'10

Taxpayers' Bill of Rights Annual Report to the Legislature

State of California
Franchise Tax Board

December 1, 2010

Table of Contents

Executive Summary

Once again we faced a difficult year. Nationally, the United States continues its struggles with a recession and hopes for an economic recovery. In California, we continue to face record deficits, decreased revenue, and cash flow problems. Unfortunately, this crisis led our department to eliminate positions and impose other severe budget cuts. In spite of all the challenges, the Franchise Tax Board (FTB) does the same quality work with fewer resources. FTB remains rock solid and continues to process tax returns, issue refunds, conduct audits, collect delinquent accounts, and support its operations.

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

The Advocate's Address briefly discusses significant issues, concerns, and challenges to both taxpayers and the department, such as auditor retention, collections, and conformity. 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 also addresses the Taxpayers' Rights Advocate's responsibilities and contacts. For Fiscal Year 2009/2010 (July 1, 2009, through June 30, 2010), the Taxpayers' Rights Advocate's Office responded to over 27,300 contacts from taxpayers. The Taxpayers' Rights Advocate:

- Explains taxpayers' rights.
- Provides education services to taxpayers and tax professionals.
- Conducts the Annual Taxpayers' Bill of Rights hearing.
- Communicates with tax professional groups and industry representatives.

To satisfy the Taxpayers' Bill of Rights requirements, the Taxpayers' Rights Advocate Office conducted a study using a sample of both corporation and personal income tax (PIT) *Notices of Proposed Assessments*. These proposed assessments result from FTB audits. The primary findings include the largest cumulative dollar amounts in proposed assessments:

- Corporation taxes: Allocation and apportionment audits.
- Personal income taxes: Filing enforcement assessments.
- Manufacturing industry: Based on California's primary business activity.

The Taxpayers' Rights Advocate's Office compiled information on taxpayers' filing errors detected during tax return processing. We issued *Return Information Notices (RINs)* to taxpayers who filed tax returns with errors that resulted in a change in tax liability. Advocate staff detected a taxpayer error rate of approximately 3.5 percent during tax return processing. They examined this data to identify and address some of the most common taxpayer errors.

Along with the Taxpayers' Rights Advocate, the department continues its efforts to reduce the number of notices it issues and makes it easier for taxpayers to meet their obligations. We continue to provide information and assistance to taxpayers and tax professionals as issues arise.

Selvi Stanislaus

Selvi Stanislaus
Executive Officer

Advocate's Address

Members of the California Legislature:

I submit for your review the 2010 Taxpayers' Bill of Rights Annual Report to the Legislature.

I would like to give special acknowledgement to FTB for their efforts to continue to assist and provide quality service to California taxpayers during this difficult economic time.

I remain proactive, visible, and accessible to taxpayers. I use many different venues to maintain constant interaction with the tax professional community and with taxpayers. I personally participated in our presentations to a variety of tax professionals, community organizations, and government groups throughout California. My involvement in over 50 events this year allowed me to stay apprised of the effects FTB's policies, processes, and procedures have on taxpayers. Meeting with these groups allows me to hear firsthand what issues, concerns, and challenges taxpayers face and the impact tax legislation has on them.

This past year, my office conducted a survey to compare the Advocate's roles and responsibilities with those of the Internal Revenue Service (IRS), Board of Equalization (BOE), and Employment Development Department (EDD). The survey results clarified the FTB Advocate's level of responsibility and authority as compared to the other advocates. Advocates can inquire about cases and may even intervene in certain situations. This past year we also clarified our procedures for audit case review and referral and Criminal Investigation cases.

Included in this report, I identified areas where FTB can improve its operations and its services to taxpayers, including systemic issues that impact the department.

My goal is to ensure that taxpayers' rights are protected. To meet that goal, we strive to improve the communication and services that FTB provides and identify systemic issues. In Fiscal Year 2009/2010, 118 issues were submitted through the Systemic Issue Management System (SIMS). Of the issues submitted, ten were identified as possible systemic issues and forwarded to program areas for research and resolution. The program areas resolved nine out of ten issues.

We are in the development stage of Phase II of the SIMS, which will allow us to track the issues online and to generate reports for management. We expect to begin using Phase II in early 2011.

The following highlights the type of issues submitted through SIMS:

- What procedures does the department use when it identifies a corporation as an insurance company? Response: Corporations that are doing business in California and are registered with the Department of Insurance and have received a Certificate of Authority are not required to file a tax return with FTB. The main problem is that FTB does not receive any information from the Department of Insurance or any other source showing this Certificate of Authority, and therefore, our systems see these entities as regular corporations with a filing requirement. After researching this issue, our Data Resources staff arranged for the Department of Insurance to provide us a list of companies who have been issued a Certificate of Authority on an annual basis.
- Limited Partnerships (LP) converts to Limited Liability Company (LLC) at midyear, or vice versa. Per FTB's policy, the entity must file two separate tax

returns, one for the period of time that it is a partnership, one for the period of time that it is an LLC. This creates a substantial burden on taxpayers and preparers, who keep two sets of books, file two tax returns, and issue two sets of K-1s for California. For federal purposes, the entity is considered a partnership for tax purposes for the entire year and only files one tax return. Taxpayers recommend that FTB design a separate form to indicate conversion during the year, which allows taxpayers to file the form with the additional $800 minimum tax for the first part of the year that it operated as an LLC or an LP. This allows taxpayers to file only one tax return with all K-1s for the entire year that reflect results of all operations. After researching this issue, our Legal Division is drafting a notice to allow midyear conversions.

In the following section, I discuss issues, areas of concern, and challenges that both taxpayers and FTB face.

1. Auditor Retention

Last year, I reported a troubling trend in our audit division. An alarming number of senior audit staff retired or left state service to accept positions with the IRS and the private sector. As the economy gets worse, employee morale dips. Some key factors in the decision for auditors to leave FTB include salary disparity, benefit losses, and an aging workforce. We were able to hire new auditors last year, which requires the department to expend more time and resources training new auditors. The cost of training a new auditor is approximately $40,000. It remains particularly difficult to keep pace with the increasingly complex and evolving tax environment when we lose the knowledge base of our most senior people. Time and resources are being further squeezed by the State's budget crisis. As the Taxpayers' Rights Advocate, my concern, once again, is the department's ability to meet the standards as set forth in the Taxpayers' Bill of Rights.

It is essential that we think long-term to retain newly hired audit staff. It may take more than four years for a new auditor to reach the program specialist level and many more years to promote to the program specialist II and III classifications. Our hope is that the resource expenditures yield a return on the investment through producing quality auditors who will one day perform at the most senior levels. When auditors accept positions outside of the department, we lose a resource and their knowledge. Of additional concern is that new auditors may be the first to be let go if the State is required to implement staff layoffs. Since these are specialized positions requiring advanced degrees, new auditors generally have the least seniority because they are usually hired from outside the state workforce or directly from college. It would be very difficult, if not impossible, to fill the vacancies from within the department.

When less experienced auditors replace senior auditors, it increases the potential of audit issues not being fully developed or even missed. Less experienced auditors may open fewer audits, take longer to complete audits, and be less efficient on the more complex audits which impact taxpayers' costs.

It is extremely important that we take the steps necessary to retain our audit staff and to promote auditors. Our audit program is struggling to train less experienced staff to fill senior positions as more departures occur, and to retain staff as this trend continues. California cannot afford to ignore this trend when we must maximize all revenue sources. Without the staff we need to make the audit program successful, California's tax gap will increase, taxpayers will be frustrated, and revenue will be lost.

2. Collections

Over the past fiscal year, the accounts receivables increased from $7.8 billion to $8.5 billion. Part of the reason for the increase is due to the changes in the withholding tables and the child exemption credit which caused more people to owe taxes. As a result, the open balances and the volume of installment agreements also increased. In the personal income tax section, the open balance grew from over $420 million to over $528 million. The number of installment agreements increased by 25,562, which represents an increase of over 21 percent. In the business entities tax section, the open balance grew from over $8 million to over $15 million. The number of installment agreements increased to 1,467, which represents an increase of over 100 percent. This increase in accounts receivable and requests for installment agreements means more taxpayers contact the department to resolve their account balances.

To better assist taxpayers, we offer e-services. Taxpayers can arrange an electronic withdrawal from their bank account to pay their personal income taxes through Web Pay. Starting in November 2010, business entities will also be able to use Web Pay. Taxpayers can enter into an installment agreement online. FTB's collection department has instituted Provisional Payment Plans, which allow taxpayers to contact FTB to start paying their liabilities while they gather data to prepare and file their tax returns.

3. Conformity

For the last two years, I raised concerns about how the lack of conformity to the Internal Revenue Code (IRC) increases the complexity for the taxpayer. This leads to low taxpayer self-compliance and greater costs of administering and enforcing income tax laws. We believe the lower taxpayer self-compliance, in many cases, is the result of unawareness of the state and federal differences that exist in income tax law.

I applaud your efforts to align California's tax laws with federal laws by passing Senate Bill (SB) 401, the Conformity Act of 2010. This allows FTB to:

- Provide homeowners modified relief from the cancellation of debt on their principle residences.
- Follow the federal Kiddie Tax rules.
- Exclude from California taxable income federal energy grants received.

However, we are still not in full conformity because California does not generally conform to any of the changes made in the 2009 federal acts retroactive to January 1, 2009, or to any of the 2010 federal acts. Thus, once again placing California taxpayers a year behind the federal law and widening the gap between federal and state conformity.

Full conformity helps:

- Simplify the taxpayer's ability to self-comply.
- Decrease unintentional taxpayer error.
- Decrease the burden of preparing tax returns for most taxpayers.
- Decrease the cost for taxpayers to prepare their tax returns.
- Decrease administrative costs to the state.

So, I reprise my call for simplification through conformity, and I encourage you to continue your efforts to pass a full conformity bill. As you are aware, getting a conformity bill passed is time intensive. The growing disparity between the federal and California tax laws makes the lack of conformity one of the biggest areas of concern for California taxpayers. Without conformity, complex tax law continues to place burdens on taxpayers, and these burdens lead to increased errors, penalties, and tax return preparation costs.

4. Late State/Federal Legislation

The passage of late legislation continues to add to the burden on both taxpayers and FTB. As I indicated last year, in many instances, the implementation of this late legislation is retroactive to the beginning of the year, and adds to the burden on taxpayers and their ability to be compliant. The constant change in tax laws and lack of conformity confuses taxpayers and leads to unintentional taxpayer errors that could lead to the assessment of penalties. Taxpayers may not have information they need to understand the changes or the most current tax forms. Industry groups may not have time to update their tax preparation products with changes resulting from late legislation.

For FTB, tax law changes require changes to programming and processing, as well as revisions to tax forms, instructions, and publications. When legislation is enacted late in the year or when laws are changed during the taxable year there is insufficient time to conduct the necessary taxpayer education. For example, Assembly Bill (AB) 1568 (Salas, Stats. 2009, Ch. 299) allowed taxpayers that suffered losses as a result of the wildfires that occurred in October 2008 in Los Angeles and Ventura Counties to elect to file an amended 2007 tax return to expedite a refund. The due date for that election was October 15, 2009, meaning the taxpayers only had four days to file the amended tax returns because they had to wait until the bill was enacted on October 11, 2009. In addition to the burden on taxpayers, it increases the likelihood of more errors on tax returns, which burdens both taxpayers and FTB.

I once again proposed FTB to dedicate staff and resources to follow and provide analysis on federal legislation. I also encourage you to consider the impact late legislation has, not only on FTB, but on the taxpayers of this state.

5. Cancellation of Debt - Foreclosure

This year California continued to be hit hard by the struggling housing market. Foreclosures and short sales occurred at record levels and Californians again faced the reality of losing their homes. As we approached the April 15 deadline, many taxpayers were also worried that they would owe tax as a result of their loss.

On April 12, 2010, there was one bright light for taxpayers in this otherwise gloomy picture when SB 401 was enacted. California law conformed, with modifications, to federal mortgage forgiveness debt relief. It allowed taxpayers who had all or part of their loan balance on their principal residence forgiven by their lender to exclude part or all of the forgiven debt from California gross income. Taxpayers who had discharges of qualified principal residence indebtedness on or after January 1, 2009, and before January 1, 2013, would qualify.

FTB felt it was extremely important to educate taxpayers and tax professionals on mortgage debt forgiveness. Areas of particular interest regarding the new California law were the implications of short sales versus foreclosures, how to calculate the mortgage debt forgiveness amount, and federal and state differences. This was one of our most requested education topics, so in response, we created a mortgage debt relief webpage with information on the new law and links to important state and federal resources. We also published several *Tax News* articles to help disseminate the information to tax professionals and provide helpful resources. Additionally, our education and outreach team included information in our California tax update presentations to help tax professionals understand the rules and computations involved.

In conclusion, we applaud the Legislature for passing such important legislation at a time when so many Californians needed it. While it may not have eased the rate at which Californians experienced foreclosures, it certainly went a long way to ease the tax burden on those already hard hit by this recession.

6. Tax Liens

Taxpayers and the tax professional community shared with me their growing concerns about the increased number of tax liens that have been filed by FTB. In Fiscal Year 2006/2007, we filed 157,401 liens. In Fiscal Year 2009/2010, we filed 295,027 liens, an increase of 87 percent. For this same period, our accounts receivables increased by 58.3 percent. FTB's current policy allows for the filing of a lien on a tax year or aggregate tax years with a balance of $1,000 or more. However, in certain circumstances a lien may be filed on a lesser amount to facilitate compliance. In previous years, FTB filed liens on balances in excess of $100, $250, and $500. In 1998, the threshold was raised to $1,000 after an FTB study reported that it would reduce departmental costs, correspondence, and telephone calls from taxpayers. In the current economic climate and the negative impact a lien has on a taxpayer's credit report, I think it is time to consider raising the threshold once again.

A review of the statistics provided by our collections department shows that as of January 2010, the total amount presently owed, open balance, is $4 billion. Furthermore, 11,334 liens were released in Fiscal Year 2006/2007 because they were filed in error. In Fiscal Year 2009/2010, the number of liens released, as filed in error, increased by 71 percent to 19,406. As stated above for this same period, our accounts receivables increased by 58.3 percent.

The majority of liens filed are on open balance ranges of $1,001 to 2,500, which are less likely for high income earners. The National Taxpayer Advocate (NTA) cited in her Annual Report to Congress, dated December 2009, that the IRS lien filing policies is the second most serious problem facing taxpayers. The NTA stated the IRS filed liens even when the taxpayer possessed minimal assets, and the lien had no effect other than damaging the taxpayer's credit report or their ability to obtain new credit. The NTA recommended, prior to filing a lien, the IRS determine if the benefits of filing a lien outweighs the harm to the taxpayer. I believe the FTB should follow the same reasoning with regard to when to file a lien.

Some of the benefits to reducing the number of liens filed are not limited to, but include the following:

- Reduces the number of partial lien/subordination requests.
- Reduces the number of derogatory marks on a taxpayer's credit bureau report.
- Reduces the number of telephone and written contacts to FTB.
- Reduces the number of liens filed in error.
- Enables staff to be available to manage the workload more efficiently.
- Reduces workload to county recorders.

FTB's collections department is committed to explore ways to reduce the number of liens filed to avoid causing undue hardship to taxpayers, and to reduce the amount of resources needed for the workload.

FTB is working to reduce the number of liens filed in error. We are also changing our lien release document to reflect the words "filed in error," in the document title to make it easier for taxpayers and credit reporting agencies to identify a lien filed in error.

7. Investigations Transparency

FTB has a criminal investigations program that maintains case inventories consisting of failure to file, false income tax returns, refund fraud, and joint task force operation cases. Special agents are peace officers, and perform most of the duties associated with the peace officer role. They write and serve search warrants, gather and analyze evidence, interview witnesses, interrogate suspects, make recommendations to prosecute, serve arrest warrants, assist prosecutors through all stages of the prosecution, track and apprehend fugitives, and monitor terms of probation. The criminal investigation program has powers and responsibilities that far exceed those of other FTB employees responsible for administering the states income tax laws.

My concern is the lack of transparency in regard to this program compared to the Criminal Investigations Division (CID) at IRS. The CID program has powers and responsibilities that are similar to our criminal investigations program.

While FTB does maintain a procedure manual, it is not complete and lacks significant detail compared to the IRS CID procedure manual. FTB criminal investigations do not make their procedure manual available online to the public. In contrast, the IRS CID procedure manual is extensive and available online. It offers a detailed table of contents, a clear investigations mission statement, and twelve topic headings with subheadings under each topic.

In addition to providing the CID procedure manual on the IRS website, the website offers information about their enforcement strategy, statistics, and United States Code Statutes for which criminal investigations has jurisdiction. The site also offers the CID annual business plan, compliance strategies, and fact sheets showing CID's involvement in investigating tax fraud and financial crimes in different industries and professions.

While we do have some information on our website in regard to the operations of our criminal investigations program, I recommend that we appear more transparent about the activities of our criminal investigations program. This should include a more comprehensive online manual and annual criminal investigations inventory statistics postings.

8. Penalties

Penalties imposed by FTB continue to be an area of concern to taxpayers and tax professionals. Often, these penalties can significantly increase the amount the taxpayer owes the state as well as to create personal liability for the tax professional or withholding agent. As a result, tax professionals requested clarification of penalties at our 2008 Taxpayers' Bill of Rights Hearing. Penalties are an important and necessary part of voluntary income tax compliance. In the current budgetary environment, however, there is an increasing public concern that penalties are being enacted as revenue raisers.

Last year, I proposed that my staff conduct a penalty study and that FTB direct dedicated resources to take a statistical look at how often penalties were assessed and withdrawn in the past three fiscal years. Unfortunately, resources were not available to complete this study. Instead, my staff worked on the *Penalty Reference Chart*, FTB 1024, which outlines each penalty, applicable Revenue and Taxation Code (R&TC) section, corresponding IRC section, reason, computation, and exceptions. This chart was updated to reflect the additional changes made by the conformity bill passed in April 2010. There are 69 penalties referenced in this chart.

This year, I recommend, once again, that FTB direct dedicated resources to take a statistical look at how often penalties were assessed and then withdrawn. I am concerned not only about the number of new penalties enacted, but also the fairness and clarity of the penalties. While penalties are necessary, as the Taxpayers' Rights Advocate, I must ensure that taxpayers receive due process and recommend that there are reasonable cause provisions that allow waivers of penalties under special circumstances.

9. Education and Outreach

Due to California and federal income tax laws continuously changing, passage of late legislation, lack of federal and state conformity, and reductions in taxpayer services, FTB needs to improve and increase our education and outreach efforts. The need to keep taxpayers and tax professionals informed is greater than ever. A good example is the impact of SB 401 enacted in April 2010. It included modified conformity to the federal Mortgage Forgiveness Debt Relief Act of 2007 for the exclusion of canceled mortgage debt for a qualified personal residence. With California being hard hit by the housing crisis, this law change impacts many taxpayers and their income tax returns. Without proper information, taxpayers may not benefit from this new law change or may make errors by excluding debt that does not qualify under the new law on their California income tax returns.

In the past year, FTB reduced the number of seminars on e-file, income tax withholding, nonprofit, and small business due to limited resources. In addition to presentations at seminars, we extend our education and outreach efforts by continuous improvement to FTB's website and use other media methods to get our information to taxpayers. We now offer a virtual seminar on State Income Tax and Small Business on our website. We use YouTube to market the benefits of ReadyReturn and CalFile. We conduct webinars on a variety of topics, and have a presence on Facebook and Twitter. It is important that despite the resource challenges, FTB continues to provide and make information available to taxpayers.

My staff currently provides materials, including *Tax News*, publications, and information on the website, about a variety of topics. This last year, we focused a large part of our education and outreach effort to inform taxpayers and tax professionals of the issues related to foreclosures, same sex married couples (SSMCs), new home credit, and enterprise zone credits. With the use of Twitter, I link my followers to late-breaking information, such as information on the new home credits, new rules for registered domestic partners, new publications, and other valuable information. I believe FTB needs to expand its services on the website to include more virtual presentations on subjects important to taxpayers.

I thank you for this opportunity to report some of the main issues of concern that have been identified throughout Fiscal Year 2009/2010. The issues and concerns that are listed above have been discussed with the responsible areas of the department, and in all cases additional action has been taken to address these concerns.

Taxpayers’ Rights Advocate Contact Information

TAXPAYERS’ RIGHTS ADVOCATE’S OFFICE MS A381
STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO BOX 157
RANCHO CORDOVA CA 95741-0157

Advocate Hotline: 800.883.5910
Fax: 916.845.6614
Website: **ftb.ca.gov**

Taxpayers’ Rights Advocate
Steve Sims, EA
Tel: 916.845.7565

To get this publication, go to **ftb.ca.gov** or write to the address above.

Taxpayers' Rights Advocate

Taxpayers' Rights Advocate Office Mission

The Taxpayers' Rights Advocate's Office works with 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's obligations. This law codified many existing department procedures and established a Taxpayers' Rights Advocate.

On July 30, 1996, the federal Taxpayers' 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.

In 2008, an amendment to California R&TC Section 21004 provided the Taxpayers' Rights Advocate the discretionary authority to grant relief from penalties, fees, additions to tax, or interest imposed on a taxpayer because of erroneous actions or inactions of the department.

Taxpayers' Rights Advocate Responsibilities

The Taxpayers' Rights Advocate has a direct reporting relationship to the Executive Officer. As enacted by the Legislature in the California R&TC, the Taxpayers' Rights Advocate:

- Coordinates the resolution of taxpayer complaints and problems, including complaints regarding unsatisfactory treatment by FTB employees.
- 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 R&TC.
- 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 FTB employees' performance based on taxpayer contact and not on the revenue produced.
- Possesses the discretionary authority to grant relief from penalties, fees, or interest imposed on a taxpayer due to erroneous actions or inactions of the department.

The Taxpayers' Rights Advocate's Office coordinates education and outreach efforts throughout California, such as tax professional and Advisory Board meetings. In addition, the Taxpayers' Rights Advocate and Advocate staff participate in tax professional 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 written content is clear, accurate, and timely. Staff is trained to apply department writing standards and follow guidelines to meet readability requirements as well as technical accuracy. We include revision dates on all of our publications. We offer quality translated publications in 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 about 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:

- FTB 4058, *California Taxpayers' Bill of Rights – Information for Taxpayers* (Revised 07-2010). This newly revised publication combines and replaces FTB 4063, *California Taxpayers' Bill of Rights 2,* and FTB 4064, *California Taxpayer Bill of Rights Act of 1999*, into one publication. It provides a basic overview of taxpayers' rights and includes the major provisions of the 1988, 1997, and 1999 California legislation.
- FTB 4058C, *California Taxpayers' Bill of Rights – A Comprehensive Guide (Revised 12-2009).* This publication describes provisions of the California Taxpayers' Bill of Rights and how we implement these provisions.

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

Advisory Board

We coordinate annual Advisory Board meetings with representatives from industry, state and federal government, and our department to discuss issues related to California income tax. This board provides our Executive Officer with insight and contributions on the various projects and programs FTB administers.

The topics from our latest meeting included updates from the Taxpayers' Rights Advocate, Audit Bureau, Settlement Bureau, Enterprise Data to Revenue (EDR) Project, filing season, and a Secure Email presentation.

Annual Meetings With Tax Professionals

We coordinate liaison meetings with the California Society of Enrolled Agents and the California Society of Certified Public Accountants. We provide legislative, filing, and audit updates. We present and discuss FTB's upcoming projects and issues. We respond to questions from tax professionals.

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 we provided information on tax law changes, available online services, and taxpayer assistance information.

Interest Abatement

We may cancel interest a taxpayer owes if the taxpayer can show that an unnecessary delay in our processing caused the interest to accrue or delay their payment, or if a 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 FTB. 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 FTB's erroneous action.

Taxpayers' Rights Advocate Contacts

Taxpayers or their representatives 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 ensure that 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, three-member Franchise Tax Board, employees, legislators, state and federal agencies, and taxpayers or their representatives contact us by mail, fax, telephone, and email. We received over 27,300 contacts in Fiscal Year 2009/2010. The majority of taxpayers (over 20,800 contacts) contacted us by telephone. We provide taxpayers a public number (800.883.5910) to contact our Advocate Hotline.

We received over 2,500 email contacts during this reporting period. Taxpayers often chose to email the Taxpayers' Rights Advocate when they could not contact the department by telephone or when the telephone wait time was too lengthy.

The top five reasons taxpayers contacted the Taxpayers' Rights Advocate's in Fiscal Year 2009/2010 include:

- Balance Due
- Earnings Withholding Order for Taxes
- Filing Enforcement
- Installment Agreement
- Refund

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

Balance Due

We updated taxpayers on their balance due or delayed collection action to allow tax returns or payments to post. We mailed tax computations, sent Offer in Compromise packages, reevaluated assessments, and encouraged taxpayers to send payments.

Earnings Withholding Order for Taxes

We modified or released these orders based on additional information provided.

Filing Enforcement

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

Installment Agreement

We updated taxpayers on their balance due and set up payment plans. When needed, we delayed collection action to allow tax returns or payments to post.

Refund

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

Systemic Issue Management System (SIMS)

The Taxpayers' Rights Advocate identifies systemic issues and finds solutions in a cooperative effort with FTB's audit, collections, and filing programs. In Fiscal Year 2009/2010, we received 118 issues through SIMS. Ten of those were identified as possible systemic issues and forwarded to program areas for research and resolution. Nine of the ten issues have been resolved.

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 tax returns.

We collected assessment information from the personal income tax *Notice of Proposed Assessment* display file for assessments that became final in Fiscal Year 2009/2010. When we used sample data, 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 was no distinct primary issue.

For corporation taxes, the largest dollar amount in proposed assessments resulted from one primary issue – allocation and apportionment audits, which involves 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, which 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 87 percent of the individuals who received *Notices of Proposed Assessment* during Fiscal Year 2009/2010 had audit changes for a single tax year.

An in-house accounting department or an accounting or legal firm prepares virtually all corporation tax returns. The data indicates that tax professionals file over 68 percent of all personal income tax returns. We consider corporation tax returns as professionally prepared. In the absence of a paid tax professional’s signature, we consider that taxpayers self-prepared their personal income tax returns.

We also compiled statistics for e-filing and payments. For these figures, see Appendix 1, Table 6. e-filing continues to increase, with a 3 percent increase from July 1, 2009, to June 30, 2010. As of June 30, 2010, we received 382,000 e-filed Business Entity (BE) tax returns, a 30 percent increase.

FTB informs taxpayers about their California filing requirements through its website, letters, and contacts with nonfilers. FTB sends first-time nonfilers who met their filing requirements in the previous four years a Request for Tax Return notice. We send repeat nonfilers a Demand for Tax Return notice. We send a Notice of Proposed Assessment to nonfilers, who do not file the necessary tax returns after receiving a request or demand notice. 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 30 percent of the taxpayers contacted for failure to file a tax return subsequently file their tax returns.

Taxpayer Filing Errors

The California R&TC requires the Taxpayers' Rights Advocate to identify the most common errors made by taxpayers when they file their tax returns and evaluate how those errors may be avoided or corrected.

We compiled taxpayer error information on approximately 15.5 million current year tax returns processed in Fiscal Year 2009/2010. During this time, FTB made approximately 550,000 adjustments and issued close to 350,000 Return Information Notices (RINs) to taxpayers who filed tax returns with errors that resulted in a change of tax liability. This equates to 2.25 percent of tax returns. The errors are explained in the notices. The number of adjustments is greater than the number of notices because many tax returns contained multiple errors. These volumes do not include counts for adjustments which did not affect the tax liability, such as adjustments to estimate transfers, voluntary contributions, or refund offsets to other tax years or other debts.

Close to 65 percent of all adjustments are made on paper-filed tax returns (29 percent of total current year tax returns filed), while only 35 percent of all adjustments are made on electronically filed tax returns (71 percent of total current year tax returns filed).

The most common taxpayer error, for all filing methods, was to claim the wrong amount of estimated tax credits. Just under one-third (32.9 percent) of all current year RINs contained an Estimate Payment Credit adjustment. Taxpayers either neglected to claim estimate payments they submitted, claimed a credit for a payment that differs from what they submitted, forgot estimate transfers, forgot adjustments to estimate transfers from the previous year, or claimed credits for payments that FTB had no record of receiving.

Tables in Appendix 2 display the number of adjustments by tax return type and filing method, and include a definition of what typically caused each adjustment.

Return Information Notices (RINs) Mailing

In the past, many taxpayers who submitted payments with their tax returns on or around April 15 received RINs. The notices acknowledged that FTB received their tax return, but did not show FTB received a payment. Since this had a potential taxpayer impact and had been a recurring issue from prior years, we established a pilot process to extend the notice delay period for the 2008 tax year an additional four weeks. This further delayed the issuance of the RINs until after FTB was able to record the payments. With a proven effective pilot program, FTB instituted the extended notice delay period as permanent policy.

Improve Compliance

Statutes

Each year, we review areas of the law and propose legislation to carry out our responsibility to improve taxpayer compliance and enhance 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 2177 (Beall, Stats. 2010, Ch. 136)
This act authorizes FTB, by regulation, to implement an alternative communication method that, at the request of a taxpayer or the taxpayer's authorized representative, allows specified electronic communications between FTB and the taxpayer. The act requires FTB to advise the taxpayer or the taxpayer's authorized representative of the ramifications of electing to receive notifications from FTB in the manner selected and of failing to take appropriate action in response to those notifications prior to the use of the alternative communication method.

AB 1530 (Skinner, Stats. 2010, Ch. 359)
This act allows FTB express authority to collect orders of restitution awarded to FTB in criminal proceedings in the same manner and with the same priority as tax liabilities.

SB 1065 (Walters, Stats. 2010, Ch. 318)
This act reenacts and makes permanent the statutory requirement that FTB grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances. The act corrects an inconsistency and makes technical changes to the existing innocent spouse statutes as well.

SB 1492 (Senate Revenue & Tax Committee, Stats. 2010, Ch. 498)
This act amends current law to do the following:

- Allows taxpayers applying for the Voluntary Disclosure Program to file the current year tax return as late as the extended due date.
- Eliminates the underpayment of estimated tax penalty when imposed because the voluntary disclosure agreement (VDA) is signed after the quarterly tax payment due date.
- Allows VDA applicants requesting an Installment Payment Arrangement (IPA) additional time to satisfy the VDA if the IPA request is denied after the VDA period ends.

Regulations

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

Areas for FTB to Improve

We are identifying areas to improve that could result in increased taxpayer compliance; although we have not addressed whether FTB has existing resources needed to make these improvements.

Customer Service Call Center Access Rates

Taxpayers continue to experience problems contacting us through our call centers. In Fiscal Year 2009/2010, the Taxpayer Services Center (800 number and Practitioner Hotline) answered approximately 47 percent of the incoming calls. In May 2010, the Queue Management Project was implemented in the call center with the expectation of improved access rates. Taxpayers who choose the virtual hold option have a much higher access rate of 90 to 95 percent. Since implementation, the abandoned call rate has also improved. We anticipate the overall access rate for Fiscal Year 2010/2011 will reflect these changes and increase.

Response to Correspondence Time Frames

Taxpayers writing to the department to either ask for or provide information continue to experience delays in processing and responding to their correspondence. The average response time to correspondence still varies greatly throughout the department. In some areas the response time is 25 to 30 days, and in other areas the response time is over 60 days.

Pending and Enacted Federal Legislation

The lack of conformity to federal legislation continues to directly affect taxpayer compliance and increases the burden on the taxpayer. The passage of the California Conformity Act of 2010 is the first change to conform to federal law since 2005. Despite this effort, we are still not in full conformity. For example, California law conformed, with modifications, to the federal Mortgage Forgiveness Debt Relief Act of 2007. California has not conformed to any of the changes made in the 2009 federal acts that were retroactive to January 1, 2009, or to any of the 2010 federal acts. Thus, placing us once again a year behind the federal law and widening the gap between federal and state conformity. There are still some other areas in which California has automatic conformity.

California's complex method of conformity results in a significant need for FTB to identify and analyze pending and passed federal legislation. When changes are made to the federal income tax law, California does not automatically adopt such provisions. Instead, state legislation is needed to conform to most of those changes.

Currently, when there is pending or passed federal legislation, FTB has to reallocate resources to analyze and understand the federal legislative changes and the impact to California taxpayers. FTB then has to train staff and respond to taxpayer and tax professional inquiries within short time frames and, in some cases, prior to the passing of legislation.

FTB needs dedicated staff and resources available to follow and provide analysis on pending and passed federal legislation on an ongoing basis. The lack of conformity to federal legislation burdens taxpayers and the department. FTB must allocate resources to reflect the federal tax law changes in our processing, programming, and revising tax forms, instructions, and publications.

In an effort to inform our tax professionals on late-breaking legislation or clarify the impact of laws, we periodically release *Tax Newsflashes* to our subscribers and post information on the Advocate's Twitter account.

Education and Outreach

We need to improve and increase our education and outreach efforts. In the last year, we had more constraints on our ability to provide taxpayers with information on California and federal tax law and FTB service changes. FTB should reconsider canceling education and outreach efforts because of limited resources. This could significantly reduce the number of taxpayer and tax professional errors. In addition to increasing our presence at seminars, we need to continue to expand our online taxpayer educational products. Increasing our online efforts is practical from both a cost and access point of view.

e-Services

In an effort to reduce the taxpayers' 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 tax-filing method where FTB uses wage and withholding information to complete tax returns for taxpayers with "simple tax returns." ReadyReturn is a voluntary program and taxpayers have the option to view, make changes, and e-file their ReadyReturn online.

In 2008 (taxable year 2007), the first year of the program, 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.

For 2009 (tax year 2008 tax returns), we expanded the eligible population to include taxpayers who filed as head of household, had dependents (up to 5) or could be claimed as a dependent, or who were renters. By including these taxpayers, ReadyReturn doubled its eligible population. In 2009, over 61,000 taxpayers used ReadyReturn, an increase of over 450 percent from the previous year. For 2010, ReadyReturn usage was down slightly, but remained steady with over 60,000 tax returns. We continue to receive positive feedback. A couple of examples are "Taxes shouldn't be complicated; what an awesome way to file my taxes with the state." and "Wow! Easy, Great, Convenient."

CalFile

CalFile is FTB's 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 tax return. With CalFile, taxpayers can automatically check to see if they are eligible for ReadyReturn. CalFile usage increased in 2010 with over 236,000 taxpayers using the service.

MyFTB Account

MyFTB Account is a secure online service allowing users to view estimated tax payments, recent payments made, and the total balance due on their account. 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.

Beginning in November of 2010, taxpayers, tax professionals, and businesses will have a new secure method to log in and access e-services on FTB's website. This new secure method, Access Your Account, requires a one-time registration. In the registration process, taxpayers and representatives choose a user name and password. Access Your Account replaces the current customer service number (CSN) based system. To view a client's account, tax professionals should have their client's written permission and will need to provide information from the client's tax return. New services available using this authentication method include:

- View and/or change address information for individuals.
- Web Pay for business entities.

In spring of 2011, service will be expanded and business entities will have access to view estimated tax payments.

Web Pay
Web Pay is a free, secure, online service that allows personal income taxpayers to make their tax payments online. In November, BE taxpayers will also have the ability to make tax payments online. Taxpayers can schedule payments up to one year in advance.

Training

To improve services to the public and encourage voluntary compliance, FTB develops employees' skills and abilities. FTB provides extensive training to our public service staff on how to deliver quality service and telephone techniques. The call center represents the front line process. Call centers that are properly staffed with well trained employees trained to provide critical pre-filing assistance, tax law explanations, and appropriate forms, can positively affect compliance. This service also minimizes the cost associated with collection and audit functions that result when tax returns are not filed timely, properly, or with the appropriate payment amount.

FTB provides technical training to its employees, including public service staff, tax technicians, compliance representatives, and auditors, on the following systems:

- Taxpayer Information System (TI).
- Business Entity Tax System (BETS).
- Accounts Receivable Collection System (ARCS).
- Integrated Nonfiler Compliance System (INC).
- Other systems as necessary.

In addition to technical training, FTB trains employees on workplace diversity, sexual harassment awareness, disability awareness, career development and upward mobility, and other administrative courses.

FTB also provides 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, FTB provides core compliance training courses which include:

- Penalties and interest.
- Filing requirements.
- Installment agreements (collection program).
- Tax assessments.
- Power of Attorney.

FTB invites subject matter experts to serve as mentors and coaches, training consultants, or guest instructors to provide new or updated training. FTB encourages 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.

FTB provides professional training to its auditors from the moment they begin their work with FTB. A four-week basic professional auditor training series was established to give 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.

FTB offers 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 provide continued guidance, direction, and on-the-job training and support for new auditors. FTB also provides broad-based development to optimize knowledge of the latest electronic technologies, evolve business practices, specialize financial transaction tracing, and improve auditing techniques.

FTB supports its auditors who seek Certified Public Accountant status. Under the Board of Accountancy guidelines, FTB provides Certified Public Accountants with the opportunity to receive continuing education credits for courses FTB develops and administers.

Enforcement

Although FTB encourages voluntary compliance through taxpayer education by providing pre-filing assistance and information, FTB continues to identify ways to improve its enforcement capabilities.

Filing Enforcement Program

The filing enforcement (FE) program identifies and contacts individuals and business entities that appear to have a requirement to file a California tax return and have not filed.

The personal income tax FE program uses various income sources to contact wage earners, self-employed individuals, individuals with unreported capital gains, nonresidents with California source income, individuals with partnership income, and any other individuals with unreported income. More than 500 million income records were provided to FTB by the IRS, BOE, EDD, financial institutions, and other sources. The FE program improved manual efforts to perform quality assurance on nonfiler cases.

The business entity nonfiler program also uses various income sources, including information from the IRS, BOE, EDD, and financial institutions, to identify potential nonfiling corporations. Recently, the program began using this data to contact limited liability companies, limited liability partnerships, and limited partnerships that appear to have a filing requirement.

FTB continuously strives to improve the filing enforcement programs and services available to both the taxpayer and the tax professional communities. FTB's website provides around-the-clock access and was implemented based on feedback that tax professionals and taxpayers provided. The following features are available to taxpayers from the website:

- 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 tax return.
- Provide updated address information.
- Request an email reminder to file for future tax years.

Audit Program

The audit program incorporates FTB's strategic goals. The program works with taxpayers and their representatives to promote fairness and compliance with the tax law and improve customer service. The program utilizes innovative methods to promote these objectives, such as self-compliance letters, tax shelter initiatives, and partnerships with other federal and state agencies. In performing these activities, the program considers the effects of its actions on taxpayers and focuses on adherence to FTB Regulation 19032, Audit Procedures.

Over the past year, the program's efforts have materialized into results:

- Self-compliance letters – Sent when FTB has information indicating potential noncompliance. These letters allow a taxpayer to voluntarily comply before we conduct an audit.
- Shelter Initiatives – Limited-time opportunities for taxpayers to voluntarily disclose participation in a tax shelter transaction, with the possibility of reduced penalties or other incentives.
- Partnerships – FTB partners with other federal and state agencies to share knowledge and information. For example, FTB partnered with other state revenue agencies and the IRS in exchanging information to address potentially abusive tax shelters. These collaboration efforts allow FTB to leverage resources for both itself and other agencies by consulting on the same taxpayer or similar issues.

FTB continues to seek new opportunities to form partnerships with taxpayers and other agencies and promote the best audit practices.

Address Tax Gap Initiatives That Promulgate Underreporting of Tax

The tax gap is the difference between the amount of taxes legally owed and voluntarily paid. FTB continues to identify those who intentionally and continually underreport taxes and contribute to the tax gap. FTB focuses its efforts to identify schemes used to evade reporting the correct tax amount. FTB dedicates specialized auditors to evaluate nontraditional sources to identify taxpayers who may not have fully self-assessed and paid the correct tax amount. Additionally, the tax professional audit program penalizes tax professionals who claimed deductions or credits erroneously. To complement these efforts, FTB takes strides to educate the citizens in common areas where noncompliance is prevalent.

Pursue Abusive Tax Shelter Investors and Promoters

FTB continues to diligently pursue the examination of abusive tax shelter participants and promoters. FTB's partnership with other states, the IRS, and other federal agencies enhanced the sharing and exchanging of abusive tax shelter information, training, and information leads. FTB focuses and dedicates audit resources to identify and evaluate investor leads, promoters, and to assess disclosure and information return penalties.

- Investor Leads – In addition to conducting audits, auditors contact taxpayers suspected of participating in tax shelters and offer them an opportunity to self-correct their tax return.
- Promoters – Audit created a database of potential promoters and began assessing abusive tax avoidance transaction promoter penalties.
- Disclosure and Information Return Penalties – In 2007, FTB issued FTB Notice 2007-3 and FTB Notice 2007-4, where investors had a 60-day grace period to file complete disclosure statements if they had failed to do so before issuance of this notice. Currently, FTB identifies and assesses penalties for investors and promoters who were required but failed to file disclosure statements or information returns.

Recent Legislation to Encourage Self-Compliance

In 2008, the Legislature enacted the large corporate underpayment penalty to deter taxpayers, primarily large corporations, from adopting aggressive filing positions. The penalty applies where the taxpayer has an understatement of tax in excess of $1 million and is equal to 20 percent of the understatement. The penalty is an effective tool to encourage corporate taxpayers to file accurate tax returns that attempt to satisfy the requirements of the tax law.

Collections Program

The Collections Program collects tax and nontax debts on behalf of the State of California. Tax debts are primarily, filing enforcements, unpaid audit, and tax return assessments for individuals and corporations. Nontax debts include vehicle registration fees and various court-ordered and industrial health and safety debts. Collections uses a variety of methods and tools to enforce the laws covering tax and nontax debt.

FTB maintains a collections call center staffed by collection experts, including several Spanish/English bilinguals. FTB also maintains an Advocate Hotline to assist taxpayers, tax representatives, and tax professionals with fast and direct access to collection experts. FTB provides online access to collection information, procedures, and electronic forms.

Liens and Levies

FTB has authority to issue notices of liens and to levy wages and bank accounts. Individual collectors or an automated system can issue notices of liens and levies.

Accounts Receivable Collection System

FTB uses this automated system to process and maintain approximately 2.5 million individual and 700,000 business accounts annually. FTB applies a customized approach to accounts, which greatly reduces the intrusion into taxpayers' lives. By automating many key collection functions, the staff uses 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, the 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, taking collection actions when voluntary compliance cannot be obtained, and properly documenting the case.

Contract Collection

FTB uses private collection agencies to collect debts in certain unfunded workloads. Both the taxpayer and the state benefit by resolving tax debts. FTB seeks 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, FTB provides a variety of options to help taxpayers resolve their tax debts.

Payment Methods

Installment Agreements – FTB provides 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 the status of their installment agreement requests online.

Provisional Payment Plans – FTB allows taxpayers to make payments while they are preparing their valid personal income tax returns. After all required and valid tax returns are filed, taxpayers may then enter into a formal installment agreement.

Offer in Compromise – FTB provides taxpayers who currently do not have (nor will have in the future) the necessary means to pay their tax liability an option to offer a lesser payment amount as 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 IRS Restructuring and Reform Act of 1998, we further expanded relief for innocent spouses. In addition, outreach events from 2000 through 2008 and legislation in 2003 and 2004 increased opportunities for relief.

Quality Assurance Practices

FTB follows quality assurance practices to validate that it meets targets and deadlines, complies with legal due process requirements, and takes corrective actions.

Criminal Investigations

Special agents focus on the underground economy and bring felony criminal R&TC charges against the most egregious cases of state income tax evasion. Special agents work cooperatively with federal, state, and local 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 tax returns, failing to pay taxes due, and making illegal cash payments to employees. Special agents present their investigative reports to prosecutors, assist in the prosecution, and seek publicity of the convictions through FTB's public affairs program. Prosecuting these criminal activities and publicizing the convictions result in many millions of dollars of tax revenue for the State of California collected from the convicted individuals and others who, due to knowledge of the consequences, are deterred from violating the income tax laws. For Fiscal Year 2009/2010, criminal investigations activities resulted in:

- 121 new cases.
- 57 cases approved for prosecution.
- 91 individuals prosecuted.
- 81 cases closed.

Legal

The Legal Division supports the enforcement effort by providing consultation and litigation support for positions developed in cooperation with the other enforcement programs. Support activities include representation in protests, representation in appeal proceedings before the BOE, 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 professionals with the information they need to file their state tax returns completely, accurately, and timely. We provide presentations to taxpayers and tax professionals on a variety of different topics including tax updates, e-file services, fraud prevention, withholding, audit, forms of ownership, enterprise zone credits, and other topics as requested. We participated in over 170 presentations throughout California. We developed two new publications in partnership with other state tax agencies and the IRS. We created the brochure *Understanding Your State Taxes,* a publication available for download from **ftb.ca.gov**, that provides general information about state taxes and filing requirements for new California residents and college students. We created a second publication through the partnership with the three state tax agencies and the IRS, FTB 3730, *Buying or Selling Online: Know Your Tax Obligations* (available for download from **ftb.ca.gov**). It provides clarification about laws such as prohibiting the taxation of Internet access (Internet Tax Freedom Act) and limiting sales tax on interstate sales. These laws led some to incorrectly believe that Internet sales income, including online auctions is not subject to income tax. We will distribute this information at small business fairs and through online auction businesses, such as eBay.

The multilingual services program mission is to provide the fundamental tools and resources necessary for our limited English proficient (LEP) customers to capitalize on the same resources available to our English proficient customers. In the collaborative effort to address these language barriers, we provide numerous resources such as quality translated materials, centralized translation coordination, and the necessary tools for our employees to provide multilingual services accurately, efficiently, and cost effectively to the state.

Starting in February 2009, we provided our Spanish speaking taxpayers with the 2008 540 2EZ instructional booklet in Spanish. Our goal for 2010 is to provide the translated 2010 540 2EZ Form and payment voucher. Education and outreach to our LEP customers has been the key to providing the most needed programs and services for taxpayers to comply with their tax requirements. We continue to enhance and expand our Spanish web portal.

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.

Our ongoing media efforts, including Spanish media, play a major role to meet our goal to reduce taxpayer errors. We give news interviews, prepare news releases, and create public service announcements to inform taxpayers of changes to tax law, new programs, and current issues of interest.

Same-Sex Married Couples (SSMCs)/ Registered Domestic Partners (RDPs)
On October 11, 2009, the Governor signed SB 54. This law provides that a valid same-sex marriage entered into outside California prior to November 5, 2008, is also a valid marriage in California. However, after November 5, 2008, a valid marriage entered into outside of California is only recognized as having the same rights and responsibilities as spouses with the sole exception of the designation of "marriage." Yet, for California income tax purposes, all couples in a valid out-of-state same-sex marriage must file their California income tax returns using either the joint or separate filing status.

On May 28, 2010, the IRS released Chief Counsel Advice (CCA) 201021050 which changes the federal tax treatment of California RDP's community income. Previously, the IRS did not recognize community property treatment; however, the IRS has now decided to extend full community property treatment to registered domestic partners in California. The IRS concluded that a California RDP must report one-half of the community property income on the federal tax returns. For tax years beginning before June 1, 2010, registered domestic partners may, but are not required to amend their tax returns to report their federal income in accordance with this CCA.

We offer three publications online (at **ftb.ca.gov**) or in print for SSMCs and RDPs regarding their California income tax treatment and their filing obligations:

- FTB 737 – *Tax Information for Registered Domestic Partners*
- FTB 776 – *Tax Information for Same-Sex Married Couples*
- FTB 1051A – *Guidelines for Married/RDP Filing Separate Returns*

Cancellation of Debt - Foreclosures

On April 12, 2010, SB 401 was enacted. California law conformed, with modifications, to the federal Mortgage Forgiveness Debt Relief Act of 2007. SB 401 allowed taxpayers who had all or part of their loan balance on their principal residence forgiven by their lender to exclude part or all of the forgiven debt from California gross income. Taxpayers who had discharges of qualified principal residence indebtedness on or after January 1, 2009, and before January 1, 2013, qualify. Areas of particular interest regarding the new California law were the implications of short sales versus foreclosures, how to calculate the mortgage debt forgiveness amount, and federal and state differences.

In response to the number of requests for information, we created a mortgage debt relief webpage with information on the new law with links to important information resources for state as well as federal information. We also wrote several articles for our *Tax News* publication to help disseminate the information to tax professionals and provide helpful resources for additional questions. Additionally, our education and outreach team included information at tax update presentations to help tax professionals understand the rules and computations involved.

Enterprise Zone Credits and Benefits

The enterprise zones program targets economically distressed areas throughout California. The program combines special state and local incentives intended to encourage business investment and promote the creation of new jobs. The Enterprise Zone Tax Incentive Program was created in 1986. Between October 2006 and March 2009, 34 original California enterprise zones expired. AB 1550 (Stats. 2006, Ch. 718), effective September 29, 2006, reformed the enterprise zones program. This bill provided for the administration and oversight of geographically targeted economic development areas, known as G-TEDAs which include enterprise zones. This bill also increased the number of enterprise zones which allowed a total of 42 enterprise zones statewide. Since its passage, we participated in events sponsored by State Assembly Members, the State Controller's Office, BOE members, and local zone managers to provide local business owners and tax professionals an opportunity to receive information relative to Enterprise Zone Tax Credits and benefits. In 2010, we continued our efforts that began in 2006.

Interactive Voice Response

FTB maintains and regularly enhances approximately 36 Interactive Voice Response (IVR) applications. These applications provide recorded responses to the most frequently asked questions regarding general state tax information, such as account information, current balance due, payment information, and current refund status. Callers can order corporation and personal income tax forms via the IVR forms applications. Most of our IVR applications offer both English and Spanish language options.

Queue Management

In May 2010, we implemented "queue management" technology for external customers who call our 800 numbers. Rather than wait on hold, customers can choose to terminate the call, maintain their place in the calling queue, and receive a call back just as promptly as if they had remained on the line. The customer is given a callback time based on the Estimated Wait Time at the time of their call. Customers welcome this new feature.

The implementation reduced our 'abandoned calls' significantly. Abandoned calls are callers who hang up because they are not able to continue waiting on the line. We saw roughly a 75 percent reduction in abandoned calls, and we saved over 7 million minutes of hold time in the first four months since implementation.

Budget constraints prevent us from expanding this service, but we continue to evaluate call center areas that would benefit from this technology.

California Tax Information

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

On the Internet, the California homepage (**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. The two new publications, FTB 989, *Understanding Your State Taxes*, and FTB 3730, *Buying or Selling Online: Know Your Tax Obligations*, created through the partnership with other state tax agencies and the IRS are available to view and download on these sites.

Tax News

Tax News, our monthly online publication, informs tax professionals about state income tax laws, regulations, policies, procedures, and events that affect the tax professional community. Tax professionals can subscribe to *Tax News* by email or go to **ftb.ca.gov**. We periodically release *Tax Newsflashes* to quickly notify subscribers of urgent, time-sensitive information. Consecutively, for the last two fiscal years, subscriptions increased by a steady 14 percent. We also experienced a positive trend when other trade media publications such as *Klienrock, Tax Express,* and *Spidell* linked to and used several of our *Tax News* articles.

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 BOE, EDD, and IRS, we develop products that simplify the process to obtain information on most business filing requirements. This year, through our partnership with the three state tax agencies and the IRS, we created publication FTB 3730, *Online Buying or Selling: Know Your Tax Obligation* (available for download from **ftb.ca.gov**). It includes basic tax information for online businesses. We also created a brochure (available for download from **ftb.ca.gov**), FTB 989, *Understanding California Taxes*, through a partnership between BOE, EDD, and FTB which covers California state tax filing requirements for new California residents and college students.

We participate in small business fairs sponsored by BOE members throughout California.

We created and updated the following publications to address common questions related to small business taxpayers:

- FTB 1123 - *Franchise Tax Board's Guide to: Forms of Ownership.*
- FTB 984 - *Franchise Tax Board: Common Business Expenses for the Business Owner and Highlights of the Federal/State Differences.*
- FTB 987 - *Top Twelve Tax Scams.*
- FTB 689 - *Don't Gamble With Your Taxes: Read the Fine Print About Incorporating in Nevada.*
- FTB 982 - *How to Select an Income Tax Return Preparer.*
- FTB 985 - *Audit/Protest/Appeals: The Process.*
- FTB 170 - *Striking Gold in California: What You Need to Know About Taxes and Your Small Business.*
- FTB 1024 - *Penalty Reference Chart (*available for view or download on **ftb.ca.gov** only*).*
- FTB 989 - *Understanding Your California Taxes (*available for view or download on **ftb.ca.gov** only*).*
- FTB 3730 - *Online Buying or Selling: Know Your Tax Obligation (*available for view or download on **ftb.ca.gov** only*).*

Our Small Business Liaison provides education and outreach to small businesses and receives calls from taxpayers. The liaison offers small business owners and taxpayers interested in starting a business tax information and information about specific filing requirements, based on their business ownership or proposed business ownership type. The liaison refers owners and taxpayers to the appropriate program areas within our department and to the other state or federal agencies to answer their questions.

We received approximately 1029 calls this year, an increase of approximately 8 percent, including many calls from out-of-state taxpayers.

Speakers' Bureau

Speakers' Bureau helps nonprofit organizations, community groups, and government-funded educational institutions learn more about tax-related issues. Speakers typically make brief presentations to groups of 25 or more. We provide speakers in other languages upon request and availability. The Speakers' Bureau is one of our ongoing ventures that acknowledge the continuing educational needs of tax professionals and nonprofit tax-related organizations.

Interested Parties Meetings

FTB holds 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 FTB and IRS 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.

FTB recruits VITA and TCE volunteers statewide, provides training to the volunteers, and provides outreach to let the public know about the programs.

FTB also provides 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
FTB collaborated with the IRS to administer the Schools' VITA Program at two area 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. Unfortunately, the current economic climate made it necessary for us to suspend our administration of the Schools' VITA program. However, one high school continues to work with the IRS to offer free tax return preparation services to the local community. FTB employees also volunteer on their own time to assist the school and student preparers with tax return preparation.

Department Initiatives and Projects

Key Initiatives for 2010

Promote and Encourage Self-Compliance

An ongoing performance management program provides a framework for relevant performance measures, productive performance discussions, and effective improvement actions.

FTB's performance is directly related to the taxpayer's ability to participate in the tax system. In order to continually improve performance, FTB must maintain a focus on taxpayers and what they need to meet their tax obligations. Through a comprehensive performance management program, FTB can manage, monitor, and improve the products and services it delivers in order to promote and encourage self-compliance.

Modernize Our Tax Systems

The EDR Project addresses many of the opportunities identified in the FTB's Strategic Plan. The EDR Project is a long-term effort spanning the next five years with significant milestones scheduled for each year.

The EDR Project promises business improvements for us and our stakeholders. For instance, EDR brings modernized tax return processing to us. We will be able to provide taxpayers faster service and better information about their accounts. Additionally, taxpayers and their authorized agents will have access to virtually all of their tax data via our online Taxpayer Folder.

The EDR Project also addresses data management. Tax data, currently stored in multiple systems, will be consolidated into a few interconnected systems. This allows us to spend less time manually connecting data to accounts. Because data won't be stored across many systems, we will be able to access information more easily and resolve taxpayers' issues more quickly and accurately.

The EDR Project is expected to achieve significant tax revenue benefits due to efficiencies in handling our day-to-day operations throughout the enterprise.

We completed a feasibility study report and received approval in 2009. Currently, we are in the procurement process which is handled by the Department of General Services. The project contract award is scheduled for July 2011.

Tax Gap Action Committee Initiatives

The Tax Gap Action Committee identified our key initiatives for the Fiscal Year 2009/2010. Leadership and membership changes prompted the team to consider its current direction and focus, given the fiscal and political climate. The team's focus this year involved the best use of existing resources, increasing compliance, and partnering with sister tax agencies. The committee realizes the budget situation may constrain the level of activity achieved under each initiative.

- Increase the Department's Taxpayer Compliance Efforts Through Better Use of Existing Data

The committee will sponsor appropriate projects to reevaluate the department's inventory of unused data sources to determine whether any of those sources can now be utilized to enhance compliance efforts in light of improvements in data quality over time and to improve the department's ability to resolve data quality issues. Initial information from the Technology Services Division indicates some of the currently unused data sources may be recovered and used to identify additional noncompliant taxpayers. The committee will assess whether departmental information reporting programs are clear and that such information is utilized.

- Consider and Evaluate the Effectiveness of Professional License Suspensions and Court Judgment Data as New Compliance Tools

Other state programs have used the suspension of professional licenses permits and similar accreditations as tax compliance tools. The committee will evaluate the effectiveness of other states' programs and explore the potential viability and effectiveness of such tools to determine whether such programs should be pursued by the department. In addition, the committee will consider an effort to gain access to information relating to civil court monetary judgments to enhance and accelerate compliance efforts.

- Expand Partnerships with Sister Tax Agencies and Other Governmental Agencies to Enhance Compliance Efforts

The committee will seek opportunities for FTB to strengthen and expand its partnerships with the BOE, EDD, IRS, and other agencies to find new ways to increase compliance and reduce the burden of filing. In addition, the committee will support FTB's efforts to continue to work cooperatively with tax preparer oversight agencies such as the California Tax Education Council (CTEC) to ensure that tax preparers maintain high professional and ethical standards. Specifically, FTB will continue to take an active role in the Fed State Partnership, support the efforts of the Joint Agency Data Sharing Team, and support the efforts of CTEC to identify and address noncompliant tax preparers.

- Enhance the Compliance Effect of FTB's Compliance and Customer Service Programs through Taxpayer Behavior Studies

FTB is currently studying the indirect impact of compliance programs and customer service programs on taxpayer compliance. During this fiscal year, the committee will analyze the results of two studies undertaken. The committee will consider additional studies with goals to inform department decision makers and make recommendations to consider when allocating resources among competing programs.

Projects

Access Your Account – Formerly External Authentication for Secure e-Services (EASE)

In November of 2010, FTB will provide taxpayers, tax professionals, and businesses a new secure method to log in and access e-services on FTB's website. This new secure method, Access Your Account (formerly EASE), requires a one-time registration. In the registration process, the taxpayer or representative chooses a user name and password. Access Your Account replaces the current customer service number-based system. To view a client's account, tax professionals need to obtain their client's permission and provide information from the client's tax return. To assist representatives to obtain a client's permission, we created a new form, FTB 743, *Online Account View Access Authorization*.

Using Access Your Account, taxpayers and tax professionals can view the following account information:

- Estimated tax payments made.
- Other payments made to FTB.
- Current account balance.
- California wage, withholding, and FTB-issued 1099 information.

Web Pay for Businesses and MyFTB Account Enhancements

In the initial implementation of Access Your Account, FTB will provide these additional e-services:

- Taxpayers can update their address online.
- Businesses can make payments online using our new Web Pay service for business entities.

In future years, we plan to add these e-services:

- View or cancel web payments for businesses and individuals.
- View account information for businesses.
- View tax return summaries for individuals.

Systemic Issues Management System

The Systemic Issue Management System Phase II is in the development stage and we expect it to be available by early 2011. The enhanced system will allow us to track the issues online and generate reports for management.

Taxpayers' Bill of Rights Hearing

Taxpayers presented proposals to the three-member Franchise Tax Board at the annual Taxpayers' Bill of Rights hearing on December 3, 2009. The meeting took place at FTB in Sacramento, California. For copies of the responses, go to **ftb.ca.gov** and search for **hearing responses**. The responses are in order of the presentations at the meeting.

Vicki Mulak, California Society of Enrolled Agents (CSEA)

Ms. Mulak presented oral comments to the Board on the following issues:

- Lack of conformity and need for standalone tax return.
- Penalty reference chart, list of available remedies and web improvements.
- Credit and debit card convenience fees.
- Retroactive tax increase and withholding table.
- 10 percent withholding increase without a tax increase and IOUs.

In his letter dated February 1, 2010, Taxpayers' Rights Advocate, Steve Sims, responded by stating California used a standalone Form 540 until 1987. Beginning with the 1987 tax year, the standalone form became obsolete. Taxpayers now complete their California tax return by starting with federal AGI. Many components of federal AGI are the same for California AGI for most taxpayers, although there are differences. Those differences are reported on Schedule CA to determine California AGI. Taxpayers would need to make these adjustments even if they were using a standalone form. Since many items of income and deduction are the same for California and federal purposes, the California instructions are dedicated to the differences in federal and California law in order to correctly compute the California adjustment amounts. Changing to a standalone form would require instructions for each income and adjustment line item, which would be duplicative of the federal Form 1040. This would result in increased complexity for taxpayers and increase the taxpayer's burden to file their California tax return. We continue to support federal conformity as the best solution to simplify taxpayer's filing requirements. For these reasons, we do not recommend a California tax return completed on a "standalone" basis.

Regarding the penalty reference chart, Mr. Sims indicated his staff is in the process of creating a penalty chart, and the target date for release on our website is June 2010.

Regarding notification about changes to our FTB web content, Mr. Sims responded that we are researching using RSS feeds.

Regarding the forms and publications tab on our website, Mr. Sims responded that we are working on the feasibility of adding the word "Pubs" or "Publications" to the Forms tab on the homepage. Additionally, with the recent implementation of the new forms locator function, we are striving to improve issues associated with finding or accessing forms and publications.

Regarding credit and debit card convenience fees, Mr. Sims responded that California conforms to IRC Section 212. Accordingly, we conform to the recent IRS conclusion allowing a deduction for credit card fees paid in connection with the payment of federal income taxes. Taxpayers that claim these credit card fees on their federal tax return and report their itemized deductions for California purposes do not need to make an adjustment on Schedule CA. Please note that the recent IRS conclusion also applies to credit card fees paid in connection with the payment of state income taxes.

Regarding retroactive tax increase and withholding table, Mr. Sims advised relief from a penalty imposed under the described scenario is already available under California R&TC section 19136(g)(1), which states: "No addition to tax shall be imposed under this section to the extent that the underpayment was created or increased by any provision of law that is chaptered and operative for the taxable year of underpayment."

Regarding 10 percent withholding increase without a tax increase and IOUs, Mr. Sims indicated the 10 percent increase in withholding is not mandatory. Even Governor Schwarzenegger's press release dated July 28, 2009, refers to the 10 percent increase in withholding as optional. A taxpayer wishing to adjust his or her withholding allowances may submit the EDD's form DE4. Employee's Withholding Allowance Certificate, to their employer's payroll unit.

Gina Rodriquez, Spidell Publishing, Inc.

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

- Automatic disaster tax relief.
- Web services enhancements.
- Statement of information coordination.
- Interest calculation on NOL carrybacks.
- Final federal determination.
- Use tax look-up tables.

In his letter dated February 1, 2010, Taxpayers' Rights Advocate, Steve Sims, responded that when the President declares a federal disaster, federal disaster loss tax relief is provided under IRC Section 165(i). In the case of a presidentially-declared disaster occurring in California, the taxpayer can elect to file an amended income tax return for the prior year so that the refund is expedited. To provide automatic disaster loss tax relief for "Governor-only" proclaimed disasters, as suggested by this proposal, would require legislation. Enacting legislation for automatic disaster loss tax relief would improve efficiency by eliminating the need for legislation on each disaster and would mitigate instances where taxpayers are unable to claim the relief due to missed filing deadlines. Mr. Sims concluded by stating it is recommended that FTB forward this proposal to the three-member Franchise Tax Board for consideration.

Regarding web services enhancements, Mr. Sims indicated we are researching using RSS feeds. We are working on the feasibility of adding the word "Pubs" or "Publications" to the Forms tab on the homepage. Additionally, with the recent implementation of the new forms locator function, we are striving to improve issues associated with finding or accessing forms and publications.

Regarding statement of information coordination, Mr. Sims responded that California law requires corporations, limited liability companies, and common interest development associations to update the records of the California Secretary of State (SOS) on an annual or biennial basis by filing a statement of information (SI). SOS and FTB also exchange information when one of the agencies changes the status of an entity (e.g., suspends, removes suspensions, etc). While every effort is made to keep each agency updated, there could be times when each agency may not have the most current information. This is generally caused through manual intervention of changes. While there could be some benefit for FTB and SOS to share more information, it becomes problematic to know which information would be appropriate for each respective agency to share and use, as well as what the entity intends each agency to use as its address. The information (e.g., address) provided to each agency may be different, and intentionally different because of who the entity wants each agency to contact.

Regarding interest calculations on NOL carrybacks, Mr. Sims responded that for many years, California did not allow NOL carrybacks, and California law never conformed to IRC Section 6611(f)(1) or IRC Section 6601(d)(1). (See R&TC sections 19340-19341 and R&TC sections 19101-19114). However, in 2008, AB 1452 (Stats. 2008, Ch. 763) amended R&TC sections 17526 and 24416.9 to allow NOL carrybacks beginning in 2011. Therefore, as Spidell correctly suggests, California law is out of conformity in this area with respect to the computation of interest on overpayments that would result from the application of an NOL carryback. It appears that the proposal is suggesting that legislation should be pursued conforming to the federal interest rules in IRC Section 6611(f) and, presumably IRC Section 6601(d), with respect to NOL carrybacks.

Other State Tax Credit Adjustments – California allows a credit for taxes paid to other states (OSTC) on income taxed by both states. See R&TC Section 18001 and 18002.

When the tax for which a credit was allowed is reduced or changed by the other state, California requires a corresponding adjustment to "recapture" the California credit. See R&TC Sections 18007-18009. Specifically, Section 18009 requires interest to be charged on this recapture of the previously-allowed OSTC back to the date that the credit was originally allowed (usually the original due date of the tax return claiming the original OSTC amount).

It is recommended that FTB forward this proposal to the three-member Franchise Tax Board for consideration.

Regarding final federal determination definition, our Legal Division concluded that the Legislature and FTB want to provide the clearest possible guidance as to when a taxpayer must report a federal change or correction. However, FTB is not presently aware of a definition that would provide greater clarity than the existing statute.

Regarding use tax look-up tables, Mr. Sims responded, use tax reporting on the state income tax return is provided for in R&TC Section 18510. This section has a sunset provision of December 31, 2009. Accordingly, legislation is needed to continue use tax reporting on the state income tax return. On November 19, 2009, the BOE Board approved a legislative proposal to eliminate the sunset date of December 31, 2009, in order to continue to require the FTB to provide a line for payment of use tax on the state income tax returns. BOE staff is aware of this proposal to include use tax look-up tables with the individual tax returns in order to ease the filing burden for taxpayers. FTB defers to BOE in regard to the inclusion of use tax look-up tables as part of the above discussed legislative proposal.

Roland Boucher, United Californians for Tax Reform

Mr. Boucher provided written proposal to the Board on the following issue:

- Raise California standard deduction to the federal level.

IIn his letter dated February 1, 2010, Taxpayers' Rights Advocate, Steve Sims, responded that this proposal results in a significant tax increase compared to the relatively small percentage of taxpayers who would be able to benefit from a move to the simpler 540 2EZ. Many taxpayers in the lower tax brackets who already claim the standard deduction will see a tax increase with no corresponding reduction in their burden to file. Likewise, the majority of taxpayers who report itemized deductions already itemize on both their California and federal tax returns. These taxpayers will also have an increased tax liability, due to the increased tax rate, with no reduction in their burden to file. As a result *of the above discussion, we are unable to recommend an FTB-sponsored legislative proposal to increase the California standard deduction to an amount equal to the federal standard deduction and elimination of the 1.0 percent tax rate.*

Andrew Myrick, Salinas Valley Enterprise Zone

Mr. Myrick presented written comments to the Board on the following issue:

- Modify 540 2EZ to allow Enterprise Zone Employee Tax Credit.

In his letter dated February 1, 2010, Taxpayers' Rights Advocate, Steve Sims, responded that because of the very low percentage of taxpayers that are actually able to claim this credit, the Enterprise Zone Employee Tax credit is only available on the Form 540. We do not recommend adding this rarely utilized credit on the Form 540 2EZ.

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 implemented a plan to ensure all eligible employees receive an annual performance appraisal by August 31 each year. This provides employees continuous feedback and allows 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 improve service to customers, and provide courteous, fair treatment to 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 that reflects the concepts. 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 2009/2010. We may have issued the assessments in prior years; however, due to cases in protest status, we did not resolve them until 2009/2010. Appendix 1 totals reflect rounded figures and may not compute exactly.

Table 1A **Corporation Tax Law**
NPAs Finalized in Fiscal Year 2009/2010 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment Per NPA
Allocation/Apportionment	527	22.1	$ 366.2	73.4	$ 694,869
Assess Minimum Tax	199	8.3	0.4	0.0	2,089
Revenue Agent Reports	1,061	44.6	95.0	19.0	89,499
State Adjustments	246	10.3	13.6	2.7	55,230
Other	341	14.2	23.1	4.6	67,817
Totals/Average	2,374	100	$ 498.3	100	$ 209,892

- *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 2009/2010 Categorized by Primary Statute (Issue)

Issue	Number of NPAs	%	Tax Assessed (Thousands)	%	Average Assessment Per NPA
CP2000	153,643	17.4	$ 147,980	6.5	$ 963
Filing Enforcement	636,323	72.1	1,848,328	80.9	2,905
Filing Status	24,235	2.7	23,938	1.0	988
Revenue Agent Reports	37,680	4.3	132,267	5.8	3,510
Other	30,735	3.5	131,497	5.8	4,278
Totals/Average	882,616	100	$2,284,011	100	$ 2,588

- 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 2009/2010

Industry	All Corporations 2008 Tax Year	%	Corporations with NPAs	%	Tax Assessed (Millions)	%
F.I.R.E.*	132,518	18.4	148	11.0	$ 63.0	12.6
Manufacturing	49,630	6.9	140	10.4	99.5	20.0
Services	290,521	40.2	221	16.5	39.0	7.8
Trade	123,809	17.1	171	12.7	39.8	7.9
Other **	125,881	17.4	657	49.1	256.9	51.6
Totals	722,358	100	1,337	100	$ 498.3	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 2009/2010 Issued by Taxable Year

Average Taxable Year	Number of NPAs	%	Tax Assessed (Millions)	%	Average Assessment Per NPA
2002 and prior	411	16.3	$ 310.9	61.4	$ 756,416
2003	177	7.4	61.7	12.3	348,505
2004	339	14.2	51.5	10.3	152,020
2005	543	22.8	44.8	8.9	82,445
2006	500	21.0	23.7	4.7	47,494
2007	258	10.8	4.4	0.8	16,914
2008 and later	146	6.0	1.3	0.2	8,886
Totals/Average	2,374	100	$ 498.3	100	$ 209,892

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 2009/2010 for the Same Taxpayer

Corporations With...	Number of Taxpayers	Tax Assessed (Millions)	Average Assessment Per Taxpayer
One NPA	686	$ 37.3	$ 54,361
Two NPAs	441	307.7	697,779
Three NPAs	123	52.5	427,187
Four or more NPAs	87	100.7	1,157,783
Totals/Average	1,337	$ 498.3	$ 372,687

Table 4 **Personal Income Tax Law**
NPAs Finalized in Fiscal Year 2009/2010 Issued by Taxable Year

Taxable Year	Number of NPAs	%	Assessment Amount (Thousands)	%	Average Assessment Amount
2003 and prior	2,634	0.3	$ 64,563	2.8	$ 24,511
2004	5,619	0.6	43,396	1.9	7,723
2005	68,286	7.7	163,309	7.2	2,392
2006	200,409	22.7	422,652	18.5	2,109
2007	427,949	48.5	1,115,738	48.8	2,607
2008 and later	177,719	20.1	474,353	20.8	2,669
Totals/Average	882,616	100	$2,284,011	100	$ 2,588

Table 5 **Personal Income Tax Law**
Resident Tax Return Preparation, Process Years 2008 and 2009

Preparer	2008 Tax Returns Processed (Thousands)	%	2009 Tax Returns Processed (Thousands)	%	% Change
Professional	10,339	68.9	10,075	68.0	-0.9
Taxpayer	4,485	29.9	4,507	30.4	0.5
VITA*	192	1.3	224	1.5	0.2
Totals	15,016	100	14,806	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 **E-filing and Payment Statistics**

Activities	July 1, 2009	June 30, 2010	% Change
Credit Card Payments (Average payment is $978)	108,000	116,000	7 .0
Direct Debit of Balance Due (Electronic Funds Withdrawal)	369,000	626,000	70 .0
Direct Deposit Refund	5,299,000	4,851,000	-8 .0
* e-file	11,083,000	11,430,000	3 .0
** *CalFile*	228,000	238,000	4 .0
** Online Filing	2,362,000	2,518,000	7 .0
** Business Entity	293,000	382,000	30 .0

* e-file volume includes Business Entity tax returns.
** We include these voulmes in the e-file volume.

Table 7A **Corporation Tax Law**
Nonfilers Detected Through the Automated Nonfiler System

Fiscal Year	Demands	NPAs Issued
2005/2006	19,047	0
2006/2007	8,927	13,271
2007/2008	31,819	18,855
2008/2009	65,954	23,807
2009/2010	26,367	27,286

Table 7B **Personal Income Tax Law**
Nonfilers Detected Through the Automated Nonfiler System

Fiscal Year	Demands/Requests	NPAs Issued
2005/2006	754,613	509,066
2006/2007	826,612	546,614
2007/2008	839,818	463,315
2008/2009	1,222,050	849,650
2009/2010	1,243,842	706,104

Table 8A **Top Errors by Tax Return Type**
Current Year Tax Returns July 1, 2009 through June 30, 2010

	Code	Grand Total	540 2EZ	540 A	540	540 NR	540 X
EP	Estimate Payment	**178,419**	**1,384**	**4,118**	**158,844**	**14,031**	42
DS	Deductions	**40,647**	86	**10,012**	**26,097**	**4,342**	110
TC	Tax Amount	**32,693**	154	**6,292**	**18,914**	**6,714**	**619**
TT	Total Credits/Liability	**30,876**	**4,471**	**8,831**	**15,762**	**1,569**	**243**
OC	Estimate Transfer Revised	**24,125**		532	**20,140**	**3,444**	9
AA	Adjusted Gross Income	**23,480**	**23,284**	60	68	63	5
AW	Withholding Did Not Match Attachments	**21,811**	**2,223**	1,277	**17,431**	772	108
TY	Total Tax Revised - AGI, Filing Status, or Dependents	**20,619**	**20,619**				
EX	Exemptions	**19,367**	99	**9,792**	**8,455**	971	50
ND	California Taxable Income Revised	**18,019**			*	**17,954**	63
SS	State Disability Insurance Revised	17,915		1,360	**16,005**	495	55
DI	Standard Deduction Greater Than Itemized Amount	10,907		**2,415**	**7,594**	841	57
RN	Renters Credit Revised	10,325	**2,317**	**3,514**	4,157	336	*
OA	Refund Revised - Incorrect Payments or Credits	9,942	**1,609**	**3,246**	**4,285**	387	**415**
NP	Nonresident Ratio Revised	9,790				**9,786**	4
OF	Amended Refund Did Not Equal Original Refund	9,541	**506**	165	3,527	267	**5,076**
CT	Amended Credits Revised to Match Original Credits	9,536	285	45	968	32	**8,206**
WS	Withhold at Source Revised	7,862		*	2,175	**5,624**	61
OM	Amended Payments Did Not Match Original	6,166	195	99	1,732	145	**3,995**
OB	Balance Revised - Incorrect Payments or Credits	5,060	**1,380**	**1,449**	2,029	94	108
AT	Withholding Documents Not Attached	4,952	376	264	3,136	**1,115**	61
TI	Taxable Income Revised	4,338	10	**2,256**	1,848	192	32
NN	Total Tax Revised - Nonresident Errors	3,536		3	*	**3,531**	*
AM	Withholding Not Verified by Employer	2,431	**452**	14	1,781	173	11
OW	Amended Withholding Did Not Match Original	1,850					**1,850**
AR	Amended Tax Return Received - No Record of Original Tax Return	975			4		**971**
OP	Amended Estimate Payments Did Not Match Original	761	*	9	208	31	**512**
OT	Taxable Income on Amended Did Not Match Original	200	6		29	*	**163**
	All Others	16,928	719	3,424	11,173	1,096	516
	Top Ten	**410,056**	**58,245**	**51,925**	**293,527**	**68,110**	**22,050**
	Total	543,071	60,176	59,179	326,365	74,007	23,344

*Reflects less than three tax returns.

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

Table 8B **Top Errors by Filing Method**
July 1, 2009 through June 30, 2010

	Code	Grand Total	Elec-tronic	Paper
EP	Estimate Payment	**178,419**	**109,877**	**68,542**
TC	Tax Amount	**32,693**	1,795	**30,898**
TT	Total Credits/Liability	**30,876**	1,005	**29,871**
DS	Deductions	**40,647**	**13,868**	**26,779**
TY	Total Tax Revised - AGI, Filing Status, or Dependents	**20,619**	191	**20,428**
EX	Exemptions	**19,367**	198	**19,169**
AA	Adjusted Gross Incolme	**23,480**	**8,419**	**15,061**
ND	California Taxable Income Revised	**18,019**	**3,449**	**14,570**
AW	Withholding Did Not Match Attachements	**21,811**	**9,218**	**12,593**
OC	Estimate Transfer Revised	**24,125**	**13,145**	**10,980**
DI	Standard Deduction Greater Than Itemized Amount	10,907	**3,115**	7,792
SS	State Disability Insurance Revised	17,915	**10,567**	7,348
NP	Nonresident Ratio Revised	9,790	**2,463**	7,327
WS	Withhold at Source Revised	7,862	**2,642**	5,220
	All Others	86,541	10,752	75,789
	Top Ten	**410,056**	**176,763**	**248,891**
	Grand Total	543,071	190,704	352,367

Table Legend:

Bold › Top ten codes issued by Tax Return Type.

Table 8 **Definitions**

AA	Amount of California adjusted gross income (AGI) adjusted.
AM	Withholding not verified by employer.
AR	Amended tax return filed with no record of original tax return.
AT	Withheld tax credit disallowed; withholding documents not attached to tax return.
AW	Withheld tax credit revised to match total shown on attached withholding documents.
CT	Child and Dependent Care Expenses Credit revised to match the amount claimed on original tax return.
DI	Standard Deduction allowed because it was greater than the Itemized Deduction amount claimed.
DS	Deduction amount revised to correct amount for allowed Filing Status.
EP	Estimated Tax Payment credit revised based on accounting system record of received payments.
EX	Total exemptions not computed or transferred correctly, or revised due to AGI limitation.
ND	California taxable income revised; computed or transferred incorrectly, deduction percentage computed incorrectly, or percentage incorrectly applied to deduction.
NN	Total Tax revised; California tax rate, California Credit Percentage, or California exemption credit percentage incorrectly computed; or error computing/transferring tax on Schedule G-1, Tax on Lump-Sum Distributions or Form 5870A, Tax on Accumulation Distribution of Trusts.
NP	Total Tax revised; ratio computed incorrectly or ratio incorrectly applied to tax amount and credits.
OA	Refund revised; total payments and credits added incorrectly or subtracted incorrectly from total tax.
OB	Balance revised; total payments and credits added incorrectly or subtracted incorrectly from total tax.
OC	Estimated Tax Transfer revised due to an error on the tax return that affected the available transfer amount.
OF	Amount of refund received reported on amended tax return does not match amount on original tax return.
OM	Amount paid with original tax return plus payments made after tax return filed does not match amount claimed on amended tax return.
OP	Amount of estimated tax payments reported on amended tax return does not match amount on original tax return.
OT	Amount of taxable income reported on amended tax return does not match amount on original tax return.
OW	Amount of California withholding reported on amended tax return does not match amount on original tax return.
RN	Nonrefundable Renter's Credit revised; wrong amount claimed for filing status, California AGI over maximum amount, part-year resident or nonresident.
SS	Excess State Disability Insurance revised/disallowed to maximum amount substantiated by W-2s attached.
TC	Tax amount incorrectly computed.
TI	Taxable income was revised.
TT	Total Tax revised; error computing total credits or tax liability.
TY	Total Tax revised based on AGI, filing status and dependents claimed.
WS	Real estate of nonresident withholding revised to the amount substantiated by attached forms or the amount of available credit identified in the accounting system.

Appendix 3

Regulation Section 17942 – Limited Liability Company (LLC) Fees

For taxable years beginning on or after January 1, 2007, the Legislature amended R&TC Section 17942 to modify the language of the statute and add a new provision. Section 17942 now provides that the LLC fee is based on total income from all sources attributable to or derrived from California. In addition, the amended LLC fee statute provides 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."

R&TC Sections 25135 and 25136 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 special rules for assigning specific items such as income from real property, which is assigned to the state where the real property is located.

The regulations adopted pursuant to R&TC 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 Uniform Division of Income Tax Purposes Act (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. Both business and nonbusiness income from items are assigned using the sales factor rules. 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 determined that a second interested parties meeting would be needed and will be held sometime in November 2010.

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 to ensure that tax is paid as it is incurred on specific transactions, encouraging taxpayers to file tax returns at the end of the year.

California law requires FTB to issue regulations to implement the withholding at source statutory requirements (R&TC 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 R&TC 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; however, staff felt it would be necessary to hold a second interested parties meeting, which will be scheduled sometime in November or December 2010.

Regulation 19523.5 – Suspension or Disbarment from Practice

In 2005, the Legislature passed and the Governor signed AB 139, which added Section 19523.5 to the Revenue and Taxation Code. This section mandates that persons who are suspended or disbarred from practice before the United States Department of Treasury shall, after notice and opportunity for a proceeding, be suspended or disbarred from practice before FTB. Section 19523.5 further mandates the imposition of a $5,000.00 penalty for the failure to provide written notification to FTB within 45 days of a final order suspending or disbarring the person from practice before the IRS.

Section 19523.5 also mandates the imposition of a $5,000.00 penalty for the failure to provide written notification to FTB within 45 days of a final order suspending or disbarring the person from practice before the United States Department of Treasury. The penalty may be contested by paying the penalty and applicable interest in full and filing a claim for refund. If FTB denies the claim or the claim is deemed denied pursuant to R&TC Section 19331, the person may file an appeal with the State Board of Equalization or an action in Superior Court upon the grounds set forth in the claim for refund.

On December 3, 2009, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss proposed regulations to implement R&TC Section 19523.5. An interested parties meeting was held on April 21, 2010; however, the regulation project has been deferred while staff pursues a legislative proposal to revise the statute authorizing suspension.

Regulation Section 19591 – Specialized Tax Service Fees

Regulation Section 19591 establishes the amount of specialized tax service fees for installment payment programs and specific expedited services.

FTB has authority under AB 1546 (Stats. 2009, Ch. 544) to charge a fee for expedited limited partnership revival confirmation letters. This fee is statutorily set at $100 until January 1, 2011, at which time it requires regulations to set it and impose it thereafter.

Staff received approval to proceed with an interested parties meeting at the December 3, 2009, three-member Franchise Tax Board meeting. An interested parties meeting was held March 16, 2010, to elicit public input regarding the amendment of Regulation Section 19591 to establish the amount of the specialized tax service fee for the issuance of expedited limited partnership revival confirmation letters for periods on or after January 1, 2011. Staff received comments and indicated it would acquire a cost summary report. A second interested parties meeting was held on October 27, 2010.

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 Sections 25137 and 25101.3; California Code of Regulations, Title 18, Section 25137-7.) The property factor for apportioning income of an air transportation company is calculated according to California R&TC 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. On March 19, 2009, staff received approval from the three-member Franchise Tax Board to proceed with the formal regulatory process. Staff held a formal hearing, on January 13, 2010, and the final approved regulations were filed by the Office of Administrative Law on March 19, 2010, and became effective April 17, 2010.

Regulation Section 25106.5-1 – Intercompany Transactions

During 1999, FTB promulgated California Code of Regulations, Title 18, Section 25106.5-1, which addresses the treatment of intercompany transaction in a combined report context occurring on or after January 1, 2001. Regulation Section 25106.5-1 generally follows the federal consolidated intercompany regulations (Treasury Regulation Section 1.150-2-13 et seq.) with respect to many of the issues in those regulations, but because income is not apportioned for federal purposes, Regulation Section 25106.5-1 also provides applicable apportionment rules.

For income tax purposes, gain or loss from intercompany transactions is ordinarily deferred until there is a triggering event, such as the sale of the deferred item outside the group to a third party. Notwithstanding this general principle, both the California and federal intercompany regulations allow taxpayers in specified circumstances to elect to account for their income or loss from intercompany transactions on a "separate entity" basis. This election allows current recognition of income or loss from intercompany transactions. The election is governed by Regulation Section 25106.5-1, Subsection (e), for California tax purposes and Treasury Regulation Section 1.1501-13, Subsection (e)(3), for federal tax purposes.

Both the California and federal regulations include "simplifying rules" provisions. This election is included within those "simplifying rules." Regulation Section

25106.5-1, Subsection (e), authorizes federal “separate entity” elections to be effective for California tax purposes. Even in situations in which the taxpayer has not made a federal “separate entity” election, taxpayers can elect to recognize intercompany income or loss on a separate entity basis as long as they have “properly reported” the intercompany income or loss on a separate entity basis for federal or foreign national tax purposes.

Questions have arisen regarding the proper sales factor treatment of intercompany transactions that are recognized on a separate entity basis due to the above described election. Some taxpayers have suggested that because the election results in current income recognition from intercompany transactions, as opposed to the normal scheme of deferral, that the sales factor for the year of election should contain the gross receipts related to the income recognized currently due to the election, which results in a higher sales factor denominator and reduced California apportioned income. Staff believes that it is prudent to clarify that a Regulation Section 25106.5-1, Subsection (e), election does not allow taxpayers to include intercompany transaction receipts in their sales factor denominator in the year of election. Instead, receipts are only included in the sales factor when the intercompany items are sold to third parties, giving rise to economic gain or loss to group as a whole. If intercompany receipts were to be recognized currently due to the election, the receipts that arise when the items are eventually sold outside the group would result in a double count of the actual economic activity in the sales factor. Furthermore, inclusion in the sales factor in the current year due to a Subsection (e) election is inconsistent with Regulation Section 25106.5(a)(5)(A) and (a)(5)(B).

On December 3, 2009, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss possible amendments to Regulation Section 25106.5-1 to provide further guidance in two areas and to address conformity with federal laws. Staff held an interested parties meeting on April 21, 2010. Comments were received. A second interested parties meeting was held on September 22, 2010, to discuss proposed amendments to Regulation Section 25106.5-1.

Regulation Section 25128.5 – Apportionment of Business Income; Election of Alternate Method

During 2009, the Legislature adopted R&TC Section 25128.5, operative for taxable years beginning on or after January 1, 2011. This new statute allows certain taxpayers subject to the California franchise or income tax the opportunity to elect an alternate method of apportionment that uses only a sales factor instead of the current three-factor formula based on property, payroll, and sales. Section 25128.5, subdivision (c), authorizes FTB to issue necessary or appropriate regulations regarding the making of the election.

There are many issues to be addressed by way of regulation so that procedures are in place to implement this new alternate method of apportionment. Some of these issues include the following: what is required to execute a valid election, the timing required to execute the election, whether the election applies to all members of a combined reporting group, any members of a combined reporting group make the election and others do not make the election, what happens when non-electing entities are acquired by an electing combined reporting group, what happens when an electing entity is acquired by a non-electing combined reporting group, what happens when an electing member leaves the combined reporting group, what happens when electing and non-electing entities are combined at audit, what happens when a taxpayer files conflicting tax returns (both electing and non-electing) prior to the due date of the tax return, and what happens when a taxpayer meets some of the requirements to execute a valid election, but not all of them.

On December 3, 2009, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss the proposed California Code of Regulations, Title 18, Section 25128.5. On January 28, 2010, an interested parties meeting was held. A second interested parties meeting was held on June 1, 2010. Public comments were received and were considered by staff. On June 22, 2010, FTB approved staff's recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act. Staff anticipates that a formal regulatory hearing will be held in November or December 2010.

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 solicits public comment on examples that were being developed prior to initiating the formal regulatory process. The formal regulatory hearing was held on January 13, 2010. As a result, staff had additional changes and held a 15-day notice period. The final approved regulations were filed by the Office of Administrative Law on June 17, 2010, and became effective July 17, 2010.

Regulation Section 25136 (2011) – Sales Factor. Sales Other Than Sales of Tangible Personal Property

In February 2009, SBX3-15 enacted new legislation operative for taxable years beginning on or after January 1, 2011, which included the repeal of the current version of California Revenue and Taxation Code Section 25136 and the enactment of a new version of R&TC Section 25136 applicable for taxable years beginning on or after January 1, 2011. R&TC Section 25136 provides the sales factor numerator assignment rules for all sales other than sales of tangible personal property.

Prior to its recent amendment, R&TC Section 25136 generally provided that sales of other than tangible personal property are assigned to the state where the income-producing activity that gave rise to the sale occurred. When income-producing activity was performed both inside and outside California, the sale would be assigned to California if the greater costs of performance in connection with the income-producing activity were incurred in California. The recent amendment to Revenue and Taxation Code Section 25136 repeals those provisions for taxable years beginning on or after January 1, 2011. As a result, the former income-producing activity/greater-cost-performance provisions of R&TC Section 25136 apply only to taxable years beginning before January 1, 2011.

California Code of Regulations, Title 18, Section 25136, is currently based on the pre-2011 version of R&TC Section 25136 and provides more detail regarding the rules on how to assign sales other than sales of tangible personal property. A public hearing was held on January 13, 2010, to discuss amending current Regulation Section 25136 to make assignments based on activities of both the taxpayer and those performed on behalf of a taxpayer. However, that public hearing did not address the recent changes to R&TC Section 25136 applicable for taxable years beginning on or after January 1, 2011.

For taxable years beginning on or after January 1, 2011, R&TC Section 25136 generally provides that sales of other than tangible personal property are assigned on a market basis. The statute states that: (1) sales from services are assigned to this state to the extent the purchaser of the service received the benefit of the service in this state; (2) sales from intangible property are assigned to this state to the extent the property is used in this state (in the case of marketable securities, sales will be assigned to this state if the customer is in this state; (3) sales from the sale, lease, rental or licensing of real property are assigned to this state if the real property is in this state; and (4) sales from the rental, lease, or licensing of tangible personal property are assigned to this state if the property is located in this state.

Because the switch to market-based rules starting in 2011 represents a marked departure from the current income-producing activity/greater-cost-of-performance rule, the existing regulation will need to be completely rewritten. This proposed regulation is intended to implement and make specific the new market-based rules.

On December 3, 2009, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss the approaches taken in other states and the elements of those approaches that the private sector would like to see adopted in California, as well as a discussion of the provisions in other states that are seen by staff or industry as potentially flawed or in need of refinement. An interested parties meeting was held on February 10, 2010. A second interested parties meeting was held on July 19, 2010, and proposed language was made available to the public. A third interested parties meeting will be held sometime in November or December 2010.

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 R&TC 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 R&TC. 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 was held on September 19, 2008. No further action has been taken.

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

Several years before the UDITPA was adopted by California, FTB 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, the issue of 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 at a meeting held on January 8, 2008. 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 November 2010.

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 MTC.

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. A second interested parties meeting was held on May 26, 2009. Discussions included the proposal to use only one category called ‘trucking activity’ and deleting the use of the term ‘trucking company’ from the regulation. Also discussed was whether ‘back haul’ mileage should be included in the interstate ratio, treatment of ‘owner operators’, and how to define ‘owner operators.’ Also discussed were freight forwarding and third-party independent contractor fact situations. Public comments were received and were considered by staff. The project is currently on hold and will resume in the fall of 2010.

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 that our customers can rely on quality information and efficient service.