

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Chesbro Analyst: Marion Mann DeJong Bill Number: SB 94

Related Bills: AB 572 (1999) Telephone: 845-6979 Amended Date: 04/20/1999

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Taxpayer's Bill of Rights of 1999

SUMMARY OF BILL

This bill would do the following:

1. Eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax. (See Personal Exemption Credits/AMT on page 3.)
2. Delete obsolete refund provisions relating to the renter's credit that are no longer necessary because the reinstated renter's credit, enacted by AB 2797 (Stats. 1998, Ch. 322), is not refundable. (See Renter's Credit on page 6.)
3. Conform to the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act) technical changes relating to the exclusion of capital gains on the sale of a principal residence. (See Capital Gain Exclusion/Principal Residence on page 6.)
4. Expand innocent spouse protections by conforming to the IRS Reform Act provisions relating to innocent spouses. (See Innocent Spouse on page 9.)
5. Provide relief to an employee whose employer withheld delinquent taxes from the employee's pay, pursuant to an earnings withholding order from the Franchise Tax Board (FTB), but failed to remit the amounts to FTB. (See Employee Relief/Unremitted Withholdings on page 11.)
6. Conform to the IRS Reform Act provision to suspend the statute of limitations (SOL) for certain refund claims for periods during which the taxpayer is "financially disabled." (See SOL/Disabled Taxpayer on page 13.)
7. Provide FTB administrative authority to compromise a tax debt similar to the IRS's current offers in compromise authority. (See Offers In Compromise on page 14.)

SUMMARY OF AMENDMENTS

The April 12, 1999, amendments deleted the provisions of the bill as introduced (a conformity spot bill) and replaced them with the Taxpayer's Bill of Rights.

The April 20, 1999, amendments deleted obsolete refund provisions related to the renter's credit that are no longer necessary, changed various operative dates and intent language, and made minor technical changes.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald Goldberg

4/30/1999

EFFECTIVE DATE

As a tax levy this bill would become effective immediately upon enactment. However, the operative dates of the specific provisions would vary, as discussed in the analysis.

LEGISLATIVE HISTORY

On July 22, 1998, President Clinton signed H.R. 2676, the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act). The IRS Reform Act provides for a massive reorganization of the way the IRS does business and creates a board of directors to help oversee the agency. The IRS Reform Act also provides various taxpayer protections (e.g., innocent spouse and disabled taxpayer relief) and instructs the IRS to promote and improve its electronic filing programs. Finally, the IRS Reform Act eliminates the 18-month holding period for long-term capital gains and contains several technical corrections to the Taxpayer Relief Act of 1997 and other recently enacted tax laws.

AB 1469 (1998) was amended to conform to selected parts of the IRS Reform Act and contained other taxpayer rights provisions. The Governor vetoed AB 1469 because of a provision relating to Subpart F income contained in that bill.

SB 93, as introduced December 7, 1998, was identical to AB 1469 except it did not contain the Subpart F provision. SB 93 was amended on February 4, 1999, to delete obsolete refund provisions related to the renter's credit that were contained in SB 2234 (1998), which was vetoed by the Governor for an unrelated issue. SB 93 was amended on February 11, 1999, to delete all provisions except Roth IRAs.

This bill is identical to AB 1469 and SB 93 (as amended February 4, 1999), except it does not contain the Subpart F income and Roth IRA provisions.

SUMMARY OF TAX REVENUE

Provision	Revenue Impact
1. Personal Exemption Credit/AMT	-\$1.5 Million annually
2. Renter's Credit	No Impact
3. Capital Gain Exclusion/Personal Residence	No Impact
4. Innocent Spouse	Minor Revenue Losses - -\$500,000 annually
5. Employee Relief/Unremitted Withholdings	Negligible Losses/- \$25,000 annually
6. SOL/Disabled Taxpayer	-\$1 Million annually
7. Officers In Compromise	Minimal Revenue Savings/ +\$40,000 annually
TOTAL	-\$3 Million annually

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

BOARD POSITION

Pending.

1. Personal Exemption Credits/AMT

OPERATIVE DATE

This provision would apply to taxable years beginning on or after January 1, 1999.

PROGRAM HISTORY/BACKGROUND

In 1987, California enacted legislation that established an Alternative Minimum Tax (AMT) in lieu of the previous tax on preference income. The California legislation substantially conformed state law to the AMT provisions in effect at the federal level, which had been adopted as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income could completely avoid tax liability by using exclusions, deductions, and credits (tax preference items). As discussed below, taxpayers are allowed an AMT exemption deduction in computing AMT. Prior to 1997, the AMT exemption deduction amounts were: \$40,000 for married taxpayers filing joint returns; \$30,000 for individuals filing as either single or as a head of household; and \$20,000 for married taxpayers filing separate returns. These AMT exemption deduction amounts were increased in 1997 to \$45,000 for married taxpayers filing joint returns; \$33,750 for individuals filing as either single or as a head of household; and \$22,500 for married taxpayers filing separate returns. Also, the AMT exemption deduction amounts will be adjusted for inflation after the 1999 taxable year.

The AMT essentially is a mechanism for recapturing some of the tax benefits available to higher-income taxpayers. Although these tax benefits are allowed under current law, the AMT effectively limits the extent to which, when taken collectively, they can reduce tax liability.

The AMT can affect tax liability in either or both of two ways: First, an AMT liability can be assessed in excess of the taxpayer's regular tax liability. Second, the AMT calculation can result in a reduction in the amount of tax credits that a taxpayer is allowed, thus effectively increasing regular tax.

Differences between the structure of state and federal laws necessitate some differences between state and federal AMT provisions. One difference is the treatment of the personal exemption. State law allows a personal exemption in the form of a credit; federal law provides a personal exemption in the form of a deduction. For federal AMT purposes, the personal exemption deduction may not be used in the calculation of alternative minimum taxable income (AMTI). State law conformed to this federal provision by not allowing the personal exemption credit to reduce regular tax below tentative minimum tax (TMT).

To claim personal exemption credits, taxpayers must first calculate their TMT to determine whether their credits will be limited. The interaction of AMT with the personal exemption credit adds complexity to personal income tax return preparation for approximately 3 million taxpayers who must make the calculation only to determine that their personal exemption credit is not limited by TMT. This interaction also increases the tax liability of approximately 30,000 moderate-income taxpayers whose personal exemption credits would be reduced by the TMT interaction.

Prior to 1997, each exemption credit amount (personal, dependent, blind) was the same. For the 1997 taxable year, each exemption credit amount was \$68. The credit amount is adjusted annually for inflation.

In 1997, SB 1233 (Ch. 612) increased the dependent exemption credit amount to \$120 for the 1998 taxable year and to \$222 beginning in the 1999 taxable year. The increased credit was not to be adjusted for inflation for the 1999 taxable year.

In 1998, AB 2797 (Ch. 322) increased the dependent exemption credit amount from \$120 to \$253 for the 1998 taxable year and from \$222 to \$227 for the 1999 taxable year and thereafter. The increased credit will be adjusted for inflation after the 1999 taxable year.

SPECIFIC FINDINGS

Existing federal law provides five tax brackets ranging from 15% to 39.6%. It also provides a two-tiered personal income AMT rate system. The AMT rate is 26% of the "taxable excess" that does not exceed \$175,000 and 28% of the "taxable excess" that exceeds \$175,000. "Taxable excess" is the amount of alternative minimum taxable income (AMTI) that exceeds the exemption deduction. The exemption deduction allowed against AMTI is: \$45,000 for married taxpayers filing joint; \$33,750 for single or head of household taxpayers; and \$22,500 for married taxpayers filing separate.

Prior to 1998, under federal law the nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit) were allowed only to the extent that the individual's regular tax liability exceeded the individual's TMT. For tax years beginning in 1998, federal law allows the nonrefundable personal credits to offset the individual's regular tax in full.

Existing state law provides six tax brackets ranging from 1% to 9.3% and a personal income AMT rate of 7%.

California AMT is calculated by increasing regular taxable income by specific tax preference items and making other adjustments for items for which treatment differs under AMT rules. The resulting figure is AMTI, from which an AMT exemption deduction is subtracted. The AMT exemption deduction amounts vary depending on filing status and are indexed annually for inflation. For 1997, the AMT exemption deduction amounts are: \$45,000 for married taxpayers filing joint returns; \$33,750 for individuals filing as either single or as a head of household; and \$22,500 for married taxpayers filing separate returns. The exemptions are phased out for taxpayers with adjusted gross income over specified amounts. The excess of AMTI over the AMT exemption deduction, multiplied by the 7% AMT rate, is TMT. Tentative minimum tax is compared to regular tax before credits; the amount by which TMT exceeds regular tax before credits is the alternative minimum tax. The Personal Income Tax Law (PITL) provides a variety of credits, some of which may be used to reduce the regular tax below TMT. However, the law specifies that certain credits cannot reduce regular tax to an amount less than the TMT. In effect, taxpayers lose some of the value of the credits that may not be carried forward and may not reduce regular tax below TMT.

Existing state law provides various exemption credits against tax, including a personal exemption and exemptions for dependents, blind persons, and individuals 65 or older. Exemption credit amounts are allowed as follows for the 1998 taxable year:

Exemption Type	Amount (1998)
Personal	\$70
Blind	\$70
Dependent	\$253

The exemption credit amounts are indexed annually for inflation as measured by changes in the California Consumer Price Index. Exemption credits are not refundable and may not be carried over to future years. Exemption credits are subject to two limitations:

1. Exemption credits begin to phase out at federal AGI levels over the amounts listed below:

Filing Status	AGI (1998)
Single/Head of Household	\$161,044
Married Filing Separate	\$107,362
Married Filing Joint	\$214,725

2. Exemption credits are limited to the amount by which regular tax before credits exceeds tentative minimum tax (TMT).

This provision would eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax.

Policy Considerations

This bill would ensure that 30,000 additional moderate-income taxpayers would be able to take full advantage of recently increased dependent exemption amounts. Also, this bill would reduce the complexity of filing a PIT return by eliminating the need for moderate-income taxpayers, with no preferences, to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

Implementation Considerations

The implementation of this provision would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

To the extent this proposal would reduce the number of telephone calls from taxpayers regarding how to complete the complex AMT calculation (Schedule P) and the number of errors that must be addressed during return processing, it would generate significant cost savings.

Tax Revenue Estimate

Based on tax model simulations, eliminating the TMT interaction with regard to all exemption credits would result in revenue losses of \$1.5 million annually beginning with the 1999-2000 fiscal year, benefiting approximately 30,000 filers.

This proposal would eliminate the need for approximately 3 million taxpayers to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

2. Renter's Credit

OPERATIVE DATE

The changes to Section 17053.5 and the repeal of Section 19052 would be operative for taxable years beginning on or after January 1, 1998. The change to Section 17039 would be operative for taxable years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

AB 2797 (Stats. 1998, Ch. 322) changed the renter's credit from a refundable tax credit to a nonrefundable tax credit. However, language relating to a refundable renter's credit was inadvertently retained in the renter's credit (Section 17053.5) and in the credit ordering provision (Section 17039). In addition, a section relating to the denial of the refundable renter's credit was not repealed (Section 19052).

This provision would remove the obsolete language and repeal the obsolete section relating to the refundable renter's credit.

Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not impact the department's costs.

Tax Revenue Estimate

As a technical correction, this provision would not impact PIT revenues.

3. Capital Gain Exclusion/Principal Residence

OPERATIVE DATE

This provision would be operative on the same dates the federal changes are operative.

BACKGROUND

Under both **California and federal law**, a taxpayer generally is able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). To be eligible for the exclusion, a taxpayer must have owned the residence and used it as a principal residence for at least two years during the five years prior to the sale or exchange.

In the case of joint filers not sharing a principal residence, an exclusion of \$250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of \$250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude \$500,000 of gain on their joint return. Special rules apply regarding the sale of a remainder interest, multiple family dwellings (e.g., cooperative housing corporations, co-ops and condominiums), involuntary conversions, and taxpayers residing in nursing homes.

An additional special rule applies to a taxpayer who fails to meet the requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances. The taxpayer is able to exclude part of the gain recognized. The law as enacted could be interpreted to limit the exclusion to the fraction of the taxpayer's realized gain on the sale equal to the fraction of two years that the requirements are met. Congress has indicated in committee reports that it was intended to exclude the fraction of the \$250,000 (\$500,000 for joint filers) equal to the portion of the two-year period that the requirements were met.

SPECIFIC FINDINGS

The **IRS Reform Act** made technical changes to the law regarding the exclusion of gain from the sale of a personal residence. The technical changes are:

- **Proration - Exclusion of Gain.** The **IRS Reform Act** corrected the provision relating to the proration of the exclusion in the case where the taxpayer does not meet the two-year ownership and use requirements if the sale is due to a change in place of employment, health, or unforeseen circumstances. The technical correction provides that the \$250,000 or \$500,000 exclusion, not the realized gain, is prorated for a taxpayer who does not meet the two-year ownership and use requirements and the sale is due to a change in place of employment, health, or unforeseen circumstances. This provision is effective for sales and exchanges after May 6, 1997.
- **Exclusion - Joint Returns.** The **IRS Reform Act** corrects the provision relating to the computation of the exclusion to clarify that the limit on the amount of excludable gain is computed separately for each spouse in the case of married individuals filing a joint return who fail to qualify for

the \$500,000 exclusion for gain on a residence because they do not satisfy the two-year ownership test, two-year use test, and the prohibition on any other sale or exchange within the last two years. Thus, the maximum exclusion for such a couple is equal to the sum of the exclusions to which each spouse would otherwise be entitled if they were not married. Each spouse is treated as owning the property during the period that either spouse owned the property. This provision is effective for sales and exchanges after May 6, 1997.

- Election of Prior Law - Sales or Exchanges on Enactment Date. The **IRS Reform Act** corrects the provision relating to the ability of a taxpayer to elect to apply prior law to a sale or exchange occurring on August 5, 1997, as well as to sales and exchanges occurring before August 5, 1997. Thus, taxpayers who sold or exchanged a home on or before August 5, 1997, could choose to use the \$125,000 once-in-a-lifetime exclusion for taxpayers age 55 or over or the rollover-of-gain rule for homes that are replaced within the replacement period.

The Internal Revenue Service anticipated the above technical corrections and interpreted the law as Congress intended it. The 1997 federal form 2119 (Sale of Your Home) was drafted with the above three changes incorporated; therefore, taxpayers should not be required to file amended returns.

California law is in conformity with the federal rules regarding the exclusion of gain from the sale of a personal residence prior to the three technical changes made by the IRS Reform Act.

This provision would conform to the three technical changes discussed above with the same federal effective dates. California does not have a separate form but uses the federal form 2119; thus, taxpayers affected by the changes should not need to file an amended return.

Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

As a technical correction, this provision would not impact PIT revenues.

4. Innocent Spouse

OPERATIVE DATE

This provision would apply to any liability for tax arising after the effective date of this bill and any liability for tax arising on or before the effective date, but remaining unpaid, as of that date.

SPECIFIC FINDINGS

Under prior federal law, spouses who filed a joint tax return were each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

Prior federal law provided relief from liability for tax, interest and/or penalties for "innocent spouses." To qualify for innocent spouse relief, the innocent spouse was required to establish that:

- A joint return was made;
- An understatement of tax, which exceeded the greater of \$500 or a specified percentage of the innocent spouse's adjusted gross income (AGI) for the most recent year, was attributable to a "grossly erroneous" item of the other spouse;
- In signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and
- It was inequitable to hold the innocent spouse liable for the deficiency in tax.

The specified percentage of AGI was 10% if AGI was \$20,000 or less. Otherwise the specified percentage was 25%. Grossly erroneous items include items of gross income omitted from reported income and claims of deductions, credits or basis in an amount for which there is no basis in fact or law.

Current federal law also provides relief for innocent spouses with respect to community property income not included on the separate return of a married person.

The IRS Reform Act makes innocent spouse status easier to obtain by eliminating all understatement thresholds and by requiring only that the understatement of tax be attributable to an erroneous item of the other spouse. Relief may be provided on an apportioned basis. An innocent spouse may be relieved of liability for the portion of an understatement of tax if the spouse did not know or have reason to know of the understatement of tax and it would be inequitable to hold the taxpayer responsible for the deficiency.

The IRS Reform Act provides a separate liability election for a taxpayer who, at the time of the election, is no longer married to, is legally separated from, or for at least 12 months has been living apart from the other spouse. The taxpayer has two years from the date the IRS begins collection action to make this election. The IRS Reform Act provides that the Tax Court has jurisdiction over disputes arising from the separate liability election. The IRS Reform Act requires the IRS to notify all taxpayers who have filed a joint return of their right to elect separate liability.

The IRS Reform Act expanded the relief provided for married persons filing separate returns to include relief for unpaid tax or any deficiency relating to the separate return that did not qualify for relief under current law.

Under current state law, as with prior federal law, spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

Current state law also provides relief from liability for tax, interest and/or penalties for "innocent spouses" if it is inequitable to hold that spouse liable for the understatement. To qualify for innocent spouse relief, the innocent spouse must have filed a joint tax return and did not know, or had no reason to know, of the understatement. The spouse must be innocent with respect to the entire understatement.

Current state law, as with prior federal law, also provides relief for innocent spouses with respect to community property income not included on the separate return of a married person.

Current state law, in the case where the self-assessed tax has not been fully paid, requires FTB to provide the other spouse with 30 days notice of any determination to provide relief to the innocent spouse so that the other spouse may appeal the determination.

This provision would conform, with modifications, state law to the innocent spouse provisions of the IRS Reform Act, including the separate liability election. Modifications to the IRS Reform Act would (1) send appeals of FTB innocent spouse determinations to the BOE rather than Tax Court and (2) expand the provision requiring FTB to provide 30-day notice to the other spouse to apply to assessments as well as underpaid self-assessed tax so that the other spouse may appeal an innocent spouse determination.

Under this provision, pursuant to procedures prescribed by FTB, equitable relief can be granted to an innocent spouse as the facts and circumstances warrant.

Policy Considerations

This provision would allow individuals to obtain relief even though they might have been the primary beneficiary or person in control of the household income, though not the person earning the income. However, this is mitigated to some extent since the election would be invalid if FTB demonstrates that the assets were transferred as part of a fraudulent scheme to avoid taxes or the department demonstrates that the individual making the election had actual knowledge at the time the return was filed.

Implementation Considerations

Collections Bureau staff is already experiencing a slight increase in workload because of the federal provision and expects an even greater impact from this provision since more taxpayers would qualify for innocent spouse relief. Further, due to the complex nature of questions regarding this issue, any calls would be referred to staff in the Collections Bureau with expertise in this area. The taxpayer information (TI) system would need modification to issue separate notices and maintain separate but equal

liabilities. To the extent information may need to be retained on the collection system, this provision would impact the new personal income tax collection system (ARCS) design and/or strategies.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this provision are preliminary. It is estimated that the costs would range from \$598,000 to \$798,000 for the first year and \$176,000 annually thereafter. The majority of the first-year cost (\$400,000 to \$600,000) would be required to program and test changes to the TI system. The remaining first-year cost and ongoing costs would be required to increase Collection Bureau staff (three senior compliance representative positions since it is projected that annual hours for working innocent spouse cases under this provision would increase from 1560 to 5460 hours.).

Tax Revenue Estimate

Current law provides innocent spouse relief under certain circumstances. The incremental impact of conforming to proportionate liability would result in minor revenue losses, on the order of \$500,000 annually.

5. Employee Relief/Unremitted Withholdings

OPERATIVE DATE

This provision would be operative for determinations made by FTB on or after the effective date of this bill, where the unremitted amounts were withheld no earlier than seven years before FTB mailed its deficiency assessments.

SPECIFIC FINDINGS

In general, Employment Development Department (EDD) administers various laws that provide for employer taxes on wages (earnings), including the withholding of personal income taxes. When employers are required to withhold and remit personal income taxes on their employee earnings, they remit the withheld earnings to EDD. If an employer fails to remit personal income taxes on employees' earnings as required, the employer is liable to EDD for the taxes.

FTB administers, among other laws, the Personal Income Tax Law (PITL). If the FTB determines a tax deficiency exists, the FTB mails a notice of proposed assessment (NPA) and the taxpayer has an opportunity to first protest and then later appeal FTB's determination. Such notices may be mailed when taxpayers make errors on their tax return or when someone other than the taxpayer is specifically liable for the taxpayer's taxes because of actions that other person took (secondary liability).

When a final personal income tax assessment is due and payable and is not voluntarily paid, FTB takes administrative collection action that does not require prior judicial action. It also takes administrative collection actions to collect certain other debts (child support delinquencies, vehicle

registration, court-ordered debts, etc.) as though they are final personal income tax assessments.

One such action is the issuance of an earnings withholding order for taxes (EWOT) pursuant to the Code of Civil Procedure. These orders require employers to withhold delinquent taxes from an employee's earnings and remit the withheld earnings to FTB. In the event the employer fails to remit the withheld amount to the FTB, the FTB may bring a civil action against the employer to recover the amount that should have been remitted. Once a judgment is rendered, FTB may collect the unremitted amount from the employer.

During the pendency of collection of a secondary liability or judgment, both the taxpayer and employer are liable for the amount due. Collection is not stayed against either party. At the point of collection, the accounts are adjusted accordingly. If the debt were collected from the employer, the amount is transferred to the taxpayer's account and the employer's liability is cancelled. If collected from the taxpayer, the taxpayer's account is credited and the employer's liability is cancelled.

If an employer files bankruptcy, the taxpayer may file a claim in bankruptcy court for his or her nonremitted earnings. The taxpayer has a better chance of collection than other creditors because earnings receive a higher payment priority than other types of debt, including taxes.

FTB has no authority to credit the account of the taxpayer for the amount that the employer withheld and failed to remit. This failure to remit withheld amounts may occur several times a year. In addition, FTB does not have the authority to stay collection against the taxpayer.

This provision would provide relief to an employee whose employer withheld delinquent PITL taxes from the employee's pay, pursuant to an EWOT, but failed to remit the amounts to FTB. Specifically, this bill would:

- Eliminate the taxpayer's liability for the unremitted amount by allowing FTB to credit the taxpayer's account for the unremitted amount.
- Hold the employer liable for the unremitted amount by allowing FTB to administratively assess an amount equal to the unremitted amount against the employer, without a civil action.
- Preserve the employer's protest and appeals rights in the event the employer disputes the records of the taxpayer. Collections would be pursued from the employer only after the NPA is final and due and payable.
- Stay collection against the taxpayer for the amount at issue for the period between the time that FTB determined a failure to remit and the employer's NPA is either final and due and payable, withdrawn or revised, and the taxpayer notified thereof.
- Provide FTB with a seven-year statute of limitation for making the proposed assessment (from the date the employer first failed to remit) in order to provide the taxpayer with ample time to find out the employer failed to remit and bring the matter to the FTB for investigation.

- Preclude the taxpayer from collecting another amount equal to the credit through a bankruptcy proceeding or other remedy.

Implementation Considerations

This provision could be implemented with minor changes to FTB's current collection programs.

FISCAL IMPACT

Departmental Costs

Departmental costs should not increase significantly. The resources currently spent to explain current law to the few affected taxpayers and evaluating when a civil action would be an effective collection remedy could be shifted to accommodate implementation of this provision.

Tax Revenue Estimate

This provision would have negligible impact on collections of PIT taxes (minor losses on the order of \$25,000 annually).

6. SOL/Disabled Taxpayers

OPERATIVE DATE

This provision would apply to all periods of disability before, on or after the effective date of this bill. However, it would not apply to any claim barred by the SOL as of the effective date.

SPECIFIC FINDINGS

Current federal law requires a taxpayer to file a claim for refund within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed the two-year limit applies). A refund claim that is not filed within these time periods is rejected as untimely.

The IRS Reform Act suspends the SOL for certain refund claims for a period where the taxpayer is "financially disabled." Individuals are "financially disabled" if they are unable to manage their financial affairs because of a medically determinable physical or mental impairment that is expected to result in death or to last for a continuous period of at least one year. An individual would not be financially disabled for any period that the individual's spouse or any other person is legally authorized to act on that individual's behalf in financial matters.

Current state law requires a taxpayer to file a claim for refund within four years from the due date (without regard to extensions) or one year from the date of payment of tax, whichever is later. In the case of a California waiver of the SOL, the period for filing a claim for refund is the period of the waiver or one year from the date of overpayment, whichever is later. In the case of a federal waiver, the period for filing a claim for refund is six months from the expiration of the federal waiver.

Current state law requires the taxpayer to notify FTB if the amount of gross income or deductions reported to the IRS for any year is changed, either by the taxpayer or federal authorities. The taxpayer has six months from the final federal determination date to report the change to FTB. Claims for refund must be filed within two years from the date of the final federal determination.

Current state law allows taxpayers to file a claim for refund up to seven years after the due date of the return in the case of bad debts, worthless securities or erroneous inclusion of recoveries.

This provision would conform state law to the IRS Reform Act provisions to suspend the SOL for certain refund claims when the taxpayer is "financially disabled."

Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses from additional refunds issued would be on the order of \$1 million annually based on federal projections.

7. Offers In Compromise

OPERATIVE DATE

This provision would be operative for compromises made on or after the effective date of this bill, without regard to when the offer is made, or to taxable or income years to which such offer relates.

BACKGROUND

When a final personal income or bank and corporation tax liability is not paid by a taxpayer when due, FTB's automated collection system will bill the debtor, search for the tax debtor's assets and take collection actions to use the asset(s) to satisfy the tax debt. For example, depending upon the type of asset, the automated collection system can issue an order to withhold funds from bank accounts, an order to attach wages and certain other business income in the case of an individual, or file a lien in the county of the address of record. For certain cases, the account is referred for manual collection actions, which may include manually searching records for assets, making telephone calls, or seizing and selling vehicles, vessels, or stocks.

In the event of a hardship, payment arrangements may be made or collection may be deferred until the financial situation of the tax debtor improves. However, if

tax debtors can obtain loans or can use credit lines to pay their tax debts, they are expected to do so.

If a debt remains unpaid for a number of years, a lien has been filed and assets cannot be located, FTB may be discharged from collecting the debts under the Government Code (discharged from accountability). When a debt is discharged, the debt is still due and owing, but routine billings and collection actions are discontinued unless assets are subsequently located. There are no statutes of limitation on FTB's collection of a tax debt, and interest and applicable penalties continue to accrue.

OFFERS IN COMPROMISE

In general, an offer in compromise is a process whereby the debtor offers to pay an amount that he or she believes to be the maximum amount that can ever be paid on a debt. If the parties agree to the amount offered, the debt is compromised (reduced) to that amount. The tax debtor may be required to promise to pay a specified percentage of any future increases in income, which is termed a "collateral agreement," as part of the compromise.

The IRS and EDD have the authority to administratively compromise final tax debts that are due and payable and the processes and procedures generally are similar. However, the oversight/review provisions differ. For EDD, the specific criteria for a compromise and its procedures and processes are codified. For the IRS, the codified authority for a compromise is general in nature. Regulations and case law generally set forth the federal procedures and processes:

- Under the Internal Revenue Code (IRC), under which relevant regulations have been adopted, **IRS may administratively compromise** a tax debt when there is doubt:
 - as to the ability to collect the full amount owed, and/or
 - as to the validity of the actual tax liability.

When a compromise is made, a statement must be placed on file as to the amount of the assessed liability and the amount paid under the terms of the compromise.

In those cases where the unpaid amount of tax assessed, including any interest, additional amount, additions to tax or assessable penalty, is \$50,000 or more, the opinion of the Chief Counsel of the IRS as to the reason for the compromise must be included in the filing. Under Treasury regulations, compromises involving liabilities of \$100,000 or more, generally, receive internal high level review, and for one year, the information on file is available to the public. The IRS is prohibited from distributing lists or releasing information in connection with the cases.

If a person defaults on the terms of the agreement, which includes filing returns and paying the required taxes for five years following acceptance of the offer, the IRS may take various judicial actions or may disregard the compromise and may proceed to collect any amount that remains unpaid.

Under the IRC, if a person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition, the tax debtor is guilty of a felony. Upon conviction, the person shall be fined not more than

\$100,000 (\$500,000 for corporations), or imprisoned not more than three years, or both, and required to pay the costs of prosecution.

- Under the Unemployment Insurance Code, **EDD may administratively compromise** a tax debt only when certain specified criteria are met, as follows:
 - the debtor must be out of business or no longer have an interest in or be associated with the business;
 - the debtor cannot have access to income sufficient to pay more than the accruing interest and 6.7% of the liability on an annual basis;
 - the debtor cannot have reasonable prospects of acquiring increased income or assets that would enable the debtor to liquidate the liability in a reasonable period; and
 - the amount offered is more than the department could reasonably expect to collect during the four years following the date of the agreement.

Reductions of \$10,000 or more must be approved by the Unemployment Insurance Appeals Board. This authority has been delegated to an administrative law judge. Once the terms of the agreement are met, a statement is placed on file and available to the public for one year. The statement must identify the debtor, reason for the compromise, total unpaid amount at issue, total amount paid under the compromise and terms thereof. EDD is prohibited from distributing lists or releasing information in connection with the cases.

If a tax debtor conceals property, withholds or falsifies any records with respect to the taxpayer's financial condition, or fails to pay subsequent tax liabilities, the compromised amount of the debt is reinstated and the entire unpaid amount is due and payable.

The FTB does not have the administrative authority to compromise a tax debt, but instead must bring a civil action in court against the tax debtor, an authority delegated by the Attorney General (AG), as discussed below.

Related to an offer in compromise is the ability to administratively **settle** (reduce) a tax matter that is not final or due and payable and is in dispute. The FTB, BOE, and IRS have administrative settlement authority. The amount in dispute may be the subject of a protest, appeal or a refund claim. Settlements are determined based on the costs and risks associated with litigation of the matter. For FTB, if the reduction in tax and penalties is in excess of \$5,000, recommendations for approval are made to the FTB, itself, after review by the AG as to whether the recommendation is reasonable from an overall perspective. For reductions under \$5,000, the executive officer and chief counsel jointly approve the recommendations. There is a public record for settlements where tax and/or penalties exceed \$500. The record includes the taxpayer's name, the total amount in dispute, the agreed amount, the reason it is in the best interest of the state, and, for those over \$5,000, the AG's opinion.

If, in conjunction with an administrative settlement by the department, any person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition in conjunction with a settlement, the person is guilty of a felony. Upon conviction, the person shall be fined up to \$50,000 (\$200,000 for banks and corporations), or imprisoned not more than three years, or both, and required to pay the costs of investigation and prosecution. This criminal penalty conforms to that provided under the IRC for

settlements (and compromises), except the amount of the fine is less for California purposes.

SPECIFIC FINDINGS

Under current law and FTB practice, taxes administered by FTB may be compromised only based on doubt as to the collectibility and through the AG's statutory authority to obtain a judgment against the tax debtor to collect the tax debt, which the AG has delegated to FTB for purposes of compromising the debt. After the offer is reviewed for completeness and reasonableness, FTB collects the amount offered and the review process commences, with final approval by the executive officer and the chief counsel jointly. A stipulated judgment is obtained followed by the filing of a satisfaction of the judgment when all terms of the agreement, including collateral agreements, have been met.

As part of the offer in compromise process, FTB staff must prepare the legal documents, keep track of the court's calendar for filing the documents, and submit payment of the court fees (costs). As the plaintiff in this civil action, the FTB is responsible for paying the court costs; however, as a condition of the compromise, the tax debtor must agree to pay the court costs. The costs are then paid by FTB from the amount offered in compromise. The court documents, which include a stipulation setting forth the terms of the compromise and whether the offer is based on the terms of a collateral agreement, are a matter of public record.

In the offer in compromise procedure, FTB generally follows the IRS procedures and EDD's law with respect to:

- the terms of the offer, which requires the filing of tax returns and payment of taxes generally for five years following the compromise;
- the process leading up to the acceptance of the offer, including high levels of review; and
- the refunding of rejected offers, at the taxpayer's discretion and without interest.

In determining whether an offer in compromise is acceptable, EDD and IRS each consider factors unique to the taxes that they administer, which are not applicable to taxes administered by FTB. With EDD, its taxpayers are all businesses that have had employees and by statute must be out of business; IRS is constrained by a 10-year statute of limitation on collection. Therefore, because these factors are important to EDD and IRS decision-making, but not to FTB, there may be cases where an offer could be acceptable to one agency but not others.

Recently, staff has reexamined its perspective used in the offer in compromise process and has changed its practice so that staff is working toward better communication with taxpayers and their agents in resolving matters relative to this process. Under current practice, staff expects to compromise approximately 200 cases for fiscal year 1998/99. In 1997/98 fewer than 100 cases were compromised, and in previous years only 12 to 24 cases were compromised.

This provision would provide FTB with administrative authority to compromise a tax debt, comparable to the authority provided the IRS. For the smaller compromises (reductions in tax of \$7,500 or less), the executive officer and chief counsel, jointly, could compromise the debt or delegate the authority to

others within the department. For those cases in which the reduction in tax exceeds \$7,500, the FTB, itself, would have the authority to compromise the debt upon recommendation by staff. However, for those cases in which the reduction in tax exceeds \$7,500, but is less than \$10,000, the FTB, by resolution, could delegate to the executive officer and chief counsel, jointly, its authority to compromise the debt. A public record would be placed on file, comparable to those required by laws governing EDD and IRS offers in compromise and FTB's settlement procedure. The record would include a summary statement as to why the compromise would be in the best interest of the state.

In addition, **this provision** would provide clearly articulated enforcement tools in the event of a default on the terms of the agreement, or if any person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition in conjunction with a compromise.

Implementation Considerations

This provision could be implemented without significant changes in procedures. Staff would no longer be required to prepare the court documents and conduct court-related activities, or issue checks for payment to the court. It is anticipated that the department under this provision would process fewer additional payments.

FISCAL IMPACT

Departmental Costs

As a result of this provision, the amount the department expends for its costs related to the stipulated judgments/civil actions process would be saved, however, the amount is anticipated to be insignificant in terms of FTB's total budget.

Tax Revenue Estimate

The revenue savings from this provision would be minimal, on the order of \$40,000 annually.

Under this provision, for each case the department compromises, taxpayers would pay the department the amount they would otherwise have paid in court costs (averaging approximately \$400). It is estimated that approximately 100 cases would be compromised annually. The court costs are \$375 for one defendant and \$555 for two (married individuals who file joint returns).