provided the majority of the tax change. We categorized the assessment as "Other" where there is no distinct primary issue.

For corporation taxes, the largest 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 nonbusiness 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 diverse interpretations of the tax laws.

For personal income taxes, the largest 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 industry group that was assessed the largest dollar amount was the manufacturing industry.

We issued a separate *Notice of Proposed Assessment* to the taxpayer for each tax year included in an audit adjustment. Individuals typically have audit changes for just one tax year. More than 93 percent of the individuals who received *Notices of Proposed Assessment* during the 2007/2008 fiscal year had audit changes for a single tax 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 self-prepared their personal income tax returns. The data indicates that tax professionals file over 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. As of July 31, 2007, we received 24,000 e-filed business entity returns.

We inform taxpayers about their California filing requirements through our website, letters, and contacts with nonfilers. We send first time nonfilers who have met their filing requirements in the previous four years a *Request for Tax Return* notice. Repeat nonfilers are sent a *Demand for Tax Return* notice. Nonfilers who do not file the necessary tax returns after receiving a request or demand notice from us are sent a *Notice of Proposed Assessment*. See Appendix 1, Tables 7A and 7B, for volumes of notices issued. Our goal is to obtain tax returns from those who have a filing requirement without having to issue a *Notice of Proposed Assessment*.

Approximately 40 percent of the taxpayers contacted for failing to file a tax return subsequently file their returns.

### Taxpayer Filing Errors

The Revenue and Taxation Code requires the Taxpayers' Rights Advocate to identify the most common errors made by taxpayers when they file their returns and evaluate how those errors may be avoided or corrected.

We compiled information on taxpayers' errors on current year tax returns we processed between July 1, 2007, and June 30, 2008. 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 is 423,437.

Out of 16,008,867 current year tax returns processed from July 1, 2007, through June 30, 2008, we made 710,298 adjustments. We had an adjustment rate of 4.44 percent. This rate increased by 1.28 percent from last year for this period (3.16 percent: 483,432 adjustments issued for 15,278,265 returns processed July 1, 2006, through June 30, 2007). 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 71.6 percent of all adjustments, while paper filed returns comprised only 34.6 percent of the total returns filed. E-filed returns, 64.2 percent of all returns, had an adjustment rate of 28.1 percent of all adjustments. Adjustments on Internet filed returns, 1.3 percent of all returns filed, comprised 0.26 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.

*ReadyReturn* is a tax filing method introduced as a pilot program in 2005 and 2006. The three-member Franchise Tax Board directed us to offer *ReadyReturn* as a service for all eligible taxpayers. This service was available beginning January 2008, for tax year 2007. This service reduces the potential for common taxpayer errors and also increases taxpayer compliance.

The most common taxpayer error, for all filing methods, dealt with estimated tax payments. Just under half, 49.6 percent, of all *Return Information Notices* that were issued contained an Estimate Payment Credit adjustment. Taxpayers either neglected to claim estimate payments submitted, claimed a credit for a payment that differs from what they submitted, or claimed credits for payments that we have no record of receiving.

Over 84 percent of *Return Information Notices* sent to taxpayers who e-filed their returns contained an estimate payment adjustment, either individually or with other adjustments. *Return Information Notices* sent to taxpayers who used an Internet method to file their return had an estimate payment adjustment on 33.6 percent of the notices. This percentage jumps to 91.1 percent for taxpayers who filed their returns on paper.

### ***Estimate Payment Information Notice Pilot Project***

To address estimated payment errors, we launched the Estimate Payment Notice Project. We mailed 103,561 letters to taxpayers in February 2007. The estimate payment notification letters were sent to all taxpayers that received an estimated payment *Return Information Notice* for their 2006 tax year and had estimated credits on file for the 2007 tax year. These letters provided taxpayers with their total estimate credits available.

The outcome of the 2007 Estimate Payment Notice Project resulted in 79 percent (80,594) fewer *Return Information Notices* generated with estimate payment errors. Due to the ongoing success of the project, in 2008, it became an annual automated process.

Our overall goal continues to be the reduction of estimate payment reporting errors, since this continues to be the most common error made by taxpayers filing current year tax returns.

## 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 1389 (Committee on Budget, Ch. 751, Stats. 2008)**
This act impacts FTB. It:

1› Modifies group return requirements to allow entities to file a return on behalf of certain nonresidents.

2› Requires taxpayers that meet certain thresholds to make future payments electronically.

3› Adds bail as a type of debt that can be referred by the courts to FTB for collection.

4› Authorizes the Department of Industrial Relations to refer assessments and penalties under the California Occupational Safety and Health Administration Targeted Inspection Program to FTB for collection.

**AB 2249 (Niello, Ch. 234, Stats. 2008)**
This act allows a taxpayer to recover an income tax refund that they misdirected to the wrong bank account, and allows FTB, where necessary, to use its assessment and collection powers to get a misdirected refund back from the unintended third-party recipient.

**AB 3078 (Assembly Revenue & Taxation Committee, Ch. 305, Stats. 2008)**
This act makes the following changes to the Revenue and Taxation Code. It:

1› Allows entities to file a tax return on behalf of certain nonresidents.

2› Closes loopholes in current tax withholding on the payments nonresident individuals and non-California businesses receive from the sale of California real property.

3› Extends the statute of limitations for claiming the credit for taxes paid to another state.

4› Gives discretionary authority to the Taxpayers' Rights Advocate to grant relief from penalties, fees, or interest imposed on a taxpayer because of erroneous actions of the department.

5› Clarifies the rules for the elimination from income of certain dividends received.

In addition, this act increases the personal income tax estimated tax penalty threshold. (This section is the result of a proposal that came from the public during the 2007 Taxpayers' Bill of Rights hearing.)

## 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 FTB to promulgate regulations. See Appendix 3 for a list of regulations.

## Areas for FTB to Improve

We are identifying areas that when improved could result in increased taxpayer compliance. In identifying these areas, we have not addressed the issue of whether FTB has the existing resources needed to make these improvements.

### *Customer Service Call Center Access Rates*

Taxpayers are experiencing problems in contacting us through our call centers. In fiscal year 2007/2008, the contact center answered an average of 45 percent of incoming calls. Most of the calls were not answered within our performance goal of 80 percent within two minutes. It was common for staff to answer only 25 percent of all incoming calls and respond to as few as two percent of the calls within two minutes. Taxpayers often waited up to 50 minutes to speak with a customer service representative.

### *Response to Correspondence Time Frames*

Taxpayers writing to the department to either ask for or provide information are experiencing delays in our processing and responding to their correspondence. The current average time for correspondence to be responded to varies greatly throughout the department. While this is not a problem in all areas that receive correspondence, we have identified areas that receive a considerable amount of written correspondence that have processing delays. In some areas the response time is 25-30 days, and in other areas the response time is 50-60 days.

### *Check Processing and Depositing*

We receive an increasing number of contacts from taxpayers inquiring regarding the status of their submitted payment. Taxpayers complained that processing times took three weeks or longer for their check to clear their banks. At the time of this report, we were nearing the end of an Internal Audit review of our cashiering function.

### *Return Information Notices (RINs) Mailing*

Taxpayers that submit payments with their tax returns on or around April 15 were receiving notices from FTB that acknowledge that the return had been filed; however, it did not show a record of the payment being received. This has been a recurring issue from prior years. Because this has a potential impact on taxpayers, we have established procedures, on a pilot basis, to further delay the issuance of the RINs until after the payments are recorded for the 2008 tax year.

### *Errors on FTB Tax Forms*

An unusually high number of errors were identified on our tax forms for tax year 2007. One reason the identified errors were high for this year was the result of a comprehensive review of all forms. Many of the errors had been in place but were never detected in earlier years. Late law changes at both the state and federal level contribute to the increase in errors because in many instances the changes occur after the forms have been revised or created.

### *Pending and Enacted Federal Legislation*

The lack of conformity to federal legislation has a direct effect on taxpayer compliance and increases the burden on the taxpayer. California has not conformed to many of the federal law changes enacted after January 1, 2005, and in other areas we have automatic conformity.

California's complex method of conformity results in a significant need for us to identify and analyze pending and passed federal legislation. We need to prepare in-depth analysis of pending and passed federal legislation.

Currently, when there is pending or passed federal legislation, we have to reallocate resources to analyze and understand the federal legislative changes and the impact to California taxpayers. We then have to provide training to our staff and respond to inquiries from taxpayers and the professional tax preparation groups within short timeframes and, in some cases, prior to the passing of legislation.

As a result, we need to have dedicated staff and resources available to follow and provide analysis on pending and passed federal legislation on an ongoing basis.

## E-Services

In an effort to reduce the taxpayer's burden, increase access to information, make filing and paying taxes easier, and improve the timeliness and accuracy of tax returns, we continue to enhance and develop our online services. Below are a few of the e-services available and some highlights of the year's activities.

### *ReadyReturn*

*ReadyReturn* was approved by the three-member Franchise Tax Board in December 2006, and was implemented in January 2008. *ReadyReturn* is a voluntary program and taxpayers have the option of viewing, making changes, and e filing their *ReadyReturn* via our website. *ReadyReturn* is a tax-filing method where we use wage and withholding information to complete tax returns for taxpayers with "simple returns" (single, no dependents, and income from only one employer). Taxpayers can also check their eligibility and request a *ReadyReturn* be mailed to them via our Interactive Voice Response System or Taxpayer Services Center.

In the first year, over 11,000 taxpayers used this filing method. Of those users, 99 percent were satisfied or very satisfied with the program and 98 percent indicated that it is the type of service government should provide.

Plans for 2009 (for tax year 2008 returns) include:

- Doubling the eligible population by expanding our definition of "simplest returns." Eligible taxpayers will include head of household taxpayers, those with dependents or can be claimed as a dependent, and renters.
- Allowing taxpayers to start checking their eligibility on January 2, 2009.

### *CalFile*

*CalFile* is our free, secure, online application allowing taxpayers to build their state income tax return and e-file it directly to FTB. *CalFile* eases the filing burden for taxpayers by guiding them through an easy question and answer process in order to complete their return. In 2008 we enabled RDPs to use *CalFile*. We also implemented a Spanish version of *CalFile* to further ease the burden on our Spanish-speaking taxpayers.

Plans for 2009 (for tax year 2008 returns) include:

- Automatically checking and notifying users if they are eligible for *ReadyReturn*.
- Providing users the option to now use *ReadyReturn* or continue on with *CalFile*.

### *My FTB Account*

My FTB Account is a secure online service allowing users to view estimated tax payments, recent payments made, and the total balance due on their account. We added additional self-service options and increased usability. Taxpayers can access their California wage and withholding information, FTB-issued 1099-G and 1099-INT information, and sign-up for estimated tax payment email reminders. We also we made access to other services easier and added a user exit survey to seek user feedback for future services and improvements.

Plans for 2009 (for tax year 2008 returns) include providing:

- Users with the ability to view and/or change address information.
- Business entity taxpayers access to information.
- Users with the ability to opt out of receiving paper 1099s.

### *Web Pay*

*Web Pay* is our free, secure, online service that allows personal income taxpayers to make their tax payments online. In 2009, we plan to provide business entity taxpayers with the ability to make tax payments online.

## 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 how to deliver quality service and telephone techniques. Our call center represents the front line process. Properly staffed employees trained to provide critical pre-filing assistance, tax law explanations, and forms, can have a positive effect on compliance. This service also minimizes the cost associated with collection and audit functions that result when returns are not filed timely, properly, or with the appropriate amount of payment.

We provide technical training to our employees, including public service staff, tax technicians, compliance representatives, and auditors, on the following systems:

- Taxpayer Information System
- Business Entity Tax System
- Accounts Receivable Collection System
- Integrated Nonfiler Compliance System
- Other systems as necessary

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 essential 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 and public service areas have the required skills and abilities to administer tax laws, we train them on core compliance courses which include:

- Penalties and interest
- Filing requirements
- Installment Agreements (Collection Program)
- 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.

We provide professional training to our auditors from the moment they begin their work at FTB. We provide a four-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.
- Disclosure and Information Security.
- Technologies, and work systems (PASS, BETS, TI, Inc, etc.).
- 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. Mentors or leads are established for our new auditors to provide continued 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*

The Filing Enforcement (FE) Program identifies and contacts individuals and business entities that have a requirement to file a California tax return and have not filed.

The Personal Income Tax FE Program contacts wage earners, self-employed individuals, individuals with unreported capital gains, nonresidents with California source income, and individuals who have partnership income. Recently, we began contacting an additional 50,000+ nonfilers using income records provided by the Internal Revenue Service via their Information Return Master File.

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. Recently, we began using 1099 and 1098 data to identify nonfiling corporations.

We continuously strive to improve our filing enforcement program, and the services that are available to both the taxpayer and the tax preparer communities. We use an Internet website with around-the-clock access. We implemented this website based on feedback that we received from preparers and taxpayers. The following features are available to taxpayers from our website:

- 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 provide updated address information.

### *Audit Program*

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:

#### Streamlining the Audit Process and Staying Current With Our Audits

By focusing on adherence to Regulation 19032, we streamline our audit process, which allows us to stay current with our audit workloads. The following is a list of tools we use to achieve our goals:

- Engage taxpayers or representatives as to the scope of the audit at the start.
- Follow-up timely, within 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.
- Emphasize use of secure electronic communication channels and utilize electronic sources of documentation during examinations.

- Consult with other state tax agencies or the Internal Revenue Service on audits of the same taxpayer or on similar issues to leverage resources for both the tax agency and the taxpayer.
- Utilize Self-Compliance letters wherein we notify taxpayers of potential noncompliance and ask them to file an amended return.

### 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 continue 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 tax amount. We dedicate specialized auditors to evaluate nontraditional sources to identify taxpayers who may not have fully self-assessed and paid the correct tax amount. 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 information leads. 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 identify 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.

### Resolving Protective Claims Filed During Tax Amnesty 2005

Taxpayers paid $3.6 billion in protective claims in 2005 because of tax amnesty. As of June 30, 2008, FTB has finalized $1.762 billion in protective claims. Of that figure, $1.228 billion was retained and the taxpayers overpaid $532 million. For the overpaid amount, $374 million of this has been refunded and taxpayers have requested $158 million be kept on account as a cash deposit for future use.

For the amounts listed above, during the past year, we completed audits on over $556 million in protective claims. Of that amount, we resolved $358 million in protective claims with no further protest or appeal rights. Protective claims cases that remain outstanding as of June 30, 2008, include cases in the following categories:

| | |
|---|---|
| Open audits | $ 158 million |
| Pending federal | $ 238 million |
| Protest | $ 987 million |
| Appeal | $ 35 million |
| Settlement | $ 283 million |
| Closed - Nonfinal | $ 137 million |

### *Collections Program*

Our collections program collects tax and nontax debts on behalf of the State of California. Tax debts are primarily unpaid audit and return assessments for individuals and corporations. Nontax 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 nontax debt.

We maintain a collections call center staffed by collection 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 taxpayers' 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

Based in field offices in various California locations, our field collectors make in-person contact with persistently noncompliant tax debtors. Collectors take appropriate actions to fully resolve cases. This includes gathering case information, securing asset information, obtaining commitment, and properly documenting the case.

#### Investigations

Our investigative specialists focus on the underground economy and bringing felony criminal charges against the most egregious cases of tax evasion. Agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These behaviors include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees. 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. Taxpayers can now apply and check status of their request online.

Offer in Compromise › We provide taxpayers who currently do not have (nor will have in the future) the necessary means to pay their tax liability with an 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 Taxpayers' Bill of Rights III in the Internal Revenue Service Restructuring and Reform Act of 1998, we further expanded relief for innocent spouses. 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, comply with legal due process requirements, and take correct actions.

### Legal

Legal department staff support 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, representation in appeal proceedings before the State 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.

## 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. We provide presentations to taxpayers and tax practitioners on a variety of different topics including tax updates, e-file services, withholding, audit, offer-in-compromise, registered domestic partners/same sex marriage couples, forms of ownership, and other topics as requested. We participated in over 170 presentations throughout California. We are also developing a publication, *Understanding Your State Income Taxes*, that provides general information about state income taxes and filing requirements. We plan to distribute this publication to a variety of audiences, including college students and newly naturalized citizens. This publication will also be available in other languages.

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 strive to make our publications, notices, and other documents available in other languages for the non-English speaking taxpayers of California. We have a task force that coordinates the translation of forms, publications, web information, news releases, and other documents as needed. We have publications available on our website in Spanish, Chinese, Korean, Russian, and Vietnamese.

Our Spanish web portal continues to expand. We provide Spanish-speaking taxpayers and tax professionals with information, how to contact us, and e-services. Starting in January 2008, we provided our Spanish-speaking taxpayers with *CalFile* in Spanish.

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, including Spanish media, 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 of interest.

### *Registered Domestic Partners (RDPs) / Same Sex Married Couples (SSMCs)*

Senate Bill 1827 (Stats. 2006, Ch. 802), effective January 1, 2007, requires Registered Domestic Partners (RDPs) to file their personal income tax returns as either married filing jointly or married filing separate. Since its passage, FTB has been working diligently to inform the public of the state tax ramifications. RDP education and outreach efforts that began in 2006 have been continued and expanded upon into 2008.

Through our education and outreach efforts for RDPs, we now offer information on Same Sex Married Couples (SSMCs). This comes after the California Supreme Court's recent ruling, which allowed same-sex couples to marry.

We conducted 35 presentations, issued several news releases, delivered 10 announcements, posted two public service bulletins, and issued FTB Notice 2008-5, all of which related to RDPs and SSMCs. FTB also created three publications now readily available online or in print form for RDPs and SSMCs regarding their California income tax treatment and their filing obligations:

› FTB 737 - *2007 Tax Information for Registered Domestic Partners*
› FTB 776 - *2008 (Draft) Tax Information for Same-Sex Married Couples*
› FTB 1051A - *Guidelines for Married/RDP Filing Separate Returns*

In addition, we have webpages dedicated to provide information on both RDPs and SSMCs. This gives taxpayers and professional tax preparation groups the opportunity to check for updated information, including frequently asked questions, important news, and other information on each tax topic. FTB provides subscription services to allow individuals and tax professionals to sign up and receive updates on RDPs and SSMCs, along with a variety of other topics.

### *Debt Cancellation*

With the recent downturn in the economy, there has been increased interest in the tax effects of debt forgiveness and related foreclosures and short-sales issues. To address these issues, FTB has begun working to inform the public of the state tax ramifications. We have added a discussion topic on foreclosures to our public presentations, participated with the IRS in presenting joint presentations, and are in the process of developing publications to be available in print and on our website.

We have a webpage dedicated to Mortgage Forgiveness Debt Relief Laws and we also have issued news releases and announcements to keep the public informed of issues related to debt and foreclosures. In January 2008, we posted the article titled *Mortgage Debt Forgiveness May Be Taxable in California* on our website. In February we posted an announcement titled *How To Avoid Foreclosure on Your Home Mortgage - 90 Days of Hope*.

We had three *Tax News* articles related to this subject:

- October 2007 - *Foreclosures and the Next Wave*
- January 2008 - *Federal Legislation on Alternative Minimum Tax, Mortgage Debt Relief*
- February 2008 - *SB 1055 Seeks To Alleviate Potential Tax*

The department also provided the following information to taxpayers and tax practitioners related to the withholding requirements:

- Real Estate Foreclosures, Short Sales, and Cash Poor Transactions on our website.
- Updated Regulation 18662-3 to address foreclosures.
- Publication 1016, *Real Estate Withholding Guidelines*, has addressed the withholding requirements on a foreclosure.

Our April 24, 2008, Interested Parties Meeting included a discussion on the Mortgage Forgiveness Debt Relief Act of 2007 (PL-110-142).

In addition, we have a new Financial Literacy website. This website offers an array of financial tools and resources, including information about financial planning, retirement, savings, investing, and taxes. The financial planning section offers education material to taxpayers on debt reduction, learning how to save, investing, saving for college, and credit counseling. As an educational website, this site also includes a section for “Kids, Parents, and Teachers” with basics on saving and investing.

### *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 Internet, the California Home Page (ca.gov) and California Tax Service Center (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*

*Tax News*, our monthly online publication, was created to inform tax professionals about state income tax laws, our regulations, policies, and procedures, and events that affect the tax professional community. Tax practitioners can subscribe to *Tax News* by email or it is available on our website. We also periodically release *Tax News* bulletins to quickly notify subscribers of urgent, time-sensitive information. In fiscal year 2007/2008, we increased the number of subscribers by nearly 14 percent.

### *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 participate in small business fairs sponsored by Board of Equalization Members throughout California.

We created publications to address common questions related to small business taxpayers:

- *Franchise Tax Board's Guide to: Forms of Ownership*
- *Franchise Tax Board: Common Business Expenses for the Business Owner and Highlights of the Federal/State Differences*
- *Top Twelve Tax Scams*
- *Don't Gamble With Your Taxes: Read the Fine Print About Incorporating in Nevada*
- H*ow to Select an Income Tax Return Preparer*
- *Audit/Protest/Appeals: The Process*

We also have a Small Business Liaison that provides education and outreach to small businesses and receives calls from taxpayers. The Liaison provides tax information about specific filing requirements, based on their business ownership or proposed business ownership type, to small business owners and taxpayers interested in starting a business. The Liaison provides referrals to the appropriate program areas within FTB and to the other state or federal agencies to answer taxpayers' questions. We received over 765 calls this year, including some from foreign countries.

### *Speakers' Bureau*

Speakers' Bureau is available to help nonprofit 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. We also provide speakers in other languages upon request and availability. The Speakers' Bureau is one of our ongoing ventures that acknowledges the continuing educational needs of tax professionals and nonprofit tax related organizations.

### *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, and other topics of interest.

### *Free Filing Assistance*

The IRS and FTB jointly administer the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) volunteer programs to provide free help to low-income, senior, disabled, and non-English speaking persons who need to file simple federal and state tax returns.

We recruit VITA and TCE volunteers statewide, provide training to the volunteers, and provide outreach to let the public know about the programs. We also provide VITA services for the U.S. Armed Forces with training and support for tax law questions and to military VITA sites throughout California.

### *Schools' Partnership Program Volunteer Income Tax Assistance*

We collaborate with the Internal Revenue Service to administer the Schools' 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.

# Department Initiatives and Projects

## Key Initiatives for 2008

### *Promote and Encourage Self-Compliance*

Implement a Performance Management Program that provides a framework for relevant performance measures, productive performance discussions, and effective improvement actions.

Our performance is directly related to the taxpayer's ability to participate in the tax system. In order to continually improve our performance, we must maintain a focus on the taxpayer and what they need to meet their tax obligations. Through a comprehensive Performance Management Program we can manage, monitor, and improve upon the products and services we deliver in order to promote and encourage self-compliance.

### *Increase Transparency*

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

"Transparency" is a process that allows citizens to openly see the activities of their government. This means making information and processes more accessible and understandable to taxpayers and the public. 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.

### *Modernize Our Tax Systems*

We have developed a tax systems IT Strategic Plan. The plan identifies an FTB enterprise business vision and goals and a corresponding technology vision including technologies and architecture needed to enable the business vision. The plan further identifies the strategic business problems that constrain our ability to achieve the business vision and goals, and the opportunities that may address the problems. The plan also identifies the strategies and roadmap for implementing the opportunities and is the point of reference for formulating IT projects with strategic objectives including operational excellence, customer service, and transparency goals.

## Projects

### *Scan and Shred Project*

Scan and Shred was successfully implemented on July 16, 2007. Staff in our processing unit, the call center, and audit use the image of the return to resolve fallout, assist taxpayers, or perform an audit. The return images are available within two to three weeks of the tax return being received by FTB. The project is proving to be so successful that we have decided to "back scan" the returns that were stored in the warehouse prior to implementation of Scan and Shred. This will increase the efficiency of departmental staff, as more tax returns are available electronically. Approximately 1.4 million returns with an average of 25.3 pages per return have been processed since implementation.

### *ReadyReturn*

As mentioned in the E-Services Section of this report, *ReadyReturn* was implemented in January 2008. In its first year, over 11,000 taxpayers used this filing method.

### *External Authentication for Secure E-services (EASE)*

FTB has begun work on implementation of a robust authentication solution for use by our external PIT and Business Entity (BE) customers, which will replace the stovepipe methods currently used for our FTBNet e-Services. In order to provide all customers access to e-Services, which will help reduce taxpayer burden and also reduce FTB's operational costs, we will implement a self-managed authentication solution that meets industry standards for security and usability. Planned implementation date is late summer 2009.

### *Taxpayer Compliance Assistance Plan (TCAP)*

FTB is looking to develop a Taxpayer Compliance Assistance Plan (TCAP). The plan is intended to provide us with an enterprise plan for delivering customer service to taxpayers. The goal of the plan will include a balanced set of strategic goals and tactical initiatives to address customer service—specifically where service can help increase taxpayer compliance.

### *Systemic Issues Management System*

The Systemic Issues Management Systems (SIMS) is being developed and will be a web-based application for taxpayers and practitioners to identify and provided recommended solutions on systemic issues they have encountered with FTB. This system will allow the Taxpayers' Rights Advocate to keep track of issues raised. Systemic issues are issues that:

- Affect multiple taxpayers.
- Impact segments of the taxpayer population, locally, regionally, or nationally.
- Relate to FTB systems, policies, and procedures.
- Require study, analysis, administrative changes, or legislative remedies.
- Involve protecting taxpayer rights, reducing or preventing taxpayer burden, ensuringequitable treatment of taxpayers, or providing essential services to taxpayers.

## Taxpayers' Bill of Rights Hearing

Taxpayers presented proposals to the three-member Franchise Tax Board (Board) at the annual Taxpayers' Bill of Rights hearing on November 28, 2007. The meeting took place at FTB 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.

### Michele Pielsticker, Cal-Tax

Ms. Pielsticker, representing Cal-Tax, provided oral comments to the Board on the following issues:

- Problems members are having with auditors in the sales tax and income tax areas when auditors take taxpayer data offsite for audit purposes, e.g., in determining entitlement to the research and development credit.
- Thanked the Board for sponsoring federal conformity legislation last year and, since it stalled in the Senate Appropriations Committee, asked the Board to sponsor the legislation again in 2008.

*In her letter dated December 21, 2007, Executive Officer Selvi Stanislaus responded by expressing that FTB will continue to work with the Legislature and all interested parties to pass a conformity date-change bill in 2008. She also indicated that FTB takes privacy and security of confidential tax information very seriously, and that we do everything we can to ensure it remains secure. She explained that FTB auditors have authority to take information necessary to conduct the audit, which includes taking relevant data offsite to document the taxpayer's position in the audit file.*

*Ms. Stanislaus acknowledged the practice of BOE auditors downloading electronic information from a taxpayer's personal computer and utilizing sampling techniques and software programs to test the data offsite. She explained this is different from FTB's audit practice. FTB auditors request documentation from the taxpayer, which can be provided on paper or media or both. The data is reviewed at the taxpayer's location or offsite. If the taxpayer has concerns about the auditor taking any information offsite, the taxpayer should discuss the matter with the auditor or audit supervisor to resolve the issue.*

### Gina Rodriquez, Spidell Publishing, Inc.

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

- Presented the Board with three specific conformity provisions to consider: 1) Dependency exemption rules for noncustodial parents; 2) waiver of the penalty tax on premature distributions for certain reservists and public safety officers; and 3) FTB should defer penalty notices on e-file returns to allow for the processing of payments made by check.
- Requested that FTB take a look at the estimated tax penalty and look at increasing the current $200 threshold for the imposition of the penalty for underpayment of estimated tax.

*In her letter dated December 21, 2007, Executive Officer Selvi Stanislaus responded by acknowledging that these are important conformity issues, along with many others. She indicated that FTB staff will continue working with the Legislature and all of the interested parties to pass conformity legislation in 2008 in the context of a general date-change conformity bill. She referenced* *that AB 1561 (Calderon), the FTB sponsored date-change bill, is still pending in the Senate Revenue and Taxation Committee. She indicated that we may need to defer to Mr. Calderon's decision regarding strategy for conformity legislation, including decisions on single-issue conformity bills, during the upcoming legislative year.*

*Ms. Stanislaus indicated that FTB will research the department costs to issue the estimated tax penalty notices and related workload costs. FTB expects to have the analysis by February 1, 2008. If it is determined that a law change is justified, FTB will prepare a Taxpayers' Bill of Rights legislative proposal to address the issue.*

*Ms. Stanislaus also indicated that FTB will evaluate the impact of changing our policy on the timing of issuing Return Information Notices when taxpayers filed electronically but sent in paper check to pay their balance due and expect to have the analysis completed by February 2, 2008.*

*In her follow-up letter dated February 25, 2008, Ms. Stanislaus provided an update to the suggestion to change FTB's policy on the timing of issuing Return Information Notices. She indicated that FTB will implement this change to help us ensure that taxpayers who filed electronically, but sent in paper checks to pay their balance due, would no longer receive notices that do not reflect their payments. FTB will implement this change as a pilot project and evaluate the project after two years.*

*Ms. Stanislaus also indicated that FTB is working on the analysis of the proposal to increase the $200 statutory threshold for assessing the estimated tax penalty. She indicated she hoped to provide the analysis at the next Board meeting, tentatively scheduled for March 6, 2008.*

### Roland Boucher, United Californians for Tax Reform

Mr. Boucher provided oral comments to the Board on the following matters:

- Thanked the Board and the members of the Franchise Tax Board for the work on the 540 2EZ form; will suggest to Congress and the Treasury Department that the IRS use the same type of form.
- Expressed interest in a tax code where almost no one would have to file taxes on April 15 - the withholding would be exact (pertaining mainly to retirees).
- Requested the banking industry withhold income tax on interest from a CD.
- Requested support of a bill that would index capital gains.

*In her letter dated December 21, 2007, Executive Officer Selvi Stanislaus responded by informing that FTB presented the suggestion from the Taxpayers' Bill of Rights hearing held on December 12, 2006 as a legislative proposal. The suggestion was to increase the standard deduction and eliminate the $87 personal income tax credit to simplify tax return filing. As requested by Board Member, Betty Yee, FTB staff is preparing a distributional impact analysis of the proposal for taxpayers at different income levels that will show the impact this legislative proposal would have on taxpayers. FTB staff will distribute this analysis when completed, so the Board may decide whether to request further discussion on the proposal.*

*Ms. Stanislaus also expressed her appreciation for Mr. Boucher's past input to improve the 540 2EZ, report capital gains from mutual funds in the 2EZ, and save information on the electronic version of the 2EZ.*

### Henry Veit, Lerner & Veit

Mr. Veit provided oral comments to the Board on the following matters:

- Suggested that FTB's standard operating procedure be to issue a receipt for payments received when a taxpayers requests a receipt.
- Suggested FTB acknowledge receipt of all correspondence relating to tax matters.
- Provide taxpayers a toll-free number for them to contact specific staff.

*In her letter dated December 21, 2007, Executive Officer Selvi Stanislaus responded that this is our current business practice. She explained that taxpayers have access to their own account information, which includes all of the payments FTB has received. She provided FTB's website address.*

*Ms. Stanislaus further explained that providing acknowledgement of the receipt of correspondence is our current business practice in some areas of the department. She indicated that FTB receives over 800,000 pieces of correspondence annually and the cost to acknowledge each piece of correspondence is just over $200,000 in postage alone. She further indicated that unfortunately at this time, it is cost prohibitive to adopt this as a standard business practice. Just as with payments, if a taxpayer requests a receipt, FTB will certainly provide one.*

*Ms. Stanislaus indicated that FTB is exploring the idea of providing a toll-free number to specific contacts and believes it is feasible at little or no cost to the department. FTB will complete its analysis by February 1, 2008, and if it is not cost prohibitive, FTB will implement this suggestion and advertise it appropriately.*

*In her follow-up letter dated February 25, 2008, Ms. Stanislaus provided an update regarding the Taxpayers' Bill of Rights proposal for the toll-free number to specific contacts. The analysis found that this change is not cost prohibitive. FTB will implement this proposal by the end of the calendar year.*

## 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."

As part of our initiative to increase employee engagement, we have implemented a plan to ensure all eligible employees receive an annual performance appraisal by August 31 of each year. This will provide employees continuous feedback and allow us to track and report on the completion of performance appraisals. We initiated a talent development program that enables employees to take control of their own development in a way that is beneficial to themselves and the organization.

We also developed mission and value statements that emphasize the commitment of management and employees to do a job well, 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 fiscal year 2007/2008. We may have issued the assessments in prior years; however, due to cases in protest status, we did not resolve them until 2007/2008. Appendix 1 totals reflect rounded figures and may not compute exactly.

Table 1A **Corporation Tax Law**
NPAs Finalized in Fiscal Year 2007/2008 Categorized by Primary Statute (Issue)

| Issue | Number of NPAs | % | Tax Assessed (Millions) | % | Average Assessment Per NPA |
|---|---|---|---|---|---|
| Allocation/Apportionment | 566 | 14.8 | $ 342.8 | 78.2 | $ 605,668 |
| Assess Minimum Tax | 1,388 | 36.3 | 1.1 | 0.3 | 826 |
| Revenue Agent Reports | 1,230 | 32.2 | 53.1 | 12.1 | 43,147 |
| State Adjustments | 201 | 5.3 | 9.0 | 2.0 | 44,672 |
| Other | 434 | 11.4 | 32.6 | 7.4 | 75,029 |
| Totals/Average | 3,819 | 100 | $ 438.6 | 100 | $ 114,838 |

- *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 Fiscal Year 2007/2008 Categorized by Primary Statute (Issue)

| Issue | Number of NPAs | % | Tax Assessed (Thousands) | % | Average Assessment Per NPA |
|---|---|---|---|---|---|
| CP2000 | 77,356 | 15.9 | $ 58,212 | 4.2 | $ 753 |
| Filing Enforcement | 331,818 | 68.1 | 1,142,096 | 81.5 | 3,442 |
| Filing Status | 32,108 | 6.6 | 28,878 | 2.1 | 899 |
| Revenue Agent Reports | 14,191 | 2.9 | 44,262 | 3.2 | 3,119 |
| Other | 31,489 | 6.5 | 128,733 | 9.0 | 4,088 |
| Totals/Average | 486,962 | 100 | $1,402,181 | 100 | $ 2,879 |

- 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 Fiscal Year 2007/2008

| Industry | All Corporations 2006 Tax Year | % | Corporations with NPAs | % | Tax Assessed (Millions) | % |
|---|---|---|---|---|---|---|
| F.I.R.E.* | 126,052 | 18.4 | 185 | 8.3 | $ 93.9 | 21.4 |
| Manufacturing | 49,248 | 7.2 | 199 | 8.9 | 139.9 | 31.8 |
| Services | 272,367 | 39.8 | 242 | 10.9 | 25.1 | 5.7 |
| Trade | 119,761 | 17.5 | 188 | 8.4 | 27.2 | 6.2 |
| Other ** | 116,935 | 17.1 | 1,414 | 63.5 | 207.9 | 34.9 |
| Totals | 684,363 | 100 | 2,228 | 100 | $ 438.6 | 100 |

*Finance, insurance, real estate, and holding companies.
** Includes agriculture, construction, utilities, transportation, communication information, 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 Fiscal Year 2007/2008 Issued by Taxable Year

| Average Taxable Year | Number of NPAs | % | Tax Assessed (Millions) | % | Average Assessment Per NPA |
|---|---|---|---|---|---|
| 2000 and prior | 551 | 14.4 | $ 225.1 | 51.3 | $ 408,524 |
| 2001 | 183 | 4.8 | 40.0 | 9.1 | 218,621 |
| 2002 | 371 | 9.7 | 80.6 | 18.4 | 217,165 |
| 2003 | 730 | 19.1 | 52.6 | 12.0 | 72,090 |
| 2004 | 1,100 | 28.8 | 27.5 | 6.3 | 25,031 |
| 2005 | 687 | 18.0 | 11.7 | 2.7 | 17,032 |
| 2006 and later | 197 | 5.2 | 1.0 | 0.2 | 5,244 |
| Totals/Average | 3,819 | 100 | $ 438.6 | 100 | $ 114,838 |

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 Fiscal Year 2007/2008 for the Same Taxpayer

| Corporations With… | Number of NPAs | Tax Assessed (Millions) | Average Assessment Per Taxpayer |
|---|---|---|---|
| One NPA | 1,228 | $ 91.3 | $ 74,362 |
| Two NPAs | 634 | 111.0 | 175,091 |
| Three NPAs | 257 | 125.9 | 489,990 |
| Four or more NPAs | 109 | 110.3 | 1,012,068 |
| Totals/Average | 2,228 | $ 438.6 | $ 196,843 |

Table 4 **Personal Income Tax Law**
NPAs Finalized in Fiscal Year 2007/2008 Issued by Taxable Year

| Taxable Year | Number of NPAs | % | Assessment Amount (Thousands) | % | Average Assessment Amount |
|---|---|---|---|---|---|
| 2001 and prior | 2,610 | 0.5 | $ 57,777 | 4.1 | $ 22,137 |
| 2002 | 2,536 | 0.5 | 23,646 | 1.7 | 9,324 |
| 2003 | 26,314 | 5.4 | 57,508 | 4.1 | 2,185 |
| 2004 | 138,250 | 28.4 | 273,532 | 19.5 | 1,979 |
| 2005 | 201,455 | 41.4 | 644,455 | 46.0 | 3,199 |
| 2006 and later | 115,797 | 23.8 | 345,263 | 24.6 | 2,982 |
| Totals/Average | 486,962 | 100 | $1,402,181 | 100 | $ 2,879 |

Table 5 **Personal Income Tax Law**
Resident Tax Return Preparation, Process Years 2006 and 2007

| Preparer | 2006 Returns Processed (Thousands) | % | 2007 Returns Processed (Thousands) | % | % Change |
|---|---|---|---|---|---|
| Professional | 9,844 | 69.9 | 10,076 | 70.1 | 0.2 |
| Taxpayer | 4,078 | 28.9 | 4,137 | 28.8 | -0.1 |
| VITA* | 165 | 1.2 | 169 | 1.2 | 0.0 |
| Totals | 14,088 | 100 | 14,383 | 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 1, 2007 | June 30, 2008 | % Change |
|---|---|---|---|
| Credit Card Payments (Average payment is $966) | 103,000 | 121,000 | 17 |
| Direct Debit of Balance Due (Electronic Funds Withdrawal) | 283,000 | 383,000 | 35 |
| Direct Deposit Refund | 4,479,000 | 5,077,000 | 13 |
| e-file | 9,557,000 | 10,650,000 | 11 |
| * *CalFile* | 141,000 | 193,000 | 37 |
| * Online Filing | 1,715,000 | 2,083,000 | 21 |
| * Business Entity | 28,000 | 177,000 | 532 |

* 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

| Fiscal Year | Demands | NPAs Issues |
|---|---|---|
| 2003-04 | 21,004 | 726 |
| 2004-05 | 10,744 | 15,064 |
| 2005-06 | 19,047 | 0 |
| 2006-07 | 8,927 | 13,271 |
| 2007-08 | 31,819 | 18,855 |

Table 7B **Corporation Tax Law**
Nonfilers Detected through the Automated Nonfiler System

| Fiscal Year | Demands/Requests | NPAs Issues |
|---|---|---|
| 2003-04 | 819,006 | 499,602 |
| 2004-05 | 756,183 | 528,856 |
| 2005-06 | 754,613 | 509,066 |
| 2006-07 | 826,612 | 546,614 |
| 2007-08 | 839,818 | 463,315 |

Table 8A **Individual Return Validation Adjustments**
Top Errors by Return Type (July 1, 2007 through June 30, 2008)

| | All Forms | 540 | 540 2EZ | 540 A | 540 NR | 540 X | N/A* |
|---|---|---|---|---|---|---|---|
| EP | **210,202** | **188,971** | **1,943** | **3,846** | **15,389** | 53 | 0 |
| DS | **50,776** | **33,560** | 111 | **12,207** | **4,627** | 229 | **42** |
| TC | **48,696** | **32,556** | 341 | **5,489** | **8,912** | **1,388** | **10** |
| TT | **45,317** | **20,427** | **11,480** | **10,159** | **2,956** | **283** | **12** |
| AA | **40,320** | 140 | **39,903** | 64 | 205 | 8 | 0 |
| EX | **33,132** | **20,036** | 259 | **9,241** | **3,485** | 94 | **17** |
| TY | **28,069** | 0 | **28,069** | 0 | 0 | 0 | 0 |
| OC | **25,399** | **21,119** | 0 | 612 | **3,642** | 26 | 0 |
| SS | **23,443** | **21,760** | 0 | 1,002 | 546 | 135 | 0 |
| ND | **20,278** | 189 | 0 | 0 | **20,002** | 86 | **1** |
| OA | 19,664 | **10,814** | **3,543** | **3,426** | 526 | **1,353** | **2** |
| DI | 17,169 | **12,075** | 2 | **3,807** | 1,136 | 147 | **2** |
| OF | 14,485 | 4,359 | **734** | 243 | 462 | **8,686** | **1** |
| NP | 13,436 | 126 | 0 | 0 | **13,306** | 3 | **1** |
| RN | 13,123 | 5,558 | **3,069** | **4,063** | 429 | 4 | 0 |
| NN | 12,153 | 111 | 0 | 0 | **12,039** | 3 | 0 |
| AW | 11,414 | **8,668** | **1,357** | 670 | 517 | 193 | **9** |
| CT | 10,793 | 800 | 40 | 52 | 53 | **9,615** | 0 |
| WS | 9,426 | 3,685 | 2 | 33 | **5,590** | 116 | 0 |
| OM | 9,118 | 3,091 | 254 | 68 | 278 | **5,427** | 0 |
| OW | 8,860 | 0 | 0 | 0 | 0 | **8,860** | 0 |
| AM | 7,861 | 6,187 | **947** | 31 | 677 | 19 | 0 |
| OB | 6,622 | 3,623 | **1,514** | **1,171** | 89 | 225 | 0 |
| TI | 5,961 | 3,728 | 18 | **1,902** | 231 | 82 | 0 |
| AT | 3,188 | 1,941 | 166 | 124 | 869 | 87 | **1** |
| EA | 1,560 | 848 | 12 | 560 | 139 | 1 | 0 |
| OP | 1,289 | 380 | 7 | 14 | 43 | **845** | 0 |
| CI | 785 | 409 | 233 | 71 | 18 | **287** | 0 |
| OT | 356 | 99 | 11 | 5 | 10 | **231** | 0 |
| AD | 113 | 39 | 32 | 35 | 2 | 0 | **5** |
| **Top Ten** | **525,632** | **369,986** | **92,559** | **55,311** | **89,948** | **36,975** | **103** |
| Total | 693,008 | 405,299 | 94,047 | 58,895 | 96,178 | 38,486 | 103 |

* Return type is undetermined

**Table Legend:**

**Bold** › Top ten codes issued by Return Type.
Light › Not top ten.

| Table 8A **Definitions** | |
|---|---|
| **EP** | Estimate Payments revised. |
| **DS** | Filing Status revised. |
| **TC** | Tax Amount revised. |
| **TT** | Total Tax revised due to credits or liability. |
| **AA** | Adjusted Gross Income revised. |
| **EX** | Exemptions revised. |
| **TY** | Total Tax revised due to AGI, status, or dependents. |
| **OC** | Estimated Tax Transfer revised due to an error. |
| **SS** | SDI revised. |
| **ND** | CA Taxable Income revised; computed or transferred incorrectly, deduction percentage computed incorrectly, or percentage incorrectly applied to deduction. (Nonresident only). |
| **OA** | Refund revised due to incorrect payments and credits. |
| **DI** | Deductions revised: Itemized claimed was less than Standard. |
| **OF** | Original refund reported on Amended return does not match original return. (Amended only). |
| **NP** | Total Tax revised; ratio computed incorrectly (NR only). |
| **RN** | Nonrefundable Renter's Credit revised. |
| **NN** | Total Tax revised; CA Tax Rate, CA Credit Percentage, or CA Exemption Credit Percentage incorrectly computed; or error computing/transferring tax on Sched. G-1 or Form FTB 5870A. (Nonresident only). |
| **AW** | Withholding revised to match W-2. |
| **CT** | Child and Dependent Care Expenses Credit revised to match the amount claimed on original return. (Amended only). |
| **WS** | Withhold at source revised. |
| **OM** | Amount paid with original return plus payments made after return filed does not match amount claimed on Amended return. (Amended only). |
| **OW** | Original withholding reported on Amended return does not match original return. (Amended only). |
| **AM** | Withholding revised, unverified. |
| **OB** | Balance revised due to incorrect payments and credits. |
| **TI** | Taxable income revised due to deductions claimed incorrectly subtracted from AGI. |
| **AT** | Withheld tax credit disallowed; withholding documents not attached to return. |
| **EA** | Personal Exemption Credit revised to correct amount. |
| **OP** | Estimated tax payments reported on Amended return does not match original return. (Amended only). |
| **CI** | Child and Dependent Care Credit disallowed; Form FTB 3506 not attached to return. |
| **OT** | Amount of taxable income reported on Amended return does not match amount on original return. |
| **AD** | Incorrect year tax form used. |

Table 8B **Individual Return Validation Adjustments**
Top Errors by Filing Method (July 1, 2007 through June 30, 2008)

| | All Sources | Paper | E-file | Internet |
|---|---|---|---|---|
| EP | **210,202** | **97,307** | **111,678** | **1,217** |
| DS | **50,776** | **38,091** | **12,616** | **69** |
| TC | **48,696** | **46,239** | **2,396** | **61** |
| TT | **45,317** | **44,045** | 1,260 | 12 |
| AA | **40,320** | **20,112** | **20,208** | 0 |
| EX | **33,132** | **32,796** | 333 | 3 |
| TY | **28,069** | **27,592** | 477 | 0 |
| OC | **25,399** | 13,677 | **11,692** | 30 |
| SS | **23,443** | 11,478 | **11,917** | **48** |
| ND | **20,278** | **18,557** | 1,721 | 24 |
| OA | 19,664 | **18,763** | 901 | **44** |
| DI | 17,169 | 13,099 | **4,030** | **40** |
| OF | 14,485 | **13,906** | 531 | **48** |
| NP | 13,436 | 11,206 | **2,230** | 38 |
| AW | 11,414 | 9,154 | **2,206** | **54** |
| AM | 7,861 | 401 | **7,306** | **154** |
| CT | 6,237 | 6,217 | 17 | 3 |
| OM | 6,068 | 5,960 | 106 | 2 |
| CH | 2,649 | 1,132 | 1,476 | **41** |
| Top Ten | 395,311 | 296,213 | 143,545 | 1,453 |
| Total | 395,311 | 245,794 | 148,158 | 1,359 |

**Table Legend:**

**Bold** › Top ten codes issued by Filing Method.
Light › Not top ten.

Table 8B **Definitions**

| | |
|---|---|
| **EP** | Estimate Payments revised. |
| **DS** | Filing Status revised. |
| **TC** | Tax Amount revised. |
| **TT** | Total Tax revised due to credits or liability. |
| **AA** | Adjusted Gross Income revised. |
| **EX** | Exemptions revised. |
| **TY** | Total Tax revised due to AGI, status, or dependents. |
| **OC** | Estimated Tax Transfer revised due to an error. |
| **SS** | SDI revised. |
| **ND** | CA Taxable Income revised; computed or transferred incorrectly, deduction percentage computed incorrectly, or percentage incorrectly applied to deduction. (Nonresident only) |
| **OA** | Refund revised due to incorrect payments and credits. |
| **DI** | Deductions revised: Itemized claimed was less than Standard. |
| **OF** | Original refund reported on Amended return does not match original return. (Amended only) |
| **NP** | Total Tax revised; ratio computed incorrectly. (Non Resident only) |
| **AW** | Withholding revised to match W-2. |
| **AM** | Withholding revised, unverified. |
| **CT** | Child and Dependent Care Expenses Credit revised to match original return amount. (Amended only) |
| **OM** | Amount paid with original return plus payments made after return filed does not match amount claimed on Amended return. (Amended only) |
| **CH** | CDC Expenses Credit revised; Another taxpayer claimed at least one of the qualifying person's SSN claimed on return. |

### *Regulation Section 17942 – LLC Fees*

In response to litigation challenging the constitutionality of the LLC fee based upon total income from all sources reportable to California, not just total income from all sources attributable to or derived from California, the Legislature amended Revenue and Taxation Code Section 17942 to add a new provision. The new provision states that "total income from all sources derived from or attributable to this state" shall be determined using the rules for assigning sales under Sections 25135 and 25136 and the regulations thereunder, as modified by regulations under Section 25137, other than those provisions that exclude receipts from the sales factor.

Revenue and Taxation Code Sections 25135 and 25136 are the sections that assign sales to the California numerator of the sales factor. Section 25135 assigns sales of tangible personal property and contains as its primary rule the assignment of the sale to California if the property is delivered to a purchaser in this State. Section 25136 assigns all other sales, and its primary rule assigns sales on the basis of where the income-producing activity associated with that sale occurred. The regulations under Section 25136 also provide specific rules for items such as real property, which is assigned to the state where the real property is located.

The regulations adopted pursuant to Revenue and Taxation Code Section 25137 provide specific apportionment rules for special industries, such as banks and financials, truckers, and franchisors. These regulations also provide specific sales factor rules for various types of income that are especially problematic.

While the new LLC fee methodology utilizes the sales factor numerator rules to determine the total income assignable to California for purposes of the LLC fee calculation, the method is not the UDITPA apportionment method. There is no calculation of a factor, only the determination of whether a given item of income is assignable to California using the sales factor numerator assignment mechanism. Once the total income of the LLC is assigned to the various states using this methodology, the fee is calculated based on the total income assignable to California.

On November 28, 2007, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss what regulatory guidance (if any) should be provided regarding the use of this new assignment mechanism. An interested parties meeting was held on June 17, 2008. Staff will be holding a second interested parties meeting sometime in October 2008.

### *Regulations Sections 18662-0 Through 18662-8 and 19002 – Withholding at Source*

Withholding at source is an essential part of the department's Tax Gap compliance initiative. Withholding's "pay as you go" process helps taxpayers by ensuring that tax is collected as income is received. It helps the state by ensuring that tax is paid as it is incurred on specific transactions, encouraging taxpayers to file returns at the end of the year.

California law requires the Franchise Tax Board to issue regulations to implement the withholding at source statutory requirements (Revenue and Taxation Code Section 18662, subdivision (a)). These regulations have not been updated in many years, and do not currently reflect statutory and other changes affecting the withholding statutes themselves. They were written at a time when electronic filing and payment were not available, and also need to be updated to align these filing and payment procedures with modern practices.

The text of the existing regulations has been rewritten and reorganized into a simpler, more descriptive order. The revised text contains a Table of Contents, and the draft regulations begin with the definitions and general rules applicable to all withholding at source, then provide specific guidance for the two major withholding areas that FTB administers: Real Estate Withholding and Withholding on Payments (Nonresident Withholding).

On June 27, 2007, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss the draft proposed regulations and instructions to reflect current statutory requirements under Revenue and Taxation Code Section 18662, subdivision (a). An interested parties meeting was held August 13, 2007. Three comments were received. On November 28, 2007, staff received approval to commence a formal regulatory project, as required under the Administrative Procedure Act, from the three-member Franchise Tax Board. Staff anticipates holding a hearing in the fall of 2008.

***Regulations Sections 23701(i) and 23772(d) – Exemption from Taxation and Information Returns and Statements of Exempt Organizations***

AB 897, Stats. 2007, Ch. 238, changed the rules for California income and franchise tax purposes for organizations that are exempt under Internal Revenue Code Section 501(c)(3). Specifically, AB 897 added a new subdivision to Revenue and Taxation Code Section 23701d that provides generally that Internal Revenue Code Section 501(c)(3) exempt organizations will be exempt for California purposes upon submission of a copy of the organization's Internal Revenue Code Section 501(c)(3) federal determination letter to the Franchise Tax Board. This change specifically applies to requests for tax-exempt status in California filed by organizations with the FTB on or after January 1, 2008.

As the legislative purpose of AB 897 is to allow federal law under Internal Revenue Code Section 501(c)(3) to control, to the extent that existing California regulations conflict with federal law under Internal Revenue Code Section 501(c)(3), consideration of any conflict in existing regulations is required to effectuate the Legislature's intent in AB 897.

Currently, both California and federal law recognize a group of organizations as tax-exempt if they are affiliated with a central organization (one which has one or more subordinates under its general supervision or control). The concept of a central organization applying for tax exemption for itself and its subordinates (i.e., chapter, local, post, or unit) is known as a "group exemption."

Staff received approval from the three-member Franchise Tax Board on June 5, 2008, to proceed with an interested parties meeting to address whether existing Regulation Sections 23701(i) and 23772(d) should be amended to allow incorporated subordinates to be able to obtain tax exemption by virtue of being part of a group. An interested parties meeting was held July 22, 2008. There were no attendees or comments submitted. Staff anticipates holding a formal regulatory hearing, as required under the Administrative Procedure Act, sometime in the fall of 2008.

***Regulations Sections 25101.3 and 25137-7 –***
***Air Transportation Companies – Allocation and Apportionment of Income***

FTB has identified the current statute and regulation used to apportion air transportation company income to this state as potentially needing both a new regulation and amendments to an existing regulation. (R&TC §§25137 and 25101.3; Cal. Code Regs., Tit. 18, § 25137-7.) The property factor for apportioning income of an air transportation company is calculated according to California Revenue and Taxation Code Section 25101.3. There currently is no regulation interpreting that statute. The discussion draft of Regulation 25137-7 includes several major amendments.

Staff received approval to proceed with an interested parties meeting at the April 4, 2007, three-member Franchise Tax Board meeting. An interested parties meeting was held September 6, 2007, to discuss updating the existing airline transportation regulations to provide a uniform apportionment formula that can be applied industry-wide, and to clarify factor representation for airfreight activities. Staff received comments and as a result drafted proposed language for Regulation Section 25101.3 and amendments to existing Regulation Section 25137-7. A second interested parties meeting was held March 27, 2008, to discuss updated model/type groupings and to discuss how to apportion airfreight company income to this state. Staff anticipates holding a formal regulatory hearing, as required under the Administrative Procedure Act, sometime in the spring of 2009.

***Regulations Sections 25111 and 25113 – Water's-Edge Election***

In 1988, the California Legislature adopted Section 25110, et seq., which allowed California taxpayers that were members of a unitary group to "elect to account for and determine their income derived from California sources by considering only the income and apportionment factors" of certain affiliated corporations, which are generally only the domestic members of the Unitary group, which is called the "water's-edge" method.

Originally, taxpayers that wanted to utilize the water's-edge method of combined reporting were required to enter into a contract with FTB for an 84-month period. The requirements for satisfying the terms of the contract were contained in Section 25111 and the regulations promulgated thereunder. For taxable years beginning on or after January 1, 2003, the provisions for making a water's-edge election were substantially changed when Section 25113 was enacted and Section 25111 was amended. Section 25113 replaced the contract provided for Section 25111 with a statutory election, which is also to be made for an 84-month period. To date, there have been no regulations promulgated with respect to Section 25113. However, FTB issued FTB Notice 2004-2 to address transition issues between the two statutes.

Regulation Section 25111 currently provides definitions or explanations of several key concepts and Section 25113 provides new rules for taxpayers to use in terminating their water's-edge election. Both sections indicate that taxpayers that have valid election for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis and will be deemed to have elected under the new rules for taxable years beginning on or after January 1, 2003. However, the election commencement date under the new rules will continue to be the commencement date as originally elected under the old rules.

On November 28, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to address changes to the existing regulation providing for the contract method of making a water's-edge election and to discuss the content of a new regulation incorporating rules on making a statutory water's-edge election. An interested parties meeting was held on March 25, 2008. Staff anticipates holding a formal regulatory hearing, as required under the Administrative Procedure Act, sometime in the late fall of 2008.

### *Regulation Section 25114 – Presumptions Arising from Federal Audits*

In 1988, the California Legislature adopted Revenue and Taxation Code Section 25110, et seq., which allowed California taxpayers that were members of a unitary group to "elect to account for and determine their income derived from California sources by considering only the income and apportionment factors" of certain affiliated corporations, which are generally only the domestic members of the unitary group, which is called the "water's-edge" method.

Previously, Revenue and Taxation Code Section 25114, subdivision (a), required FTB to examine all returns filed by taxpayers pursuant to the water's-edge rules. If FTB then determined that there was potential noncompliance, it was required to conduct a detailed examination under the federal transfer pricing rules of Internal Revenue Code Section 482 unless the Internal Revenue Service was examining the taxpayer for the same years and issues. This detailed examination was required to be conducted notwithstanding the "potential net revenue benefit to the state." The mandatory audit requirement was included in the water's-edge legislation to provide a disincentive for companies to misrepresent their U.S. income through, for example, transfer pricing arrangements between their U.S. and foreign operations.

On October 5, 2007, the Governor signed SB 788 (Stats. 2007, Ch. 306), which amended Revenue and Taxation Code Section 25114. Under amended Revenue and Taxation Code Section 25114, FTB is still required to examine all returns filed by taxpayers pursuant to the water's-edge rules. The amendments to Revenue and Taxation Code Section 25114 have deleted the requirement for FTB to conduct a detailed examination in cases of potential noncompliance.

On November 28, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to address statutory changes to the existing regulation requiring the Franchise Tax Board to examine the returns filed by taxpayers pursuant to the water's-edge rules. An interested parties meeting was held on March 25, 2008. Staff anticipates holding a formal regulatory hearing, as required under the Administrative Procedure Act, sometime in the spring of 2009.

### *Regulation Section 25128 – Apportionment of Business Income*

In 1993, Revenue and Taxation Code Section 25128 was amended to require that the sales factor be double-weighted for most taxpayers. Exceptions to double-weighting are provided for in subdivision (b) of Revenue and Taxation Code Section 25128 when an apportioning trade or business derives more than a threshold percent of its gross business receipts from one or more of the four activities that are enumerated in subdivision (c).

One enumerated exception is "banking or financial business activity" (subdivision (c)(4) of Revenue and Taxation Code Section 25128). Banking or financial activity is defined generally in subdivision (d)(5) as "activities attributable to dealings in money or moneyed capital in substantial competition with national banks." The remaining three activities are defined comprehensively, either in separate regulations (extractive business activity in Regulation Section 25128-1 and agricultural business activity in Regulation Section 25128-2), or in subsection (c) (savings and loan activity). Only “banking or financial business activity” lacks a comprehensive definition, either in the statute itself or in Regulation Section 25128.

On September 5, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to address identified concerns and include a comprehensive definition of “banking or financial business activity.” Staff plans on holding a working group meeting sometime in September or October of 2008.

### *Regulation Section 25136 – Sales Factor. Sales Other than Sales of Tangible Personal Property in this State*

California Code of Regulations, title 18, Section 25136 (Regulation section 25136), is based upon, and is virtually identical to, Multistate Tax Commission (MTC) Regulation IV.17 prior to the most recent amendments. Regulation Section 25136 generally provides that sales of other than tangible property are assigned to the numerator of the sales factor based upon where the income-producing activity is performed. Under subsection (b) of the current regulation, income-producing activity only includes “activity directly engaged in by the taxpayer in the regular course of its trade or business” and “does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.”

FTB issued Legal Ruling 2006-2 on May 3, 2006. This Legal Ruling held that: Due to the effects of combined reporting when the contractor and the subcontractor are in a unitary relationship and are members of the same combined reporting group, the activities of the subcontractor in performance of the contract will be considered income-producing activities directly engaged in by the contractor for purposes of the sales factor in order to more accurately assign the receipt to the place where the services were performed.

At the Annual Meeting of the MTC held on August 2, 2007, the MTC approved amendments to the Commission’s Regulation IV.17. The amendments adopted by the MTC reverse the general rule found in Regulation Section 25136, subsection (b), and make assignments based upon activities of both the taxpayer and those performed on behalf of the taxpayer.

On September 5, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss the possibility of adopting and, to what extent, the amended MTC model regulation for Regulation Section 25136. On January 9, 2008, an interested parties meeting was held. Public comments were received and were considered by staff. On June 5, 2008, FTB approved staff’s recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act, providing staff solicit public comment on examples that were being developed prior to initiating the formal regulatory process. Staff anticipates holding a formal regulatory hearing sometime in the fall of 2008.

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

The 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 FTB. 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 FTB, 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.

FTB staff 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. FTB staff, 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 State 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. 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 then published a fifteen-day notice incorporating the proposed revisions on March 18, 2008, and the final approved regulations were filed by the Office of Administrative Law with the Secretary of State on April 29, 2008.

### *Regulation Section 25137-1 – Apportionment and Allocation of Partnership Income*

When a taxpayer subject to the Corporation Tax Law is a partner in a partnership as defined in Revenue and Taxation Code Section 17008, the computation of its distributive share of partnership items is determined in accordance with Chapter 10 of Part 10 of Division 2 of the Revenue and Taxation Code. The portion of such distributive share (constituting business and nonbusiness income) that has its source in this state, or that is included in the taxpayer's business income, is determined in accordance with California Code of Regulations, Title 18, Section 25137-1 (the "partnership regulation"), which was first promulgated in 1972 and last amended in 1985.

The partnership regulation has generally functioned well over the years, but the passage of time has rendered some of its provisions out of date and new business models have arisen that the regulation does not address. For these reasons, FTB staff has studied the regulation and identified several issues that it believes should give rise to consideration of amending the regulation.

On November 28, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to address numerous issues identified by staff. An interested parties meeting has been scheduled for September 19, 2008.

### *Regulation Section 25137-8 – Apportionment of Income for Motion Picture and Television Film Producers and Television Networks*

Several years before the Uniform Division of Income for Tax Purposes Act (UDITPA) was adopted by California, the Franchise Tax Board and the motion picture industry recognized that special rules were needed for the allocation and apportionment of income from the industry's activities. Working together, the department and industry developed special rules which were adopted in 1982 as Regulation Section 25137-8. Since the regulation in its current form was adopted over 25 years ago, it may be time to revisit the regulation to determine what, if any, changes might be appropriate.

Subsequent to the adoption of the existing regulation in 1982, the television network broadcasting industry has undergone significant changes, and is continuing to do so. Today, television networks operate almost exclusively on a multistate basis. Technology has changed as well and network programs and advertising are transmitted as a digital signal to satellites, accessed by affiliates and released to subscribers across the country and, in some cases, around the world.

At the time the regulation was drafted, the focus was on major studios, and independent distributors do not appear to have been represented at the hearings. While the regulation was subsequently enlarged to include independent television broadcasters, there was no discussion or inclusion of independent film distributors and they are not covered by the existing regulation.

The changes in advertising-driven media continue to cross industry lines. Today, television, print and film industries regularly utilize online advertising formats and web companies are brokering advertisements in the television, radio, print, and gaming industries, as well as the internet. These multiple formats mean that what is defined as an advertisement is rapidly changing.

On September 5, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss updating the existing regulation to address the need for definitions of "gross receipts," "advertisement," "independent film distributor," and "tangible/intangible" with regard to distribution rights. In addition, advertising revenues from online advertising in the Motion Picture and Television Industries as well as whether other online advertising-driven media industries should be included in Regulation Section 25137-8 were discussed with interested parties. On January 8, 2008, an interested parties meeting was held. Public comments were received and were considered by staff. A working group meeting was held as a result of the January 8, 2008, interested parties meeting. Staff anticipates holding a formal regulatory hearing sometime in the spring of 2009.

### *Regulation Section 25137-11 – Allocation and Apportionment of Income of Trucking Companies*

Due to the mobile nature of the trucking industry, it is often difficult to isolate and measure the level of California activity in comparison to the level of activity everywhere in order to assign property, payroll, and sales to this state. For this reason, FTB promulgated California Code of Regulations, Title 18, Section 25137-11, to calculate the property, payroll, and sales factors of trucking companies. This regulation provides an efficient way for trucking companies to calculate their apportionment factors, as mileage is routinely recorded, and hence, it provides a readily available measure of business activity both within and without California. The rules for determining the apportionment factors for the trucking industry, pursuant to Regulation Section 25137-11, have generally been derived from, and are parallel to, the trucking regulation promulgated by the Multi-State Tax Commission.

The apportionment formula found in Regulation Section 25137-11 uses an interstate ratio to apportion property, payroll, and sales related to the transport of goods between states. Shipments that are driven only inside of California are assigned to the California numerator of the property, payroll, and sales factors. The interstate ratio for hauls crossing state lines is miles driven inside of California divided by total miles. In this way, property, payroll, and sales are assigned in proportion to the miles driven within California.

On November 28, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss whether to update or add definitions to the existing regulation. An interested parties meeting was held July 17, 2008. Discussions included whether the "trucking company" definition should be amended and whether a "trucking activity" definition should be added. Also discussed were freight forwarding and third-party independent contractor fact situations. Public comments were received and were considered by staff. Staff anticipates holding a formal regulatory hearing sometime in the spring of 2009.

### *Regulation Section 25137-12 – Print Media*

Regulation Section 25137-12, adopted in 1995, addresses both the nature and sourcing of advertising in magazines and periodicals ("print media"). The precursor to this regulation was Legal Ruling 367, issued in 1973, in which the department ruled (1) that sales of advertising in print media generated business income under Revenue and Taxation Code Section 25120, (2) that the advertising was so intrinsically a part of the printed media itself, and (3) that the sale of advertising was to be treated as a sale of tangible personal property under Revenue and Taxation Code Section 25134 (the ruling noted that the advertiser's primary purpose was to reach the market established by the print media publisher). Further, sales of advertising were to be sourced on a geographical basis according to circulation statistics: they were sourced to California in the ratio that sales of the printed media bore to the total sales of printed media everywhere.

The regulation also addresses the issue of "nowhere income" by including a throw-back rule that requires advertising receipts to be thrown back to the state from which the printed media containing the advertising was shipped, stored, etc. To the extent that a publisher is not taxable in the state of the purchaser/subscriber of its printed media, the gross receipts from the sales and subscriptions of the printed material are thrown back to the state from which the printed media was shipped.

Traditional "print media" activities now include online advertising services that are not covered under any of the Revenue and Taxation Code Section 25137 special industry regulations. Some corporations provide online advertising services that are geographically targeted. FTB has identified the following scenarios that are not currently covered by Regulation Section 25137-12: (1) sales of online advertising, (2) sales of "embedded advertising," and (3) sales of advertising distributed via cable or satellite transmission.

Staff received approval from the three-member Franchise Tax Board on September 5, 2007, to proceed with an interested parties meeting to discuss updating the existing regulation to encompass advertising revenue from all technology used by print media to distribute advertising, determine the characteristics of advertising revenue (i.e., as tangible or intangible property), and update the regulation in response to other changes occurring in the print media industry. An interested parties meeting was held January 8, 2008. A working group meeting will be scheduled for this fall.

**The Taxpayers' Rights Advocate Office** works with Franchise Tax Board's program areas to ensure taxpayers' rights are protected. We identify systemic problems and find solutions in a cooperative effort while protecting taxpayers' rights and recognizing the goals of our audit, collection, and filing programs. We also coordinate the resolution of taxpayer complaints and problems, including complaints regarding unsatisfactory treatment of taxpayers by employees. We promote integrity and responsibility so that our customers can rely on quality information and efficient service.