

Request for Permission to Proceed with the Formal Regulatory Process to Adopt Proposed Regulation Section 17052.6, Relating to the Child and Dependent Care Expenses Credit

California Revenue and Taxation Code (RTC) section 17052.6 provides for a tax credit based on a percentage of the qualifying employment-related expenses incurred by the taxpayer for household or dependent care services which allow the taxpayer to work or seek employment. The requirements for claiming this credit, known as the Child and Dependent Care Expenses (CDC) Credit, are set forth in RTC section 17052.6 by reference to Internal Revenue Code (IRC) section 21. While Federal Treasury Regulation section 1.21-1(k) generally mandates that a taxpayer must maintain adequate records or other sufficient evidence to substantiate entitlement to the CDC credit, the proposed regulation would clarify the specific requirements for records for the CDC credit as a means of assisting taxpayers.

This regulation is authorized by RTC section 19503, which provides in subdivision (a) that "[t]he Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with Section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), and this part and may prescribe the extent to which any ruling (including any judicial decision or any administrative determination other than by regulation) shall be applied without retroactive effect."

An Interested Parties Meeting was held on May 31, 2011, allowing the public an opportunity to raise issues to be addressed in the proposed regulation. The Discussion Topics from the May 31, 2011 Interested Parties Meeting provided a general background of the purpose behind the proposed Regulation, and general principles upon which staff intended to base the proposed regulation language. After this first Interested Parties Meeting, language for the proposed regulation was drafted based upon the public comments received. A second Interested Parties Meeting was held on February 15, 2012, in which a draft of the proposed language was discussed with the public. The meeting was successful and the language of the proposed regulation section was found generally acceptable by the public.

Much of the public response to the draft language was centered on ensuring that the public would have sufficient access to the contents of the regulation upon its adoption. Staff explained that part of the Franchise Tax Board's long term goal has always been to provide public outreach to educate both taxpayers and tax preparers on the contents of the regulation and to continue to help taxpayers navigate their way through claiming and proving entitlement to the CDC credit.

After the second Interested Parties Meeting, staff considered the public comments and determined to add minor clarifying language to subsection (b)(3), limiting the subsection's applicability to individual care providers, and (b)(5), adding "year-end statements" to the non-exhaustive list of items that can be provided by the taxpayer as proof of payment. Additionally, staff amended the language of subsection (b)(3) to remove the requirement that the taxpayer provide documentation which establishes the

care provider's employment authorization. Staff also made minor grammatical changes to Examples 1 through 4, and added Example 5, detailing sufficient evidence that may establish the location at which the care was provided, in an effort to provide further guidance to taxpayers.

Staff believes that the regulation as proposed provides appropriate guidance regarding the substantiation requirements for the CDC credit provided in RTC section 17052.6, and requests permission to commence the formal regulatory process under the Administrative Procedure Act.

Summary and Explanation of Proposed Regulation

The purpose of proposed California Code of Regulations (CCR) section 17052.6 is to provide clarity as to the documents that taxpayers must retain and provide upon request to establish entitlement to the Child and Dependent Care Expenses (CDC) Credit. Through such clarity, the taxpayer will have the advantage of knowing what documents to obtain and retain, at the time that they are procuring their child or dependent care services, rather than at the time that they are contacted by the Franchise Tax Board to provide such documentation, thus eliminating the challenge of retroactively collecting documentation.

Subsection (a) of the regulation provides a general rule that a taxpayer must maintain adequate records to substantiate entitlement to the CDC Credit, as provided in the remainder of the regulation.

Subsection (b), made up of five subparts, detailed individually below, provides a description of each legal requirement that the Franchise Tax Board looks to when verifying entitlement to the CDC Credit and specific documents that the taxpayer can provide to establish that each legal requirement is met.

- Subsection (b)(1) references the legal requirement that the care be provided to an individual, identified by a taxpayer identification number, that is the taxpayer's "qualifying person." As such, the qualifying person's identity, taxpayer identification number, and age must be established by the taxpayer. The subsection indicates that the qualifying person's birth certificate and Social Security Account Number card can establish that this legal requirement is met¹.
- Subsection (b)(2) references the legal requirement that the qualifying person be mentally or physically disabled if the qualifying person is thirteen or older. The subsection indicates that medical records that demonstrate the physical or mental incapacity of the qualifying person can establish that this legal requirement is met.
- Subsection (b)(3) references the legal requirement that the taxpayer establish their care provider's identity and taxpayer identification number. The subsection provides documents that can be provided to establish identity and documents that can be provided to establish the taxpayer identification number².

¹ Staff amended the language of subsection (b)(1) following the introduction of the language at the second Interested Parties Meeting to reference the requirement that the taxpayer establish the qualifying person's taxpayer identification number.

² Staff amended the language of subsection (b)(3) following the introduction of the language at the second Interested Parties Meeting. Upon discussion with program staff, staff determined that the requirements of subsection (b)(3) were applicable only to care providers who are individuals, as opposed to organizations; therefore staff amended the language to make this clarification. Additionally, staff amended the language of subsection (b)(3) to remove the requirement that the taxpayer provide documentation which establishes the care provider's employment authorization. Staff made this amendment to account for the likelihood that taxpayers utilize care providers who are not required to complete an I-9, Employment Eligibility Verification, or provide proof of employment authorization. As such, they should not be required to produce such documentation to show entitlement to the CDC Credit.

- Subsection (b)(4) references the legal requirement that the care be provided within California. The subsection indicates that the provider's California driver's license or identification card reflecting the provider's California address or a utility bill in the provider's name for the address at which the care was provided can establish that this legal requirement is met. The subsection exempts taxpayers from providing this information if the care is provided within their home.
- Subsection (b)(5) speaks to the legal requirement that the taxpayer substantiate their care expenses. The subsection indicates that proof of payment such as canceled checks/money orders, receipts, invoices, or year-end statements can establish that this legal requirement is met³.

Subsection (c) provides an alternative method of producing "other sufficient evidence" to establish compliance with the legal requirements set forth in subsection (b) when the taxpayer is unable to produce the specific documents identified in subsection (b).

Subsection (d) provides a standard for maintaining the records required by this regulation section through reference to Internal Revenue Code section 6001 and the regulations thereunder. Subsection (d) is consistent with the substantiation standard for claiming the federal CDC credit, set forth in Treasury Regulation section 1.21-1(k).

Subsection (e) provides that the taxpayer shall produce the records required by this regulation section upon the Franchise Tax Board's request. Subsection (e) further provides that the CDC credit will be denied in the event that the taxpayer fails to produce such records.

Subsection (f) provides five examples illustrating scenarios in which evidence which is not identified in subsection (b) is provided by a taxpayer to establish the legal requirements referenced in subsection (b).

The example in subsection (f)(1) illustrates a scenario in which the taxpayer paid her care provider, an individual, in cash and did not have receipts for her payments. The taxpayer submits a notarized statement, signed under penalty of perjury, from her provider which confirms the amounts paid by the taxpayer for childcare services. The example in subsection (f)(1) provides that such a statement may be sufficient evidence under subsection (c) to establish the proof of payment required by subsection (b)(5)⁴.

The example in subsection (f)(2) illustrates a scenario in which the taxpayer paid her care provider, an individual, in cash and did not have receipts for her payments. The taxpayer submits a federal form W-10, Dependent Care

³ Staff amended the language of subsection (b)(5) following the introduction of the language at the second Interested Parties Meeting to include "year-end statements" as an example of proof of payment.

⁴ Staff amended the language of the example in subsection (f)(1) following the introduction of the language at the second Interested Parties Meeting to clarify the care provider's status as an individual and to reference the establishment of the provider's taxpayer identification number as required by subsection (b)(3).

Provider's Identification and Certification, that is notarized and signed by the care provider, with a handwritten statement above the signature confirming the amounts paid by the taxpayer for childcare services. The example in subsection (f)(2) provides that while the W-10 may be sufficient evidence under subsection (c) to establish the provider's identity and taxpayer identification number, it is not sufficient to establish proof of payment required by subsection (b)(5)⁵.

The example in subsection (f)(3) illustrates a scenario in which the qualifying person's care was provided in the child care provider's home by an individual care provider. The taxpayer submitted a notarized statement, signed under penalty of perjury, from the provider confirming the California address at which the care was provided. The example in subsection (f)(3) provides that such a statement may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4)⁶.

The example in subsection (f)(4) illustrates a scenario in which the qualifying person's care was provided at location that the care provider, an individual residing outside of California, rents in California. The taxpayer submitted a notarized statement, signed under penalty of perjury, from the provider confirming the California address at which the care was provided. The example in subsection (f)(4) provides that such a statement may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4)⁷.

The example in subsection (f)(5) illustrates a scenario in which the qualifying person's care is provided by an organization. The taxpayer submitted a copy of the year-end statement from the care provider which is printed on the organization's letterhead. The example in subsection (f)(5) provides that the organization's letterhead may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4).

Subsection (g) provides that this regulation section shall apply to records requested by the Franchise Tax Board on or after January 1, 2013.

⁵ Staff amended the language of the example in subsection (f)(2) following the introduction of the language at the second Interested Parties Meeting to reference the establishment of the provider's taxpayer identification number as required by subsection (b)(3) and to remove the reference to employment authorization.

⁶ Staff amended the language of the example in subsection (f)(3) following the introduction of the language at the second Interested Parties Meeting to clarify the care provider's status as an individual and to reference the establishment of the provider's taxpayer identification number as required by subsection (b)(3).

⁷ Staff amended the language of the example in subsection (f)(4) following the introduction of the language at the second Interested Parties Meeting to correct a typographical error which incorrectly stated that the taxpayer rented the location in California.

Summary of Second Interested Parties Meeting
Regulation §17052.6, Child and Dependent Care Expenses Credit

- I. **Administration:** On February 15, 2012 at 1:30 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board central office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and phone participants introduced themselves. The session was audio recorded for reference but there will be no attribution of comments and no transcript.

The hearing officer, Jaclyn Appleby, listed the available handout documents: the notice of the meeting, the summary of the first interested parties meeting for this regulation, and draft language for this regulation. Parties were told they had until March 16, 2012 to submit written comments and that a summary of the interested parties meeting and any written comments would be posted online. The hearing officer explained that the purpose of the meeting was to provide the public with an opportunity to discuss and provide comments on the draft language for proposed Regulation Section 17052.6, which seeks to provide clarification for the taxpayer on the documents that can be used to establish the identity of the qualifying individual, care provider, and amount paid for qualifying expenses for purposes of the Child and Dependent Care Expenses (CDC) Credit.

- II. **Discussion:** The comments are not necessarily replicated in the order spoken but rather are grouped topically. The numbering of the comments is for ease of reference and thus readers should not assign any importance to one comment over any other comment. Public questions/comments have been italicized.

A. *The average taxpayer may not be familiar with the Code of Regulations and may not understand how to access it. How will the Franchise Tax Board make taxpayers aware of the new regulation and the clarifications that it provides?*

While individual taxpayers may not currently be aware of the opportunity to review the regulation, part of the Franchise Tax Board's long term goal has always been to provide public outreach to educate both taxpayers and tax preparers on the contents of the regulation and to continue to help taxpayers navigate their way through claiming and proving entitlement to the CDC credit.

- III. **Written Comments Received by March 16, 2012:** The comments are paraphrased for ease of readability and consistency.

A. *Why doesn't the Franchise Tax Board just provide these clarifications in its forms and instructions?*

The Franchise Tax Board's proposed regulations are rules of general application which seek to provide taxpayers with clarity on what is needed to

claim the CDC credit. As such, the Administrative Procedures Act requires that the Franchise Tax Board adopt a regulation. Often times, taxpayers do not reference our publications until the point at which they are doing their taxes, which can be several months after the tax year has ended. As a result, the taxpayer is tasked with the often difficult job of retroactively collecting the documents that they need to prove entitlement to the credit. The regulation, on the other hand, will be available to taxpayers and practitioners to provide clarity and will create the advantage of the taxpayer knowing the exact documents that they must produce or requirements that they must meet going forward, rather than retroactively.

- B. *With a few exceptions unrelated to record retention, California conforms to the federal rules for the CDC credit. Why does California need a regulation to discuss record retention?*

While the federal regulations discuss records maintenance very generally, FTB seeks to clarify the specific requirements for records for the CDC credit as a means of assisting taxpayers. Further, since these regulations are rules of general application the Administrative Procedures Act requires that the Franchise Tax Board adopt a regulation,

Staff is currently in the process of preparing the Request for Permission to Proceed with the formal regulatory process to adopt the proposed regulation.

Section 17052.6 is adopted to read:

§ 17052.6. Child and Dependent Care Expenses Credit.

(a) *Substantiation.* A taxpayer claiming a credit for employment-related expenses must maintain adequate records to substantiate entitlement to the Child and Dependent Care Expenses Credit, as provided in this regulation.

(b) *Adequate records.* A taxpayer must retain:

(1) The qualifying child/dependent's birth certificate and Social Security Account Number card to establish the identity, age, and taxpayer identification number of the taxpayer's qualifying child/dependent.

(2) Medical records that demonstrate the physical or mental incapacity of the qualifying child/dependent, if applicable.

(3) If the care provider is an individual, a combination of at least one document from subsection (b)(3)(A) and one document from subsection (b)(3)(B) to establish the identity and taxpayer identification number of the taxpayer's care provider.

(A) Documents that establish identity:

(i) U.S. Passport.

(ii) Driver's license issued by any state within the United States.

(iii) U.S. Passport Card.

(iv) Permanent Resident Alien Card.

(v) Alien Registration Receipt Card (Form I-551).

(vi) Foreign passport that contains a temporary I-551 stamp.

(vii) Temporary I-551 printed notation on a machine-readable immigrant visa.

(viii) Employment Authorization Document that contains a photograph (Form I-766).

(ix) State-issued ID card with a photograph issued by any state within the United States.

(x) School ID card with a photograph.

(xi) Native American tribal document.

(B) Documents that establish taxpayer identification number:

(i) Social Security Account Number card.

(ii) Individual Taxpayer Identification Number card.

(4) Documents that establish the physical location at which the care was provided, if the care was not provided in the taxpayer's home, such as the provider's California driver's license or identification card reflecting the address at which the care was provided or utility bills in the provider's name for the address at which the care was provided.

(5) Proof of payment, such as canceled checks/money orders, receipts, year-end statements, or invoices, to substantiate the employment-related expenses paid to the care provider by the taxpayer.

(c) *Other sufficient evidence.* In the event that the taxpayer is not able to acquire or maintain adequate documentation as provided in subsection (b), the taxpayer may produce other such evidence which is sufficient to establish each of the requirements under subsection (b) and entitlement to the Child and Dependent Care Expenses Credit.

(d) *Maintenance and retention of records.* The records or evidence required by this regulation shall be kept in accordance with Internal Revenue Code section 6001 and the regulations thereunder.

(e) *Production of records.* Upon the Franchise Tax Board's request, the taxpayer shall produce the records or evidence for inspection by the Franchise Tax Board. If the taxpayer fails to comply with this subsection, the Child and Dependent Care Expenses Credit will be denied.

(f) *Examples.*

(1) Taxpayer A paid her babysitter, an individual, \$2,500 in cash to provide childcare for A's daughter in A's home so that she could work. A's babysitter did not provide A with receipts for the cash payments made by A. A claimed the Child and Dependent Care Expenses Credit for these expenses and upon request by the Franchise Tax Board, A provided a copy of her qualifying child's birth certificate and Social Security Account Number card, and a copy of her babysitter's U.S. passport and Social Security Account Number card. Since A did not have canceled checks/money orders, receipts, or an invoice for the expenses that she paid, A instead submitted a notarized letter from her babysitter, signed under penalty of perjury, which indicated that A had paid the babysitter \$2,500 to care for A's daughter, as proof of payment required by subsection (b)(5). The notarized letter, signed under penalty of perjury, may be sufficient evidence under subsection (c) to prove entitlement to the credit.

(2) Same facts as Example (1), but upon request by the Franchise Tax Board, A submitted only a completed Form W-10, Dependent Care Provider's Identification and Certification, notarized and signed by the babysitter, with a handwritten statement above the signature stating, " A paid \$2,500 to me for babysitting services." The W-10 may be sufficient evidence under subsection (c) to establish the identity and taxpayer identification number of the care provider as required by subsection (b)(3); however, it is not sufficient to substantiate the amounts paid to the care provider by the taxpayer as required by subsection (b)(5) or the age and identity of the qualifying child/dependent as required by subsection (b)(1).

(3) Taxpayer B paid his babysitter, an individual, \$1,500 by check to provide childcare for B's daughter in the childcare provider's home so that B could work. B claimed the Child and Dependent Care Expenses Credit for these expenses, and upon request by the Franchise Tax Board, B provided a copy of B's qualifying child's birth certificate and Social Security Account Number card, a copy of his babysitter's U.S. passport and Social Security Account Number card, and copies of the canceled checks made payable to his babysitter. Since the care was not provided in B's home, B submitted a notarized letter, signed under penalty of perjury, from his babysitter which provided the California address at which the babysitter provided the care. The notarized letter, signed under penalty of perjury, may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4), and prove entitlement to the credit.

(4) Same facts as Example (4), except B's babysitter resides in Nevada and provides the care at a location that the babysitter rents in California. Since the care was not provided in B's home, B submitted a notarized letter, signed under penalty of perjury, from his babysitter which provided the California address at which the babysitter provided the care. The notarized letter, signed under penalty of perjury, may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4), and prove entitlement to the credit.

(5) Taxpayer C paid her care provider, an organization, \$3,000 by check to provide childcare for C's son in the organization's California business location so that C could work. C claimed the Child and Dependent Care Expenses Credit for these expenses, and upon request by the Franchise Tax Board, C provided a copy of C's qualifying child's birth certificate and Social Security Account Number card and a copy of the year-end statement (on the organization's letterhead) from the organization detailing the expenses paid by C. The year-end statement on the organization's letterhead may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4), and prove entitlement to the credit.

(g) *Effective date.* This section shall apply to records requested by the Franchise Tax Board on or after January 1, 2013.

NOTE: Authority cited: Section 19503, Revenue and Taxation Code.

Reference cited: Section 17052.6, Revenue and Taxation Code.