Legislative Proposal 08-02
Financial Institution Record Match (FIRM)
Staff Actions Since Last Board Meeting

During the Franchise Tax Board (FTB) Meeting of November 28, 2007, then-Member Betty Yee asked staff to examine this proposal further on the following two issues:

- Volumes of records, and
- Compensation to financial institutions for costs.

Volumes of Record

Staff reviewed the criteria for determining which debtor accounts would be subject to the proposed data match to find a balance between the interests of the state to collect debts and privacy concerns. The proposal has been revised to provide three alternatives for debtor criteria. The proposal originally submitted would include 1.4 million debtors in the data match. The second and third alternatives added to the proposal would limit the number of debtors to 1.3 million and 217,000, respectively. Orders to Withhold would still be controlled by staff at levels starting at 50,000 and increasing by an additional 50,000 per year to full implementation in 2012.

Compensation to Financial Institutions for Costs

Ms. Yee's request contemplated that information on costs would be provided to staff by industry. Since the last Board meeting, staff contacted the industry representatives several times to obtain the industry cost information. No cost information was provided.

Industry asked staff to include language in the proposal that would, upon invoicing, allow reimbursement for costs incurred by a financial institution to conduct the data match. The proposed language contained no limit on the amount of reimbursement or criteria.

To provide the Board some meaningful information on industry costs, staff contacted the vendor that operates the Kentucky tax debt data match. The vendor also operates Kentucky's child support data match, commonly called FIDM. The vendor disclosed that there were no start-up costs when the Kentucky tax data match began because the same system and file format already used for FIDM are used for the tax debt match. In addition, staff was told by the vendor that quarterly charges to each financial institution to process the match range from $150 to $350. Kentucky law reimburses the financial institutions for costs of the data match by authorizing the financial institution to deduct an additional charge from funds that are levied as a result of the data match.

Due to the lack of complete cost information, the proposal has been revised to state that FTB staff shall work with the financial institution industry to develop a methodology for industry to be reimbursed a reasonable amount for actual costs to conduct the data match that would be required by the proposal.

LEGISLATIVE PROPOSAL 08-02
EXECUTIVE SUMMARY

- **Title:** Financial Institution Record Match (FIRM) System For Collection Of Delinquent Income Tax Debts

- **Problem:** Of the three largest sources of asset data that could be used for collection of unpaid tax debts--real property records, wage and payment reporting, and financial institution accounts--the department lacks access only to financial institution account information.

- **Proposed Solutions:** Require financial institutions doing business in California to match Franchise Tax Board (FTB) information on delinquent income tax and non-tax debtors against customer records on a quarterly basis.

  Staff provides three alternatives for the Board's consideration.

  1. Amend the Revenue and Taxation Code to require financial institutions doing business in California to match information on delinquent income tax debtors against customer records on a quarterly basis. This alternative would result in the processing of data for approximately 1.4 million tax debtors.
  2. Limit the FTB debtor accounts sent to financial institutions for matching to those that failed to resolve their debt after 90 days and with a balance due greater than $250. These criteria would result in the processing of data for approximately 1.3 million tax debtors.
  3. Limit the FTB debtor accounts sent to financial institutions for matching to those that failed to resolve their debt after 180 days and with a balance due greater than $10,000. These criteria would result in the processing of data for approximately 217,000 tax debtors.

- **Major Concerns/Issues:** This proposal would impact financial institutions; however, because current federal law requires these entities to participate in the Financial Institution Data Match (FIDM) process for child support obligors, the extent of the impact may be minimized by use of a file format similar to the existing FIDM program.

  The costs to financial institutions can be offset by fees that may be charged to customers for processing of levies. These fees can range up to $125 per levy. Although the financial institutions cannot be reimbursed for the costs of levies that do not find open accounts, the levies issued under this proposal would utilize more current financial information and would be more likely to attach to active accounts, which would result in reimbursement for the financial institutions on a higher percentage of levies processed.

- **Revenue:**

Estimated Revenue Impact of L.P 08-02
Effective for accounts past due after 1/1/09
Assumed Enactment Date After 6/30/08
($ in Millions)

	2008/09	2009/10	2010/11	2011/12
Alternative #1	No impact	$40	$60	$85
Alternative #2	No impact	$45	$75	$110
Alternative #3	No impact	$25	$90	$100

Title

Financial Institution Record Match (FIRM) System For Collection Of Delinquent Income Tax Debts

Introduction

This proposal would establish a record match process between financial institution customer records and the Franchise Tax Board (FTB) debtor records for the collection of delinquent state income tax debts.

Current Federal/State Law

Current federal law mandates the Financial Institution Data Match (FIDM) program for the collection of delinquent child support debts. This process involves the matching of child support obligors with financial institution customer records in order to identify and levy the funds belonging to the obligors. Federal law prohibits the information received through FIDM to be used for any purpose other than child support collection. Current state law prohibits FTB from collecting against taxpayers with income tax debts that also have child support debts.

Under federal and state law, every individual, partnership, limited liability company, bank, corporation, estate, trust, or other organization engaged in a trade or business is required to file information returns to report various types of non-payroll compensation and other miscellaneous income. The types of transactions reported on the information return include, among other things, payments of interest, dividends, and certain gambling winnings. The filing requirements and dollar reporting thresholds vary and are generally contingent on the reporting requirements for the state in which the form 1099 recipient resides.

The California Right to Financial Privacy Act (the Act) prohibits financial institutions from disclosing confidential account records, unless certain exceptions are met. Criminal search warrants and subpoenas are two examples of exceptions. Current law provides that the Act supersedes any law that appears to violate the provisions of the act, unless that other law specifically provides that the Act does not apply to that particular law.

Current state law authorizes FTB to use several collection tools in order to collect delinquent tax liabilities, one of which is an Order to Withhold (OTW). An OTW can be issued to any third person in possession of funds or properties belonging to the debtor. Upon receipt of an OTW, the recipient notified is required to freeze the taxpayer’s assets in their possession and hold those assets for ten days, and then remit to the department all cash or cash equivalents held that will satisfy the amount of the OTW. If the recipient of the OTW is in possession of any assets other than cash or cash equivalents, they must hold that item, notify FTB, and await further instructions.

Under current state tax law, FTB is prohibited from disclosing any confidential taxpayer information unless specifically authorized by law.

Program History/Background

Information return data is used primarily by FTB to identify nonfilers and collect delinquent income taxes. In the nonfiler program, information returns are used in FTB’s Integrated Nonfiler Compliance (INC) system to identify taxpayers that have sufficient income to require them to file a return but have failed to do so. Under the INC system, more than 220 million records received from employers, financial institutions, the Internal Revenue Service (IRS), and other sources are sorted and matched against tax returns filed. Taxpayers with California income for whom FTB has no record of an income tax return being filed are sent a letter requesting the past due tax return be filed. If a return is not filed as required, the taxpayer's net income is estimated from the available information, and a proposed deficiency assessment is issued.

Information returns are used to collect delinquent income taxes by associating the reported interest, dividend, or miscellaneous payments to the taxpayer with outstanding tax liabilities and issuing a levy to seize the assets of the taxpayer in the hands of a third party. In 2005, FTB issued approximately 100,000 financial institution levies and collected approximately $70 million using this process. Information returns do not identify the non-interest bearing assets that may be held at a financial institution and due to the reporting cycle, those returns do not generally provide current information.

In addition to the non-filer and collection programs, FTB has an audit staff designed to encourage compliance with the income tax laws. For this purpose, computer programs search state and federal income records to detect leads as to discrepancies between income items that were reported and should have been reported on income tax returns. Based on the computerized searches of these records, one of many audit-type activities may be initiated, ranging from clerical inquiries, computer-generated inquiries, manual desk audits, or field audits to a combination of computer and manual audits.

Despite these FTB programs, failure to report income still exists. One reality that contributes to failure to report income is the ability of the taxpayer to escape detection. For example, a payer may fail to report a disbursement and the payee may fail to report the income. In the event that the payer and payee have a personal relationship, the likelihood of accurate information return reporting is decreased. Likewise, accurate information return reporting is decreased if an individual is aware of the absence of an income and/or expense paper trail.

Under the FIDM program, financial institutions have two methods of transmitting data to comply with the requirements of the program. Method 1 allows financial institutions to send their complete file of financial institution accounts on a quarterly basis to be matched by FTB against child support debtor records. Method 2 requires FTB to send a file of child support debtors to the financial institution or their third party data processor to match with account holders. A file of matched records is returned to FTB. Generally, the method chosen by each financial institution depends on the financial institution's data processing capabilities.

Problem

Of the three largest sources of asset data that could be used for collection of unpaid tax debts--real property records, wage and payment reporting, and financial institution accounts--the department lacks access only to financial institution account information.

Proposed Solutions

Alternative No. 1 - All Delinquent Debtors Up to $25,000

Require financial institutions doing business in California to match information on delinquent income tax and non-tax debtors against customer records on a quarterly basis. This alternative would result in the processing of data for approximately 1.4 million tax debtors.

Financial institutions without the technical ability to process the data exchange or without the ability to employ a third-party data processor to process the match could opt for the Method 1 data process of forwarding a file containing customer data to FTB to match against delinquent income tax and non-tax debtor records.

Alternative No. 2 - Moderately Delinquent Debtors

The match would be limited to income tax and non-tax debtors who have failed to pay or otherwise disregarded billing notices for more than 90 days and have an unpaid balance over $250. These criteria would result in the processing of data for approximately 1.3 million tax debtors.

If concern for privacy of financial institution data remains, the Method 1 process for matching data could be eliminated so that FTB would be required to send its tax debtor data to the financial institutions to process the matching.

Alternative No. 3 - Significantly Delinquent Debtors

The match would be limited to tax debtors who have failed to pay or otherwise disregarded FTB billing notices for more than 180 days and have an unpaid balance over $10,000. These criteria would result in the processing of data for approximately 217,000 tax debtors.

Effective/Operative Date of Solution

If enacted in the 2008 legislative session as an administrative measure, this proposal would be effective and operative beginning January 1, 2009, and would apply to collection efforts made on and after that date.

Justification

A financial institution record match process for income tax collection would, in a timely and efficient manner, permit the department to identify previously unknown deposit accounts held by delinquent income tax debtors to collect outstanding income tax debts and help close the tax gap.

Use of timely financial data will reduce current collection process inefficiencies due to levies being issued based on outdated account information.

According to FTB's Tax Gap Plan, the annual income tax gap for California is estimated to be $6.5 billion. Approximately ten percent of this figure represents reported but unpaid taxes. This proposal would further the department's efforts to narrow the tax gap by increasing enforcement measures that enhance the state's ability to collect outstanding taxes due.

Financial institutions currently receive no reimbursement for their costs for levies that do not find open accounts. Levies issued based on current financial information would be more likely to attach to active accounts, which would result in reimbursement on a higher percentage of levies processed.

Implementation

FTB would utilize existing systems and functionality to implement this new process. Implementing this proposal would have a significant impact on the department, as described below under Fiscal Impact, and due to the changes required, the department anticipates it would become fully operational July, 2010.

Fiscal Impact

Alternative No. 1 – All Delinquent Debtors Up to $25,000

Staff estimates a one-time cost to FTB of $7.6 [1]million to program, develop, and test a new financial institution record match system for income tax and non-tax debt administration. Additionally, to ensure that existing collection processes can handle the increased volume of data expected under this proposal, modifications to core processes would be required. Staff estimates on-going annual costs of $2.3[2] million to maintain the system and process the data matches. This proposal would impact core functions in the collection system and would require system programming, development, and testing to ensure successful integration. Increased workloads would require staff augmentation of approximately 36.2 Personnel Years for the development phases and 26.7 Personnel Years for the ongoing workload. A Budget Change Proposal would be submitted to fund this proposal.

Additionally, industry representatives have indicated that this proposal would create non-reimbursed costs for the affected financial institutions. Financial institutions currently charge customer fees for levies that range up to $125 per levy, depending on the institution.

Data obtained from the Kentucky Department of Revenue, (Kentucky has a statutory requirement similar to this proposal) shows that using the same file formats prescribed under FIDM results in no additional programming costs to financial institutions to match tax debtor files. Not providing reimbursement to the financial institutions for the data matches is consistent with the long-standing California policy decision for no reimbursement to financial institutions for FIDM costs.

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[1] The one-time cost is increased from the original estimate of $3.6 million to $7.6 million. Staff determined that the increased volume of data expected under this proposal would necessitate replacement of part of an existing computer system used for collections. .

[2] This on-going costs increased from the original estimate of $2 million to $2.3 million because staff determined that it will cost more to maintain updates for the replaced system described in Footnote 2.

Alternative No. 2 - Moderately Delinquent Accounts

Staff estimates that development and ongoing costs would be the same for this alternative as under Alternative No.1, $7.6 million in one-time costs to program, develop, and test the financial institution record match system and $2.3 million annually in ongoing expenses.

Alternative No. 3 - Significantly Delinquent Debtors

This alternative would eliminate nontax debtors, thus reducing the volume of affected debtors significantly. System modifications would still be required with an estimated one-time cost to FTB of $6.3 million. One-time costs for this alternative are less than the other alternatives because the extent of changes to the non-tax collection system would be reduced. There would be on-going annual costs of $ 1.9 million. The on-going costs are determined by the number of levies issued, so the difference in on-going costs compared to the other alternatives is modest. Increased workloads resulting from this alternative would require staff augmentation of approximately 36.2 Personnel Years for the one time costs and 26.7 Personnel Years for ongoing costs.

<u>Economic Impact</u>

Based on data and assumptions discussed below, this proposal would result in the following revenue gains.

Estimated Revenue Impact of L.P 08-02 Effective for accounts past due after 1/1/09 Assumed Enactment Date After 6/30/08 ($ in Millions)				
	2008/09	2009/10	2010/11	2011/12
Alternative #1	No impact	$40	$60	$85
Alternative #2	No impact	$45	$75	$110
Alternative #3	No impact	$25	$90	$100

Tax Revenue Discussion

The revenue impact of this proposal would be determined by the number of successful matches identified by financial institutions and the collection rate on such accounts. Because, on average, tax accounts have larger delinquent balances than non-tax accounts, the revenue estimate is predominately driven by the volume and balance of delinquent tax accounts. Due to the difference in average balances, the estimate of accelerated and additional collections starts by analyzing tax accounts and then adjustments are made to include non-tax accounts.

Under this proposal, the department would submit taxpayer-identifier information to financial institutions to match against their customer information. The department sends approximately 125,000 OTWs annually to financial institutions, as a result of form 1099 interest information, resulting in $75 million in collections ($70 million tax + $5 million non-tax accounts). It is anticipated that the ability of financial institutions to process additional OTWs would be limited to an increase of 50,000 accounts for the first full year and increase by 50,000 accounts each year thereafter. This proposal would result in both accelerated revenue and new money.

Acceleration (the same for all alternatives)

Based on delinquent tax account data, of the $70 million currently collected using OTWs, the department estimates that the issuance of additional OTWs could accelerate 50% of collections by one year, or approximately $34 million during the first year of implementation. However, because it is anticipated that financial institutions would have processing limitations, this potential acceleration is reduced 25% to approximately $9 million ($34 million x 25%).

New Money

Alternative No. 1 - All Delinquent Debtors Up to $25,000

Based on a review of open and discharged accounts, these delinquent accounts total $4.5 billion[3]. FTB staff estimates that matches would be made on approximately 20%[4] of these outstanding balances, which would total $900 million ($4.5 billion x 20%).

The delinquent balance of $900 million would be associated with over 280,000 cases. Of these cases, it is anticipated that financial institutions could process 15% of all requests. As a result, department staff would identify and submit accounts that would yield the highest return. Because the accounts with a higher return would be selected for the levies, FTB staff estimates that the balance of accounts pursued would be increased by 20%. Based on historical Accounts Receivable Management collection rates of the additional OTWs that would be processed, 15% of the balance would be collected. Thus, during the first-year, new money would equal approximately $25 million ($900 million x 15% x 120% x 15%). The combined impact of accelerated collections and additional collections would total $34 million ($9 million + $25 million).

To include non-tax accounts, the additional 50,000 OTWs that financial institutions would be able to process during the first year are allocated between tax and non-tax accounts, 80% and 20% respectively. The average balance for tax accounts pursued through the new match process is $680 ($34 million ÷ 50,000 additional OTWs). Allocating 40,000 OTWs to tax account collections reduces the revenue impact for the first year from $34 million to $27 million ($680 x 40,000). The average collection for non-tax accounts that would be pursued through the new match process is estimated to total $175. Allocating 10,000 OTWs to the non-tax program would accelerate collections by approximately $2 million ($175 x 10,000).

This estimate assumes that taxpayer payments would begin in July, 2010. Growing this estimate using the Consumer Price Index, the impact for fiscal year 2010-11 would total $40 million. The estimate in the table has been accrued back one year and attributed to fiscal year 2009-10 and has been rounded.

Subsequent to fiscal year 2010-11, as financial institutions are able to process additional OTWs, accelerated and additional collections would increase. However, it is assumed that financial

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[3] This figure is reduced from 5.8 billion in the original proposal. Upon review of the universe of accounts identified in the original proposal, staff discovered that some ineligible accounts had been included in the total.

[4] This match rate was increased from the historical match rate used in the original proposal to account for increased matches that would result from the use of more current financial institution data under this proposal.

institutions would not be able to process OTWs for the entire population of matches until 2014-15. Additionally, it is assumed that 30% of new OTWs would lead to installment agreements and would generate revenue for the following two years. When the proposal is fully phased-in by 2014-15, additional collections are projected at $110 million per year for both tax and non-tax programs.

For Alternatives No. 2 and No. 3 discussed below, unless otherwise discussed, the methodology and assumptions described above are applicable.

Alternative No. 2-Moderately Delinquent Accounts

Under this alternative, the department would submit taxpayer-identifier information to financial institutions for accounts that are over 90 days past due and have a minimum balance of $250. The open and discharged delinquent accounts that meet the criteria total $11.8 billion. Because this alternative would include higher balance accounts not included in Alternative No. 1,, the collection rate is reduced to 8% to account for the disparity in collection rates as balances increase. All other assumptions described in Alternative No. 1 were applied to the remainder of this estimate. The revenue impact for Alternative No. 2 for fiscal year 2010-11, including non-tax debt accounts, would total $45 million.

Alternative No. 3 - Significantly Delinquent Accounts

Under this alternative, the department would submit taxpayer-identifier information to financial institutions for accounts that are over 6 months past due and have a minimum balance of $10,000. Total open and discharged delinquent accounts that meet the criteria totals $8.8 billion. Because this alternative would be pursuing a reduced number of accounts with larger balances, the collection rate is reduced to 4% to account for the disparity in collection rates for higher balance accounts. Additionally, because these accounts are associated with a reduced number of cases, OTWs are not anticipated to increase by 50,000 each year, but rather, hold constant at 50,000 per year. All other assumptions described above in Alternative No. 1 were applied to the remainder of this estimate. The revenue impact for Alternative No. 3 for fiscal year 2010-11 would total $25 million. In addition to the factors discussed above, the revenue estimate is less than the other alternatives in the first year because it is anticipated that more of the affected taxpayers would establish installment agreements for the unpaid debts, resulting in less revenue in the first year but additional revenues in the subsequent years.

Other Agency/Industry Impacted

This proposal would impact financial institutions; however, because current federal law requires these entities to participate in the Financial Institution Data Match (FIDM) process for child support obligors, the extent of the impact may be minimized by use of a file format similar to the existing FIDM program.

Financial institutions charge fees to their customers for processing of levies that can range up to $125 per levy. Although the financial institutions are not reimbursed for the costs of levies that do not find open accounts, the levies issued under this proposal would utilize more current financial information and would be more likely to attach to active accounts; which would result in reimbursement for the financial institutions on a higher percentage of levies processed.

Additionally, Alternatives No. 2 and No. 3 would provide for cost reimbursement to those financial institutions that are currently Method 1 filers under FIDM in an amount up to $250 per quarter to alleviate the cost impacts to those financial institutions.

Other States

Laws in *Kentucky, Maryland*, *Massachusetts,* and *New Jersey* provide the revenue departments of those states authority to use a financial institution record match process for the collection of delinquent income taxes. In *Kentucky*, the financial institutions that provide debtor records may charge a fee against an account levied by the Department of Revenue under the match process. The fee may not exceed $20.

Maryland financial institutions are reimbursed the actual costs incurred. It does not appear that the laws in *Massachusetts* or *New Jersey* permit reimbursement to financial institutions that provide customer records.

In July, 2007, *Indiana* enacted legislation to authorize a financial institution record match process for the collection of tax debts. *Arizona* introduced legislation in the 2007 legislative session to implement a similar record match process, but it does not appear that the bill progressed during the legislative session.

The state of Minnesota published a survey of tax agency collection techniques in December, 2007, which indicated that the District of Columbia, Florida, Georgia, Iowa, and New Mexico were considering legislation in the upcoming sessions that would implement some level of financial institution data matching for tax debts.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO LP 08-02

ALTERNATIVE #1

AMENDMENT 1

Section 19266 is added to the Revenue and Taxation Code to read:

19266. (a) The Franchise Tax Board, in coordination with financial institutions doing business in this state, shall operate a Financial Institution Record Match System utilizing automated data exchanges to the maximum extent feasible. The Franchise Tax Board shall prescribe any regulations that may be necessary or appropriate to implement the provisions of this section. These regulations shall include a structure by which financial institutions, or their designated data-processing agents, shall receive from the Franchise Tax Board the file or files of delinquent debtors that the institution shall match with its own list of account-holders to identify delinquent tax debtor accountholders at the institution. The regulations shall include an option by which financial institutions without the technical ability to process the data exchange, or without the ability to employ a third-party data processor to process the data exchange, may forward to the Franchise Tax Board a list of all accountholders and their social security numbers or other taxpayer identification numbers, so that the Franchise Tax Board shall match that list with the file or files of delinquent tax debtors.

(b) The Financial Institution Data Record Match System shall not be subject to any limitation set forth in Chapter 20 (commencing with Section 7460) of Division 7 of Title 1 of the Government Code. However, any use of the information provided pursuant to this section for any purpose other than the collection of delinquent franchise or income tax or other debts referred to Franchise Tax Board for collection, as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) shall be a violation of Section 19542.

(c) To effectuate the Financial Institution Record Match System, financial institutions subject to this section shall provide to the Franchise Tax Board on a quarterly basis the name, record address, and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor, as identified by the Franchise Tax Board by name and social security number or other taxpayer identification number, who maintains an account at the institution.

(d) Unless otherwise required by applicable law, a financial institution furnishing a report or providing information to the Franchise Tax Board pursuant to this section shall not disclose to a depositor or an accountholder, or a co-depositor or co-accountholder, that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor has been received from or furnished to the Franchise Tax Board.

(e) A financial institution shall incur no obligation or liability to any person arising from any of the following:

(1) Furnishing information to the Franchise Tax Board as required by this section.

(2) Failing to disclose to a depositor or accountholder that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor was included in the data exchange with the Franchise Tax Board required by this section.

(3) Any other action taken in good faith to comply with the requirements of this section.

(g) The Franchise Tax Board may institute civil proceedings to enforce the provisions of this section.

(h) Any financial institution that willfully fails to comply with the rules and regulations promulgated by the Franchise Tax Board for the administration of delinquent tax collections, unless it is shown to the satisfaction of the Franchise Tax Board that the failure is due to reasonable cause, shall be assessed a penalty upon notice and demand of the Franchise Tax Board and collected in the same manner as tax. The penalty imposed under this section shall be in an amount equal to fifty dollars ($50) for each record not provided, but the total imposed on that financial institution for all such failures during any calendar year shall not exceed $100,000.

(i) For the purpose of this section:

(1) "Account" means any demand deposit account, share or share draft account, checking or negotiable withdrawal order account, savings account, time deposit account, or money market mutual fund account, regardless of whether the account bears interest.

(2) "Financial institution" means:

(A) A depository institution, as defined in Section 1813(c) of Title 12 of the United States Code;

(B) An institution-affiliated party, as defined in Section 1813(u) of Title 12 of the United States Code;

(C) Any Federal credit union or State credit union, as defined in Section 1752 of Title 12 of the United States Code, including an institution-affiliated party of such a credit union, as defined in Section 1786(r) of Title 12 of the United States Code; and

(D) Any benefit association, insurance company, safe deposit company, money-market fund, or similar entity authorized to do business in this state.

(3) "Delinquent tax debtor" means any person liable for any income or franchise tax or other debt referred to the Franchise Tax Board for collection as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) including tax, penalties, interest, and fees, where the tax or debt, including the amount, if any, referred to Franchise Tax Board for collection remains unpaid after thirty (30) days from demand for payment by the Franchise Tax Board; and the person is not making current timely installment payments on the liability under an agreement pursuant to section 19006.

(j) Franchise Tax Board shall work with financial institution representatives to develop a reasonable methodology to reimburse actual costs incurred by financial institutions to conduct tax data matches pursuant to this section.

AMENDMENT 2

Section 19560 is added to the Revenue and Taxation Code to read:

Notwithstanding any law to the contrary, to effectuate the Financial Institution Record Match System prescribed under Section 19265, the Franchise Tax Board may disclose the name and social security number or taxpayer identification number to designated financial institutions or their authorized processing agent for purposes of matching debtor records to account holder records at the financial institution. Any use of the data provided by the Franchise Tax Board for a purpose other than those identified by Section 19265 is prohibited and considered a violation of Section 19542.

ALTERNATIVE #2

AMENDMENT 1

Section 19266 is added to the Revenue and Taxation Code to read:

19266. (a) The Franchise Tax Board, in coordination with financial institutions doing business in this state, shall operate a Financial Institution Record Match System utilizing automated data exchanges to the maximum extent feasible. The Franchise Tax Board shall prescribe any regulations that may be necessary or appropriate to implement the provisions of this section. These regulations shall include a structure by which financial institutions, or their designated data-processing agents, shall receive from the Franchise Tax Board the file or files of delinquent debtors that the institution shall match with its own list of account-holders to identify delinquent tax debtor accountholders at the institution. The regulations shall include an option by which financial institutions without the technical ability to process the data exchange, or without the ability to employ a third-party data processor to process the data exchange, may forward to the Franchise Tax Board a list of all accountholders and their social security numbers or other taxpayer identification numbers, so that the Franchise Tax Board shall match that list with the file or files of delinquent tax debtors.

(b) The Financial Institution Data Record Match System shall not be subject to any limitation set forth in Chapter 20 (commencing with Section 7460) of Division 7 of Title 1 of the Government Code. However, any use of the information provided pursuant to this section for any purpose other than the collection of delinquent franchise or income tax or other debts referred to Franchise Tax Board for collection, as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) shall be a violation of Section 19542.

(c) To effectuate the Financial Institution Record Match System, financial institutions subject to this section shall provide to the Franchise Tax Board on a quarterly basis the name, record address, and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor, as identified by the Franchise Tax Board by name and social security number or other taxpayer identification number, who maintains an account at the institution.

(d) Unless otherwise required by applicable law, a financial institution furnishing a report or providing information to the Franchise Tax Board pursuant to this section shall not disclose to a depositor or an accountholder, or a co-depositor or co-accountholder, that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor has been received from or furnished to the Franchise Tax Board.

(e) A financial institution shall incur no obligation or liability to any person arising from any of the following:

(1) Furnishing information to the Franchise Tax Board as required by this section.

(2) Failing to disclose to a depositor or accountholder that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor was included in the data exchange with the Franchise Tax Board required by this section.

(3) Any other action taken in good faith to comply with the requirements of this section.

(g) The Franchise Tax Board may institute civil proceedings to enforce the provisions of this section.

(h) Any financial institution that willfully fails to comply with the rules and regulations promulgated by the Franchise Tax Board for the administration of delinquent tax collections, unless it is shown to the satisfaction of the Franchise Tax Board that the failure is due to reasonable cause, shall be assessed a penalty upon notice and demand of the Franchise Tax Board and collected in the same manner as tax. The penalty imposed under this section shall be in an amount equal to fifty dollars ($50) for each record not provided, but the total imposed on that financial institution for all such failures during any calendar year shall not exceed $100,000.

(i) For the purpose of this section:

(1) "Account" means any demand deposit account, share or share draft account, checking or negotiable withdrawal order account, savings account, time deposit account, or money market mutual fund account, regardless of whether the account bears interest.

(2) "Financial institution" means:

(A) A depository institution, as defined in Section 1813(c) of Title 12 of the United States Code;

(B) An institution-affiliated party, as defined in Section 1813(u) of Title 12 of the United States Code;

(C) Any Federal credit union or State credit union, as defined in Section 1752 of Title 12 of the United States Code, including an institution-affiliated party of such a credit union, as defined in Section 1786(r) of Title 12 of the United States Code; and

(D) Any benefit association, insurance company, safe deposit company, money-market fund, or similar entity authorized to do business in this state.

(3) "Delinquent tax debtor" means any person liable for any income or franchise tax or other debt referred to the Franchise Tax Board for collection as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) including tax, penalties, interest, and fees, where the tax or debt, including the amount, if any, referred to Franchise Tax Board for collection remains unpaid after ninety (90) days from demand for payment by the Franchise Tax Board; the balance owed is in excess of $250; and the person is not making current timely installment payments on the liability under an agreement pursuant to Section 19006.

(j) Financial institutions that participate in the federal Financial Institution Data Match program as Method 1 filers that would be required to switch to a Method 2 filing for purposes of matching tax debtors as prescribed by this section shall be reimbursed by the Franchise Tax Board for actual costs incurred to comply with the requirements of this section up to an aggregate amount of $250 per quarter.

(j) Franchise Tax Board shall work with financial institution representatives to develop a reasonable methodology to reimburse actual costs incurred by financial institutions to conduct tax data matches pursuant to this section.

AMENDMENT 2

Section 19560 is added to the Revenue and Taxation Code to read:

Notwithstanding any law to the contrary, to effectuate the Financial Institution Record Match System prescribed under Section 19265, the Franchise Tax Board may disclose the name and social security number or taxpayer identification number to designated financial institutions or their authorized processing agent for purposes of matching debtor records to account holder records at the financial institution. Any use of the data provided by the Franchise Tax Board for a purpose other than those identified by Section 19265 is prohibited and considered a violation of Section 19542.

ALTERNATIVE #3

AMENDMENT 1

Section 19266 is added to the Revenue and Taxation Code to read:

19266. (a) The Franchise Tax Board, in coordination with financial institutions doing business in this state, shall operate a Financial Institution Record Match System utilizing automated data exchanges to the maximum extent feasible. The Franchise Tax Board shall prescribe any regulations that may be necessary or appropriate to implement the provisions of this section. These regulations shall include a structure by which financial institutions, or their designated data-processing agents, shall receive from the Franchise Tax Board the file or files of delinquent debtors that the institution shall match with its own list of account-holders to identify delinquent tax debtor accountholders at the institution. The regulations shall include an option by which financial institutions without the technical ability to process the data exchange, or without the ability to employ a third-party data processor to process the data exchange, may forward to the Franchise Tax Board a list of all accountholders and their social security numbers or other taxpayer identification numbers, so that the Franchise Tax Board shall match that list with the file or files of delinquent tax debtors.

(b) The Financial Institution Data Record Match System shall not be subject to any limitation set forth in Chapter 20 (commencing with Section 7460) of Division 7 of Title 1 of the Government Code. However, any use of the information provided pursuant to this section for any purpose other than the collection of delinquent franchise or income tax or other debts referred to Franchise Tax Board for collection, as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) shall be a violation of Section 19542.

(c) To effectuate the Financial Institution Record Match System, financial institutions subject to this section shall provide to the Franchise Tax Board on a quarterly basis the name, record address, and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor, as identified by the Franchise Tax Board by name and social security number or other taxpayer identification number, who maintains an account at the institution.

(d) Unless otherwise required by applicable law, a financial institution furnishing a report or providing information to the Franchise Tax Board pursuant to this section shall not disclose to a depositor or an accountholder, or a co-depositor or co-accountholder, that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor has been received from or furnished to the Franchise Tax Board.

(e) A financial institution shall incur no obligation or liability to any person arising from any of the following:

(1) Furnishing information to the Franchise Tax Board as required by this section.

(2) Failing to disclose to a depositor or accountholder that the name, address, social security number, or other taxpayer identification number or other identifying information of that delinquent tax debtor was included in the data exchange with the Franchise Tax Board required by this section.

(3) Any other action taken in good faith to comply with the requirements of this section.

(g) The Franchise Tax Board may institute civil proceedings to enforce the provisions of this section.

(h) Any financial institution that willfully fails to comply with the rules and regulations promulgated by the Franchise Tax Board for the administration of delinquent tax collections, unless it is shown to the satisfaction of the Franchise Tax Board that the failure is due to reasonable cause, shall be assessed a penalty upon notice and demand of the Franchise Tax Board and collected in the same manner as tax. The penalty imposed under this section shall be in an amount equal to fifty dollars ($50) for each record not provided, but the total imposed on that financial institution for all such failures during any calendar year shall not exceed $100,000.

(i) For the purpose of this section:

(1) "Account" means any demand deposit account, share or share draft account, checking or negotiable withdrawal order account, savings account, time deposit account, or money market mutual fund account, regardless of whether the account bears interest.

(2) "Financial institution" means:

(A) A depository institution, as defined in Section 1813(c) of Title 12 of the United States Code;

(B) An institution-affiliated party, as defined in Section 1813(u) of Title 12 of the United States Code;

(C) Any Federal credit union or State credit union, as defined in Section 1752 of Title 12 of the United States Code, including an institution-affiliated party of such a credit union, as defined in Section 1786(r) of Title 12 of the United States Code; and

(D) Any benefit association, insurance company, safe deposit company, money-market fund, or similar entity authorized to do business in this state.

(3) "Delinquent tax debtor" means any person liable for any income or franchise tax or other debt referred to the Franchise Tax Board for collection as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001) including tax, penalties, interest, and fees, where the tax or debt, including the amount, if any, referred to Franchise Tax Board for collection remains unpaid after one hundred and eighty (180) days from demand for payment by the Franchise Tax Board; the balance owed is in excess of $10,000; and the person is not making current timely installment payments on the liability under an agreement pursuant to Section 19006.

(j) Financial institutions that participate in the federal Financial Institution Data Match program as Method 1 filers that would be required to switch to a Method 2 filing for purposes of matching tax debtors as prescribed by this section shall be reimbursed by the Franchise Tax Board for actual costs incurred to comply with the requirements of this section up to an aggregate amount of $250 per quarter.

(j) Franchise Tax Board shall work with financial institution representatives to develop a reasonable methodology to reimburse actual costs incurred by financial institutions to conduct tax data matches pursuant to this section.

AMENDMENT 2

Section 19560 is added to the Revenue and Taxation Code to read:

Notwithstanding any law to the contrary, to effectuate the Financial Institution Record Match System prescribed under Section 19265, the Franchise Tax Board may disclose the name and social security number or taxpayer identification number to designated financial institutions or their authorized processing agent for purposes of matching debtor records to account holder records at the financial institution. Any use of the data provided by the Franchise Tax Board for a purpose other than those identified by Section 19265 is prohibited and considered a violation of Section 19542.

Legislative Proposal 08-3
SIMPLIFICATION OF REPORTING INCOME FOR CONTROLLED FOREIGN CORPORATIONS IN A WATER'S-EDGE COMBINED REPORT
Staff Actions Since Last Board Meeting

At the November 28, 2007, Franchise Tax Board (FTB) meeting, staff was directed to hold an interested parties meeting for Staff Legislative Proposal (LP) 08-3, *Simplification of Reporting Income for Controlled Foreign Corporations in a Water's-Edge Combined Report*, to answer questions and solicit comments and suggestions regarding the statutory amendments proposed by LP 08-3.

The department held an interested parties meeting for LP 08-3 on January 15, 2008, which lasted just over two hours. Sixteen interested parties participated in the meeting. At the conclusion of the meeting, interested parties requested the following information from staff:

- Written responses to questions and comments received from all interested parties. (Attachment 1)
- An example illustrating the mechanics of LP 08-3. (Attachment 2)
- An expanded revenue estimate discussion for LP 08-3. Additional details are underlined. (Attachment 3)

The attachments, including Attachment 4 below, were submitted to the interested parties on February 7, 2008, and posted to the FTB website on February 13, 2008.

As a result of the interested parties meeting, staff proposes the following amendments to LP 08-3's original language (Attachment 4):

- Provide that Revenue and Taxation Code section 24425 does not apply to the exclusion from gross income of previously taxed earnings and profit.
- Clarify that a taxpayer would be disallowed from receiving greater than a 100% dividend elimination or deduction against the dividend it receives.

The interested parties also requested that LP 08-3 be amended to allow a separate California Subpart F High Foreign Tax election. This suggestion has been declined by staff because it would add significant complexity to the proposal. In addition, for nearly a decade, FTB has supported legislation that requires binding federal elections with no separate California election. (See question 3 in Attachment 1.)

ATTACHMENT 1

LEGISLATIVE PROPOSAL 08-3 (SUBPART F INCOME)
JANUARY 15, 2008, INTERESTED PARTIES MEETING
QUESTIONS/RESPONSES

Item #	Question	Response
1	In section 25117(a) of the proposed amendments, what is meant by "is treated as a dividend actually paid?" Is clarity needed?	The legislative proposal treats Subpart F income as a deemed dividend, even though nothing is actually "paid." The intention of this phrase is to remove any potential ambiguity relating to the interaction of other code provisions that refer to a dividend "paid" or "received," by specifying in the language that Subpart F income shall be treated as a dividend actually paid for all purposes. Franchise Tax Board (FTB) staff believes no additional clarity is necessary because the language states "for all purposes."
2	Would there be circumstances when an actual dividend paid by a Controlled Foreign Corporation (CFC) would be subject to sections 24411 or 25106 instead of receiving previously taxed income (PTI) treatment?	In some cases, there may be overlap between PTI distributions and sections 24411 or 25106. The federal Subpart F rules provide a special ordering rule that accelerates earnings and profits eligible for PTI before all other earnings and profits are taken into account. Legislative Proposal (LP) 08-3 would conform to the federal special ordering rules. To the extent that a draw from earnings and profits of a given year is simultaneously eligible for treatment as PTI and is excluded from income under sections 24411 or 25106, a taxpayer should not be eligible to claim an exclusion that exceeds the amount of the distribution. Staff will recommend clarifying language to provide to that effect.

3	In section 25117(b)(6) of the proposed amendments, why is FTB changing current law to disallow a separate California election for the Subpart F High Foreign Tax exception?	The goal of this proposal is to significantly simplify the method used to report a water's-edge taxpayer's portion of its CFC's income by conforming to the federal Subpart F rules. LP 08-3 was designed so that taxpayers could simply pick up the amounts of federal Subpart F income, PTI, and stock basis. The federal high-tax election is very complex. It is made on a country-by-country, CFC by CFC, and income item-by income item basis. It requires obtaining detailed foreign country tax law information and CFC income and expense data, making a number of difficult calculations and the application of special foreign tax credit rules that do not otherwise apply for California purposes. Allowing a California-only high tax election runs counter to the proposal's goal of simplicity because it would result in substantial state and federal differences in PTI and the CFC's stock basis, and could result in complex state audits on the eligibility and calculation of the "state only" High Foreign Tax exception. In addition, for nearly a decade, the FTB has regularly supported legislation that would require binding federal elections with no separate California election.
4	Should clarifying language be added to the proposed amendments related to the inclusion of Subpart F income in the sales factor?	FTB staff believes that clarifying language is unnecessary. The proposal's language specifically states that Subpart F income shall be treated as a dividend actually paid. The Subpart F income would be included in the numerator and denominator of the sales factor using the same rules for assigning dividend income to the sales factor when a "real" dividend is paid. See Legal Rulings 2003-03 and 2006-01.
5	Could section 24425 be applied to the 27% dividend-received deduction amount?	Because the foreign investment interest offset (section 24344(c)) applies to interest expense, and serves a similar

		purpose to section 24425, there would probably not be any adjustment for interest under section 24425. However, section 24425 might apply to expenses other than interest consistent with the broad principles of *Great Western Financial Corp. v. Franchise Tax Board* (1971) 4 Cal.3d 1.
6	Will taxpayers get factor representation in addition to the 27% dividends-received deduction?	No. Under this proposal, CFC's are no longer included in the water's-edge combined report, therefore, a CFC's apportionment factors are excluded. The tax effects of the CFC's apportionment factors under current law have been reflected in the calculation of the 27% dividends-received deduction for Subpart F income (deemed dividend) included in the income of the members of the water's-edge group. "Factor relief" would require gathering essentially the same data as current law, which would run counter to the simplification goal of the proposal. In addition, "factor relief" would also require a reduction in the dividend received deduction attributable to Subpart F income, in order to maintain revenue neutrality.
7	There is a question about federal foreign dividends. It appears they would be subject to a 75% dividends-received deduction, but it is not clear whether the same dividends could be eliminated if they traced back to years in which the company filed worldwide rather than water's-edge.	Under existing law (Cal. Code of Regs., tit. 18, section 24411), dividends that are eligible for elimination under section 25106 take precedence over dividends eligible for the 75% dividend received deduction of section 24411. Under this proposal, for distributions of PTI from years before the effective date of LP 08-3 (i.e., the transitional PTI rules), PTI might be attributable to an earnings and profits pool that was also included in world-wide combined reporting income. In that case, section 25106 would apply, but a taxpayer should be ineligible for an exclusion or elimination in an amount that exceeds the amount of the distribution. See response to question 2.
8	Please clarify how the PTI and basis rules	Under this proposal, a taxpayer subject to a water's-edge

	would work if a taxpayer were subject to a water's-edge election, terminated that election, and then made a new water's-edge election in a subsequent year.	election is entitled to the benefits of its federal PTI and federal stock basis amounts with respect to years before 01/01/2008. However, a taxpayer that terminates its water's-edge election is required to adjust its PTI and stock basis amounts to reflect only Subpart F income actually taken into account during the period of the water's-edge election (California-only PTI.) A taxpayer that returns back to a water's-edge election in a later year reacquires its federal PTI and stock basis adjustments, although there may be timing issues related to California-only PTI distributions while the water's edge-election was not in effect.
9	Can you explain the reason for the last sentence of proposed section 25117(a), dealing with business or nonbusiness income?	That sentence was added as a continuing clarification of the proposal's treatment of Subpart F income as a dividend actually paid. The business or nonbusiness treatment of the proposal's Subpart F income would be determined in the same manner as if the income was a dividend actually received.
10	What happens when a dividend distribution is paid from earnings and profits in excess of Subpart F income?	This proposal would use the federal ordering rules that specify that a dividend distribution is paid first from earnings and profits eligible for PTI exclusion. Any other distribution follows the normal rules for earnings and profits eligible for elimination under section 25106 or deduction under section 24411.
11	Could section 24425 expenses applied to the 27% amount of excluded Subpart F income ever exceed the actual 27% amount?	In theory, yes, although that is likely to be uncommon. This is consistent with other types of excluded income subject to the provisions of section 24425.
12	If a dividend was paid from U.S. source income earnings and profits, would the	Federal rules prevent specified U.S. source income (generally U.S. income effectively connected with a U.S. trade or

	dividend receive any dividend deduction?	business from being included in Subpart F income. (See IRC section 952(b).) This proposal would conform to those rules. Thus, dividends paid from such earnings and profits would not be affected by this proposal and would be treated under current law. If eligible, the dividend would be eliminated under section 25106 or deductible under section 24411. Any U.S. source income included in Subpart F income under federal law would be treated under this proposal in the same manner as federal law.
13	In the calculation of the revenue estimate, was the amount of Subpart F income added to the taxpayer's sales factor denominator?	Yes. The net amount of Subpart F income (73% in accordance with FTB Legal Ruling 2006-01) was assumed to be includable in the sales factor denominator.
14	How was the 27% dividend-received deduction determined?	See attached Expanded Economic Impact.
15	Was the revenue gain that determined the 27% dividend received deduction generated because the proposal would exclude a CFC from the water's-edge combined report, including a CFC's property, payroll, and sales factors?	Yes. The revenue gain is mainly the result of excluding a CFC's factors from the denominator of the apportionment formula.
16	Why does the revenue estimate use only tax year 2004 data instead of multiple tax years?	At the federal level and throughout various states, the standard approach to estimating revenue effects of proposed law changes, for official governmental estimates and those provided by private consultants, is to use only one year of data. The FTB's Economic and Statistical Research Bureau consistently adheres to this approach. For this specific

		proposal, the 2004 corporate sample data was used, as this was the most current and representative data at the time the estimate was initiated.
17	Is the revenue estimate provided in the proposal the same revenue estimate used by the Legislature?	If the proposal's language remains unchanged and is introduced into a bill, the revenue estimate discussed in the bill analysis prepared by FTB would be the same.
18	This proposal excludes a CFC from the water's-edge combined report, therefore, does the revenue estimate exclude intercompany transactions?	When computing the revenue estimate, we were unable to identify intercompany transactions, but feel this would have an immaterial tax effect on the revenue estimate. However, to the extent that the taxpayer adjusted the CFC income and factors to eliminate intercompany transactions, our computation accounts for these intercompany transactions.

ATTACHMENT 2: Comparison Example of Current Law and LP 08-03

US Corporation P owns 100 percent of CFC1, a controlled foreign corporation. P elected to file its California returns on a water's-edge basis. Assume CFC1 has the following facts:

		Year 1	Year 2
Taxable income (TI)		$ 100.00	$ -
Subpart F income		10.00	-
Earnings and profits:			
Beginning of the year	5.00		
Current year	100.00	105.00	
Inclusion ratio = Sub F/current yr E&P		10.00%	0.00%
Cash dividend to P		-	100.00
Factors:			
Property		3,204	3,204
Payroll		851	851
Sales		17,600	17,600

Assume that the $5 accumulated E&P at the beginning of the year is PTI under IRC section 959.

Current Law: WATER'S-EDGE COMBINED REPORT

Income:	**Year 1**	**Year 2**	
CFC income x inclusion ratio (I/R)	$ 10.00	$ -	($100 TI x 10% I/R)
Dividend income	-	100.00	
Dividend elimination - R&TC sec 25106	-	(10.00)	($100 div x Yr1 10% I/R)
Dividend deduction - R&TC sec 24411	-	(67.50)	($90 qualifying div x 75%)
Foreign investment interest offset - Assume a 10%	-	6.75	
Pre-Apportionment Income	**$ 10.00**	**$ 29.25**	
Apportionment factor (see below computation)	7.7249%	7.9468%	
Net income	0.77	2.32	
Tax at 8.84%	**0.068**	**0.205**	

Proposed Law: WATER'S-EDGE COMBINED REPORT

Income:	**Year 1**	**Year 2**	
CFC income x inclusion ratio = N/A	$ -	$ -	
Dividend income	10.00	100.00	
Dividend exclusion - 27%	(2.70)	-	
Previously Taxed Income (PTI)	-	(15.00)	($5 IRC sec 959 + $10)
Dividend deduction - R&TC sec 24411	-	(63.75)	($85 qualifying div x 75%)
Foreign investment interest offset - Assume a 10%	0.27	6.375	
Pre-Apportionment Income	**$ 7.57**	**$ 27.63**	
Apportionment factor (see below computation)	8.0255%	8.0237%	
Net income	0.61	2.22	
Tax at 8.84%	**0.054**	**0.196**	

Apportionment factor - Current Law

Assume P's water's-edge combined report factors are:

Property					
California		1,151		1,151	
Everywhere	14,200		14,200		
CFC1 x Inclusion Ratio	320		-		
		14,520		14,520	
Percent within California		7.9268%		7.9268%	
Payroll					
California		319		319	
Everywhere	4,564		4,564		
CFC1 x Inclusion Ratio	85		-		
		4,649		4,649	
Percent within California		6.8615%		6.8615%	
Sales					
California		2,680		2,680	
Everywhere	31,509		31,509		
LR 2006-1	-		22.5		($100 - $10 - $67.50)
CFC1 x Inclusion Ratio	1,760		-		
		33,269		31,532	
Percent within California		8.0555%		8.4994%	
Double weighed sales factor		8.0555%		8.4994%	
Average apportionment percentage		**7.7249%**		**7.9468%**	

Apportionment factor - Proposed Law

Assume P's water's-edge combined report factors are:

Property				-	
California		1,151		1,151	
Everywhere	14,200		14,200		
CFC1 x Inclusion Ratio	N/A		N/A		
		14,200		14,200	
Percent within California		8.1056%		8.1056%	
Payroll					
California		319		319	
Everywhere	4,564		4,564		
CFC1 x Inclusion Ratio	N/A		N/A		
		4,564		4,564	
Percent within California		6.9895%		6.9895%	
Sales					
California		2,680		2,680	
Everywhere	31,509		31,509		
LR 2006-1	7.30		21.25		($100 - $15 - $63.75)
CFC1 x Inclusion Ratio	N/A		N/A		
		31,516		31,530	
Percent within California		8.5035%		8.4998%	
Double weighed sales factor		8.5035%		8.4998%	
Average apportionment percentage		**8.0255%**		**8.0237%**	

ATTACHMENT 3
January 15, 2008, Interested Parties Meeting Request
Expanded Economic Impact (Additions Underlined)

Tax Revenue Estimate

Based on data and assumptions discussed below, this proposal would result in the following net revenue impact.

Estimated Revenue Impact of LP 08-03 Effective for Taxable Years BOA 1/1/08 ***Enactment Assumed After 6/30/08***		
2008-09	2009-10	2010-11
<-$500,000	<-$500,000	<-$500,000

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

Tax Revenue Discussion

The revenue impact of the proposal would depend on the difference in amounts of net CFC income included in the water's-edge group tax filing under current state law (partial inclusion of subpart F income and unitary factors) versus conforming to federal law's Subpart F provisions (Subpart F income treated as a deemed dividend).

The estimate was derived in the following steps:

1. Selected a statistically representative sample of water's-edge filers reporting CFC income or a foreign dividend deduction (Forms 100W– Water's Edge Filers for the 2004 taxable year);
2. Calculated the change in tax (increase or decrease) if each filer reported Subpart F income according to the proposal. This was accomplished as follows:
   - Reversed the amount of CFC income reported on line 7a of Form 100W.
   - Added Subpart F income as reported on the federal Form 5471.
   - Excluded the amount of the CFC's property, payroll, and sales reported in the denominator of the apportionment factors.
   - Added the amount of the CFC's Subpart F income (100%) in the taxpayer's denominator of the sales factor.

3. Multiplied the calculated tax change for each corporation by its respective weight and summed the results: a revenue gain of $21.4 million;
4. Assumed the approximate revenue offset for the taxpayer favorable transitional rules, interest offset, and intercompany transactions: a revenue loss of $3 million;
5. Calculated a dividends-received deduction that would result in a roughly revenue neutral tax impact for the proposal: 27% dividend deduction. The dividends-received deduction reduces the amount of CFC income and the amount included in the sales factor denominator.

At the 2004 level, conforming to the federal Subpart F rules and including 100% of Subpart F income results in a revenue gain of $21.4 million. This revenue gain would be reduced somewhat by proposed transition rules: (1) income previously taxed as Subpart F income before this proposal is effective would be considered previously taxed income for state purposes, and (2) federal adjustments to the stock basis of a CFC before this proposal is effective would become the new stock basis for the CFC for state purposes. For purposes of an estimate, it is assumed the revenue reduction is approximately $3 million annually. This assumption is based on discussions with knowledgeable audit and legal department staff. This impact could drop in future years beyond those for which estimates are developed here. At the 2004 level, allowing a 27% dividends-received deduction for Subpart F income would result in a net revenue loss.

For each component of the estimate, except for the $ 3 million impact discussed in item 4 above, the tax effect is grown by the forecast in corporate profits as projected by the Department of Finance. At the 2009 level, allowing the 27% dividends-received deduction results in a minor net revenue loss of less than $500,000 for the proposal. The 2009 taxable year results are presented in the table below, as this is the first year that both calendar year and fiscal year filers would be represented.

Estimated Revenue Effects Projected to the 2009 Taxable Year Level ($ in Millions)	
Conformity with federal rules	+$34.1
Transitional rules	-$ 3.0
Dividends-received deduction	-$31.6
Net Impact for 2009	-$ 0.5

Although the net tax effect for the proposal is roughly revenue neutral, most corporations in the sample experienced a tax decrease. Specifically, 44% had a tax decrease, 25% a tax increase, and 31% had no tax effect.

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ATTACHMENT 4

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS
LP 08-03 (Revised After January 15, 2008, Interested Parties Meeting – Changes Shown In Italics)

AMENDMENT 1

SECTION 1: Section 25110 of the Revenue and Taxation Code is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b), that is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer, that makes a water's-edge election on or after January 1, 2006, shall take into account that portion of its own income and apportionment factors and the income and apportionment factors of its affiliated entities to the extent provided below:

(1) The entire income and apportionment factors of any of the following corporations:

(A) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code.

(D) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(2) ~~(A)~~ With respect to a corporation that is not described in subparagraphs (A), (B), (C), and (D) of paragraph (1), ~~as provided in either one or both of the following clauses:~~

~~(i) T~~the income and apportionment factors of that corporation to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to, and determined from, the books of account maintained by the corporation with respect to its activities conducted within the United States.

~~(ii) The income and apportionment factors of that corporation that is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, to the extent determined by multiplying the income and apportionment factors of that corporation without application of this subparagraph by a fraction not to exceed one, the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year.~~

~~(B) For purposes of this paragraph, both of the following apply:~~

~~(i) "Subpart F income" means "Subpart F income" as defined in Section 952 of the Internal Revenue Code.~~

~~(ii) "Earnings and profits" means "earnings and profits" as described in Section 964 of the Internal Revenue Code.~~

(3) The income and apportionment factors of the corporations described in this subdivision shall be taken into account only to the extent that they would have been taken into account had no election under this section been made.

~~(4) The Franchise Tax Board shall prescribe regulations to coordinate implementation of subparagraph (A) of paragraph (2) to prevent multiple inclusion or exclusion of income and factors in situations where the same item of income is described in both clauses.~~

(b) For purposes of this article and Section 24411, all of the following definitions apply:

(1) An "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A "qualified taxpayer" means a corporation that does both of the following:

(A) Files with the state tax return, on which the water's-edge election is made, a consent to the taking of depositions, at the time and place most reasonably convenient to all parties, from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board, as provided in Section 19504, by the State Board of Equalization, as provided in Section 5005 of Title 18 of the California Code of Regulations, or by the courts of this state, as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses that a taxpayer may otherwise have. The consent shall remain in effect as long as the water's-edge election is in effect, and shall be limited to providing that information necessary to review or adjust income or deductions in a manner authorized by Section 482, 861, Subpart F of Part III of Subchapter N, or similar provisions, of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that, for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on, or measured by, net income in that state. If a state does not impose a tax on, or measured by, net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on, or measured by, net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

AMENDMENT 2

SEC. 2 Section 24411 of the Revenue and Taxation Code is amended to read:

24411. (a) For purposes of those taxpayers electing to compute income under Section 25110, to the extent not otherwise allowed as a deduction or eliminated from income:

(1) 100 percent of the qualifying dividends described in subdivision ~~(c)~~(d), ~~and~~

(2) 27 percent of qualifying dividends described in Section 25117, and

(3) 75 percent of ~~other~~ qualifying dividends, other than those referred to in paragraphs (1)or(2). ~~to the extent not otherwise allowed as a deduction or eliminated from income~~.

(b) "Qualifying dividends" means those received by the water's-edge group from corporations if both of the following conditions are satisfied:

(1) The average of the property, payroll, and sales factors within the United States for the corporation is less than 20 percent.

(2) More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group.

~~(b)~~ (c) The water's-edge group consists of corporations whose income and apportionment factors are taken into account pursuant to Section 25110.

~~(c)~~(d) Dividends derived from a construction project, the location of which is not subject to the taxpayer's control.

For purposes of this subdivision:

(1) "Construction project" means any activity which meets the following requirements:

(A) Is undertaken for any entity, including a governmental entity, which is not affiliated with the taxpayer.

(B) The majority of its cost of performance is attributable to an addition to real property or an alteration of land or any improvement thereto as those terms are utilized for purposes of this code.

"Construction project" does not include the operation, rental, leasing, or depletion of real property, land, or any improvement thereto.

(2) "Location of which is not subject to the taxpayer's control" means that the place at which the majority of the construction takes place results from the nature or character of the construction project and not as a result of the terms of the contract or agreement governing the construction

project.

AMENDMENT 3

SEC. 3. Section 25117 of the Revenue and Taxation Code is added to read:

25117. (a) Except as otherwise provided, income taken into account by all affiliated entities whose income and apportionment factors are determined pursuant to Section 25110 shall include income described in Subpart F of the Internal Revenue Code (commencing with Section 951). The income that is taken into account shall for all purposes be treated as a dividend actually paid, and be subject to any provision or limitation related to the treatment of dividends, including, but not limited to, Sections 24344, 24410, 24411, and 25106. The amount taken into account shall be treated as business or nonbusiness income (as defined in Section 25120), as the case may be.

(b) In the application of Subpart F of the Internal Revenue Code:

(1) Exclusions from gross income under Section 959 of the Internal Revenue Code, relating to previously taxed income, shall apply, including amounts related to income previously taxed under federal law in years prior to the water’s edge election.

(2) Federal adjustments to stock basis made pursuant to Section 961 of the Internal Revenue Code, relating to adjustments to basis of stock in controlled foreign corporations and of other property, including adjustments made prior to the water’s edge election, shall apply.

(3) The provisions of and any reference to Section 1248 of the Internal Revenue Code, relating to gain from certain sales or exchanges of stock in certain foreign corporations, shall not apply.

(4) Section 960 of the Internal Revenue Code, relating to special rules for foreign tax credit, shall not apply.

(5) Section 965 of the Internal Revenue Code, relating to temporary dividends received deduction, shall not apply.

(6) For purposes of this section, a federal election to exclude from Subpart F income the income described in Section 954(b)(4) of the Internal Revenue Code shall apply, including amounts related to income previously taxed under federal law in years prior to the water’s edge election. No election under this subparagraph shall be allowed for state purposes unless a valid election was made for federal purposes.

(c) In the event that a water’s-edge election is terminated, for taxable years thereafter, the following rules apply:

(1) Subpart F of the Internal Revenue Code shall not apply, except as provided in this subdivision.

(2) Section 959 of the Internal Revenue Code, relating to exclusion from gross income of previously taxed earnings and profits, shall apply, but only to the extent attributable to income that has been taken into account pursuant to subdivision (a) during the period

of the water's edge election. *Section 24425 shall not apply to the exclusion from gross income of previously taxed earnings and profits discussed in this paragraph.*

(3) Stock basis shall be determined as if this section did not apply, except that stock basis shall be--

(A) Increased by income taken into account pursuant to subdivision (a) during the period of the water's edge election, and

(B) Reduced by the following:

(i) That portion of amounts excluded from income under paragraph (2) of subdivision (b) that are attributable to income taken into account pursuant to subdivision (a) during the period of the water's edge election, and

(ii) Amounts described by paragraph (2) of subdivision (c) excluded from income after termination of the water's edge election.

(d)(1) Except as provided in paragraph (2) this section shall apply to taxable years beginning on or after January 1, 2008.

(2) In the event that two or more taxpayers subject to the same election under section 25110 have different taxable years, this section shall apply as of the first day of the first taxable year of those respective taxpayers that begins on or after January 1, 2008.

(e) If a distribution with respect to earnings and profits from a given year is eligible for treatment as previously taxed income and would, without regard to the effects of this section, be eligible for deduction, exclusion, or elimination under another section under this part if paid as a dividend, in no event shall combined effect of those sections and the rules relating to previously taxed income result in a deduction, exclusion, or elimination greater than the amount of the earnings and profits that apply to the distribution.

~~(e)~~*(f)* The Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the purposes of this Section.

Title

Controlled Foreign Corporations In Water's-Edge Combined Report

Introduction

This proposal would simplify a complex area of "stand alone" state tax law for certain taxpayers by conforming to the federal tax law treatment for a controlled foreign corporation (CFC).

Current Federal Law

To understand this proposal, it is necessary to understand the general federal rules for taxing a U.S. corporation versus a foreign corporation. In general, a U.S. corporation is taxed on all its income, regardless of source, and is allowed a credit for any taxes paid to a foreign country on its foreign-source income. Foreign corporations are generally excluded from filing a federal tax return, except for income effectively connected with the conduct of that trade or business in the U.S. Deductions are allowed to net this income, and the net taxable income is taxed at the U.S. graduated tax rates. In addition, foreign corporations are taxed at a flat 30% rate (or a lower rate if provided by treaty) on specified types of fixed, determinable, annual, or periodic income, usually from investments, derived from U.S. sources. This is noneffectively connected income.

Subpart F of the Internal Revenue Code (IRC) (Sections 951-965), provides a comprehensive set of special rules for taxing certain U.S. shareholders of CFCs. In general, a CFC is defined as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock, or more than 50 percent of the total value of the stock, is owned by U.S. shareholders. A U.S. shareholder includes a U.S. citizen or resident, domestic corporation or partnership, or an estate or trust, other than a foreign estate or trust, that owns 10 percent or more of a foreign corporation. The CFC provisions were originally enacted to combat perceived abuses where income that could be taxed by the U.S. was assigned to foreign subsidiaries located in "tax havens."

U.S. shareholders of a CFC must include in their gross income certain types of income and investments of the CFC that would otherwise be excluded from taxable income under general federal tax rules. Any income of a CFC that meets the definition of Subpart F income is treated as a deemed dividend received by the U.S. shareholder, regardless of whether the income was actually distributed to the shareholder. Subpart F income generally includes passive income such as dividends, interest, royalties, and rents. Subpart F income may also include foreign personal holding company income, services income, shipping income, oil related income, insurance income, and income from certain sales of goods that are neither manufactured nor sold for use in the CFC's home country. In addition, a U.S. shareholder must include in federal income the increase in earnings invested in U.S. property. A U.S. shareholder must treat its CFC's Subpart F income as if the Subpart F income was distributed to the U.S. shareholder in the form of a dividend and must report their pro rata share of the CFC's Subpart F income based on ownership as of the last day of the CFC's taxable year. The basic formula for determining a U.S. shareholder's pro rata share of Subpart F income is illustrated in the attached Appendix A.

The amount of Subpart F income includable in a U.S. shareholder's gross income for any taxable year may not exceed the CFC's earning and profits for the taxable year. The CFC will compute its earnings and profits as if such corporation were a domestic corporation. The amounts reported in financial statements of the foreign companies must be recomputed to clearly reflect income based on U.S. tax accounting principles and methods. Dividends paid out of previously taxed earnings and profits are excluded from Subpart F income. This is referred to as previously taxed income.

<u>Miscellaneous Federal Provisions Relating to CFCs.</u>

- A U.S. shareholder may have dividend income on the sale or exchange of stock in a foreign corporation if at some time during the five years ending on the date of disposition both of the following conditions are met[1]:
  - The U.S. shareholder owned at least a 10% voting interest in the corporation, and
  - The corporation was more than 50% controlled by U.S. persons.
- The U.S. shareholder's basis in the stock of its CFC is increased by the amount of Subpart F income and decreased by any distributions that have been paid out of previously taxed Subpart F income[2].
- A temporary elective 85% dividends received deduction is allowed for cash dividends paid by CFCs to a U.S. corporate shareholder during either of the following two periods[3]:
  - The taxpayer's last tax year that begins before October 22, 2004, or
  - The taxpayer's first tax year that begins during the one-year period beginning on October 22, 2004.
- A credit for taxes imposed by foreign countries may be taken on the federal tax return and is referred to as the "foreign tax credit[4]."
- Foreign base company income and insurance income are excluded from Subpart F income, by election, if it is established that such income was subject to an effective tax rate imposed by a foreign country greater than 90% of the maximum federal corporate tax rate[5]. (High Foreign Tax Rule).

Current State Law

If a taxpayer uses the worldwide unitary method to file its state taxes, its unitary business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that business income is "apportioned" to California. The amount to be apportioned to California is determined by a formula. The formula measures relative levels of business activity in the state using the amounts of the taxpayer's property, payroll, and sales in California. These measures of activities are commonly called "factors." The factors from both domestic and foreign activities are included in the calculation of the apportionment formula.

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[1] Internal Revenue Code (IRC) Section 1248.
[2] IRC section 961.
[3] IRC section 965.
[4] IRC section 960.
[5] IRC section 954(b)(4).

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. There are exceptions to this general rule as certain affiliated foreign corporations, if unitary with an entity that is a water's-edge taxpayer, are includable in the water's-edge combined report (group tax filing). One of these exceptions is an affiliated CFC with Subpart F income.

California conforms to the federal definitions of a CFC and U.S. shareholder, but does not conform to the federal Subpart F provisions discussed in the "Current Federal Law" section above. Instead, state law requires a CFC with Subpart F income to include a portion of its net income[6] and apportionment factors[7] in the water's-edge group tax filing based on an inclusion ratio. The inclusion ratio determines the amount of the CFC's income and apportionment factors included in the water's-edge group tax filing. The numerator of the inclusion ratio is the CFC's current year total Subpart F income[8] and the denominator is the CFC's current year total earnings and profits. In addition, California does not include increases in earnings invested in U.S. property as Subpart F income.

The CFC's net business income, nonbusiness income, and apportionment factors that are included in the U.S. shareholder's water's-edge California income are calculated as follows:

1. CFC's Includable Business Income[9]

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Business Net Income} = \text{CFC's Includable Business Income}$$

2. CFC's Includable Nonbusiness[10] Income

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Nonbusiness Net Income} = \text{CFC's Includable Nonbusiness Income}$$

3. CFC's Includable Apportionment Factors (Property, Payroll, and Sales that relate to Subpart F income

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Factors} = \text{CFC's Includable Apportionment Factors}$$

See Appendix A for an example of the inclusion ratio.

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[6] As reflected on the CFC's current year books and records, adjusted to conform to California tax law.
[7] Property, payroll, and sales. Used to determine percentage used to assign business income to California.
[8] The numerator includes 100% of the CFC's Subpart F income.
[9] Revenue and Taxation Code (R&TC) section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

[10] R&TC section 25120(d) defines nonbusiness income as all income other than business income.

The inclusion ratio cannot fall below zero or exceed 100%. When the above calculations are determined for each CFC, then any CFC with an inclusion ratio between 1-100% is included in the water's-edge group tax filing as a subsidiary and included in the calculation of state taxable income.

The basis of a CFC's stock is determined by using the original cost basis, net of any returns or contributions of capital. No adjustment is made to increase basis in the stock with respect to Subpart F income included in the combined report or to reduce the basis to the extent dividends are declared.

If a dividend is declared, an elimination is allowed under Revenue and Taxation Code (R&TC) section 25106 to the extent the dividend is paid from earnings and profits, which were previously included in the combined report. In addition, any dividends remaining after elimination may qualify for a deduction under R&TC section 24411.

When a water's-edge provision refers to a provision of the IRC, this means the IRC in effect for federal purposes.[11]

Program History/Background

Because of the complexity of the calculations involved in the state's current treatment of Subpart F income, department staff find low taxpayer compliance with the current statutory method. When calculating includable income for a CFC, many taxpayers use the federal "deemed Subpart F dividends" amount as reported on their federal return, rather than using the inclusion ratio to determine the amount of CFC income and factors to be included for California purposes.

Compliance with the law requires all unitary taxpayers to perform the recordkeeping and analysis for each of their CFCs, regardless of whether the result materially affects California tax or not. This requirement is particularly burdensome for taxpayers that do not have a large presence in California because the computations in the partial inclusion ratio are unique to California.

In addition, the CFC inclusion ratio rules are burdensome for the department to administer. Department auditors spend numerous hours recalculating incorrect methods used by taxpayers to include a CFC's income and factors in the water's-edge group tax filing often only to discover that the audit adjustments have minor tax effect. One reason for the minor tax effect is because the taxpayer included the federal Subpart F deemed dividend amount in income, which sometimes results in almost the same tax amount. In addition, any adjustments to the amount of a CFC's income and factors includable in a water's-edge taxpayer's income affects the calculation of the dividend elimination, foreign dividend deduction, foreign investment interest offset, and any deferred intercompany transactions.

This proposal differs from prior years' LP 01-24 and LP 03-23 in that it conforms to the federal Subpart F provisions and allows dividend deductions to offset the Subpart F "deemed" dividend. Executive Management approved LP 01-24 in 2000 and LP 03-23 in 2002. Spidell Publishing and Cal-Tax raised concerns that the proposals lacked factor relief or a dividend-received deduction, resulting in FTB staff withdrawing LP 01-24 and contributing to LP 03-23's rejection by the three-member Franchise Tax Board. This proposal includes conformity to the federal Subpart F provisions and the allowance of a dividend deduction to neutralize the tax effect.

[11] R&TC Section 25116.

Problem

Calculating a CFC's income and apportionment factors for a California water's-edge taxpayer is extremely burdensome—time consuming and expensive—for the taxpayer and the department, resulting in frequent taxpayer misapplications of the law and the need for audit.

Proposed Solution

Simplify the method used to report a water's-edge taxpayer's portion of its CFC's income by conforming to the federal Subpart F rules for computing the amount of a CFC's income that is included in a shareholder's income. This proposal would accomplish the following:

- Remove current law's "stand alone" inclusion ratio method for computing the amount of a CFC's net income and apportionment factors that are included in the water's-edge group tax filing. (Amendment 1).
- Conform to the federal Subpart F provisions and provide that the amount of a CFC's Subpart F income that would be included in a water's-edge taxpayer's income would be treated as a "deemed dividend" eligible for current state law's dividend exclusion and deductions relief[12]. (Amendment 3).
- Provide that a 27% dividend deduction would be allowed against the CFC's Subpart F income included in the water's-edge taxpayer's income. (Amendment 2).
- Add the following transitional rules for conforming to the federal Subpart F provisions: (Amendment 3).
    - Income previously taxed as Subpart F income before this proposal is effective would be considered previously taxed income for state tax purposes.
    - Federal adjustments to the CFC's stock basis before this proposal is effective would become the new stock basis for the CFC for state purposes.
- Specify that state law would not conform to the following rules relating to CFCs: (Amendment 3).
    - The gain from certain sales or exchanges of stock in certain foreign corporations[13],
    - The temporary 85% dividend received deduction for dividends received from CFCs[14].
    - The foreign tax credit[15],
- Specify that if a water's-edge election is terminated, the Subpart F rules would no longer apply and only the previously taxed income and stock basis adjustments accumulated during the water's-edge election would be allowed. (Amendment 3).
- Add that the High Foreign Tax Rule election would be valid for state purposes only if a valid election was made for federal purposes. (Amendment 3).

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[12] Revenue and Taxation Code (R&TC) Section 24344, 24410, 24411, and 25106.
[13] Internal Revenue Code (IRC) Section 1248.
[14] IRC section 965.

[15] IRC section 960.

- Specify that the Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the provisions of this proposal. (Amendment 3).

Effective/Operative Date of Solution

If this proposal were enacted as a tax levy during the 2008 legislative session, it would be effective upon enactment and operative for taxable years beginning on or after January 1, 2008. In the event that two or more water's-edge taxpayers have different taxable years, this proposal would apply as of the first day of the first taxable year that begins on or after January 1, 2008, of those respective taxpayers.

Justification

This proposal would eliminate the complexities with using current state law's CFC partial inclusion rules for calculating how much of a CFC's income and factors to include in the taxable income of a water's-edge taxpayer and allow taxpayer's to use the federal Subpart F rules—an amount the taxpayers have already calculated for their federal tax return.

Implementation

Implementing this proposal would require some changes to existing tax form instructions and publications, which could be accomplished during the normal annual update.

Fiscal Impact

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

Economic Impact

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following net revenue impact.

Estimated Revenue Impact of LP 08-03 Effective for Taxable Years BOA 1/1/08 ***Enactment Assumed After 6/30/08***		
2008-09	2009-10	2010-11
<-$500,000	<-$500,000	<-$500,000

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

Tax Revenue Discussion

The revenue impact of the proposal would depend on the difference in amounts of net CFC income included in the water's-edge group tax filing under current state law (partial inclusion of subpart F income and unitary factors) versus federal law's provisions (Subpart F income treated as a deemed dividend).

The estimate was derived in the following steps:

1. Selected a statistically representative sample of water's-edge filers reporting CFC income (Forms 100W–Water's Edge Filers or the 2004 taxable year);
2. Calculated the change in tax (increase or decrease) if each filer reported Subpart F income according to the proposal;
3. Multiplied the calculated tax change for each corporation by its respective weight and summed the results: a revenue gain of $21.4 million;
4. Assumed the approximate revenue offset for the taxpayer favorable transitional rules: a revenue loss of $3 million;
5. Calculated a dividends-received deduction that would result in a roughly revenue neutral tax impact for the proposal: 27% dividends deduction.

Using data from 2004, conforming to the federal deemed dividend rules result in a revenue gain of $21.4 million. This revenue gain would be reduced somewhat by proposed transition rules: (1) income previously taxed as Subpart F income before this proposal is effective would be considered previously taxed income for state purposes, and (2) federal adjustments to the stock basis of a CFC before this proposal is effective would become the new stock basis for the CFC for state purposes. For purposes of an estimate, it is assumed the revenue reduction is approximately $3 million annually. This assumption is based on discussions with knowledgeable audit and legal department staff. This impact could drop in future years beyond those for which estimates are developed here. Using data from 2004, taxpayers allowed a 27% dividends-received deduction for Subpart F income would result in a minor net revenue loss of less than $500,000 for the proposal.

For each component of the estimate, except for the impact for transition rules, the tax effect is grown by the forecast in corporate profits as projected by the Department of Finance. The 2009 taxable year results are presented in the table below, as this is the first year that both calendar year and fiscal year filers would be represented.

Estimated Revenue Effects Projected to the 2009 Taxable Year Level ($ in Millions)	
Conformity with federal rules	+$34.1
Transitional rules	-$ 3.0
Dividend-received deduction	-$31.6
Net Impact for 2009	-$ 0.5

Although the net tax effect for the proposal is roughly revenue neutral, most corporations in the sample would experience a tax decrease.

<u>Other States</u>

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Research was performed to determine if these states conform to the federal Subpart F provisions.

Florida uses federal taxable income as the starting point for computing *Florida* taxable income and requires Subpart F income to be excluded from *Florida* taxable income. *Illinois* adopts federal law and includes federal Subpart F income subject to Illinois state tax. *Massachusetts* adopts federal tax law and follows the federal treatment of Subpart F income. *Massachusetts's* Supreme Court held that the amount of Subpart F income that is included in a corporation's federal gross income is treated as a dividend for *Massachusetts's* corporate income tax and a dividend deduction is allowed against such income. *Michigan*, effective January 1, 2008, includes dividends and royalties received from foreign operating entities, including Subpart F income, in the computation of taxable income. *Minnesota* includes Subpart F income in the computation of *Minnesota* taxable income with modifications. *New York's* starting point for computing a corporation's tax base is federal taxable income, which includes federal Subpart F income.

Research found that none of these states use an inclusion ratio for calculating the amount of a CFC's income that is subject to tax.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS
LP 08-03

AMENDMENT 1

SECTION 1: Section 25110 of the Revenue and Taxation Code is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b), that is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer, that makes a water's-edge election on or after January 1, 2006, shall take into account that portion of its own income and apportionment factors and the income and apportionment factors of its affiliated entities to the extent provided below:

(1) The entire income and apportionment factors of any of the following corporations:

(A) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code.

(D) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(2) ~~(A)~~ With respect to a corporation that is not described in subparagraphs (A), (B), (C), and (D) of paragraph (1), ~~as provided in either one or both of the following clauses:~~

~~(i) T~~<u>t</u>he income and apportionment factors of that corporation to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to, and determined from, the books of account maintained by the corporation with respect to its activities conducted within the United States.

~~(ii) The income and apportionment factors of that corporation that is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, to the extent determined by multiplying the income and apportionment factors of that corporation without application of this subparagraph by a fraction not to exceed one, the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year.~~

~~(B) For purposes of this paragraph, both of the following apply:~~

~~(i) "Subpart F income" means "Subpart F income" as defined in Section 952 of the Internal Revenue Code.~~

~~(ii) "Earnings and profits" means "earnings and profits" as described in Section 964 of the Internal Revenue Code.~~

(3) The income and apportionment factors of the corporations described in this subdivision shall be taken into account only to the extent that they would have been taken into account had no election under this section been made.

~~(4) The Franchise Tax Board shall prescribe regulations to coordinate implementation of subparagraph (A) of paragraph (2) to prevent multiple inclusion or exclusion of income and factors in situations where the same item of income is described in both clauses.~~

(b) For purposes of this article and Section 24411, all of the following definitions apply:

(1) An "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A "qualified taxpayer" means a corporation that does both of the following:

(A) Files with the state tax return, on which the water's-edge election is made, a consent to the taking of depositions, at the time and place most reasonably convenient to all parties, from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board, as provided in Section 19504, by the State Board of Equalization, as provided in Section 5005 of Title 18 of the California Code of Regulations, or by the courts of this state, as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses that a taxpayer may otherwise have. The consent shall remain in effect as long as the water's-edge election is in effect, and shall be limited to providing that information necessary to review or adjust income or deductions in a manner authorized by Section 482, 861, Subpart F of Part III of Subchapter N, or similar provisions, of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that, for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on, or measured by, net income in that state. If a state does not impose a tax on, or measured by, net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on, or measured by, net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

AMENDMENT 2

SEC. 2 Section 24411 of the Revenue and Taxation Code is amended to read:

24411. (a) For purposes of those taxpayers electing to compute income under Section 25110, to the extent not otherwise allowed as a deduction or eliminated from income:

(1) 100 percent of the qualifying dividends described in subdivision ~~(c)~~(d), ~~and~~

(2) 27 percent of qualifying dividends described in Section 25117, and

(3) 75 percent of ~~other~~ qualifying dividends, other than those referred to in paragraphs (1)or(2). ~~to the extent not otherwise allowed as a deduction or eliminated from income~~.

(b) "Qualifying dividends" means those received by the water's-edge group from corporations if both of the following conditions are satisfied:

(1) The average of the property, payroll, and sales factors within the United States for the corporation is less than 20 percent.

(2) More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group.

~~(b)~~ (c) The water's-edge group consists of corporations whose income and apportionment factors are taken into account pursuant to Section 25110.

~~(c)~~(d) Dividends derived from a construction project, the location of which is not subject to the taxpayer's control.

For purposes of this subdivision:

(1) "Construction project" means any activity which meets the following requirements:

(A) Is undertaken for any entity, including a governmental entity, which is not affiliated with the taxpayer.

(B) The majority of its cost of performance is attributable to an addition to real property or an alteration of land or any improvement thereto as those terms are utilized for purposes of this code.

"Construction project" does not include the operation, rental, leasing, or depletion of real property, land, or any improvement thereto.

(2) "Location of which is not subject to the taxpayer's control" means that the place at which the majority of the construction takes place results from the nature or character of the construction project and not as a result of the terms of the contract or agreement governing the construction project.

AMENDMENT 3

SEC. 3. Section 25117 of the Revenue and Taxation Code is added to read:

25117. (a) Except as otherwise provided, income taken into account by all affiliated entities whose income and apportionment factors are determined pursuant to Section 25110 shall include income described in Subpart F of the Internal Revenue Code (commencing with Section 951). The income that is taken into account shall for all purposes be treated as a dividend actually paid, and be subject to any provision or limitation related to the treatment of dividends, including, but not limited to, Sections 24344, 24410, 24411, and 25106. The amount taken into account shall be treated as business or nonbusiness income (as defined in Section 25120), as the case may be.

(b) In the application of Subpart F of the Internal Revenue Code:

(1) Exclusions from gross income under Section 959 of the Internal Revenue Code, relating to previously taxed income, shall apply, including amounts related to income previously taxed under federal law in years prior to the water's edge election.

(2) Federal adjustments to stock basis made pursuant to Section 961 of the Internal Revenue Code, relating to adjustments to basis of stock in controlled foreign corporations and of other property, including adjustments made prior to the water's edge election, shall apply.

(3) The provisions of and any reference to Section 1248 of the Internal Revenue Code, relating to gain from certain sales or exchanges of stock in certain foreign corporations, shall not apply.

(4) Section 960 of the Internal Revenue Code, relating to special rules for foreign tax credit, shall not apply.

(5) Section 965 of the Internal Revenue Code, relating to temporary dividends received deduction, shall not apply.

(6) For purposes of this section, a federal election to exclude from Subpart F income the income described in Section 954(b)(4) of the Internal Revenue Code shall apply, including amounts related to income previously taxed under federal law in years prior to the water's edge election. No election under this subparagraph shall be allowed for state purposes unless a valid election was made for federal purposes.

(c) In the event that a water's-edge election is terminated, for taxable years thereafter, the following rules apply:

(1) Subpart F of the Internal Revenue Code shall not apply, except as provided in this subdivision.

(2) Section 959 of the Internal Revenue Code, relating to exclusion from gross income of previously taxed earnings and profits, shall apply, but only to the extent attributable to income that has been taken into account pursuant to subdivision (a) during the period of the water's edge election.

(3) Stock basis shall be determined as if this section did not apply, except that stock basis shall be--

(A) Increased by income taken into account pursuant to subdivision (a) during the period of the water’s edge election, and

(B) Reduced by the following:

(i) That portion of amounts excluded from income under paragraph (2) of subdivision (b) that are attributable to income taken into account pursuant to subdivision (a) during the period of the water’s edge election, and

(ii) Amounts described by paragraph (2) of subdivision (c) excluded from income after termination of the water’s edge election.

(d)(1) Except as provided in paragraph (2) this section shall apply to taxable years beginning on or after January 1, 2008.

(2) In the event that two or more taxpayers subject to the same election under section 25110 have different taxable years, this section shall apply as of the first day of the first taxable year of those respective taxpayers that begins on or after January 1, 2008.

(e) The Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the purposes of this Section.

APPENDIX A

Federal Treatment: The Basic Formula For Determining A U.S. Shareholder's Pro Rata Share Of Subpart F Income

U.S. Shareholder's Shares / Total Outstanding Shares	X	Subpart F Income of the CFC	=	Amount of Subpart F Income Treated As A Deemed Dividend

For example:

Shareholder Y, a domestic corporation, owns 60 percent (60 shares/100 total shares outstanding) of a CFC. The CFC generated $100,000 of subpart F income for the taxable year. Shareholder Y's pro rata share of the CFC's subpart F income is $60,000 (60% x $100,000). The $60,000 is reported in Shareholder Y's federal tax return as a deemed dividend included in taxable income.

California Treatment: Inclusion Ratio Example

CFC, Inc. is a unitary foreign subsidiary with subpart F income of $60,000 and current earnings and profits of $120,000. CFC, Inc. has $100,000 of net business income, $50,000 of net nonbusiness income, property with an historic cost of $150,000, payroll of $75,000 and total sales everywhere of $300,000. The following amounts from the CFC would be included in the water's-edge group tax filing:

- $50,000 of the CFC's business income ($60,000/$120,000 x $100,000).
- $25,000 of the CFC's nonbusiness income ($60,000/$120,000 x $50,000).
- $75,000 of property in the denominator of the property factor (($60,000/$120,000 x $150,000)
- $37,500 of payroll in the denominator of the payroll factor (($60,000/$120,000 x $75,000)
- $150,000 of sales in the denominator of the sales factor. ($60,000/$120,000 x $300,000).

The inclusion ratio cannot fall below zero or exceed 100%. Once the above calculations are determined for each owned CFC, then any CFC with an inclusion ratio between 1-100% is included in the water's-edge combined report as a subsidiary and included in the calculation of state taxable income.

Taxpayer Proposal 07-1
REDUCE COMPLEX TAX RETURN FILINGS/INCREASE STANDARD DEDUCTION AND ELIMINATE PERSONAL EXEMPTION
Staff Actions Since Last Board Meeting

Former Board Member Betty Yee requested at the Taxpayers' Bill of Rights Hearing held on November 28, 2007, that staff provide a distributional impact analysis of the taxpayer proposal that would both increase the standard deduction amount to $7,406 for a single or married filing separate taxpayer ($14,812 for married filing a joint return) and eliminate the personal exemption.

Impact of TP 07-1 - Increase Standard Deduction and Eliminate Exemption Credit
Impacts Calculated at 2004 Levels

Quintile	AGI range	Current law tax (Billions)	Current law average tax per taxpayer	Proposed law tax (Billions)	Proposed law average tax per taxpayer	Percentage change in tax
Bottom Quintile	zero to $13,099	$25	$9	$31	$11	25.8%
2nd Quintile	$13,100 to $25,599	$203	$75	$210	$77	3.6%
3rd Quintile	$25,600 to $43,399	$1,008	$368	$962	$351	-4.6%
4th Quintile	$43,400 to $75,799	$3,416	$1,251	$3,343	$1,224	-2.1%
Top Quintile	$75,800 and above	$31,443	$11,509	$31,533	$11,542	0.3%
Total		$36,095	$2,642	$36,079	$2,641	0.0%

The chart above shows the impact this proposal would have for taxpayers at different income levels. The taxpayers impacted the most by this proposal are those with adjusted gross income (AGI) in the bottom quintile; these taxpayers would have a 25.8% tax increase. The reason for the tax increase is taxpayers with smaller AGI generally benefit from a tax credit versus a deduction.

TAXPAYER PROPOSAL 07-01
EXECUTIVE SUMMARY

- **Title:** Reduce Complex Tax Return Filings/Increase Standard Deduction and Eliminate Personal Exemption

- **Problem:** Taxpayers claiming itemized deductions over the standard deduction must prepare a more complex return.

- **Proposed Solution:** Raise the standard deduction amount from $3,410 for single or married/RDP filing a separate return to $7,406 (from $6,820 to $14,812 for married/RDP filing a joint return) and eliminate the personal exemption to encourage taxpayers to claim the standard deduction instead of itemizing deductions.

- **Major Concern/Issue:** Even with the higher standard deduction amounts, there will be taxpayers still itemizing deductions. The taxpayers claiming itemized deductions will lose personal exemption amounts without any benefit. Therefore, for these taxpayers this proposal would be a tax increase.

- **Revenue:** This proposal would result in the following revenue losses:

Revenue Estimate for TP 07-01 Effective On Or After January 1, 2008 Assumed Enactment Early 2008 ($ In Millions)			
	2007/2008	2008/2009	2009/2010
Raise Standard Deduction & Eliminate Personal Exemption	-$6	-$12	-$7

2007 Taxpayer Bill of Rights Legislative Proposal
TP 07-01

<u>Suggested By:</u> Roland Boucher, United Californians for Tax Reform

<u>Title</u>

Reduce Complex Tax Return Filings/Increase Standard Deduction and Eliminate Personal Exemption

<u>Introduction</u>

This proposal would raise the standard deduction amount to $7,406 for a single or married filing separate ($14,812 for married filing a joint return) and eliminate the personal exemption.

<u>Current Federal Law</u>

<u>Personal Exemption</u>

Existing federal law provides for a personal exemption subject to income limitations. The personal exemption was originally enacted by Congress in 1948 to compensate for the increase in the cost of living brought about by post-war conditions. It continued thereafter to ensure that every family would enjoy a modest level of income free of tax and also to simplify compliance and enforcement with the individual income tax by removing low-income families from the tax rolls. A personal exemption is a statutorily set amount that is treated as a deduction from Adjusted Gross Income (AGI). The personal exemption amount is indexed annually for inflation and was $3,300 for the 2006 tax year. The personal exemption begins to phase out at federal AGI levels in excess of the amounts listed below:

Filing Status	AGI (2006)
Married Filing Separate	$112,875
Single	$150,500
Head of Household	$188,150
Married Filing Joint/Qualifying widow(er)	$225,750

The personal exemption amount is reduced by 2% for every $2,500 ($1,250 for married filing a separate return).

<u>Standard Deduction</u>

Existing federal laws allow individuals to choose between a standard deduction and itemized deductions. The standard deduction is a dollar amount that reduces the amount of taxable income on which an individual is taxed, thereby reducing the total income for the taxpayer. Congress enacted the standard deduction in 1944 for the purpose of simplifying the preparation and audit of individual tax returns. It simplifies individual tax returns in situations where a taxpayer's itemized deductions are only a modest fraction of the amount available to pay for the individual's living expenses.

The standard deduction, along with personal and dependency exemptions, plays an important role in increasing the progressivity of the tax system by exempting from the income tax those individuals and families whose incomes are below or only slightly above the poverty level. For the 2006 tax year, the standard deduction was $5,150 for single or married filing a separate return, $10,300 for married filing a joint return, and $7,550 for head of household.

Individuals are allowed itemized deductions such as medical expenses in excess of 7.5% of AGI, charitable contributions, mortgage interest, and specific taxes. Certain other expenses, including those for the production of income and certain employee business expenses, are considered miscellaneous itemized deductions and only the amount that exceeds 2% of AGI may be deducted. In addition, itemized deductions may be further limited for high-income taxpayers via phase-out limitations based on AGI.

Current State Law

Existing state law requires married or Registered Domestic Partner (RDP) taxpayers to file an income tax return if they are filing a joint return and have a combined adjusted gross income (AGI) of $21,840 or gross income of $27,426. Single or married filing separate taxpayers are required to file an income tax return if they have AGI in excess of $10,970 or gross income of $13,713.

These amounts applied for the 2006 tax year and are indexed annually for inflation. Individuals who have less income than the filing thresholds are not required to file an income tax return because the standard deduction and personal exemption credit eliminate any tax liability.

Exemption Credit

State law provides exemption credits, including a personal exemption credit and exemption credits for dependents, blind persons, and individuals 65 or older. Unlike federal law, these exemptions are not deductions from AGI but are credits against tax. The personal exemption amounts for the 2006 tax year were $182 for taxpayers filing a joint return and $91 for all other filers.

The exemption credit amounts are indexed annually for inflation. The exemption credits are not refundable and may not be carried over to future years. Exemption credits begin to phase out at federal AGI levels in excess of the amounts listed below:

Filing Status	AGI (2006)
Single/Married(RDP) Filing Separate	$150,743
Head of Household	$226,119
Married(RDP) Filing Joint/Qualifying widow(er)	$301,491

The exemption credit amount is reduced by six dollars for every $2,500 ($1,250 for married filing a separate return) that the taxpayer's federal AGI exceeds the above threshold amounts, not to exceed the full amount of the credit. Taxpayers filing a joint return or as a surviving spouse must reduce their credit by $12 for every $2,500.

Standard Deduction

Existing state laws allow individuals to choose between a standard deduction and itemized deductions. For the 2006 tax year, the standard deduction was $3,410 for single or married/RDP filing a separate return and $6,820 for married/RDP filing a joint return or for head of household.

The forms and instructions for the federal and state tax returns provide the annually indexed amounts of the personal exemption and standard deduction for taxpayers each year so that the taxpayers can use the tax tables or the tax computation worksheets in the instructions to calculate the amount of tax due.

Problem

Taxpayers claiming itemized deductions over the standard deduction must prepare a more complex return.

Proposed Solution

Raise the standard deduction amount from $3,410 for single or married/RDP filing a separate return to $7,406 (from $6,820 to $14,812 for married/RDP filing a joint return) and eliminate the personal exemption to encourage taxpayers to claim the standard deduction instead of itemizing deductions.

Effective/Operative Date of Solution

Assuming this proposal is enacted as a tax levy, it would be effective upon enactment and would be operative for taxable years beginning on or after January 1 of the year the law is effective. If enacted in 2008 as a tax levy, the change would be operative for taxable years beginning on or after January 1, 2008.

Justification

By increasing the standard deduction this proposal would streamline income tax reporting for many taxpayers who now must itemize.

Implementation

Implementing this proposal would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

Fiscal Impact

Taxpayer Costs

This proposal would switch approximately 1.19 million taxpayers from itemizing deductions to the standard deduction. The time and costs associated with tax preparation for these taxpayers may be reduced by this proposal.

Departmental Costs

No significant departmental costs are associated with this proposal

Tax Revenue Estimate

Based on data and assumptions discussed below, the Personal Income Tax and Corporation Tax revenue loss from this bill would be as follows:

Estimated Revenue Impact Of TP 07-01 Effective On Or After January 1, 2008 Enactment Assumed Early 2008 ($ in Millions)			
	2007-2008	2008-2009	2009-2010
Raise Standard Deduction & Eliminate Personal Exemption	-$6	-$12	-$7

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

Tax Revenue Discussion:

This revenue estimate is based on the department's latest microsimulation tax model. These provisions are estimated to impact approximately 9 million taxpayers. The estimated impact for tax year 2008 is $16 million.

This proposal would have two impacts on tax liability. First, this proposal would increase the standard deduction substantially above current law levels, helping those taxpayers who do not currently itemize and some of those who do itemize, but take an itemized deduction less than the proposed new standard deduction amounts. It is estimated that if this provision were enacted by itself, it would reduce tax liabilities for 2008 by $1.2 billion. It is also estimated that this provision would cause approximately 1.19 million taxpayers to switch from itemizing their deductions to taking the standard deduction.

Second, this proposal would eliminate the personal exemption credit. If this provision were enacted by itself, it would generate a revenue gain for tax year 2008 of $1.28 billion.

This estimate was adjusted to reflect the interaction between the two provisions in this proposal that could mitigate the impact when applied separately. In addition, the two provisions in this proposal could grow and fluctuate at different rates each year, resulting in the net impact being negative even though the sum of the two proposals taken separately is positive.

The revenue impact has been estimated for years beyond 2008. These liability-year numbers have been converted to fiscal-year numbers in the table above.

Other States

The states surveyed include *Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Illinois does not allow standard or itemized deductions.

Massachusetts has certain deductions and exemptions instead of allowing itemized deductions. *Massachusetts* does not allow standard deductions.

Michigan allows standard and itemized deductions. For the 2006 tax year, the standard deduction amount for single is $5,150, for married filing a joint return is $10,300, and for head of household is $7,550.

New York allows standard and itemized deductions. For the 2006 tax year, the standard deduction amount for single is $7,500, for married filing a joint return is $15,000, and for head of household is $10,500.

Policy Consideration

Even with the higher standard deduction amounts, there will be taxpayers still itemizing deductions. The taxpayers claiming itemized deductions will lose personal exemption amounts without any benefit. Therefore, for these taxpayers this proposal would be a tax increase.

Additional Comments

The idea behind this proposal is to reduce the complexity of filing returns for taxpayers. Taxpayers complete their federal returns before preparing the California return. The actual burden for taxpayers is when they complete the federal returns, not the state returns. This proposal could result in taxpayers claiming itemized deductions for their federal returns and claiming standard deductions for their state returns, resulting in more complexity for the taxpayers and the department.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO TP 07-1

AMENDMENT 1

Section 17073.5 of the Revenue & Taxation Code is amended as follows:

17073.5. (a) A taxpayer may elect to take a standard deduction as follows:

(1) In the case of a taxpayer, other than a head of a household or a surviving spouse (as defined in Section 17046) or a married couple filing a joint return, the standard deduction shall be ~~one thousand eight hundred eighty dollars ($1,880)~~ seven thousand four hundred six dollars ($7,406).

(2) In the case of a head of household or a surviving spouse (as defined in Section 17046) or a married couple filing a joint return, the standard deduction shall be ~~three thousand seven hundred sixty dollars ($3,760)~~ fourteen thousand eight hundred twelve dollars ($14,812).

(b) The standard deduction provided for in subdivision (a) shall be in lieu of all deductions other than those which are to be subtracted from gross income in computing adjusted gross income under Section 17072.

(c) (1) The provisions of this section shall be applied in lieu of the provisions of Sections 63(c) and 63(f) of the Internal Revenue Code, relating to standard deductions.

(2) Notwithstanding paragraph (1), Section 63(c)(5) of the Internal Revenue Code, relating to limitations on the standard deduction of certain dependents, and Section 63(c)(6) of the Internal Revenue Code, relating to certain individuals not eligible for the standard deduction, shall apply, except as otherwise provided. For purposes of this paragraph, the amount specified in Section 63(c)(5) of the Internal Revenue Code shall be adjusted for inflation in accordance with the provisions of Section 63(c)(4) of the Internal Revenue Code.

(d) For each taxable year beginning on or after January 1, 1988, the Franchise Tax Board shall recompute the standard deduction amounts prescribed in subdivision (a). That computation shall be made as follows:

(1) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(2) The Franchise Tax Board shall compute an inflation adjustment factor by adding 100 percent to that portion of the percentage change figure which is furnished pursuant to paragraph (1) and dividing the result by 100.

(3) The Franchise Tax Board shall multiply the standard deduction amounts in the preceding taxable year by the inflation adjustment factor determined in paragraph (2), and round off the resulting products to the nearest one dollar ($1).

(4) In computing the standard deduction amounts pursuant to this subdivision, the amount provided in paragraph (2) of subdivision (a) shall be twice the amount provided in paragraph (1) of subdivision (a).

AMENDMENT 2

Section 17054 of the Revenue & Taxation Code is amended as follows:

17054. In the case of individuals, the following credits for personal exemption may be deducted from the tax imposed under Section 17041 or 17048, less any increases imposed under paragraph (1) of subdivision ~~(d)~~ (b) or paragraph (1) of subdivision ~~(e)~~ (c), or both, of Section 17560.

~~(a) In the case of a single individual, a head of household, or a married individual making a separate return, a credit of fifty-two dollars ($52).~~

~~(b) In the case of a surviving spouse (as defined in Section 17046), or a husband and wife making a joint return, a credit of one hundred four dollars ($104). If one spouse was a resident for the entire taxable year and the other spouse was a nonresident for all or any portion of the taxable year, the personal exemption shall be divided equally.~~

~~(c)~~ (a) In addition to any other credit provided in this section, in the case of an individual who is 65 years of age or over by the end of the taxable year, a credit of fifty-two dollars ($52).

~~(d)~~ (b) (1) A credit of two hundred twenty-seven dollars ($227) for each dependent (as defined in Section 17056) for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents. The credit allowed under this subdivision for taxable years beginning on or after January 1, 1999, shall not be adjusted pursuant to subdivision (i) for any taxable year beginning before January 1, 2000.

(2) The credit allowed under paragraph (1) may not be denied on the basis that the identification number of the dependent, as defined in Section 17056, for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents, is not included on the return claiming the credit.

~~(e)~~ (c) A credit for personal exemption of fifty-two dollars ($52) for the taxpayer if he or she is blind at the end of his or her taxable year.

~~(f)~~ (d) A credit for personal exemption of fifty-two dollars ($52) for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

~~(g)~~ (e) For the purposes of this section, an individual is blind only if either

(1) his or her central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or

(2) his or her visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

~~(h)~~ (f) In the case of an individual with respect to whom a credit under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the credit amount applicable to that individual for that individual's taxable year is zero.

~~(i)~~ (g) For each taxable year beginning on or after January 1, 1989, the Franchise Tax Board shall compute the credits prescribed in this section. That computation shall be made as follows:

(1) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index as modified for rental equivalent home ownership for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(2) The Franchise Tax Board shall add 100 percent to the percentage change figure which is furnished to them pursuant to paragraph (1), and divide the result by 100.

(3) The Franchise Tax Board shall multiply the immediately preceding taxable year credits by the inflation adjustment factor determined in paragraph (2), and round off the resulting products to the nearest one dollar ($1).

(4) In computing the credits pursuant to this subdivision, the credit provided in subdivision (b) shall be twice the credit provided in subdivision (a).

2008 Taxpayer Bill of Rights Legislative Proposal
TP 08-01

<u>Taxpayer Bill of Rights Hearing: November 28, 2007</u>
<u>Suggested By:</u> Gina Rodriguez, Spidell Publishing, Inc.

<u>Title</u>

Study of the personal income tax (PIT) estimated tax penalty threshold.

<u>Introduction</u>

This proposal explores the impact of increasing the PIT estimated tax penalty threshold amount.

<u>Current State and Federal Law</u>

Existing federal law requires estimated tax payments if both of the following apply:

- Tax is expected to be at least $1,000 after subtracting withholding and credits.
- Withholding and credits are expected to be less than the smaller of 90% of current year's tax or 100% (110% for higher income taxpayers[1]) of prior years' tax.

For any PIT underpayment of estimated tax, federal law provides that a penalty equal to the current interest rate[2] will be assessed on the underpaid amount for the period of underpayment. Federal law provides an exception to the penalty if the total tax after applied credits is less than $1,000.

California law generally conforms to federal law and requires estimated tax payments if both of the following apply:

- Tax is expected to be at least $200 ($100 if married/RDP filing separate) after subtracting withholding and credits.
- Withholding and credits are expected to be less than the smaller of 90% of current years' tax, or 100% (110% for higher income taxpayers) of prior years' tax.

California law also provides an exception to the penalty. If the total tax after application of credits is less than $200 ($100 if married/RDP filing separate) for the preceding or current taxable year, a penalty is not assessed.

[1] Adjusted gross income for the prior year was more than $150,000 or $75,000 if married filing separate.
[2] The interest rate charged on underpayments of the personal income tax is 8% for the period of 1/1/08 to 6/30/08.

Study

For the 2006 taxable year the department identified approximately 42,428 returns that had a tax liability ranging from $200 to $1,000 that were assessed the estimated tax penalty. The table below provides a breakdown of the average penalty amount for tax liabilities ranging from $200 to $1,000.

Total Tax Liability Ranges	Total Return Count	Total Estimate Penalty Amount	Average Penalty Amount
$200 - $300	5160	$46,640.07	$9.04
$301 - $400	5629	$63,635.79	$11.30
$401 - $500	5641	$71,955.48	$12.76
$501 - $600	5217	$72,289.49	$13.86
$601 - $700	5170	$72,248.74	$13.97
$701 - $800	5162	$82,242.27	$15.93
$801 - $900	5347	$91,447.76	$17.10
$901 - $1000	5102	$91,191.08	$17.87
Totals	**42,428**	**$591,650.68**	**$13.94**

Problem

According to the proponent, the department is wasting department, taxpayer, and tax professional resources by mailing billing notices for small penalty amounts.

Proposed Solution

Increase the threshold for imposing the estimated tax penalty from $200 ($100 if married/RDP filing separate) after subtracting withholding and credits to $500 ($250 if married/RDP filing separate).

Effective/Operative Date of Solution

Assuming this proposal is enacted as a tax levy, it would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1 of the year immediately after the year the law is effective.

Justification

Staff recommends the threshold be raised to $500 because it would reduce the number of notices sent by the department for small penalty amounts and save resources for the department, taxpayers, and tax professionals. For the 2006 taxable year, staff identified approximately 16,430 returns with a tax liability of $500 or less and an average estimated tax penalty of $11.

Increasing the threshold amount for the estimated tax penalty from $200 to $500 would result in cost savings of approximately $91,300 for processing, printing, mailing, and personnel costs. (See Fiscal Impact below.) There would be a resultant revenue loss of $250,000 per year. (See Tax Revenue Estimate below.) The annual net fiscal impact to the state from this proposal would be a revenue loss of approximately $158,700 ($250,000 - $91,300).

Implementation

Implementing this proposal would require some changes to existing tax forms and instructions and information systems, which would be accomplished during the normal annual update.

Fiscal Impact

Departmental Cost Savings

By increasing the threshold for imposing the estimated tax penalty to $500, each year this proposal would both reduce the number of estimated tax penalties assessed and decrease the number of billing notices by approximately 16,430. As a result, the department would realize cost savings from mailing, printing, personnel, service center correspondence, and payment processing of approximately $91,300.

Tax Revenue Estimate

Based on data and assumptions below, the revenue loss from this proposal would be as follows:

Estimated Revenue Impact from Increasing The Estimated Tax Penalty Threshold Effective for Tax Years BOA January 1, 2009			
Threshold	2008-09	2009-10	2010-11
$500	-$500,000	- < $250,000	- < $250,000

This estimate does not account for changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

Under current law, the penalty for underpayment of estimated tax is assessed on PIT returns if the total tax liability exceeds $200. This proposal would increase the threshold to assess this penalty for taxable years beginning on or after January 1, 2009.

The revenue impact of this proposal would be determined by the reduction in the amount of estimated tax penalties that would be assessed on PIT returns and any deceleration of revenue because some taxpayers will choose to stop making estimated tax payments.

Penalty Loss

Based on departmental data for taxable year 2006, taxpayers with total tax less credits and withholding that ranged from $201 to $500 were assessed approximately $182,000 in penalties for underpayment of estimated tax. This estimate assumes a growth of 2% in assessed penalties from 2006 to 2011, based on estimated growth in personal income tax returns filed, This would result in approximately $193,000 in penalties that would no longer be imposed for tax year 2009.

Whether the penalty is paid when the return is filed, or the taxpayer is billed and pays through collection, the penalties received will accrue back to the date the return was due, April 15, 2010. It is assumed that 95% of the amount due would ultimately be collected. This would result in a revenue loss of approximately $183,000 for the 2009 tax year ($193,000 x 95%). The first impacted tax return would be the 2009 taxable year, which cannot be filed until after January 1, 2010.

Deceleration

In addition, there would be a deceleration of revenue, as some taxpayers will choose not to make estimated tax payments because of the change in the penalty rules. It is assumed that a small percentage, approximately 5%, of these taxpayers will take advantage of this new law and reduce or eliminate their estimated payments. The amount of deceleration is shown in the table above as the 2008-09 revenue loss of approximately $500,000. There will be a slight revenue loss (less than $50,000) in subsequent years. .

Total Losses

The 2009-10 and 2010-11 fiscal years would each have a revenue loss rounded up to less than - $250,000 (penalty revenue loss of $183,000 + deceleration of $50,000 = - $233,000).

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FRANCHISE TAX BOARD'S PROPOSED AMENDMENTS TO TP 08-01

AMENDMENT 1

Section 19136 of the Revenue & Taxation Code is amended as follows:

19136. (a) Section 6654 of the Internal Revenue Code, relating to failure by an individual to pay estimated income tax, shall apply, except as otherwise provided.

(b) Section 6654(a)(1) of the Internal Revenue Code is modified to refer to the rate determined under Section 19521 in lieu of Section 6621 of the Internal Revenue Code.

(c) (1) Section 6654(e)(1) of the Internal Revenue Code, relating to exceptions where the tax is a small amount, does not apply.

(2) No addition to the tax shall be imposed under this section if the tax imposed under Section 17041 or 17048 and the tax imposed under Section 17062 for the preceding taxable year, minus the sum of any credits against the tax provided by Part 10 (commencing with Section 17001) or this part, or the tax computed under Section 17041 or 17048 upon the estimated income for the taxable year, minus the sum of any credits against the tax provided by Part 10 (commencing with Section 17001) or this part, is less than ~~two hundred dollars ($200)~~five hundred dollars ($500), except in the case of a separate return filed by a married person the amount shall be less than ~~one hundred dollars ($100)~~ two hundred and fifty dollars ($250).

(d) Section 6654(f) of the Internal Revenue Code does not apply and for purposes of this section the term "tax" means the tax imposed under Section 17041 or 17048 and the tax imposed under Section 17062 less any credits against the tax provided by Part 10 (commencing with Section 17001) or this part, other than the credit provided by subdivision (a) of Section 19002.

(e) The credit for tax withheld on wages, as specified in Section 6654(g) of the Internal Revenue Code, shall be the credit allowed under subdivision (a) of Section 19002.

(f) This section shall apply to a nonresident individual.

(g) (1) No addition to tax shall be imposed under this section to the extent that the underpayment was created or increased by any provision of law that is chaptered during and operative for the taxable year of the underpayment.

(2) Notwithstanding Section 18415, this section applies to penalties imposed under this section on and after January 1, 2005.