

| Taxpayers'
Bill of Rights
Annual Report
to the
Legislature



State of California
Franchise Tax Board

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Executive Summary

Although the recession might be officially over, struggles continue for the United States during this period of economic recovery. Throughout the world, other countries struggle with dramatic economic changes as well. In California, we still face record deficits and decreased revenue. This situation places our department in a precarious position to collect taxes in hopes of increasing the state revenue so that California can reduce its deficit. If we are unable to do so, we may again experience severe budget cuts to our department. Despite the many recent challenges, the Franchise Tax Board (FTB) remains rock solid and continues to efficiently 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), California Revenue and Taxation Code (R&TC) Sections 21006 and 21009.

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 (FY) 2010/2011 (July 1, 2010, through June 30, 2011), the Taxpayers' Rights Advocate's Office responded to over 23,500 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's 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 2.8 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 make 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
Executive Officer

Advocate's Address

Members of the California Legislature:

I submit for your review the 2011 Taxpayers' Bill of Rights Annual Report to the Legislature.

I would like to give Franchise Tax Board (FTB) special acknowledgement for their efforts and quality service to California taxpayers during this difficult economic time.

I continue 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 40 events this year allowed me to stay apprised of the effects that law changes, 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 of tax legislation.

Included in this report, I identified areas where FTB can improve its operations and 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 FY 2010/2011, 284 issues were submitted into Systemic Issue Management System (SIMS) compared to 118 issues submitted in FY 2009/2010, a 140 percent increase. Of the issues submitted, seven were identified as possible systemic issues and forwarded to program areas for research and resolution. The program areas resolved five out of the seven, and the other two issues are in research status. We are hearing that part of the reason SIMS issues dramatically increased, is that taxpayers are using the system to vent their frustrations about not being able to get through to our phone lines, and they are entering their individual problems into the system.

We completed Phase II of SIMS, which now allows us to track the issues online and to generate reports for management.

The following excerpt highlights the type of issues submitted through SIMS:

"This regards line 26 of the schedule CA of 540 NR. Moving expenses are not deducted from column E if one moves out of state, but are if one moves in state. Recently, I joined the Federal Government as an Had I joined ... in California, I would be entitled to the deduction. In this particular instance, this raises personal concerns about state interference with a federal function. More broadly, this raises dormant commerce clause concerns. These are my opinions and have not been expressed to my superiors or any agent of the Federal Government. I hope that you are able to answer my concerns before I would take any such step. I may be reached at my office at XXX.XXX.XXXX and XXX.XXX.XXXX. This also affects my Tax Year 2007 return as my accountant did not take the moving expense deduction...."

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

1. Auditor Retention

For the past two years, I reported that the Audit Division was losing significant numbers of senior audit staff to retirement, the IRS, or the private sector. This year, however, we are seeing a different trend. Instead of senior auditors leaving, a significant number of newly hired auditors resigned. Given that we had two years of increased senior staff attrition, and now our newest auditors are resigning, a concerning trend appears to be occurring. 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.

In FY 2010/2011 the Audit Division was able to hire 37 new auditors. During the same period, 22 new auditors with an average of two years experience or less left the Audit Division. This represents an increased level of attrition over the previous year when 16 new auditors left the Audit Division. A common reason given by staff who resigned was that they could not adjust to the reduced compensation package provided in budget negotiations. This came after the state spent an estimated \$40,000 for each auditor in new auditor training. This increased level of attrition requires the department to expend more time and resources training new auditors, an investment designed to yield a return through producing quality auditors who will one day perform at the most senior levels. When auditors leave soon after being hired, not only are they taking their knowledge, but they also take our resources with them. It is imperative that we find ways to retain qualified audit staff that will stay with the Audit Division and ultimately perform at the senior auditor levels.

A less experienced audit workforce has the potential to impact not only the revenue brought in by the department, but also the quality of product produced. Currently, 36 percent of the audit staff have five years or less job experience. There are potential lost opportunity costs of audit issues not being fully developed or even missed because senior auditors are replaced with less experienced auditors.

Less experienced auditors may also impact our taxpayers' costs with longer audit times and the potential for more mistakes. Therefore, it is not only imperative that we retain our audit staff, but we must also provide the training necessary to develop them into more experienced auditors. Tax professionals are required to take a minimum number of training hours in order to retain their professional license. It is difficult, however, to quantify how much training each of our auditors receives, although formal and informal training is available to audit staff throughout the year. Informal training, such as collaboration, has increased over the last few years to further staff development. Collaboration allows for increased quality and job knowledge transfer among staff. It takes on many forms such as team audits as well as having technical and legal experts get involved with ongoing cases. This type of informal training is deemed invaluable by our Audit Division to develop auditors' technical and analytical skills; however, much of it is not formally tracked. Though there are formal training events offered to auditors such as a general tax law update, the focus of the Audit Division is on-the-job training.

Our audit program is struggling to train less experienced staff and to retain staff as these trends continue. This remains difficult due to negotiated salary concessions and a limited budget for travel and training expenses. While our audit program does provide several opportunities for audit staff to receive formal training, as the Taxpayers' Rights Advocate, I feel our audit program must provide more formal training to each auditor that is measurable and ensures that our auditors are qualified to meet the challenges ahead of them. The department should consider conducting a training needs assessment to determine Audit Division staff's training needs.

2. Collections

The accounts receivables remained high at \$8.5 billion.* Part of the reason for the increase is due to the economic climate. Taxpayers are not filing tax returns, and some are filing, but are not paying the balance due. In addition, we have more data available to us to identify and address areas of noncompliance, and as a result we are sending out more filing enforcements (FEs). The chart below represents the number of FEs issued and the dollar amount for the fiscal years noted.

Fiscal Year	Volume	Dollars
2008/2009	241,231	952 million
2009/2010	306,010	1 billion
2010/2011	426,162	1.4 billion

*In last year's annual report, we noted the accounts receivables had increased to \$8.5 billion, while it was actually \$8.4 billion. Over the past fiscal year, the accounts receivables increased two percent.

This increase in FEs sent means more taxpayers contact the department to resolve their accounts. As the Advocate, my concern is that we cannot keep up with the customer service demands of such a high volume of accounts receivables. FEs cannot be resolved through our online services. Tax practitioners and taxpayers must speak to a customer service specialist. Tax practitioners and taxpayers routinely inform me of their inability to get through to our phone lines. We are understaffed, call center hold times are too long, and we have backlogs in answering correspondence.

As we have seen in recent years, many taxpayers continue to find it difficult to pay their accounts in full. Taxpayers are now opting for installment payment agreements or entering into the collection cycle. As a result, installment agreement inventories have increased and at the end of FY 2010/2011, there were over 200,000 taxpayers in an installment payment agreement.

In FY 2010/2011, the number of taxpayers entering into installment agreements increased by 24 percent, while the dollar amount of the accounts in installment agreements increased by 29 percent. Generally, the average length of an installment agreement is 36 months, but not more than 60 months.

Again, my concern is that we do not have the staff and resources to respond to the influx of phone calls and correspondence due to the volume of notices being sent out and the number of taxpayers contacting us to enter into an installment agreement. As a result, tax practitioners and taxpayers are frustrated. Without the staff and resources we need, California's tax gap will increase, and potential revenue will be lost.

In addition, tax practitioners complain often about their requests to delay collection actions being denied while their client's amended return is processing. We recently received two systemic issue entries in our database addressing this issue.

I recommend additional staffing and that FTB better communicate procedures and policy changes to staff throughout the division and consider correspondence processing backlogs when issuing additional notices.

3. Conformity

The growing disparity between 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.

The FY 2010/2011 saw two major events that further complicated the conformity picture for California taxpayers. During the November election, taxpayers approved Proposition 26, which put into question the validity of SB 401, the Conformity Act of 2010, enacted on April 12, 2010. SB 401 was the first conformity bill to pass in three years. Many Californians were relieved when the Act passed allowing them extended mortgage forgiveness debt relief. Unfortunately, the relief is now in question again as Proposition 26 language threatens to make the entire Conformity Act void if legislation is not "reenacted" by November 3, 2011.

The second example of taxpayer burden occurred when federal law was changed in 2010 to allow exclusions or deductions for certain health care coverage for a

child under 27 years old. The exclusions or deductions were for expenses incurred and benefits provided on or after March 30, 2010. California did not immediately conform to this change, leaving taxpayers and employers wondering how to report this difference in taxable income. When California finally conformed to the change a year later, it did so on April 7, 2011, just eight days before the April 15 deadline to file the tax return. Even though we did conform retroactively, employers who provided benefits were forced to amend and reissue tax year 2010 W-2s to eligible employees.

The state does not go without its share of burden when legislation is enacted late or we fail to have conformity. In both cases above, taxpayers may amend returns already filed to comply with law changes. Amended tax returns, due to law changes, require additional administrative costs through special processing and training of customer service specialists to help taxpayers understand changing requirements.

While efforts to bring us into alignment with federal law are highly commended, I reprise my call for simplification through conformity, and I encourage you to continue your efforts to pass a timely full conformity bill.

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.

4. Late State/Federal Legislation

The passage of late legislation continues to add to the burden on both taxpayers and FTB. The constant change in tax laws, particularly late in the tax year, confuses taxpayers and leads to unintentional taxpayer errors that could lead to penalty assessments. Taxpayers may not have the 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. 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 propose that FTB be funded to dedicate staff and resources to follow and provide analysis on pending federal legislation. I also encourage you to consider the impacts of late legislation, not only on FTB, but on the taxpayers of this state.

5. Tax Liens

In last year's report, I raised concerns about the increased number of tax liens being filed, and the hardship liens cause taxpayers. I noted that the National Taxpayer Advocate (NTA) recommended that, prior to filing a lien, the Internal Revenue Service (IRS) determines if the benefits of filing a lien outweigh the harm to the taxpayer, and my belief is that Franchise Tax Board should follow the same reasoning with regard to filing a lien.

In February of this year, the IRS announced a "fresh start" program and made major changes to the lien process. The goal of the program is to help individuals and businesses meet their tax obligations, without adding unnecessary burden to taxpayers.

One of the major changes to the IRS lien process was to significantly increase the dollar threshold when liens are generally filed, which is what I suggested FTB consider doing in last year's report.

We do have some help available for people with liens filed against them. For people experiencing a financial hardship who cannot pay what they owe, FTB specialists can establish payment plans, grant temporary relief from state tax liens, or, in some cases, delay collection actions. FTB generally approves installment payment requests if the balance owed is less than \$25,000 and can be paid within 60 months.

FTB can generally grant relief from state tax liens within two weeks for financially distressed homeowners trying to sell or refinance their homes. When a home sells for less than the loan balance, FTB can sometimes remove its tax lien from the property to allow the homeowner to complete the sale. Tax liens typically must be paid before a real estate escrow can close. The tax lien remains in effect on any other property the taxpayer currently holds or later acquires.

FTB can help people refinancing or modifying an existing home loan. Homeowners can request that FTB allow the new or modified loan to have priority over the tax lien. This allows prior home loans to be refinanced or modified without first having to pay the lien.

While I am pleased to see an 11 percent decrease in lien filings from FY 2009/2010 to 2010/2011 (295,027 to 264,138), I am still concerned about the burdens liens cause taxpayers, employers, and financial institutions.

In spite of the steps we are taking to assist taxpayers, again I recommend FTB take a serious look at the IRS' fresh start program and consider implementing some of the same steps to provide additional relief when taxpayers are trying to return to compliance.

6. Investigations Transparency

In last year's annual report, I discussed the lack of transparency of our Criminal Investigations Bureau (CIB) as compared to the IRS' Criminal Investigations Division. Specifically, I recommended that we appear more transparent about the activities of our criminal investigations, and that we develop a more comprehensive online manual and that we post annual criminal investigations inventory statistics.

I applaud your efforts to work toward addressing these issues by increasing the division's FTBNet homepage presence, and using this forum to publish arrest reports and CIB manuals. Resource needs have prevented the updating of the manuals, but with additional resources to be acquired, updates will be completed in the near future. Although there is a very limited presence on the external site, I am especially pleased to find out that information about CIB is being developed and should also be present on the external site in the near future. Again, I want to recommend that the external webpage include annual criminal investigations inventory statistics, policies, and procedures similar to what is presented by the IRS' Criminal Investigations Division. The goal is to be more transparent with regards to the activities of the CIB.

7. 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 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 FTB 1024, *Penalty Reference Chart*, which outlines each penalty, applicable California Revenue and Taxation Code (R&TC) section,

corresponding Internal Revenue Code (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.

8. Education and Outreach

The need to educate, provide outreach to, and inform our taxpayers and tax professionals continues to grow 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. Without our education and outreach efforts, taxpayers may not be properly informed of new law changes or the services available to them.

In the past year, FTB has participated in fewer seminars due to limited resources. However, we have participated in many education and outreach seminars sponsored by Board of Equalization members and the State Controller's Office. In addition to seminar presentations, 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 utilize YouTube to market our programs like ReadyReturn, CalFile, and Voluntary Compliance Initiative 2 (VCI 2) and to provide tips and news releases on critical filing errors and credits not being taken advantage of. 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 our 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 new jobs credit, same sex married couples, and enterprise zone credits. With the use of Twitter, I link my followers to late-breaking information, such as information on the new rules for registered domestic partners, new publications, and other valuable information. TaxNews expanded its products to include video articles. 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 FY 2010/2011. The issues and concerns that are listed above have been discussed with the responsible areas of the department, and in all cases additional action is being taken to address these concerns.

Taxpayers' Rights Advocate Contact Information

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To get this publication, go to ftb.ca.gov and search for **2011 Legislature Report** or write to the address above.

Taxpayers' Rights Advocate

Taxpayers' Rights Advocate's 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's staff participates 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 current. We train staff 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 about Taxpayers' Bill of Rights legislation in our Taxpayers' Rights Advocate's Office publications:

- FTB 4058, *California Taxpayers' Bill of Rights – Information for Taxpayers*. 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*. 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 Division, Settlement Bureau, Enterprise Data to Revenue (EDR) Project, filing season, and presentations on Secure Email and the External Authentication for Secure e-Services (EASE) Project.

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 23,500 contacts in FY 2010/2011. The majority of taxpayers (over 17,400 contacts) contacted us by telephone. We provide taxpayers a public number (800.883.5910) to contact our Advocate Hotline.

We received over 2,900 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 extensive.

The top five reasons taxpayers contacted the Taxpayers' Rights Advocate's in FY 2010/2011 include:

- Balance Due
- Filing Enforcement
- Earnings Withholding Order for Taxes
- 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.

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.

Earnings Withholding Order for Taxes

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

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 FY 2010/2011, we received 284 issues through SIMS. Of the issues submitted, seven were identified as possible systemic issues and forwarded to program areas for research and resolution. The program areas resolved five out of the seven, and the other two are in research status.

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 FY 2010/2011. 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 assessed with 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 FY 2010/2011 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 67 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 10 percent increase from July 1, 2010, to June 30, 2011. As of June 30, 2010, we received 497,000 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 taxpayer errors when they file their tax returns and evaluate how those errors may be avoided or corrected.

We compiled taxpayer error information on approximately 15.7 million current year tax returns processed between July 1, 2010, and June 30, 2011. During this time, FTB made approximately 425,000 adjustments and issued close to 320,000 Return Information Notices (RINs) to taxpayers who filed tax returns with errors that resulted in a change of tax liability. This equates to 2.05 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 55 percent of all adjustments are made on paper-filed tax returns (23 percent of total current year tax returns filed), while only 45 percent of all adjustments are made on electronically filed tax returns (77 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 over half (53.3 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.

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 an area of the law during the review process for which we proposed legislation to facilitate administration of our duties.

Chaptered Legislation –

AB 1369 (Gatto, Stats. 2011, Ch. 454)

This act amends current law to deny a deduction for expenses and costs of goods sold attributable to the following:

- Any person that commits insurance fraud by referring or procuring clients, cases, patients, or customers to a third party for compensation or inducement.
- Crimes listed under the “California Control of Profits of Organized Crime Act” found in California Penal Code sections 186, et seq.

Regulations

The laws administered by FTB broadly authorize the dissemination of rules and regulations necessary for their enforcement. Occasionally, specific statutory provisions require us to disseminate 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

In FY 2010/2011, the Taxpayer Services Center (800 number and practitioner hotline) answered approximately 67 percent of the incoming calls. This is an improvement over the previous year of 47 percent calls answered. A large part of the success is due to the Queue Management Project that was implemented in May 2010. Since implementation, the abandoned call rate has also improved.

Response to Correspondence Time Frames

Taxpayers writing to the department 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 up to 90 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. In FY 2010/2011, we saw two major events that further complicated conformity for California. During the November election, California taxpayers approved Proposition 26, which may affect the validity of SB 401, the Conformity Act of 2010. Proposition 26 threatens to make some, or all, of the entire Conformity Act void if the legislation is not reenacted by November 3, 2011. The second event was the federal law change in 2010 to allow exclusion or deduction of certain health care coverage for a child under 27 years of age.

The exclusion or deduction was for expenses incurred and benefits provided on or after March 30, 2010. California did not immediately conform, which left taxpayers and employers wondering how to report this difference in taxable income. When California did finally conform to the change a year later, it did so just eight days before the April 15 deadline to file the tax return. The delay and retroactive qualifying date burdened

employers who provided benefits to amend and reissue tax year 2010 W-2s for eligible employees. In both instances, we are a year behind the federal law, which widens the gap between federal and state 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 final 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 state conformity legislation.

FTB needs dedicated staff and resources available to follow and provide analysis on pending and final 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 to clarify the impact of laws, we write articles for *TaxNews* monthly, periodically release *TaxNews* flashes to our subscribers, and post information on the Advocate's Twitter account.

Education and Outreach

We need to continue to increase our education and outreach efforts and utilize the social media tools available. In the last year, we have used new media tools, such as Twitter and Facebook, to provide taxpayers with information on California and federal tax law and FTB service changes. We also participate in Board of Equalization and State Controller's Office sponsored events to provide small business education and outreach throughout California. 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. We now offer a short virtual presentation on the New Jobs Credit. We will focus our future efforts to increase the number of short presentations available on our website.

e-Services

In an effort to reduce taxpayer 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 is a voluntary tax-filing method where FTB uses wage and withholding information to complete "simple tax returns" for taxpayers. FTB pre-selects taxpayers who filed as single or head of household, have income only from wages, and claim the standard deduction. Taxpayers may choose to view, update, and e-file their ReadyReturn online. Usage has climbed from approximately 11,000 tax returns in 2008 to over 80,000 tax returns in 2011.

The ReadyReturn program continues to receive positive feedback from taxpayers. Over 98 percent of users report they were "satisfied" or "very satisfied" with the program and that it is the type of service government should provide. Several taxpayers left comments, including: "Thank you for making my life easier! It's about time the government adds a program that is so efficient." and "Wow this is painless. Thank you Franchise Tax Board!"

CalFile

CalFile is FTB's free, secure, online application that allows taxpayers to e-file their state income tax return 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. CalFile usage increased in 2011 with over 250,000 taxpayers using the service.

MyFTB Account

MyFTB Account is the secure web program that serves as the central location for taxpayers and tax professionals to interact with FTB online. Users complete a one-time registration and select a user name and password that they manage going forward. Taxpayers must provide key pieces of information from their tax returns to register, while tax professionals must provide their industry credentials. 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.

MyFTB Account for Individuals gives users access to estimated tax payment information, recent payments made, the total balance due on their account, their California wage and withholding information, and FTB-issued 1099-G and 1099-INT information. Individual taxpayers can update their address and telephone number, sign up for estimated tax payment email reminders, and access additional services such as CalFile, ReadyReturn, and Web Pay.

MyFTB Account for Businesses lets users view their entity's estimated tax payments and make payments using Web Pay.

Web Pay

Web Pay is a free, secure, online service that allows individual and business taxpayers to make their tax payments online. Taxpayers can schedule payments to come out of a checking or savings account up to one year in advance. In late 2011, taxpayers will also have the ability to view scheduled payments and cancel those that have not been processed.

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 who 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 regarding:

- 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 including:

- 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 auditors baseline expertise in the following areas:

- Organizational mission and values and customer service.
- 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 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 business entity nonfiler program also uses various income sources, including information from the IRS, BOE, EDD, and financial institutions, to identify potential nonfiling corporations, 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 our 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 on taxpayers and focuses on adherence to FTB Regulation Section 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 Result in 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. To complement these efforts, FTB takes strides in educating the citizens of California 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.

Recent Legislation to Encourage Self-Compliance

The legislature enacted a second Voluntary Compliance Initiative which allows taxpayers who engaged in abusive tax avoidance transactions or who failed to report income from the use of offshore financial arrangements to correct their state income tax returns for

tax years 2010 and prior. Taxpayers electing to participate in the initiative will avoid most penalties and any future criminal action. The initiative's filing period runs from August 1 and extends to October 31, 2011. FTB is promoting public awareness and participation in the initiative by informing taxpayers of the benefits of participating and also the consequences of not participating in the initiative. In addition, FTB has published articles and given presentations to tax professionals and is using other media to encourage taxpayer participation.

Collections Program

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

FTB maintains a call center staffed by collection experts, including several Spanish/English speaking employees. 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 lien notices and to levy wages and bank accounts. Individual collectors or an automated system can issue these notices and levies.

Accounts Receivable Collection System

FTB uses this automated system to process and maintain approximately 2.0 million 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, so collectors can 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

Outsourcing collection accounts provides FTB with an alternative collection strategy for accounts that are not economically feasible to assign to an FTB collector. We view outsourcing as a way to broaden our ability to collect debts owed the state. FTB uses Private Collection Agencies (PCAs) to collect debts in certain workloads. 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. FTB takes great care to safeguard taxpayers' data and protect their rights when outsourcing accounts to PCAs. FTB requires all PCAs to adhere to the Fair Debt Collection Practices Act, FTB's Taxpayers' Bill of Rights, California R&TC, and all other FTB applicable policies.

Payment Methods

Installment Agreements – FTB provides taxpayers who are unable to pay the full amount they owe in one payment the option of installment payments. 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 be converted into a formal installment agreement if they meet the requirements. Since the program's inception in December 2009, 14,000 tax returns have been filed and \$11 million collected. This program increases fairness and compliance with tax laws, increases efficiency, and improves customer service by making it easier for taxpayers to comply with their filing requirements and pay their tax liabilities.

Outbound Messaging Pilot – The Personal Income Tax Collection Contact Center partnered with an outside vendor to contact taxpayers before the taxpayers' accounts moved to involuntary collections. In addition to helping taxpayers, prior to involuntary collection action, this pilot provided taxpayers with an additional avenue to contact FTB to resolve their outstanding liabilities. The pilot ran from November 17, 2010, to March 18, 2011. Of the 9,800 outbound calls dialed, FTB received over 3,000 incoming contacts. A total of \$4 million was collected through this effort. Feedback from customers who participated was very positive.

Offer in Compromise – FTB's Offer in Compromise Program is for taxpayers who do not have, and will not have in the foreseeable future, the money, assets, or means to pay their tax liability. It allows a taxpayer to offer a lesser amount for payment of an undisputed final tax liability.

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 fraud and 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 individuals for these criminal activities and publicizing the convictions result in 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.

Special agents also work with federal agencies and prosecutors assisting in the investigation and prosecutions of federal charges such as mail fraud and money laundering. They participate in refund fraud investigations where there has been a dramatic increase in national and international dimensions, particularly with the explosion of debit card refund fraud schemes. The trend away from violent and drug related crimes to income tax refund schemes has received national publicity.

For FY 2010/2011, criminal investigations activities resulted in:

- 99 new cases.
- 60 cases approved for prosecution.
- 87 individuals prosecuted.
- 116 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, small business, foreign scholars, withholding, audit, forms of ownership, enterprise zone credits, and other topics as requested. We participated in over 160 presentations throughout California. Our education and outreach staff responded to over 1,500 inquiries from taxpayers and tax professionals. We now have a presence on Facebook and Twitter and use it as another vehicle to provide information to taxpayers and tax professionals. We continue to expand our online educational products, for example, we now offer a short virtual presentation on the New Jobs Credit. We will focus our future efforts to increase the number short presentations available on our website.

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.

We have updated the Spanish VITA webpages and will be translating more information on our website into Spanish next year.

Our goal is to provide more resources in Spanish on the web and make it easier for the public to access. We also plan to meet with media to get the word out as well, along with other public services messages on the web.

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 in reducing 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)

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 RDPs' 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 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*

California Tax Law and FTB Services Updates

In our commitment to provide timely information to promote complete, accurate, and timely filed returns, we developed a California tax and FTB services update presentation and presented it throughout the year statewide to tax professionals.

This year's presentations provided information, explanations, and promoted discussions about:

- Use Tax Tables included on individual income tax returns and instructions to facilitate the estimation and reporting of the use taxes owed.
- Dependent and Child Care Credit no longer refundable.
- Voluntary Compliance Initiative 2 program that allows participants who were associated with abusive tax avoidance transactions or have unreported offshore account income to avoid penalty and criminal prosecution.
- Development of a new Financial Institutions Records Match system that will allow us to exchange information with California financial institutions and collect delinquent debts.
- Conformity to federal law allowing exclusions or deductions for certain health care coverage for a child under 27 years of age.
- Community property tax guidance for RDPs and SSMCs.
- New Jobs Credit available to small business for hiring new employees.
- Online Services, such as, *TaxNews*, MyFTB Account, Web Pay, Installment Agreements, Systemic Issues Management System, and Secure E-mail.

Interactive Voice Response

FTB maintains and regularly enhances approximately 37 Interactive Voice Response (IVR) applications. These applications provide recorded responses to the most frequently asked questions regarding general state tax information. In addition, the IVR provides account information, such as current balance due, payments and refund status. Callers can also order common personal income tax and business entity forms through the IVR. Most of the applications are available in both English and Spanish. In many cases, callers may choose to speak to a representative after navigating through the IVR applications. If they are transferred to one of the larger call centers, they may be given the option to wait on hold, or request a call back without losing their place in queue. They would receive a call back utilizing Queue Management technology (also known as Virtual Hold).

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 the number of 'abandoned calls' by approximately 65 percent. Abandoned calls are callers who hang up because they are not able to continue waiting on the line. We saved over 10 million minutes of hold time in the first six months since of operation. When offered the option, 63 percent of the callers chose to have a call-back. We successfully connected with 89 percent of the callers.

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. As of July 1, 2011,

the site will be maintained by the Board of Equalization.

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.

TaxNews

TaxNews, our monthly online publication, informs tax professionals about state income tax laws, regulations, policies, procedures, and events that affect the tax professional community. In February 2011, we conducted a survey to explore ways to better serve our subscribers. One point of interest subscribers expressed is the need for more transparency. Within *TaxNews*, we provide a calendar of events our Taxpayers' Advocate and staff are participating in and articles describing our internal processes and procedures. Also, we utilized our *TaxNews* Flashes to push time-sensitive information quickly to our subscribers on subjects such as disaster relief, disclosure obligations, mandatory e-pay, Voluntary Compliance Initiative 2, several webinars, forums, and other educational opportunities. We doubled the number of flashes in comparison to the previous year providing a fast and cost-efficient mode of communication, as well as sharing like information and links through social media like Twitter and Facebook. We also expanded our product base with short video articles, *TaxNews* Live, focusing on services and information that is not being utilized such as the New Jobs Credit. *TaxNews* continues to experience positive feedback by our subscription base doubling in size since December 2009 and trade media publications linking to and using our 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.

We participate in small business fairs sponsored by BOE members and the State Controller's Office 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 - *Read the Fine Print About Forming a Business Entity Outside of California*
- FTB 982 - *How to Select an Income Tax Return Preparer.*
- FTB 985 - *Audit/Protest/Appeals: The Process.*
- FTB 1024 - *Penalty Reference Chart (ftb.ca.gov only).*
- FTB 989 - *Understanding Your California Taxes (ftb.ca.gov only).*
- FTB 3730 - *Online Buying or Selling: Know Your Tax Obligation (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 business owners and taxpayers to the appropriate program areas within our department and to the other state or federal agencies to answer their questions.

The education and outreach staff received over 1,500 calls this year, and 1,271 of those calls were to the Small Business Liaison. This is an increase in calls to the Small Business Liaison of approximately 23.5 percent. Many calls were from out-of-state taxpayers inquiring about California tax requirements.

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 laws or proposed initiatives, regulations, projects, 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 2011

Promote and Encourage Self-Compliance

FTB's performance management program continues to mature; there is greater awareness across the enterprise about the benefits of the program and the understanding that FTB's performance is directly related to the taxpayer's ability to participate in the tax system.

We will continue to maintain a focus on taxpayers and what they need to meet their tax obligations. Through a comprehensive performance management program, FTB will manage, monitor, and reach higher levels of excellence with the products and services it delivers in order to promote and encourage self-compliance.

Modernize Our Tax Systems

The Enterprise Data to Revenue Project (EDR) is the first of several planned FTB modernization projects described in our Strategic Plan.

EDR brings us new technologies that we will use to leverage the data we collect to more effectively administer our tax systems. This means more efficient operations throughout FTB, better customer service, a higher level of transparency, and more revenue. In short, EDR gives us the opportunity to provide better service, reduce taxpayer burden, and make significant progress toward reducing the tax gap.

EDR includes four major components:

- **A new return processing system.**
The new system automates manual processes, enhances our capacity to capture and validate data, standardizes our processes, and combines personal income tax and business entity tax processing into one system.
- **An enterprise data warehouse.**
The data warehouse makes all data accessible to our legacy systems and to FTB users.
- **A secure online taxpayer folder.**
The folder provides FTB staff and our stakeholders secure access to information such as tax returns, payments, notices, etc.
- **Updated systems.**
Legacy systems are updated so they will work with the new processing system, the data warehouse, and the taxpayer folder.

The state can count on EDR revenue benefits starting in FY 2011/2012. EDR Project revenue will continue to increase during the project resulting in about \$4.7 billion over the term of the project. Revenue benefits will level out at approximately one billion dollars annually starting in 2016, and will continue each year thereafter. EDR revenue estimates are based on current tax law and do not factor in any new taxes or penalties. The primary source of funding for EDR is drawn from more efficient collections and increased tax compliance.

The EDR contract was awarded to CGI Technology Solutions, Inc. CGI has extensive experience on large, complex information technology projects. We have worked with CGI on several large tax projects in the past. We signed the EDR contract on June 6, 2011. The project kick off was July 1, 2011. EDR is a 66-month project.

Tax Gap Action Committee Initiatives

- Support and facilitate the implementation of the EDR Project as the department's primary effort to address the tax gap.
The committee will support the EDR Project by providing analyses and expertise on tax gap issues and by making policy and procedure recommendations as appropriate. We will work to identify additional opportunities for the EDR Project to reduce the tax gap, and we will communicate with various tax gap stakeholders, including our partner tax agencies, about the EDR Project and opportunities to leverage a new and existing data and services.
- Identify and support enterprise efforts to reduce accounts receivable balances.
The committee will seek to identify, review, and support initiatives to improve the department's ability to manage and reduce accounts receivable balances from an enterprise perspective. In addition, we will work to identify new collection methods, compliance strategies, and tools to improve collection of our accounts receivable. We will collaborate with various tax gap stakeholders, including our partner tax agencies, to exchange data and leverage knowledge and expertise with our partners.

Projects

Live Chat

Live Chat was launched as a six-month pilot on March 11, 2011. This communication channel was designed so the public could ask FTB representatives nonaccount specific questions regarding personal income tax, finding a form or publication, and to get help with our website.

Live chat was advertised only as an alternative channel on our website's Contact Us page. We have since expanded our web presence to links on the FTB Home, Individuals, and Tax Professionals webpages. Since its inception to June 30, 2011, our Live Chat agents have conducted over 37,000 chats. In addition, our customer feedback for the service has been extremely positive with an approval rating of four out of five stars (9,000 responses). At the end of August 2011, the pilot program became a permanent service.

Systemic Issues Management System

The Systemic Issue Management System Phase II was completed in April 2011. The enhanced system allows 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 2, 2010. 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:

- Conformity to Federal Tax Law with the Same Dates
- Power of Attorney Notification on all FTB Taxpayer Correspondence
- Implementation of a Hold-time Message
- Combining Secretary of State Statement of Information (SI) Filings
- Increase Lien Filing Threshold to \$5,000.00 or More
- Decrease Processing Times for Account Resolution

In his letter dated February 3, 2011, Taxpayers' Rights Advocate Steve Sims responded regarding conformity to federal tax law with the same dates, by stating FTB staff already communicates with staff at the legislature to educate them regarding the effects of Proposition 26 on SB 401 and how taxpayers and tax professionals will be impacted. It is also important that the Enrolled Agents have a significant voice at the Capitol on conformity generally and specifically on solutions for the impending repeal of SB 401 in November 2011. We encourage the Enrolled Agents to participate in the legislative process--individually by contacting their respective legislators on the issue and collectively through the Society's legislative advocate at the Capitol.

Regarding Power of Attorney notification, Mr. Sims indicated our current method of capturing and maintaining power of attorney information is limited and not readily available for the purposes of our automated noticing processes. As a result, it is cost prohibitive in most instances to provide a duplicate notice to both the taxpayer and the taxpayer representatives. A subsequent copy of a notice may be provided, when available, at the request of the taxpayer or authorized representative. This is on a case by case basis.

Regarding implementation of a hold time message, Mr. Sims responded on the 800 number with the Virtual Hold Technology (VHT) service active, a caller will first hear the estimated wait time and then be given the option to receive a call back or wait for an agent. Once a caller chooses a call back, she/he will get a range when to expect to receive the call back. It is the same estimated wait time simply provided in a range format taking into account the variables that can occur with longer or shorter call duration and changes in staffing. For example, the caller initially may get an estimated wait time of 10 minutes. If the call back is chosen by the caller, a taxpayer may be told to expect a call back in 9 to 13 minutes.

When selecting VHT (call back) the caller keeps his/her place in line in the queue, but instead of actually waiting online, a taxpayer gets a call back within the timeframe stated.

Regarding combining Secretary of State Statement of Information (SI) filings, Mr. Sims responded we will contact SOS and do additional research and analysis to fully explore this issue. We will report our findings by March 31, 2011, regarding the feasibility and potential solutions to improve this process.

Regarding increasing the lien threshold to \$5,000.00 or more, Mr. Sims responded that in the 2010 Taxpayers' Bill of Rights Annual Report, the FTB Taxpayer Advocate recommended "...the FTB collection department re-consider raising the lien threshold in this economic climate to avoid causing undue hardship to taxpayers and improve operational efficiencies." FTB understands the impacts to the taxpayer, and as a

result is in the process of establishing a team of experienced collection staff to closely examine methods and alternatives that would address the Advocate's concerns and the recommendation by CSEA to raise the lien filing threshold. The team will begin meeting in early January, and expects to present a proposal to FTB's Executive Management by the end of June, 2011.

Gina Rodriquez, Spidell Publishing, Inc.

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

- FTB Return to Standalone Tax Return Similar to the Federal Return.

In his letter dated February 3, 2011, Taxpayers' Rights Advocate Steve Sims responded that this proposal highlights the potential impact of Proposition 26 in relation to federal conformity. We agree that a lack of updated federal conformity impacts taxpayers' burden to file, and we continue to support and encourage federal conformity in order to simplify taxpayers' burden to file. While the number of state and federal differences will continue to increase without updated federal conformity, our findings show that the majority of taxpayers are able to complete their California tax return with few, if any, state adjustments.

For the reasons stated above, we do not believe reverting to a standalone return will result in an overall reduction in taxpayers' burden to file. We also continue to earnestly support updated federal conformity. We will continue to monitor the reporting of state adjustments, federal non-conformity, and the related impact on the taxpayer's burden to file.

Roland Boucher, United Californians for Tax Reform

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

- Raise California standard deduction to the federal level.

In his letter dated February 3, 2011, Taxpayers' Rights Advocate Steve Sims responded that California voters recently passed Proposition 26. The provisions of Proposition 26 state that a change that results in a tax increase to any taxpayer requires a 2/3rds majority vote. Thus, even if overall revenue neutrality is achieved, this proposal results in an increase to some taxpayers and appears to come under the 2/3rds vote requirement of Proposition 26.

For taxpayers who wish to report itemized deductions, there are many free e-file options available, including FTB's "CalFile." These applications help taxpayers to easily compute itemized deductions and e-file their return for free. In addition, e-file is fast, secure, and saves paper. As a result of the above discussion, we are unable to recommend an FTB sponsored legislative proposal to increase the CA standard deduction to an amount equal to the Federal standard deduction and elimination/adjust the tax rate for the 1 percent tax bracket. We believe this type of proposal may be more appropriate for consideration by a legislative representative.

David Feldman, ZF Micro Solutions

Mr. Feldman provided oral comments to the Board on the following issue:

- Law change that requires CA courts to require proof of compliance at the time a lawsuit is filed.

In his letter dated March 9, 2011, Taxpayers' Rights Advocate Steve Sims responded that our staff will develop a Taxpayers' Bill of Rights legislative proposal to present to the Board at a meeting this year.

Kimberly Reeder, Morgan, Lewis, & Bockius LLP

Ms. Reeder submitted written comments to the Board on the following issue:

- FTB does not follow certain rules governing the settlement of civil tax matters.

In his letter dated February 4, 2011, Taxpayers' Rights Advocate Steve Sims responded that because the issue addressed in your letter is the subject of a lawsuit in Superior Court, it is the policy of the Board that I not respond to your letter.

Evaluating Franchise Tax Board Employees

In previous years, we reported changes to the employee performance evaluation and probationary reports as well as changes in the evaluation process itself. We explained that “Customer Service” was included as a performance dimension in the evaluations for supervisors and employees, and that 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.” The primary change in the evaluation process was the implementation of a plan to ensure all eligible employees receive an annual performance appraisal by August 31 each year. Since 2008, when this change was implemented, the percentage of employees and supervisors who receive a required performance appraisal has risen to nearly 95 percent.

During 2010, we concentrated our efforts on improving the communication process between supervisors and those employees evaluated and holding staff accountable for expected results/behaviors. These efforts included:

- Development and presentation of training to all supervisors that focused on honest and respectful communication with staff. The class included tips on developing an environment of open communication as well as ways to properly hold people accountable for expected performance and behavior.
- Development and communication of a series of “performance evaluation” tips to all supervisors, including:
 - Identifying and addressing potential issues early.
 - How to identify whether the employee’s failure to meet expectations is due to ability, motivation, or both- and how to remedy it.
- Focusing on the employee’s areas of strength, encouraging them to continue developing, and strategizing how to manage around areas that they might be weaker in.

We are continuing our training efforts in the upcoming year. We plan to roll out a version of the honest communication training to all staff, and are developing some targeted “performance appraisal” training for supervisors before next year’s process.

Appendices

Appendix 1

All tables in Appendix 1 reflect tax increase assessments only. The assessments became final in FY 2010/2011. We may have issued the assessments in prior years; however, due to cases in protest status, we did not resolve them until FY 2010/2011. Appendix 1 totals reflect rounded figures and may not compute exactly.

Table 1A Corporation Tax Law					
NPAs Finalized in Fiscal Year 2010/2011 Categorized by Primary Statute (Issue)					
Issue	Number of NPAs		Tax Assessed (Millions)		Average Assessment Per NPA
		%		%	
Allocation/Apportionment	581	26.6	\$ 269.4	77.7	\$ 463,599
Assess Minimum Tax	33	1.5	0.0	0.0	764
Revenue Agent Reports	1,072	49.1	29.5	8.5	27,473
State Adjustments	181	8.2	20.5	5.9	
Other	316	14.5	27.0	7.8	85,515
Totals/Average	2,183	100	\$ 346.3	100	\$ 158,654

- *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 2010/2011 Categorized by Primary Statute (Issue)					
Issue	Number of NPAs		Tax Assessed (Thousands)		Average Assessment Per NPA
		%		%	
CP2000	152,209	16.1	\$ 117,692	4.7	\$ 772
Filing Enforcement	686,840	72.4	2,083,329	82.7	3,033
Filing Status	28,296	3.0	28,312	1.1	
Revenue Agent Reports	46,952	5.0	130,450	5.2	2,778
Other	33,474	3.5	159,932	6.3	4,778
Totals/Average	948,071	100	\$2,519,716	100	\$ 2,658

- 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 2010/2011

Industry	All Corporations 2008 Tax Year		Corporations with NPAs		Tax Assessed (Millions)	
		%		%		%
F.I.R.E.*	124,901	17.2	154	11.8	\$ 25.2	7.2
Manufacturing	48,260	6.6	135	10.4	79.9	23.1
Services	300,371	41.3	259	20.0	12.3	3.6
Trade	147,471	20.3	168	13.0	25.6	7.4
Other **	106,672	14.7	580	44.8	203.3	58.7
Totals	727,675	100	1,296	100	\$ 346.3	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 through a combined report, we base the industry designation on the corporation's primary business activity in California. In the case of corporations filing through 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 2010/2011 Issued by Taxable Year

Average Taxable Year	Number of NPAs		Tax Assessed (Millions)		Average Assessment Per NPA
		%		%	
2003 and prior	422	19.3	\$ 233.8	67.5	\$ 553,923
2004	184	8.4	21.5	6.2	116,905
2005	350	16.0	36.3	10.5	103,651
2006	508	23.3	34.1	9.9	67,205
2007	429	19.7	15.6	4.5	36,260
2008	207	9.5	4.5	1.3	21,871
2009 and later	83	3.8	0.6	0.2	6,916
Totals/Average	2,183	100	\$ 346.3	100	\$ 158,654

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 2010/2011 for the Same Taxpayer

Corporations With...	Number of Taxpayers	Tax Assessed (Millions)	Average Assessment Per Taxpayer
One NPA	708	\$ 71.9	\$ 101,599
Two NPAs	400	82.9	207,367
Three NPAs	126	90.5	717,894
Four or more NPAs	62	101.0	1,629,156
Totals/Average	1,296	\$ 346.3	\$ 267,239

Table 4 **Personal Income Tax Law**

NPAs Finalized in Fiscal Year 2010/2011 Issued by Taxable Year

Taxable Year	Number of NPAs		Assessment Amount (Thousands)		Average Assessment Amount
		%		%	
2004 and prior	3,074	0.3	\$ 69,369	2.8	\$ 22,566
2005	5,248	0.6	43,760	1.7	8,338
2006	52,403	5.5	186,210	7.4	3,553
2007	240,360	25.4	476,415	18.9	1,982
2008	299,852	31.6	817,075	32.4	2,725
2009 and later	347,134	36.6	926,888	36.8	2,670
Totals/Average	948,071	100	\$2,519,716	100	\$ 2,658

Table 5 **Personal Income Tax Law**

Resident Tax Return Preparation, Process Years 2009 and 2010

Preparer	2009 Tax Returns Processed (Thousands)		2010 Tax Returns Processed (Thousands)		% Change
		%		%	
Professional	10,075	68.0	9,901	67.6	-0.4
Taxpayer	4,507	30.4	4,513	30.8	0.4
VITA*	224	1.5	225	1.5	0.0
Totals	14,806	100	14,638	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, 2010	June 30, 2011	% Change
Credit Card Payments (Average payment is \$978)	116,000	137,000	18 .0
Direct Debit of Balance Due (Electronic Funds Withdrawal)	626,000	414,000	-34 .0
Direct Deposit Refund	4,851,000	5,624,000	16 .0
* e-file	11,430,000	12,553,000	10 .0
** <i>CalFile</i>	238,000	258,000	8 .0
** Online Filing	2,518,000	2,848,000	13 .0
** Business Entity	382,000	497,000	30 .0

* e-file volume includes Business Entity tax returns.

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

Table 7A **Corporation Tax Law**

Nonfilers Detected Through the Automated Nonfiler System

Fiscal Year	Demands	NPAs Issued
2006/2007	8,927	13,271
2007/2008	31,819	18,855
2008/2009	65,954	23,807
2009/2010	26,367	27,286
2010/2011	43,924	23,629

Table 7B **Personal Income Tax Law**

Nonfilers Detected Through the Automated Nonfiler System

Fiscal Year	Demands/Requests	NPAs Issued
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
2010/2011	1,067,776	774,627

Appendix 2

Table 8A **Top Errors by Tax Return Type**

Current Year Tax Returns July 1, 2010 through June 30, 2011

Code		Grand Total	540 2EZ	540 A	540	540 NR	540 X
EP	Estimate Payment	171,364	1,688	2,747	151,795	146	12,907
AW	Withholding Did Not Match Attachments	31,932	6,143	981	22,112	704	803
OC	Estimate Transfer Revised	24,559		384	20,234	25	3,386
OF	Amended Refund Did Not Equal Original Refund	21,831	1,013	303	7,099	12,924	486
TC	Tax Amount	20,442	117	6,070	10,938	1,129	2,185
EX	Exemptions	19,183	116	7,479	10,159	102	955
TY	Total Tax Revised - AGI, Filing Status, or Dependents	18,290	18,287			*	
OM	Amended Payments Did Not Match Original	18,085	479	176	3,938	13,153	337
SS	State Disability Insurance Revised	13,362		1,019	11,783	187	373
TT	Total Credits/Liability	10,397	1,416	3,865	4,198	321	223
RN	Renters Credit Revised	9,986	1,951	3,153	4,592	8	282
WS	Withhold at Source Revised	9,385		3	2,610	168	6,517
OA	Refund Revised - Incorrect Payments or Credits	8,904	1,394	1,933	3,935	1,101	365
AT	Withholding Documents Not Attached	8,327	903	405	4,170	230	1,528
DS	Deductions	6,360	30	1,494	4,220	136	475
TI	Taxable Income Revised	4,364	6	1,979	2,082	97	197
ND	California Taxable Income Revised	4,268			*	34	4,231
OB	Balance Revised - Incorrect Payments or Credits	3,198	742	608	1,420	241	83
AR	Amended Tax Return Received - No Record of Original Tax Return	3,160	*		*	3,040	
NN	Total Tax Revised - Nonresident Errors	2,481			*	*	2,478
OP	Amended Estimate Payments Did Not Match Original	1,860	5	27	465	1,323	40
AA	Adjusted Gross Income	1,336	1,226	57	52		*
CI	CDC - FTB 3506 Not Attached	819		84	343	353	10
	All Others	18,955	758	2,194	12,785	1,256	1,370
	Top Ten	348,905	34,763	30,720	247,130	34,289	35,476
	Total	432,308	36,275	34,961	278,934	36,681	39,232

*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, 2010 through June 30, 2011

Code		Grand Total	Electronic	Paper
EP	Estimate Payment	171,364	104,107	67,257
AW	Withholding Did Not Match Attachments	31,392	17,353	14,039
OC	Estimate Transfer Revised	24,559	12,655	11,904
OF	Amended Refund Did Not Equal Original	21,831	449	21,382
TC	Tax Amount	20,442	202	20,240
EX	Exemptions	19,183	338	18,845
TY	Total Tax Revised - AGI, Filing Status, or Dependents	18,290	132	18,158
OM	Amended Payments Did Not Match	18,085	102	17,983
SS	State Disability Insurance Revised	13,362	8,172	5,190
TT	Total Credits/Liability	10,397	898	9,499
RN	Renter's Credit Revised	9,986	1,643	8,343
WS	Withhold at Source Revised	9,385	3,928	5,457
OA	Refund Revised - Incorrect Payments and Credits	8,904	386	8,518
DS	Deductions	6,360	1,579	4,781
NH	New Home Credit	2,994	2,031	963
CH	Qualifying SSN Already Used	2,543	1,516	1,027
	All Others	83,403	278,426	224,483
Top Ten		348,905	153,882	207,825
Grand Total		432,308	158,134	272,806

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.
CH	CDC - Qualifying SSN already used by another taxpayer.
CI	CDC - FTB 3506 not submitted with return.
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.
NH	New Home or First-Time Buyer Credit revised or denied.
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, <i>Tax on Lump-Sum Distributions</i> or Form 5870A, <i>Tax on Accumulation Distribution of Trusts</i> .
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 amount 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 17052.6 – California Child and Dependent Care Expenses (CDC) Credit

In 2000, the legislature passed and the governor signed Assembly Bill (AB) 480, which added Section 17052.6 to the Revenue and Taxation Code. This section provided for a credit against net California tax of a percentage (determined by adjusted gross income) of the federal credit allowed under Internal Revenue Code Section 21 for tax years beginning on or after January 1, 2000. This section provided for a refundable credit as originally enacted. However, in 2011 Senate Bill (SB) 86 amended this section to make the credit nonrefundable for tax years beginning on or after January 1, 2011.

Section 17052.6 incorporates by reference the provisions of Internal Revenue Code Section 21, which requires taxpayers to identify their qualifying individual and care provider, and the amount paid for qualifying expenses. This proposed regulation seeks to provide clarification, for the taxpayer, as to the documents that can be used to establish the identity of the qualifying individual, the care provider, and the amount paid for qualifying expenses.

On December 2, 2010, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss proposed amendments to the existing regulations for Revenue and Taxation Code Section 17052.6. An interested parties meeting was held on May 31, 2011, and staff is currently preparing draft language for the proposed regulations, incorporating the comments received at the interested parties meeting. A second interested parties meeting will be scheduled to elicit comments from the public on the draft language of the proposed regulations.

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 derived 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. Interested parties meetings were held on June 17, 2008 and November 19, 2010. Staff held a third interested parties meeting on October 4, 2011, to provide proposed language for public input.

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 was held on July 14, 2011. A third interested parties meeting will be held in the future to discuss the withholding rules to be applicable for domestic (U.S.) pass-through entities subject to withholding under Regulation Section 18662-7.

Regulation 19089 – Notice of Bankruptcy or Receivership

Revenue and Taxation Code Section 19089 provides, in part, that "[e]very trustee in a case under Title 11 of the United States Code, receiver, assignee for the benefit of creditors or like fiduciary shall give notice of qualification as such to the Franchise Tax Board in the manner and at the time that may be required by regulations of the Franchise Tax Board" and that "[t]he Franchise Tax Board may by regulation provide any exemptions from the requirements of this section that the Franchise Tax Board deems proper." The Franchise Tax Board has not yet adopted regulations under this section.

The potential new regulation would be designed to implement the section. The regulation would address such issues as who is required to give notice of qualification, the manner in which notice must be provided, the time requirement for providing the

notice, and whether any exemptions to the notice requirement are appropriate.

An interested parties meeting was held on December 3, 2010, with the purpose of eliciting public input into the potential new regulation and discussing issues to be considered in drafting the language of the new regulation. At the conclusion of the meeting, staff reiterated its interest in hearing and receiving additional comments. Staff is drafting language for the regulation and will hold a second interested parties meeting in the fall of 2011 to elicit comments on the draft language.

Regulation Section 19131 and 19132 – Failure to File a Return and Failure to Pay Tax

The Franchise Tax Board imposes penalties under Revenue and Taxation Code Sections 19131 and 19132 for a taxpayer's failure to file a return (19131) and failure to pay tax (19132). Both of these penalties are imposed unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

These sections generally conform to Internal Revenue Code Section 6651. The Internal Revenue Service has an administrative policy in the IRS Penalty Manual that provides for a "first-time" abatement procedure. This policy applies if the taxpayer had not previously been required to file a return or if no prior late filing or underpayment penalties have been assessed in the prior three years. If a taxpayer meets the requirements for this first-time abate procedure, the Internal Revenue Service abates the federal failure to file or failure to pay tax penalty without considering any reasonable cause argument. The Revenue and Taxation Code has no provision similar to this federal first-time abate policy, nor does the Franchise Tax Board have any formal administrative policy that is similar to the federal policy.

On December 3, 2010, an Interested Parties Meeting was held to discuss proposed regulations to address whether abatement of these penalties may be appropriate under standards similar to the federal first-time abatement procedure. Presently staff is determining the scope of the federal procedure and drafting the proposed regulations. An additional Interested Parties Meeting will be held after draft language has been developed so that the public may have an opportunity to comment on the proposed language of the new regulations.

Regulations Sections 19266 – Financial Institutions Record Match (FIRM)

The Financial Institution Record Match (FIRM) program was enacted March 24, 2011 (SB 86, Stats. 2011, ch. 14). Sections 19266 and 19560.5 were added to the Revenue and Taxation Code, which authorizes FTB to match FTB tax and non-tax debtor files referred to FTB for collection (collectively, "delinquent debtor files") against accounts held at financial institutions (banks, credit unions, insurance and brokerage companies) doing business in California.

On July 25, 2011, FTB hosted a FIRM Advisory Workshop. The invitees included the financial institution trade associations. The purpose of this workshop was to obtain input from the financial institutions as to the steps FTB is taking to implement the FIRM statutory provisions and to mitigate potential impacts to the financial institutions. FTB provided the Advisory Workshop participants with the draft FIRM documents to review and provide feedback.

On August 16, 2011, FTB held the first interested parties meeting to discuss FIRM processes, procedures, and the necessary components of the FIRM regulations. A second interested parties meeting was held on September 27, 2011 to solicit public input on the draft regulations.

Regulation Section 19322 – Refund Claim

In 1993, SB 3 added Section 19322 to the Revenue and Taxation Code by consolidating separate sections that previously were in the Personal Income Tax Law and the

Corporate Tax Law into this new section. This section provides that all claims for refund must be made in writing and be signed by the taxpayer or the taxpayer's representative. Section 19322 further mandates that all claims for refund state the specific grounds upon which the claim is based.

The current claim for refund Regulation Section 19322 provides requirements for the manner of filing refund claims, grounds that must be set forth in refund claims, and information regarding the oral hearing process. The current rulemaking project proposes regulatory amendments to update current Regulation Section 19322. The potential amendments to the existing regulation aim to clarify the manner of filing refund claims both to make clear the preference for claims to be reported on the prescribed amended tax return form and also to encompass electronic means of filing claims which may become available in the future. Additionally, the potential amendments seek to clarify the grounds that must be set forth in a valid refund claim both through additional specific language in the regulation and through the use of examples of valid and invalid claims. Finally, the regulation seeks to clarify the oral hearing process available to taxpayers for their claims for refund.

On December 4, 2008, staff received authorization from the three-member Franchise Tax Board to proceed with an interested parties meeting to discuss proposed amendments to the existing regulations for Revenue and Taxation Code Section 19322. An interested parties meeting was held on December 3, 2010, and staff is currently preparing draft language for the regulation amendments based on the comments received at the interested parties meeting. A second interested parties meeting will be scheduled to elicit comments from the public on the draft language of the regulation amendments.

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 penalty for the failure to provide written notification to FTB within 45 days of a final order suspending or disbaring the person from practice before the IRS.

Section 19523.5 also mandates the imposition of a \$5,000 penalty for the failure to provide written notification to FTB within 45 days of a final order suspending or disbaring 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.

The Franchise Tax Board 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. There were no comments made or questions asked. On December 2, 2010, the three-member Franchise Tax Board approved staff's recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act. Staff held a formal regulatory hearing on June 14, 2011. The rulemaking file was submitted to the Office of Administrative Law on August 11, 2011, for review and filed with the Secretary of State on September 26, 2011.

Regulations Sections 24465 – Transfer of Appreciated Property to an Insurer

In 2004, the Legislature passed and the Governor signed AB 263, which added Section 24465 (and other provisions) to the Revenue and Taxation Code. This section would, in connection with specified exchanges, provide that if a taxpayer transfers property to an insurer, the insurer shall not, for purposes of gain recognition, be considered to be a corporation for purposes of the Corporation Tax Law.

On March 8, 2011, staff held an interested parties meeting to discuss proposed regulations to implement specific subdivisions of Revenue and Taxation Code Section 24465.

Regulations Sections 25106.5 – Finnigan/Joyce Sales Factor

Revenue & Taxation Code (RT&C) Section 25135 provides the sales factor numerator assignment rules for sales of tangible personal property. During 2009, the Legislature amended RT&C Section 25135, operative for taxable years beginning on or after January 1, 2011. As amended, RT&C Section 25135 requires that sales of tangible personal property delivered or shipped to a purchaser in California be assigned to California if the seller or any member of the seller's combined reporting group is taxable in California. In addition, all sales of tangible personal property delivered to a state other than California are not assigned (thrown back) to California if any member of the seller's combined reporting group is taxable in that state.

The first interested parties meeting was held on May 26, 2011 and a summary of that meeting was posted on the Franchise Tax Board website. Public input regarding possible regulatory language was elicited at the first interested parties meeting. During the first interested parties meeting, an attendee suggested that the Hearing Officer draft proposed language to amend the existing California Code of Regulations, title 18 (Regulation), Section 25106.5 based on a prior discussion draft the FTB prepared but did not adopt during the 2000 regulation amendment. A second interested parties meeting was held on October 4, 2011, to discuss the proposed language.

Regulations Sections 25106.5-1 – Intercompany Transactions

During 1999, the Franchise Tax Board 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 the regulation. On August 16, 2011, staff held a third interested parties meeting to discuss proposed amendments to the Deferred Intercompany Stock Account (DISA) provisions to provide additional guidance to the taxpayers.

Regulations Sections 25128.5 – Apportionment of Business Income; Election of Alternative Method

During 2009, the legislature adopted Revenue and Taxation Code 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 the Franchise Tax Board 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, what happens when 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 returns (both electing and non-electing) prior to the due date of the 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, the three-member Franchise Tax Board approved staff's recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act. Staff held a formal regulatory hearing on March 29, 2011. As a result of the hearing, there was a 15-day notice with language issued with a comment period ending May 31, 2011. A second 15-day notice with language was issued on June 7, 2011, with a comment period ending June 23, 2011. The Board approved the regulation at the July 7, 2011, Franchise Tax Board meeting. The rulemaking file was submitted to the Office of Administrative Law on August 9, 2011, for review and filed with the Secretary of State on September 22, 2011.

Regulations Sections 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 Revenue and Taxation Code Section 25136 applicable for taxable years beginning on or after January 1, 2011. Revenue and Taxation Code Section 25136 provides the sales factor numerator assignment rules for all sales other than sales of tangible personal property.

Prior to its recent amendment, Revenue and Taxation Code 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 Revenue and Taxation Code 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 Revenue and Taxation Code 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 by a taxpayer. However, that public hearing did not address the recent changes to Revenue and Taxation Code Section 25136 applicable for taxable years beginning on or after January 1, 2011.

For taxable years beginning on or after January 1, 2011, Revenue and Taxation Code 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 was held on November 8, 2010. On December 2, 2010, the three-member Franchise Tax Board approved staff's recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act. Staff held a formal regulatory hearing on August 10, 2011.

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

When a taxpayer subject to the Corporation Tax Law is a partner in a partnership as defined in Revenue and Taxation Code Section 17008, the computation of its distributive share of partnership items is determined in accordance with Chapter 10 of Part 10 of Division 2 of the 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.

Regulations Sections 25137-8.1 and 25137.8-2 – 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 was 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. A second interested parties meeting was held on May 15, 2009. On June 16, 2009, the three-member Franchise Tax Board approved staff's recommendation to proceed with the formal regulatory process, as required under the Administrative Procedure Act. Staff held a formal hearing on September 13, 2011.

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 Multistate Tax Commission.

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

On November 28, 2007, staff received permission from the three-member Franchise Tax Board to hold an interested parties meeting to discuss whether to update or add definitions to the existing regulation. An interested parties meeting was held July 17, 2008. Discussions included whether the "trucking company" definition

should be amended and whether a “trucking activity” definition should be added. 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, the 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. This project is currently on hold and will resume in the fall of 2011.



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.

