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LEGISLATIVE PROPOSAL 07-12
EXECUTIVE SUMMARY

- **Title:** Award of Attorney Fees in Tax Refund Lawsuits

- **Problem:** What is the correct code section to be used by the courts to base an award of attorney fees in a tax refund lawsuit?

- **Proposed Solution:** Amend Revenue and Taxation Code (R&TC) section 19717, amend Code of Civil Procedure (CCP) section 1028, and add section 1028.1 to the CCP to specify/clarify that R&TC section 19717 is the exclusive attorney fee remedy for a party that prevails in a tax refund lawsuit against the Franchise Tax Board (FTB). Although staff believes this proposed solution is consistent with the intent of the Legislature when it intended to conform to IRC section 7430, to avoid any adverse impact to pending cases, the amendments would apply to any court proceeding filed on or after the effective date of the act with no inference language for any pending court proceeding filed before that date.

- **Major Concerns/Issues:** The California Constitution requires a state agency to enforce a statute without regard to the issue of constitutionality until an appellate court determines the statute unconstitutional.[1] Consequently, if CCP section 1021.5 applies to tax refund litigation, FTB must enforce a statutory provision of the R&TC without regard to the constitutionality of that statute, which subjects the state to possible significant awards for attorney's fees under CCP section 1021.5.

- **Revenue:** This proposal could reduce state expenditures by specifying/clarifying that R&TC section 19717 is the exclusive attorney fee remedy for a party that prevails in a tax refund lawsuit against FTB. In August 2006, for the first time, a prevailing party in litigation with FTB was awarded attorney's fees under CCP section 1021.5. If upheld, this single award will cost the state $3 million more than "reasonable fees" allowable under R&TC section 19717. There is a risk that this recent award will lead to increases in the number of litigants seeking awards and in the courts' willingness to make such awards.

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[1] Cal. Const. Art. III section 3.5.

Title

Award of Attorney Fees in Tax Refund Lawsuits

Introduction

This proposal would specify/clarify that California Revenue and Taxation Code (R&TC) section 19717 is the exclusive attorney fee and litigation cost remedy for a party that prevails in a tax refund lawsuit against the Franchise Tax Board (FTB). This proposal is consistent with the federal approach that provides that attorney fee recovery statutes do not apply in addition to the Internal Revenue Code (IRC) recovery statutes.

Background

R&TC section 19717

SB 813 (Chapter 498, Stat. 1983) originally enacted R&TC section 19717 as R&TC sections 19420 and 26491, effective with respect to proceedings commenced on or after July 28, 1983. The legislative policy decision was to conform to the federal enactment of the Tax Equity and Fiscal Responsibility Act of 1982[2] (TEFRA) section 292, which added the new attorney fees provision to the IRC[3] **and** amended Title 28, Judiciary and Judicial Procedure, 28 USC section 2412, to make the new IRC provision exclusive for federal tax cases. FTB staff believe this 1983 conformity bill had an inadvertent drafting error.

The legislative history of SB 813 did not evidence the Legislature's intent to simply conform to the new IRC section, but rather, that legislative history evidences the Legislature's intent to conform to TEFRA section 292 in its entirety (which also contained the "exclusive remedy" piece of the federal enactment that was codified in Title 28, Judiciary and Judicial Procedure, 28 USC section 2412). However, when originally enacted in 1983, the conformity statute failed to explicitly state it was to be an exclusive remedy because no corresponding amendment was made to the Code of Civil Procedure (CCP).

Private Attorney General Doctrine

In 1974, the United States Court of Appeals for the District of Columbia awarded the Wilderness Society, Environmental Defense Fund, and Friends of the Earth attorney fees for serving as a private attorney general.[4] The attorney fees were sought for the plaintiff's litigation to prevent construction of an Alaskan pipeline. The Court of Appeals found that the plaintiffs acted as a private attorney general by enforcing public policy and should not have to finance litigation that was for a public benefit. The fee shifting was not intended to be punitive. In 1975, the United States Supreme Court reversed the decision in *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*[5] because the Court of Appeals awarded the attorney fees without a statutory basis and because this award was contrary to "the general 'American rule' that the prevailing party may not recover attorneys' fees as costs or otherwise." The Supreme Court in this case also stated that it was within the authority of Congress to create a private attorney general doctrine.

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[2] Public Law 97-248.
[3] New IRC section 7430.
[4] *Wilderness Soc. v. Morton*, 495 F.2d 1026 (D.C. Cir. 1974).
[5] *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 241 (1975).

The Equal Access to Justice Act (EAJA) was enacted by Congress and became effective October 21, 1980.[6] It has a justification similar to the private attorney general doctrine. The purpose of the EAJA was to reduce the disincentive for certain parties to engage in litigation with the federal government because of the high cost involved in protecting their rights.[7]

In 1977, the California Supreme Court created the private attorney general doctrine in *Serrano v. Priest*.[8] The court found in that case that the United States Supreme Court's ruling against a federal private attorney general doctrine did not prevent state courts from creating it as a state-based doctrine. Additionally, that case explained that even though California statutes followed the general American rule regarding attorney fees, the California courts had already established two exceptions "based upon the inherent equitable power of the court." The first exception was the common fund principle: those who benefit from another's litigation that creates a fund should share in the expense that created the fund. The second exception was the substantial benefit rule: non-litigants who benefit from litigation that acts in a representative capacity and creates a substantial benefit for the non-litigants should share in the expense that created the substantial benefit.

In *Serrano v. Priest* the California Supreme Court first applied the private attorney general doctrine. That case determined that the financing system for California schools violated the state constitution's equal protection provisions. The court's rationale for the doctrine was that many citizens have common interests. The benefit to society of these interests is momentous, but not large enough for one private citizen to litigate alone.

The court applied the doctrine to constitutional rights and left the determination of whether it should apply to statutory rights for another case. The California legislature acted immediately to apply the private attorney general doctrine to statutory rights.[9] Effective January 1, 1978, CCP section 1021.5 codified the California Supreme Court's decision.

On August 21, 2006, in *Northwest Energetic* a superior court awarded attorney fees against FTB under CCP section 1021.5. The lodestar was $214,287.50. "Lodestar" is the product of hours the attorney worked times a reasonable hourly rate. The trial court may increase or decrease the lodestar by a multiple. The multiple applied by the court was 16.33. The total award of attorney fees was $3.5 million.[10] The case is on appeal to the California Court of Appeal. If upheld, this single award will cost the state $3 million more than "reasonable fees" allowable under R&TC section 19717. On February 27, 2007, in a second case, *Ventas Finance*, the award under CCP section 1021.5 was 1.5 times the lodestar or about $225,000, but in that case there had been no exhaustion of administrative remedies, as required to receive an award under R&TC section 19717. That case is also currently on appeal.[11] The underlying tax cases in both deal with the constitutionality of the Limited Liability Company (LLC) fee imposed under R&TC section 17942.

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[6] Oct. 21, 1980, PL 96-481, Title II, section 201 et seq., 94 Stat. 2325 -2330. That federal Act added 5 USC section 504 for administrative adjudications and amended 28 USC section 2412 for judicial proceedings.
[7] Oct. 21, 1980, PL 96-481, Title II, section 202, 94 Stat. 2325.
[8] *Serrano v. Priest*, 20 Cal. 3d 25 (1977).
[9] *County of Inyo v. City of Los Angeles*, 78 Cal. App. 3d 82, 89 (1978).
[10] *Northwest Energetic Services, LLC v. Franchise Tax Board*, (A114805, A115841, and A115950 [Consolidated], app. pending First District of the California Court of Appeal.).
[11] *Ventas Finance I, LLC v. Franchise Tax Board*, (A116277, app. pending First District of the California Court of Appeal.)

The department argues in these appeals, among other arguments, that R&TC section 19717 is the exclusive remedy for an award of attorneys' fees in a tax refund lawsuit against FTB and that R&TC section 19717, as a specific statute, controls an award of attorneys' fees to the exclusion of general statutes authorizing attorneys' fees.

Current Law

State Law

R&TC section 19717 provides that certain parties that prevail against FTB in a civil proceeding may be awarded reasonable litigation costs, which is defined by that section to include court costs, expert witness fees, the cost of studies, and attorney fees. To receive attorney fees, a prevailing party must meet three requirements: (1) have exhausted all available administrative remedies prior to initiating the lawsuit, (2) have reasonable litigation costs allocable solely to the State of California, and (3) have reasonable litigation costs during the civil proceeding, except for the period in which the prevailing party has unreasonably protracted that proceeding. The hourly rate for attorney fees is capped. The cap is adjusted each calendar year using a statutory cost-of-living rate. The rate for calendar year 2006 is $140 per hour. The rate for calendar year 2007 is $150 per hour. A court may award attorney fees above the capped rate when a special factor presents itself. The statutory examples of special factors are: the availability of qualified attorneys for the type of case, the difficulty of the case, and the local availability of tax attorneys. To be considered a prevailing party, the party must substantially prevail on the disputed amount, or substantially prevail on the significant issues in the case. However, if the State of California establishes that its position was substantially justified, then the prevailing party may not recover any litigation costs.[12] To be substantially justified, the state's position must have a reasonable basis in law and fact. It does not need to be a winning argument.[13]

CCP section 1021.5 provides that a prevailing party whose litigation results in the enforcement of an important public interest may be awarded attorney fees. To receive attorney fees a party must meet three requirements: (1) provide a significant benefit to the general public, (2) have a financial burden that makes the attorney fee award appropriate, and (3) to achieve justice the circumstances require that attorney fees be provided in addition to the recovery. A significant benefit may be monetary or non-monetary. It does not need to be a concrete benefit.[14] The significant benefit requirement is met if the benefit only affects the general public. A financial burden that makes an award appropriate is one where the cost of victory exceeds the party's personal interest so that the cost of the lawsuit is disproportionate to the disputed issue. A court may award less than the full amount of attorney fees when a successful party's financial gain warrants. Public entities may not receive attorney fees in litigation against individuals.[15] Attorney fees are calculated by determining the lodestar and applying a multiplier. The lodestar is the product of hours the attorney worked times a reasonable hourly rate.

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[12] R&TC section 19717(c)(2)(B)(i).
[13] *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 26 Cal. App. 4th 1789, 1798 (Cal. Ct. App. 1994).
[14] *Woodland Hills Residents Ass'n v. City Council of L.A.*, 23 Cal. 3d 917, 939 Footnote 12 (Cal. 1979).
[15] Cal. Code Civ. Proc. section 1021.5.

The trial court may increase or decrease the lodestar by a multiplier.[16] For example, if an attorney worked ten hours at a reasonable hourly rate of $350, then the lodestar is $3,500. If a multiplier of 2 is applied, the final attorney fees awarded are $7,000.

Unlike R&TC section 19717, CCP section 1021.5 does not require the exhaustion of administrative remedies and allows an award of attorney fees even if the defendant (here FTB) was substantially justified in defending the lawsuit. For example, in *Ventas* the award under CCP section 1021.5 was 1.5 times the lodestar or about $225,000, but in that case there had been no exhaustion of administrative remedies and thus would not have been awarded under R&TC section 19717.

The California Constitution requires a state agency to enforce a statute until an appellate court determines it unconstitutional.[17]

<u>Federal Law</u>

IRC section 7430 provides that certain parties that prevail against the Internal Revenue Service (IRS) may be awarded reasonable litigation costs. To receive attorney fees, a prevailing party must meet three requirements: (1) have exhausted all available administrative remedies prior to initiating the lawsuit, (2) have reasonable litigation costs allocable solely to the United States, and (3) have reasonable litigation costs during the court proceeding, except for the period in which the prevailing party has unreasonably protracted that proceeding. Reasonable litigation costs include court costs, expert witness fees, the cost of studies, and attorney fees. The hourly rate for attorney fees is capped. The cap is adjusted each calendar year using a statutory cost-of-living rate. The rate for calendar year 2006 is $160 per hour.[18] A court may award attorney fees above the capped rate when a special factor presents itself. The statutory examples of special factors include the following: the availability of qualified attorneys for the type of case, the difficulty of the case, and the local availability of tax attorneys. To be considered a prevailing party, the party must substantially prevail on the disputed amount, or substantially prevail on the significant issues in the case.[19] The IRC contains a net worth requirement that is not found in R&TC section 19717. Under the IRC, to qualify for the award, an individual's net worth may not exceed $2,000,000, and a business may not have a net worth over $7,000,000 and over 500 employees.[20] However, if the IRS establishes that its position was substantially justified, then the prevailing party may not recover any attorney fees or litigation costs. To be substantially justified, the IRS's position must have a reasonable basis in law and fact.[21] It does not need to be a winning argument.[22]

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[16] *Downey Cares v. Downey Community Development Com.*, 196 Cal. App. 3d 983, 994 (1987).
[17] Cal. Const. Art. III, section 3.5.
[18] Rev. Proc. 2005-70, 2005-47 I.R.B. 979.
[19] 26 U.S.C.S. section 7430(c)(4)(A)(i).
[20] 28 U.S.C.S. section 2412(d)(2)(B).
[21] *Pierce v. Underwood*, 487 U.S. 552, 565 (1988).
[22] *Estate of Baird v. Comm'r*, 416 F.3d 442, 447 (5th Cir. 2005).

The EAJA added Section 504 of Title 5 of the United States Code (USC), relating to award of fees and other expenses in administrative adjudications[23] and amended Section 2412 of Title 28 of the USC, relating to award of fees and other expenses in certain judicial proceedings. For administrative adjudications, Section 504 of the USC provides that "[a]n agency that conducts an adversary adjudication shall award, to a prevailing party other than the United States, fees and other expenses incurred by that party in connection with that proceeding." A prevailing party may not receive such an award under either administrative adjudications or judicial proceedings if the agency's position was substantially justified. When IRC section 7430 was added to the IRC as part of TEFRA, the same section of that federal act amended Section 2412 of Title 28 of the USC to expressly state that it does not apply to IRS proceedings under IRC section 7430. It did not, however, amend Section 504 of Title 5 of the USC. In 1988, Public Law 100-647 amended Section 504 of Title 5 of the USC to expressly state that it does not apply to IRS proceedings under IRC section 7430. The EAJA net worth requirement limitations are the same as those discussed above for recovery of litigation costs against the IRS and apply to administrative adjudications and judicial proceedings.

Problem

What is the correct code section to be used by the courts to base an award of attorney fees in a tax refund lawsuit?

Proposed Solution

Amend R&TC section 19717, amend CCP section 1028, and add CCP section 1028.1 CCP to specify/clarify that R&TC section 19717 is the exclusive attorney fee remedy for a party that prevails in a tax refund lawsuit against FTB. Although FTB staff believes this proposed solution is consistent with the intent of the Legislature when it intended to conform to IRC section 7430, to avoid any adverse impact to pending cases, the amendments would apply to any court proceeding filed on or after the effective date of the act with no inference language for any pending court proceeding filed before that date.

Effective/Operative Date of Solution

Unless enacted as an urgency measure, this bill would be effective on January 1, 2009, and apply to lawsuits filed on or after that date.

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[23] "Much of section7430 is borrowed from the Equal Access to Justice Act (EAJA), which allows awards of attorney fees and other litigation expenses to parties other than the government in various civil proceedings to which the government is a party. The EAJA originally applied to tax cases in courts other than Tax Courts, but was superseded in this context by section7430 for cases begun after February 28, 1983." Bittker, Boris I. and Lokken, Lawrence, *Federal Taxation of Income, Estates and Gifts*. 2nd ed., vol. 4. (Boston: Warren, Gorham & Lamont, 1981 and 1992), 115.10.1.

Justification

This proposal would codify the attorney fee and litigation cost remedy for a party that prevails in a tax refund lawsuit against FTB as originally intended by the Legislature in SB 813 (Chapter 498, Stat. 1983).

This proposal would conform California law to the federal law provision that limits a prevailing taxpayer in a tax refund lawsuit to an award of attorney fees and costs, if at all, only under the tax code.

Applying the CCP provisions for attorney fee and litigation cost awards in tax cases with different standards and limitations from those provided in the R&TC would defeat the purpose of R&TC section 19717.

Implementation

Implementing this proposal would not significantly impact the department's programs and operations.

Fiscal Impact

This proposal may result in some departmental savings of administrative costs resulting from reduced litigation expenses because awards under CCP section 1021.5 would not be permitted. The amount that may be saved is speculative because there have been few awards made under CCP section 1021.5, and this proposal would not impact those earlier cases.

Economic Impact

This proposal could reduce state expenditures by specifying/clarifying that R&TC section 19717 is the exclusive attorney fee remedy for a party that prevails in a tax refund lawsuit against FTB. The amount of this savings is unknown because it depends on the frequency of relevant litigation and on the size of future awards, both of which are unknown.

In August 2006, for the first time, a prevailing party in litigation with FTB was awarded attorney's fees under CCP section 1021.5. If upheld, this single award will cost the state $3 million more than "reasonable fees" allowable under R&TC section 19717. Because amounts awarded are additional taxable income to the recipient, the cost to the state will be reduced by the recipient's marginal tax rate of approximately 9%.

There is a risk that this recent award will lead to an increase in the number of litigants seeking awards and in the courts' willingness to make such awards. It is unknown how many cases there might be or how large the fees actually awarded might be.

Because this proposal only applies to future litigation and there are typically three to four years between the date litigation is filed and the date an award for litigation costs is paid, no fiscal impact is expected until fiscal year 2012/2013.

Policy Considerations

The California Constitution requires a state agency to enforce a statute without regard to the issue of constitutionality until an appellate court determines the statute unconstitutional.[24] Consequently, FTB must enforce a statutory provision of the R&TC without regard to the constitutionality of that statute, which subjects the state to possible significant awards for attorneys fees if CCP section 1021.5 applies to tax refund litigation.

Congress made the policy decision in 1982 in TEFRA section 292 to make the IRC the exclusive statutory authority for award of attorneys fees in tax litigation against the federal government and thus, except tax litigation from the incentive aspect of the EAJA.

Alternatively, if CCP section 1021.5 applies to tax refund litigation, lawyers would have the financial incentive to identify and litigate unconstitutional statutes in the R&TC to assure that defective provisions are removed from the code.

Other States

The laws of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were surveyed because their tax laws are similar to California's income tax laws.

None of these states have an Equal Access to Justice Act as broad and encompassing as California's private attorney general doctrine as codified in CCP section 1021.5. Nor do they have a private attorney general act as broad and encompassing as California's. *Florida* has a private attorney general provision in Florida Statute section 400.023.

The statute pertains to the rights of those in nursing homes and related health care facilities. Recovery of costs and reasonable attorney fees not to exceed $25,000 are available to parties who prevail in seeking injunctive relief or an administrative remedy.

Under *Florida* law, a prevailing taxpayer may be awarded attorney fees and litigation costs when the tax agency's position is not substantially justified. The statute does not state it is an exclusive remedy. Under the Florida Equal Access to Justice Act, a qualifying party may recover attorney fees and litigation costs resulting from adjudicatory proceedings or administrative proceedings. In an action initiated by the state, an award for attorney fees and costs may not exceed $50,000.

Illinois, *Massachusetts*, and *Minnesota* law have no equivalent mention of attorney fee and litigation cost recovery in the tax code. *Illinois* and *Massachusetts* law does not contain an EAJA type act. *Minnesota* law contains a provision similar to the federal EAJA. It permits a prevailing party in a civil proceeding with the state to recover fees and other expenses if the party shows the state's position was not substantially justified. The act includes attorney fee awards in tax cases.

Michigan law permits a taxpayer to recover actual damages, which include attorney fees, up to $10,000 when the tax agency intentionally or recklessly ignores a rule, guideline, procedure, or the law. *Michigan* does not have an EAJA-type act.

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[24] Cal. Const. Art. III section 3.5.

Of these states, *New York* most closely mirrors the IRC model of serving as the sole remedy in awarding attorney fees and litigation costs to certain prevailing parties in tax disputes. New York Tax Law section 3030 provides that certain parties that prevail against the Department of Taxation and Finance in a civil proceeding may be awarded reasonable litigation costs.

Reasonable litigation costs include court costs, expert witness fees, the cost of studies, and attorney fees. The hourly rate for attorney fees is capped. The court may adjust the rate upon a determination that there is an increase in the cost of living. The statutory rate is $75 per hour. A court may award attorney fees above the capped rate when a special factor presents itself. The statutory example of a special factor is the limited availability of qualified attorneys for such proceedings. To be considered a prevailing party, the party must substantially prevail on the disputed amount or substantially prevail on the significant issues in the case. However, if the tax agency establishes that its position was substantially justified, then the prevailing party may not recover any litigation costs.

The statute is the exclusive remedy for a prevailing party to be awarded litigation costs and attorney fees in connection with the determination, collection, or refund of any tax. New York has an EAJA, but it is not applicable to tax cases because the tax law provides an exclusive remedy.

LEGISLATIVE STAFF CONTACT

John Pavalasky	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-4335	845-6333
john.pavalasky@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst John Pavalasky
Telephone # 845-4335
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS LP 07-12

AMENDMENT 1

SECTION 1. Section 19717 of the Revenue and Taxation Code is amended to read:

19717. (a) The prevailing party may be awarded a judgment for reasonable litigation costs incurred, in the case of any civil proceeding brought by or against the State of California in a court of record of this state in connection with the determination, collection, or refund of any tax, interest, or penalty under this part.

(b) (1) A judgment for reasonable litigation costs shall not be awarded under subdivision (a) unless the court determines that the prevailing party has exhausted all administrative remedies available to that party under this part, including the filing of an appeal as provided in Section 19324. Any failure to agree to an extension of the time for the assessment of any tax shall not be taken into account for purposes of determining whether the prevailing party meets the requirements of the preceding sentence.

(2) An award under subdivision (a) shall be made only for reasonable litigation costs which are allocable to the State of California and not to any other party to the action or proceeding.

(3) No award for reasonable litigation costs may be made under subdivision (a) with respect to any portion of the civil proceeding during which the prevailing party has unreasonably protracted that proceeding.

(c) For purposes of this section:

(1) "Reasonable litigation costs" includes any of the following:

(A) Reasonable court costs.

(B) Based upon prevailing market rates for the kind or quality of services furnished, any of the following:

(i) The reasonable expenses of expert witnesses in connection with the civil proceeding, except that no expert witness shall be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the State of California.

(ii) The reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case.

(iii) Reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding, except that those fees shall not be in excess of one hundred twenty-five dollars ($125) per hour unless the court determines that a special factor, such as the limited availability of qualified attorneys for the proceeding, the difficulty of the issues presented in the case, or the local availability of tax expertise justifies a higher rate. In the case of each calendar year beginning with calendar year 2001, the Franchise Tax Board shall recompute the dollar amount referred to in the preceding sentence. That computation shall be made by increasing the amount in this clause by an amount equal to the cost-of-living adjustment determined under subdivision (h) of Section 17041. If any resulting dollar amount is not a multiple of ten dollars ($10), that dollar amount shall be rounded to the nearest multiple of ten dollars ($10).

(iv) The court may award reasonable attorney fees under subdivision (a) in excess of the attorney fees paid or incurred if the fees are less than the reasonable attorneys' fees because the attorney is representing the prevailing party for no fee or for a fee which (taking into account all the facts and circumstances) is no more than a nominal fee. This clause shall apply only if the award is paid to the attorney or the attorney's employer.

(2) (A) "Prevailing party" means any party to any proceeding described in subdivision (a) (other than the State of California or any creditor of the taxpayer involved) that meets either of the following criteria:

(i) Has substantially prevailed with respect to the amount in controversy.

(ii) Has substantially prevailed with respect to the most significant issue or set of issues presented.

(B) (i) A party shall not be treated as the prevailing party in a proceeding to which subdivision (a) applies if the State of California establishes that its position in the proceeding was substantially justified.

(ii) For purposes of clause (i), the position of the State of California shall be presumed not to be substantially justified if the Franchise Tax Board did not follow its applicable published guidance in the administrative proceeding. This presumption may be rebutted.

(iii) For purposes of clause (ii), the term "applicable published guidance" means either of the following:

(I) A regulation, legal ruling, notice, information release, or announcement.

(II) Any chief counsel ruling or determination letter issued to the taxpayer.

(iv) For purposes of clause (i), in determining whether the position of the Franchise Tax Board was substantially justified, the court shall take into account whether the Franchise Tax Board has lost in any California Court of Appeal in another district on substantially similar issues, as reflected in a decision certified for publication.

(C) Any determination under this paragraph as to whether a party is a prevailing party shall be made by either of the following:

(i) The court.

(ii) An agreement of the parties.

(3) The term "civil proceeding" includes a civil action.

(d) For purposes of this section, in the case of multiple actions which could have been joined or consolidated, or a case or cases involving a return or returns of the same taxpayer (including joint returns of married individuals) which could have been joined in a single proceeding in the same court, the actions or cases shall be treated as one civil proceeding regardless of whether the joinder or consolidation actually occurs, unless the court in which the action is brought determines, in its discretion, that it would be inappropriate to treat the actions or cases as joined or consolidated for purposes of this section.

(e) An order granting or denying an award for reasonable litigation costs under subdivision (a), in whole or in part, shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner as the decision or judgment.

(f) For purposes of this section, "position of the State of California" includes either of the following:

(1) The position taken by the State of California in the civil proceeding.

(2) Any administrative action or inaction by the Franchise Tax Board (and all subsequent administrative action or inaction) upon which that proceeding is based.

(g) The amendments made by ~~the act amending this subdivision~~ Chapter 931 of the Statutes of 1999 are effective for costs incurred and services performed more than 180 days after the effective date of the act amending this subdivision.

(h) Notwithstanding any other provision or rule of law to the contrary, the provisions of the Code of Civil Procedure regarding the awarding of litigation costs, including attorney's fees, in civil proceedings shall not apply to any costs, fees, or other expenses in connection with any civil proceeding to which this section applies.

SEC. 2. Section 1028 of the Code of Civil Procedure is amended to read:

1028. Notwithstanding any other provisions of law, other than section 1028.1, when the State is a party, costs shall be awarded against it on the same basis as against any other party and, when awarded, must be paid out of the appropriation for the support of the agency on whose behalf the State appeared.

SEC. 3. Section 1028.1 is added to the Code of Civil Procedure, to read:

1028.1. The provisions of this chapter shall not apply to any costs, fees, and other expenses in connection with any proceeding to which Section 19717 of the Revenue and Taxation Code applies (determined without regard to subdivision (b) of that section). Nothing in the preceding sentence shall prevent the payment of costs, fees, and other expenses awarded pursuant to Section 19717 of the Revenue and Taxation Code out of the appropriation for support of the Franchise Tax Board.

SEC. 4. (a) The amendments made to Section 19717 of the Revenue and Taxation Code by section 1 of this act, the amendments made to Section 1028 of the Code of Civil Procedure by section 2 of this act, and Section 1028.1 of the Code of Civil Procedure, as added by section 3 of this act, shall be applied to any court proceeding filed on or after the effective date of this act.

(b) It is the intent of the Legislature that no inference be drawn from the amendments made by section 1, section 2, and section 3 of this act for any court proceeding filed before the effective date of this act.

LEGISLATIVE PROPOSAL 08-01
EXECUTIVE SUMMARY

- **Title:** Failure To Resolve Outstanding Liabilities As Grounds For Suspension Of An Occupational or Professional License By Franchise Tax Board (FTB)

- **Problem:** Current state law lacks an effective method to collect from a tax debtor who is an individual licensed to engage in an occupation or profession operating on a cash basis.

- **Proposed Solution:** Allow FTB to do the following:

  - Suspend occupational or professional licenses because of unpaid tax liabilities.
  - Disclose delinquent state income tax information to all licensing boards and notify the licensing boards that the licensee is suspended.
  - Provide a hearing for license holders who would experience a hardship from the suspension.

  Eliminate duplicate provisions that currently exist between the Contractor's State Licensing Board (CSLB) and FTB to exchange delinquent state tax information.

  This proposal would include intent language that specifies due process is satisfied at the time the unpaid tax liabilities may be protested and appealed.

- **Major Concerns/Issues:** This proposal would supersede the current statutory scheme that allows FTB to match income tax debtors with the CSLBs list of licensees.

- **Revenue:**

Estimated Revenue Impact of LP 08-01 Effective On or After January 1, 2009 Enactment Assumed After June 30, 2008 ($ in Millions)			
Suspend Occupational Licenses	2009-10	2010-11	2011-12
	+$16	+$29	+$13

Title

Failure To Resolve Outstanding Liabilities As Grounds For Suspension Of An Occupational or Professional License By Franchise Tax Board (FTB)

Introduction

This proposal would allow FTB to suspend occupational and professional licenses and notify the licensing agencies of the suspension because of unpaid tax liabilities.

Program History/Background

The department uses an automated tax collection system to collect delinquent taxes. The automated system searches through more than 220 million income records, including wage, dividend, and interest information, to locate an individual's assets. Once assets are located, the system can issue levies on bank accounts, wages, commissions, rents, and other miscellaneous sources of income.

Current data indicates that there are over 25,000 delinquent taxpayers that possess an occupational or professional license. Generally, the department is able to collect on these debts by intrusive and expensive actions (seizure of assets) or legal actions (Notice of Tax Lien, nominee assessments) if the individual has real property.

The department is unable to use its most effective collection tools to collect delinquent liabilities from individuals who operate on a cash basis because of the lack of current information available, for example, interest, dividends, commission, rents, and gross proceeds from services provided. Without income information, FTB is unable to issue a tax levy, Earnings Withholding Order for Taxes (EWOT) or Order To Withhold (OTW) to collect on those debts.

Current Federal/State Law

Under both federal and state income tax laws, in general, if taxpayers have delinquent tax amounts, a tax lien automatically arises by operation of law for that amount, known as a statutory tax lien. A statutory tax lien is a claim upon real and personal property for the satisfaction of a tax debt. For federal purposes, the statutory tax lien exists as long as the delinquency exists or until automatically released ten years after a tax is assessed.

For state purposes, a statutory tax lien arises automatically when the debt becomes final and exists for ten years, unless the liability becomes satisfied or a Notice of State Tax lien is recorded. The recording of the notice provides notice to the world of the debt against all real and personal property belonging to the taxpayer and located in the California county where recorded.

Current state law authorizes FTB to use several collection tools to collect delinquent tax liabilities.

An OTW can be issued to any third-person in possession of funds or properties belonging to the debtor, for example vacation trust funds, interest, financial assets, and 1099 miscellaneous payors. Upon receipt of an OTW, the entity notified is required to submit to the department all cash or cash equivalents due the debtor that will satisfy the amount of the OTW.

FTB is authorized to issue warrants to a marshal to collect tax, interest, or penalties. The warrant is used to seize property and convert it to cash to satisfy a debt. The most common use of the warrant is to seize and sell vehicles.

Current state law also authorizes FTB to issue EWOTs to collect delinquent tax liabilities for which a tax lien is in effect. An EWOT is a continuing wage garnishment based on a percentage of a debtor's earnings, not to exceed 25% of disposable income.

Current state law specifies that the Contractor's State Licensing Board (CSLB) may refuse to issue, reinstate, reactivate, or renew a contractor's license or may suspend a license for the failure of a licensee to resolve all outstanding final liabilities, which include taxes, additions to tax, penalties, interest, and any fees that may be assessed by the CSLB, the Department of Industrial Relations, the Employment Development Department, or FTB. Current state law further specifically provides, under the Business and Professions Code, that FTB and CSLB may match licensee information with delinquent income tax information. Licensees with delinquent income tax debts are suspended.

Current state law also authorizes professional license denial and suspension for failure to pay court-ordered child support debt. The local child support agencies compile a list for the Department of Child Support Services (DCSS) of obligors that are no more than 30 days late on their child support payments. DCSS reviews the list to verify the information is accurate and then sends the list of obligors to the various licensing boards. Once the list is received, those boards immediately send a 150-day compliance letter to the obligor. If the obligor fails to comply within the 150-day timeframe and the licensing board fails to receive a release letter from the local child support agency, the occupational, professional, or driver's license is suspended by the licensing board.

Under current state tax law, FTB is prohibited from disclosing any confidential taxpayer information unless an exception to the general disclosure law specifically authorizes the disclosure.

Current state law provides the California Supreme Court may suspend or disbar an attorney from practice for act of professional misconduct or convicted of serious crimes

Problem

Current state law lacks an effective method to collect from a tax debtor who is an individual licensed to engage in an occupation or profession operating on a cash basis.

Proposed Solution

Amend the Revenue and Taxation Code to allow FTB to do the following:

- Suspend occupational or professional licenses because of unpaid tax liabilities.
- Disclose delinquent state income tax information to all licensing boards, including CSLB, and notify the licensing boards that the licensee is suspended.
- Provide a hearing for license holders who would experience a hardship as a result of the suspension.

Amend the Business and Professions Code to eliminate duplicate provisions that give CSLB and FTB the authority to exchange delinquent state tax information.

This proposal would allow FTB to suspend attorneys rather than the California Supreme Court because of delinquent income taxes.

This proposal would include intent language that specifies due process is satisfied at the time the unpaid tax liabilities may be protested and appealed.

Effective/Operative Date of Solution

If enacted in the 2008 legislative session, this proposal would be effective and operative beginning January 1, 2009.

Justification

The annual income tax gap for California is estimated to be $6.5 billion and is based in part upon estimates of the federal gap. The IRS estimates underreporting of business income by personal income taxpayers makes up nearly 70 percent of the total tax gap. It is estimated by IRS that the majority of this underreported income is from business sectors that do business largely in cash.[1]

This proposal would reduce the tax gap by increasing enforcement measures to collect outstanding taxes due. The possibility of loosing and the actual loss of the privilege to hold an occupational or professional license would be an effective collection tool to assure payment of income tax debts by licensees who do businesses in cash.

Where a licensee fails to pay the correct amount of income tax, he or she has a competitive advantage over other businesses that report and pay the correct amount of tax. By suspending occupational or professional licenses, income tax laws would promote fairness among businesses.

Implementation

Implementing this proposal would include a one-time system enhancement that would require changes to existing notices, letters and instructions, and information systems. The changes needed are estimated to be moderate. The cost to implement this proposal is discussed below under “Fiscal Impact.”

Fiscal Impact

Staff estimates a one-time cost of approximately $2.4 million (22.4 PYs) to program, develop, and test a new process within existing systems and add collection support to the functional aspects of this proposal. Staff estimates on-going annual costs of approximately $1.1 million (12.4 PYs) for mailing notices and responding to taxpayer inquiries resulting from those notices. This new function would be operative in the later part of the 2009-10 fiscal year. Implementing this proposal would be contingent upon funding approval.

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[1] A Comprehensive Strategy for Reducing the Tax Gap issued by IRS-September 2006

Economic Impact

Revenue Estimate

The revenue gain from this proposal would be as follows:

Estimated Revenue Impact of LP 08-01 Effective On or After January 1, 2009 Enactment Assumed After June 30, 2008 ($ in Millions)			
Suspend Occupational Licenses	2009-10	2010-11	2011-12
	+$16	+$29	+$13

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

Revenue Discussion

The revenue impact of this proposal would depend on the number of delinquent taxpayers that possess an occupational or professional license. This estimate was calculated using the actual account balances of the department's accounts receivables for the affected taxpayers, excluding accounts in bankruptcy and installment agreements. Taxpayers subject to this proposal are those with an outstanding liability of $1,000 or more and have owed that debt for one year or more.

It is estimated that 17,200 taxpayers with occupational and professional licenses will enter the collection process annually. Of the 17,200 taxpayers, it is estimated 38%, or 6,600, are expected to pay their delinquent debts upon notice from FTB. Current departmental data indicates the average payment amount for compliant taxpayers would be approximately $2,000. Resulting in an annual revenue increase of approximately $13 million (6,600 x $2,000 = $13.2 million). The average payment amount was calculated by the amount of payments made in response to Filing Enforcement notices.

Current departmental data also indicates unresolved cases of approximately 25,000 delinquent taxpayers with occupational and professional licenses in the collection process. Based on the 25,000 taxpayers, it is estimated that nearly 9,500 taxpayers would comply upon notice from FTB resulting in a revenue increase of $19 million in the first year ($2,000 x 9,500 = $19 million). The revenue for fiscal year ending 2009-10 is estimated to total $32 million ($19 million + $13 million). It is assumed that 50 percent of the $32 million would be collected in fiscal year 2009-10, reducing revenue to $16 million. The remaining revenue of $16 million from fiscal year 2009-10 would be collected in 2010-11, in addition to the $13 million that is assessed annually, for a revenue impact of $29 million ($16 million + $13 million = $29 million) in 2010-11. Thereafter, the annual fiscal impact of $13 million would be collected.

Policy Considerations

If this proposal were enacted, it would supersede the current data match statute between the CSLB and FTB.

Other Agency/Industry Impacted

This proposal would impact the Department of Consumer Affairs (DCA), which governs 36 different licensing agencies, in addition to the Department of Real Estate, the Department of Insurance, California Horse Racing Board, Board of Chiropractic Examiners, and the State Bar of California. This proposal would require these agencies to add a new workload that would require additional staff. Discussions with licensing boards identified concerns over due process hearings and consumer protection—not to file and pay their state income taxes.

Other States

Illinois, Massachusetts, Minnesota, New York, Oregon, and *Wisconsin* tax laws provide for suspension of licensees, but the revenue department of those states notifies the licensing authority to suspend the licenses.

Missouri income tax laws provide that the revenue department can suspend an occupational or business license for delinquent liabilities and notifies the licensing board to suspend the licensee. The *Missouri* statutory scheme relies on the underlying administrative tax appeal to satisfy the due process requirement of a hearing before suspending a licensee. This scheme was recently upheld by the Court of Appeals for the Eighth Circuit.

Recently, *Pennsylvania* enacted an information exchange program to ensure that individuals and businesses licensed by the state pay their state taxes. The revenue department will notify licensing boards when it determines that an applicant or licensee has a state tax delinquency. The licensing board will deny or suspend licenses for failure to comply with state tax laws. *Pennsylvania* provides a hearing for the underlying tax liability, and the licensing board provides an administrative hearing before suspending a license.

Florida and *Michigan* do not have statutory authority to suspend business and professional licenses for delinquent tax liabilities.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Angela Raygoza	Barbara Ellison	Franchise Tax Board
(916) 845-7814	(916) 845-4950	(916) 845-6333
angela.raygoza @ftb.ca.gov	barbara.ellison@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Name Angela Raygoza
Telephone # (916) 845-7814
Attorney Tommy Leung

FRANCHISE TAX BOARD
PROPOSED AMENDMENTS
FOR LP 08-01

Section 1. Section 19265 is added to the Revenue and Taxation Code to read:

19265 (a) (1) All state governmental licensing entities issuing professional licenses, certificates, registrations, or permits shall provide to the Franchise Tax Board the name and social security number of each applicant for licensure with or licensee of that state governmental licensing entity. If any licensee has failed to pay taxes, including any penalties, interest, and any applicable fees, imposed under Part 10, Part 11, or this part, for which a notice of state tax lien has been recorded in any county recorder’s office in this state, pursuant to Chapter 14 (commencing with Section 7150) of Division 7 of Title 1 of the Government Code, the Franchise Tax Board shall send a notice of suspension to the applicable state governmental licensing entity and the licensee. The rights, powers, and privileges of any licensee whose professional license, certificate, registration, or permit has been suspended pursuant to this section will be subject to the same prohibitions, limitations, and restrictions as if the professional license, certificate, registration, or permit was suspended by the state governmental licensing entity that issued the professional license, certificate, registration, or permit. The suspension authorized by this section shall be applicable only if the Franchise Tax Board has mailed a preliminary notice of the suspension that indicates that the license will be suspended by a date certain. This preliminary notice shall be mailed to the licensee at least 60 days before that date certain.

(2) The Franchise Tax Board shall, within ten business days of compliance by the licensee, notify both the governmental entity issuing the professional or occupational license and the licensee that the unpaid taxes have been paid or an installment payment agreement as described in Section 19008 has been entered into to satisfy the unpaid taxes.

(b)(1) The Franchise Tax Board may defer or cancel any suspension authorized by this section if a licensee would experience substantial financial hardship. The Franchise Tax Board shall, if requested by the taxpayer in writing, provide for an administrative hearing to determine if the taxpayer will experience substantial financial hardship from the suspension of that taxpayer's license, certificate, registration, or permit.

(2) The request specified in paragraph (1) must be made within 30 days from the mailing date of the preliminary notice described in subdivision (a).

(3) If the taxpayer requests a hearing, the Franchise Tax Board shall conduct the hearing within 30 days after receipt of the request.

(4) A taxpayer seeking relief under this subdivision shall only be entitled to relief described in paragraph (1) of this subdivision if the taxpayer provides the Franchise Tax Board with financial documents that substantiate a substantial financial hardship and agrees to an acceptable payment arrangement.

(c) For purposes of this section, the following definitions shall apply:

(1) “State Governmental Licensing Entity” means any entity listed in Section 101, and the entities referred to in Sections 1000 and 19420 of the Business and Professions Code, the Department of Insurance, the State Bar, the Department of Real Estate, and any other state agency, board, or commission that issues a license, certificate, or registration authorizing a person to engage in a business or profession.

(2) “Licensee” same meaning a described in section 30, subdivision (e)(1), of the Business and Professions Code.

(3) “License” has the same meaning as described in section 30, subdivision (e)(2), of the Business and Professions Code.

(4) “Hardship" means financial hardship, as determined by the Franchise Tax Board, and shall exist if the taxpayer is financially unable to pay any part of the amount described in subdivision (a)and is unable to qualify for an installment payment arrangement as provided for by Section 19008. In order to establish the existence of a financial hardship, the taxpayer shall submit any information requested by the Franchise Tax Board for the purpose of making that determination.

(d) Implementation of this section shall be contingent on the appropriation of funds for the purposes of this section in the Annual Budget Act.

Sec. 2 Section 19571 is added to the Revenue and Taxation Code to read:

19571 (a) Franchise Tax Board may disclose to state governmental licensing entities information regarding suspension of licensees for delinquent tax pursuant to Section 19265.

(b) Neither the state governmental entity nor any officer, employee, or agent, or former officer, employee, or agent of the state governmental entity may disclose or use any information obtained from the Franchise Tax Board pursuant to this section except to inform the public of the suspension of a license, certification, registration or permit of a licensee to engage in an occupation or profession pursuant to Section 19265.

Sec. 3 Section 31 of The Business and Professions Code is amended to read as follows:

(a) As used in this section, "board" means any entity listed in Section 101, the entities referred to in Sections 1000 and 3600, the State Bar, the Department of Real Estate, and any other state agency that issues a license, certificate, or registration authorizing a person to engage in a business or profession.
(b) Each applicant for the issuance or renewal of a license, certificate, registration, or other means to engage in a business or profession regulated by a board who is not in compliance with a judgment or order for support shall be subject to Section 11350.6 of the Welfare and Institutions Code.
(c) "Compliance with a judgment or order for support," has the meaning given in paragraph (4) of subdivision (a) of Section 11350.6 of the Welfare and Institutions Code.
(d) <u>Each applicant for the issuance or renewal of a license, certificate, registration, or other means to engage in a business or profession regulated by a board who has not paid their state income tax including interest, penalties, and other fees shall be subject to Section 19265 of the Revenue and Taxation Code.</u>

Sec. 4 Section 7145.5 of the Business and Professions Code is amended to read as follows:

7145.5. (a) The registrar may refuse to issue, reinstate, reactivate, or renew a license or may suspend a license for the failure of a licensee to resolve all outstanding final liabilities, which include taxes, additions to tax, penalties, interest and any fees that may be assessed by the board, the Department of Industrial Relations, the Employment Development Department, or the Franchise Tax Board.

(1) Until the debts covered by this section are satisfied, the qualifying person and any other personnel of record named on a license that has been suspended under this section shall be prohibited from serving in any capacity that is subject to licensure under this chapter, but shall be permitted to act in the capacity of a nonsupervising bona fide employee.

(2) The license of any other renewable licensed entity with any of the same personnel of record that have been assessed an outstanding liability covered by this section shall be suspended until the debt has been satisfied or until the same personnel of record disassociate themselves from the renewable licensed entity.

(b) The refusal to issue a license or the suspension of a license as provided by this section shall be applicable only if the registrar has mailed a notice preliminary to the refusal or suspension that indicates that the license will be refused or suspended by a date certain. This preliminary notice shall be mailed to the licensee at least 60 days before the date certain.

~~(c) In the case of outstanding final liabilities assessed by the Franchise Tax Board, this section shall be operative within 60 days after the Contractor's State Licensing Board has provided the Franchise Tax Board with the information required under Section 30, relating to licensing information which includes the federal employee identification number or social security number.~~

~~(d) All versions of the application for contractor's licenses shall include, as part of the application, an authorization by the applicant, in the form and manner mutually agreeable to the Franchise Tax Board and the board, for the Franchise Tax Board to disclose the tax information that is required for the registrar to administer this section. The Franchise Tax Board may from time to time audit these authorizations.~~

Sec. 5. It is the understanding and intent of the Legislature that, consistent with the decision in *Crum* v. *Vincent, Missouri Director of Revenue* (8^{th} Cir. 2007) 493 F.3^{rd} 988, the suspension of a professional or occupational license for failure to file returns or pay delinquent taxes satisfies the due process requirements of the California and federal constitutions if a taxpayer is provided an opportunity for a hearing to challenge a proposed tax assessment prior to it becoming final and collectable. Because California law provides an opportunity for a hearing prior to a proposed assessment becoming final, due process is satisfied without an additional hearing prior to the suspension of a professional or occupational license of a delinquent taxpayer. To prevent financial hardship, section 19265 of the Revenue and Taxation Code, as added by Section 1 of this act, grants a delinquent taxpayer the opportunity for an additional hearing for financial hardship prior to the suspension of a professional or occupational license.

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 Solution:** 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.

  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, would have the option to forward a file containing customer data for the department to match against delinquent tax and non-tax debtor records.

- **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 LP 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
No impact	+$35	+$60	+$90

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 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.

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 to only financial institution account information.

Proposed Solution

Amend the Revenue and Taxation Code to require financial institutions doing business in California, including designated data-processing agents, to match information on delinquent income tax debtors against customer records on a quarterly basis.

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 would have the option to forward a file containing customer data for the department to match against delinquent tax and non-tax debtor records.

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 records match process 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.

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.

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

Financial institutions currently receive no reimbursement for the costs of 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 by July, 2010.

Fiscal Impact

Staff estimates a one-time cost to FTB of $3.6 million to program, develop, and test a new financial institution record match system for income tax and non-tax debt administration. Staff estimates on-going annual costs of $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 15.7 Personnel Years for the development phases and 24.2 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. Financial institutions in California are not reimbursed for conducting data matches for the FIDM program. Data obtained from the Kentucky Department of Revenue 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 California policy decision for no reimbursement to financial institutions for FIDM program costs.

Economic Impact

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

Estimated Revenue Impact of LP 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
No impact	+$35	+$60	+$90

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

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.

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 $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 by approximately 75% to $9 million ($70 million x 50% x 25%).

Because larger cases are normally worked manually by collection staff, it is expected that cases with balances less than $25,000 could most effectively be worked using an automated process such as this proposal. Accordingly, it is estimated that the financial match process would generate additional collections. Based on a review of open and discharged accounts, these delinquent accounts total $5.8 billion. FTB staff estimates that matches would be made on approximately 12.5% of these outstanding balances, which would total $725 million ($5.8 billion x 12.5%).

The delinquent balance of $725 million would be associated with over 250,000 cases.
Of these cases, it is anticipated that financial institutions would only be able to process 17% 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, 16.5% of the balance would be collected. Thus, during the first year total, new money would equal approximately $25 million ($725 million x 17% x 120% x 16.5%). 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 $35 million to $27 million ($680 x 40,000). The average balance 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 $35 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 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 $130 million a year for both tax and non-tax programs.

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.

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.

LEGISLATIVE STAFF CONTACT

Deborah Barrett
Franchise Tax Board
845-4301
Deborah.Barrett@ftb.ca.gov

Stephanie Rios
Franchise Tax Board
845-4204
Stephanie.Rios@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Name Deborah Barrett
Telephone # 916-845-4301
Attorney Patrick Kusiak

FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO LP 08-02

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.

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 08-03
EXECUTIVE SUMMARY

- **Title:** Controlled Foreign Corporations In Water's-Edge Combined Report

- **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 removing current law's "stand alone" inclusion ratio method and conforming to the federal Subpart F rules for computing the amount of a CFC's income that is included in a shareholder's income with some specific exceptions.

  This proposal would allow a 27% dividend deduction against the CFC's Subpart F income included in the water's-edge taxpayer's income.

- **Major Concerns/Issues:** None

- **Revenue:**

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

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.

Miscellaneous Federal Provisions Relating to CFCs.

- 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.

[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]

<u>Program History/Background</u>

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.

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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.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Gail Hall	Mark Ford	Franchise Tax Board
(916) 845-6111	(916) 845-3408	(916) 845-6333
Gail.Hall@ftb.ca.gov	Mark.Ford@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Gail Hall
Telephone # (916) 845-6111
Attorney Patrick Kusiak

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~~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.

(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.

LEGISLATIVE PROPOSAL 08-06
EXECUTIVE SUMMARY

- **Title:** Mandatory Personal Income Tax Electronic Payments
- **Problem:** Low use by taxpayers of electronic technologies to make income tax payments contributes to increased processing costs and significant loss of interest to the State.
- **Proposed Solution:** Add Revenue and Taxation Code section 19011.5 to require personal income taxpayers with estimated tax or extension payments in excess of $20,000 or tax liabilities in excess of $80,000 to make all payments through an electronic method prescribed by Franchise Tax Board.
- **Major Concerns/Issues:** None
- **Revenue:**

Estimated Revenue Impact of LP 08-06 Enactment Assumed after 6/30/08 Effective for Tax Payments Made for Tax Years BOA 1/1/09			
Fiscal Year	**2008-09**	**2009-10**	**2010-11**
Penalty Revenues	Gain < $150,000	Gain < $150,000	Gain < $150,000
Reduced Taxes	N/A	Loss < $500,000	Loss < $500,000

*Interest Income due to Reduced Float Time	+$4 million	+$ 9 million	+$9 million

*Because this indirect revenue effect does not involve the collection of income tax revenues, they are outside the scope of this tax revenue estimate.

Title

Mandatory Personal Income Tax (PIT) Electronic Payments

Introduction

This proposal would require Personal Income Tax (PIT) taxpayers with estimate tax or extension payments that exceed $20,000 or with tax liabilities of $80,000 or more to remit their payments electronically.

Program History/Background

The Franchise Tax Board (FTB) processed 8.1 million PIT paper payments in fiscal year (FY) 2006-07. These large volumes of paper payments require extensive manual processing. In addition, delays in depositing these payments of several days after receipt occur during tax return filing season, which results in significant loss of interest income to the State.

During FY 2006-07, FTB processed approximately 141,000 paper payments over $20,000 totaling $14.2 billion. FTB received approximately 58,791 payments over $20,000 between April 16 and April 27. It took an average of seven days to deposit these payments. The remaining paper payments received in FY 2006-07 took an average of three days for deposit. The following table highlights this scenario:

Criteria	Number of Days To Make Deposits	Annual Daily Interest Rate[1]	Annual Deposit	Increase in Interest Earned
Estimated Paper Deposits: payments greater than $20,000 received 4/16/07-4/27/07	7	0.0142465753%	$6,770,392,318	$6,751,843
Estimated Paper Deposits: payments greater than $20,000 (remainder of year)	3	0.0142465753%	$7,400,288,004	$3,162,862
TOTAL			$14,170,680,322	$9,914,705

Paper payment processing results in a minimum two-day delay in depositing the paper payment (one day for the post office and one day to deposit) and can take up to 16 days. Currently, 13.6% of PIT payments are electronically remitted, which represents 2.4% of all PIT payment dollars. For corporations, the volume of electronic payments is 3.2% of the total payments made, representing approximately 80% of the total payment dollars remitted.

[1] Per State Treasurer's Office, Annual Interest rate – 5.2%, daily Interest Rate Annualized - 0.0142465753%

Personal income taxpayers can currently exercise the following options to pay their taxes:

- Payment by paper check, money order, or cashier's check,
- Payment by credit card, subject to payment of a "convenience fee,"
- Payment through an electronic filing application that debits the taxpayer's bank account for a designated amount at a time determined by the taxpayer, or
- Payment through FTB's Web-pay service that debits a bank account for a designated amount at a time determined by the taxpayer.

Businesses and individuals can pay all their federal taxes using the Electronic Federal Tax Payment System (EFTPS). Individuals can pay their quarterly estimated taxes electronically using EFTPS, and they can make payments weekly, monthly, or quarterly, as well, as schedule payments for the entire year in advance. EFTPS is accessible via the Internet or telephone. Businesses can initiate a transaction from their financial institutions that will credit their FTB account through Electronic Funds Transfers (EFT), or can instruct FTB to initiate the transaction to debit their financial institution account for their tax liabilities or estimated payments.

Current Federal Law

Federal Reserve Banks and certain financial institutions that are depositaries or financial agents of the United States have authority to accept tax payments for tax imposed under the federal tax laws. Because federal tax payments can be made at most local banks, the need for electronic payment processing is reduced significantly at the federal level.

Taxpayers with aggregate tax payments over $200,000 in a calendar year are required to make those tax payments by EFT methods.

Current State Law

Under current state law, a corporate taxpayer with tax liability exceeding $200,000 in a taxable year or with an estimated tax payment in excess of $50,000 is required to remit its tax payment electronically. If a taxpayer is required to remit payment electronically and remits payment in another method, it is subject to a penalty calculated at 10% of the amount paid, unless the failure was due to reasonable cause. Taxpayers subject to these requirements may request a waiver from FTB under certain circumstances. PIT taxpayers can voluntarily choose to remit funds by EFT.

Problem

Low use by taxpayers of electronic technologies to make income tax payments contributes to increased processing costs and significant loss of interest to the State.

Proposed Solution

Add Revenue and Taxation Code section 19011.5 to require personal income taxpayers with estimated tax or extension payments in excess of $20,000 or tax liabilities in excess of $80,000 to make all payments through an electronic method prescribed by FTB.

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 tax payments made on or after that date.

Justification

Electronically transmitted payments eliminate deposit delays, thus giving the state immediate use of the deposits. This proposal would improve the cashiering and processing functions of FTB. The department would expect to see reduced processing times in receiving, information validation, and key data entry functions in addition to increased accuracy in the application of payments to taxpayers' accounts. This proposal would provide greater security for taxpayer transactions and help prevent taxpayer identify theft.

Requiring electronic payment by certain personal income taxpayers at this threshold would affect less than 1.8% of taxpayers making payments, but represents over 50% of the total funds deposited.

Implementation

FTB can implement this proposal with existing processes and resources. Cost savings to the department for this proposal are discussed in the Fiscal Impact section below.

Fiscal Impact

From an operational cost reduction standpoint, FTB estimates that it would save approximately 72 cents in processing costs for each paper payment converted into an electronic payment. Assuming this proposal would convert approximately 141,000 paper payments into electronic payments, the department anticipates it will save over $100,000 in processing costs annually.

The proposal would require system reprogramming and processing changes. The department estimates that one-time costs of $260,000 would offset the anticipated processing savings of $100,000 in the first year. FTB would incur ongoing costs of approximately $171,000 to provide customer service for electronic payment specific issues, which would also be offset by $100,000 in processing savings annually.

Economic Impact

Revenue Estimate

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

Estimated Revenue Impact of LP 08-06 Enactment Assumed after 6/30/08 Effective for Tax Payments Made for Tax Years BOA 1/1/09			
Fiscal Impact	2008-09	2009-10	2010-11
Penalty Revenues	Gain < $150,000	Gain < $150,000	Gain < $150,000
Reduced Taxes	N/A	Loss < $500,000	Loss < $500,000
*Interest Income due to Reduced Float Time	+$4 million	+$ 9 million	+$9 million

*Because this indirect revenue effect does not involve the collection of income tax revenues, they are outside the scope of this tax revenue estimate.

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

Revenue Discussion

The revenue impact of this proposal would depend on the amount of penalty for failure to remit electronically that is collected and the extent taxpayer’s interest income is reduced by reduced deposit delays.

FTB estimates approximately 28,000 taxpayers would be impacted by this proposal. [140,000 total PIT payments greater than $20,000 divided by a total of five payments (four quarterly estimated payments + one return payment) per taxable year = 28,000 individual taxpayers]. Based on the high compliance rate under mandatory EFT for corporations, FTB expects potential revenue attributable to penalty assessment to be less than $150,000 annually.

FTB expects this proposal to reduce the interest income of affected taxpayers by approximately $6 million annually. ($14 billion targeted EFT payments x money market daily rate of 0.0082% x five fewer float days = $6 million reduced taxable interest income). Assuming a marginal tax rate of 8%, the revenue loss from the reduced taxable incomes of affected taxpayers would be approximately $500,000 ($6 million interest income x 8%).

Additionally, FTB estimates that this proposal would indirectly result in an increase of $9 million of interest income to the General Fund. ($14 billion targeted payments x pooled money investment daily rate of 0.0123% x 5 fewer days of delayed deposits = $9 million interest income). The amount is reduced in the first fiscal year to reflect the calendar year implementation.

Other Agency/Industry Impacted

Financial institutions may see an increase in electronic payment transactions between the department and taxpayers, which would reduce the volume of paper transactions for banks. Because these transactions can generally be processed more safely and economically than standard paper check transactions, financial institutions are likely to be supportive of this proposal.

Other States

Laws from the states of *New Jersey, Illinois, Massachusetts, Michigan, Minnesota, and New York* were reviewed due to their similarities to California's economy, business entity types, and tax laws. While all of the states provide electronic payment options, only *New Jersey*, *Massachusetts,* and *Illinois* have mandatory EFT requirements.

- *New Jersey* requires any taxpayer with a prior year liability of $10,000 or more in any one tax year to remit payments for all taxes by using EFT methods.
- *Massachusetts* limits mandatory EFT requirements to business taxes and withholding payments, but does not have mandatory EFT requirements for PIT payments.
- *Illinois* requires EFT for any PIT tax payments that exceed $200,000. *Illinois* also participates in an IRS pilot program that allows taxpayers to remit both federal and state tax payments through EFTPS.

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Deborah Barrett
(916) 845-4301
Deborah.Barrett@ftb.ca.gov

Revenue estimated by:
Keith York
(916) 845-5299
Keith.York@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
Brian.Putler@ftb.ca.gov

Analyst Deborah Barrett
Telephone # 845-4301
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-06

AMENDMENT 1

Revenue and Taxation Code Section 19011.5 is added to read:

19011.5 (a) All payments required under this part, regardless of the taxable year to which the payments apply, made on or after January 1, 2009, shall be electronically remitted to the Franchise Tax Board in a form and manner prescribed by the Franchise Tax Board, once any of the following conditions are met:

(1) With respect to any individual, any installment payment of estimated tax made pursuant to this part in excess of twenty thousand dollars ($20,000) or any payment made pursuant to Section 18567 with regard to an extension of time to file exceeds twenty thousand dollars ($20,000) for any taxable year beginning on or after January 1, 2009.

(2) With respect to any individual, the total tax liability exceeds eighty thousand dollars ($80,000) in any taxable year beginning on or after January 1, 2009. For purposes of this section, total tax liability shall be the total tax liability as shown on the original return, after any adjustment made pursuant to Section 19051.

(b) A taxpayer required to remit electronic payments to the Franchise Tax Board may elect to discontinue making payments where the threshold requirements set forth in paragraphs (1) and (2) of subdivision (a) were not met for the preceding taxable year. The election shall be made in a form and manner prescribed by the Franchise Tax Board.

(c) Any taxpayer required to electronically remit payment pursuant to this section who makes payment by other means shall pay a penalty of 10 percent of the amount paid, unless it is shown that the failure to make payment as required was for reasonable cause and was not the result of willful neglect.

(d) Any taxpayer required to electronically remit payment pursuant to this section may request a waiver of those requirements from the Franchise Tax Board. The Franchise Tax Board may grant a waiver only if it determines that the particular amounts paid in excess of the threshold amounts established in this section were not representative of the taxpayer's tax liability. If Franchise Tax Board grants a waiver to a taxpayer, subsequent electronic remittances shall be required only on those terms set forth in the waiver.

(e) For purposes of this section, Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code does not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax Board pursuant to subdivision (a).

(f) For purposes of this section, "remit electronically" means to send payment through use of any of the electronic payment applications provided by the Franchise Tax Board.

LEGISLATIVE PROPOSAL 08-07
EXECUTIVE SUMMARY

- **Title:** Conformity to Federal Backup Withholding

- **Problem:** Some California resident and nonresident taxpayers underreport income or fail to file a California tax return entirely, thereby contributing to the tax gap.

- **Proposed Solution:** Conform to the federal backup withholding regime to require such withholding at a rate of 7% for California purposes whenever it is required for federal purposes.

- **Major Concerns/Issues:** None

- **Revenue:** The revenue impact of this proposal is estimated to be as shown in the following table:

Estimated Revenue Impact of LP 08-07 Effective 1/1/2009 Enacted by 6/1/2008 ($ in Millions)			
2008/09	2009/10	2010/11	2011/12
+$35	+$35	+$35	+$40

Title

Conformity to Federal Backup Withholding

Introduction

This proposal would require withholding on certain payments whenever such payments are subject to federal backup withholding.

Program Background

The California tax gap is estimated to be about $6.5 billion per year. Almost 80% of the tax gap is attributable to underreporting of income or overreporting of deductions, primarily by individuals. Studies conducted by the IRS indicate that taxpayers voluntarily report 96% of income that is subject to information reporting. That rate increases to 99% when the income is subject to withholding.

Current federal and California law requires business payers to file with the government and payees information returns on many types of payments that generally produce taxable income. The federal Form 1099 series is used to report various types of income such as nonemployee compensation, interest and dividends, or brokerage proceeds. Information reporting is effective at improving compliance because the information is shared with the government and this reporting encourages taxpayers to include this reported income on their voluntarily filed returns. The effectiveness of information returns as a compliance tool is compromised if the information cannot be successfully linked to the correct taxpayer because of bad or missing taxpayer identification numbers (TINs).

To address the problem of bad or missing TINs, federal law requires backup withholding—that is, withholding at the time and source of payment—at a rate of 28% on certain payments if the payee fails to furnish a TIN to the payer or the payer is notified by the IRS that the provided TIN is incorrect. Backup withholding also applies to interest and dividend payments if the taxpayer has previously underreported such payments.

Payers are instructed to use federal Form W-9, Request for Taxpayer Identification Number and Certification, to request a payee's TIN. A TIN is usually a federal employer identification number (FEIN) or social security number (SSN). In general, the TIN used for information reporting for IRS purposes is accepted by the Franchise Tax Board (FTB). However, California state agencies are required to use Std. 204 to request a service-provider's (i.e., payee's) TIN and the service-provider must provide a correct TIN in order to do business with the State of California. For this purpose, the appropriate TIN for an individual or sole proprietor is their SSN.

FTB currently administers a withhold-at-source program on payments to nonresidents for services performed by independent contractors, rents, royalties, estate distributions, trust distributions, and partnership distributions and allocations of income. Withholding, generally at a rate of 7%, is required when payments to a nonresident exceed a threshold amount. FTB also administers withholding on sales of California real estate by residents and nonresidents. California does not have a backup withholding program.

Current Federal Law

Banks and other businesses that make payments of the type that are required to be reported on an information return— i.e., Form 1099 series—may be required to backup withhold on those payments. As described above in Program Background, a payee is required to provide a correct TIN to the payer who must report that information on the applicable Form 1099.

Payments subject to backup withholding include interest (Form 1099-INT); dividends (1099-DIV); certain patronage dividends (1099-PATR); rents, profits, or other gains (Form 1099-MISC); commissions, fees, or other payments to independent contractors (1099-MISC); payments by brokers (1099-B); certain payments by fishing boat operators (1099-MISC); royalty payments (1099-MISC); and certain gambling winnings (W-2G). Payments that are excluded from federal backup withholding include, among other things, real estate transactions, unemployment compensation, and state or local income tax refunds.

Payments to the payee will be subject to backup withholding at a rate of 28% in the following situations:

- Payee does not give the payer his or her TIN in the required manner.
- The IRS notifies the payer that the TIN payee gave was incorrect.
- Payee is required, but fails, to certify that he or she is not subject to withholding.
- The IRS notifies the payer to start withholding on interest or dividends because the payee has underreported interest or dividends on his or her federal income tax return. The IRS will do this only after it has mailed the payee four notices over at least a 210-day period.

Federal law provides civil and criminal penalties for giving false information to avoid backup withholding. This civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000 or imprisonment of up to one year, or both.

Current State Law

California does not conform to federal backup withholding rules.

Problem

Some California resident and nonresident taxpayers underreport income or fail to file a California tax return entirely, thereby contributing to the tax gap.

Proposed Solution

Conform to the federal backup withholding regime to require such withholding at a rate of 7% for California purposes whenever it is required for federal purposes.

Effective/Operative Date of Solution

If enacted in 2008, this proposal would become effective January 1, 2009, and operative for payments made on or after that date.

Justification

Bad or missing TINs compromise FTB's enforcement efforts—including its ability to pursue nonfilers—by preventing FTB from linking reported income to the correct taxpayer. Backup withholding would address an element of the tax gap by ensuring the state receives advance payment for such income and encourage an otherwise nonfiling taxpayer to file a tax return.

Implementation

Implementation of this proposal could be performed during normal annual updates: forms and instructions would be modified and developed, minor systems changes would be made, and education and outreach efforts would be conducted to inform payers of the new requirement. The department would generally rely on the IRS to determine whether backup withholding should start or stop; however, the department would develop a process to address payee requests to stop or prevent withholding if they claim it is not required for California purposes. On an ongoing basis, it would be necessary for the department to manually process a high percentage of tax returns filed that claim backup withholding credits due to missing or mismatched TINs on withholding documents.

Fiscal Impact

Departmental costs to implement this proposal are anticipated to be minor and would be performed during normal annual forms and systems updates. Estimated annual costs to administer and process backup withholding remitted to the department are also expected to be minor and would be absorbed by the withhold-at-source business area. Estimated annual costs to process tax returns claiming backup withholding credits and to respond to taxpayer contacts would be approximately $200,000.

Economic Impact

Tax Revenue Estimate

The revenue impact of this proposal is estimated to be as shown in the following table:

Estimated Revenue Impact of LP 08-07 Effective 1/1/2009 Enacted by 6/1/2008 ($ in Millions)			
2008/09	2009/10	2010/11	2011/12
+$35	+$35	+$35	+$40

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 above revenue impact was estimated in three steps. First, federal backup withholding amounts were estimated based on the federal total tax withheld on taxpayers with California addresses as reported on IRS forms 1099-B, 1099-DIV, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and W-2G. It was assumed that: (1) 50% of the tax reported as withheld on form 1099-MISC, (2) 75% of the amount reported as withheld on form W-2G, and (3) 100% of the tax reported as withheld on the remaining forms represent federal backup withholding. It was estimated that about $543 million of federal backup withholding were withheld on 376,000 taxpayers with California addresses in 2005.

Next, the California backup withholding amount was estimated. Because California does not have jurisdiction over out-of-state banks, brokers, and firms that do not have nexus with this state, not all payments subject to federal backup withholding would be subject to California backup withholding. The assumed percentages of federal backup withholding that are subject to California backup withholding vary by tax forms, ranging from 20% for forms 1099-B and 1099-DIV to 75% for form 1099-MISC. In addition, the estimates were adjusted to reflect that the proposed California backup withholding rate of 7% versus the federal rate of 28%. It was estimated that approximately $74 million of backup withholding would be withheld on 143,000 California taxpayers in 2005.

Finally, the estimated California backup withholding amount was adjusted to discount for: (1) the amount of tax that taxpayers would have paid anyway under current law (assumed to be 50%), and (2) the refunds due to over-withholding that would occur under this proposal (assumed to be 12%). The net impact of the proposed California backup withholding program was then extrapolated to later years. The extrapolation was based upon the latest Department of Finance forecast for corporate profits. For the 2009 tax year, California backup withholding was estimated to be $85 million. The amount of tax that taxpayers would have paid anyway under current law was estimated to be $42 million. The refunds due to over-withholding were estimated to be $11 million.

The extrapolated results on a tax-year basis were then converted to a fiscal-year basis. For example, it was estimated that only $44 million of the 2009 backup withholding, $9 million of the amount of tax that taxpayers would have paid anyway under current law, and none of the 2009 refunds due to over-withholding would occur in the 2008/2009 fiscal year. The result is an estimated net revenue gain of $35 million from approximately 76,000 taxpayers. ($44m − $9m = $35m). Similarly, for the 2009/10 fiscal year, it was estimated that $87 million would be withheld under this proposal. This amount was reduced by $9 million in refunds of amounts withheld under this proposal and $42 million that would have been otherwise collected under current law, resulting in a net revenue gain of $35 million from approximately 145,000 taxpayers. ($87m − ($9m + $43m) = $35m). Similar calculations were performed for subsequent years.

Policy Considerations

- Gambling winnings are subject to federal backup withholding if the winner fails to give the payer his or her SSN. Indian tribal gaming operations are subject to federal backup withholding requirements, but it is unclear what methods are available to enforce withholding obligations of tribal gaming operations at the state level.
- It is not clear whether California can compel federal government payers to backup withhold for California purposes.

Industry Impacted

Any business that makes payments in the course of its trade or business of the type that is required to be reported could be impacted by this proposal. This proposal would particularly impact financial institutions, brokerage houses, and other firms that pay interest or dividends because backup withholding would be required both for bad or missing TINs *and* for underreported interest and dividends. However, the impact would be mitigated by the fact that the California backup withholding regime would only apply when backup withholding is also required for federal purposes.

Other States

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.

Minnesota law follows the federal provisions for backup withholding on payments for personal services only. The amount withheld is determined by applying the highest individual income tax rate, currently 7.85%. In addition, if an entertainment entity fails to provide the payer with a TIN, the payer must withhold at the backup rate of 8.5%. Corporations are exempt from backup withholding.

Illinois law expressly states that no withholding is required on payments subject to federal backup withholding.

Review of the laws of *Florida*, *Massachusetts*, *Michigan*, and *New York* did not reveal any backup withholding requirements.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Anne Mazur	Hoang Nguyen	Franchise Tax Board
(916) 845-5404	(916) 845-4985	(916) 845-6333
anne.mazur@ftb.ca.gov	hoang.nguyen@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Anne Mazur
Telephone # 916-845-5404
Attorney Douglas Powers

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP 08-7

AMENDMENT 1

SECTION 1. Section 18661 of the Revenue and Taxation Code is amended to read:

18661. When necessary to make effective the provisions of this article or Article 4 (commencing with Section 18631), the name, address, social security number or other taxpayer identification number ~~and address~~ of the recipient of income shall be furnished upon demand of the person paying the income.

AMENDMENT 2

SEC. 2. Section 18664 is added to the Revenue and Taxation Code to read:

18664. (a)(1) Section 3406 of the Internal Revenue Code, relating to backup withholding, shall apply, except as otherwise provided.

(2) For purposes of this section, the term "reportable payment," as defined in Section 3406(b) of the Internal Revenue Code, shall include only payments of items of income as defined in Section 18662 and any regulations thereunder.

(b) The amount of tax to be withheld shall be computed by applying a rate of 7 percent.

(c) Where withholding under both this section and other provisions of this article would otherwise be required, withholding shall only be required under this section.

(d) Any payer required to withhold tax pursuant to this section shall notify the payee of such withholding at a time and in a manner as may be prescribed in forms and instructions by the Franchise Tax Board.

(e) This section shall apply to payments made on or after January 1, 2009.

LEGISLATIVE PROPOSAL 08-09
EXECUTIVE SUMMARY

- **Title:** Modify The Group Return Provisions

- **Problem:** Certain nonresident taxpayers excluded from filing a group nonresident return in some instances avoid both filing a return and enforcement detection thereby contributing to the tax gap.

- **Proposed Solution:** Amend current law to allow the following to be included in a group nonresident return:

  - Entities with less than two electing nonresident individuals, and
  - Individuals with more than $1,000,000 in California taxable income.

- **Major Concern/Issue:** None

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

Revenue Estimate for LP 08-09 Effective for Tax Years BOA 1/1/2009 Assumed Enactment Date After 6/30/2008 ($ in Millions)			
	2008/2009	2009/2010	2010/2011
General Fund Revenue	+$2	+$6	+$6
Mental Health Fund Revenue	+$3	+$7	+$7

Title

Modify The Group Return Provisions

Introduction

This proposal would expand the concept of group nonresident returns to allow entities with fewer than two electing nonresident individuals and individuals with more than $1,000,000 in California taxable income to elect to be included in a group nonresident return.

The rationale to allow additional taxpayers to elect to use the group nonresident returns is to make filing state returns more convenient, thereby encouraging those nonresidents who might not be filing returns currently to at least start participating in filing a California return via a group return.

Current State Law

Existing state law imposes tax on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

California statutes do not explicitly establish rules to source income. Instead, the relevant California statute, as well as a body of case law, delegates to the Franchise Tax Board (FTB) authority to prescribe sourcing rules by regulation.

These legislative regulations provide that income from services is sourced to California to the extent the services are performed in this state. When nonresidents perform services in California and other states, compensation for these services is sourced to California by using various apportionment methods that reasonably reflect the value of the California services as compared to the total services performed. These regulations are consistent with federal statutes that limit or preempt California's ability to tax the California source income of nonresidents.

California allows certain nonresidents who receive a distributive or pro rata share of income from a pass-through entity (partnerships[1] or S corporations) that derives income from California sources or is doing business in California to elect to have the pass-through entity file a group nonresident return on their behalf.[2] In addition, California allows filing of a group nonresident return for electing nonresident directors of a corporation. Electing nonresident directors would be those individuals that receive California source wages, salaries, fees, or other compensation from that corporation for director services, including attendance at board of directors' meetings that take place in this state.

Existing state law imposes tax on individuals, corporations, and certain business entities, and each is treated as a distinct entity for tax purposes.

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[1] This includes limited liability companies classified as partnerships, registered limited liability partnerships, and foreign limited liability partnerships.
[2] Revenue & Taxation Code section 18535.

Under existing state law and instructions specifically prescribed by FTB, all of the following conditions must be met to be eligible to be included in a group nonresident return:

1) The partner/member/shareholder/director must be an individual. Estates, trusts, partnerships, LLCs, C corporations, S corporations, or other business entities cannot be included in the group nonresident return.
2) The individual must be a full-year nonresident of California.
3) The individual must not have California taxable income in excess of $1,000,000.

The individual's only California source income must be from pass-through entities for the partner, member, or shareholder, and for directors, compensation from the corporation must be for director related services.

Assuming these requirements are satisfied, the business entity files the group nonresident return and pays the tax on behalf of the electing nonresidents. The return must be for a calendar year and, except in the case of an S corporation shareholder, must include at least two electing nonresidents. An S corporation may file a group nonresident return on behalf of one shareholder. The business entity must use Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, for the group nonresident return. A nonresident individual can be included on more than one group nonresident return.

Nonresidents subject to the mental health tax (taxable income in excess of $1,000,000) are ineligible to be included in a group nonresident return.

Program History/Background

Currently, electing individuals included in group nonresident returns are taxed at the highest marginal rate (9.3%), without deductions. While individuals with more than $1,000,000 in California taxable income are ineligible to be included in a group nonresident return because their taxable income in excess of $1,000,000 would need to be taxed at the highest marginal rate plus the additional 1% (mental health tax) rate, for a total of 10.3%.

Under this proposal, the electing individuals with more than $1,000,000 in taxable income would be taxed at the highest marginal rate plus the additional 1% (10.3%) on their entire income, not just the amount over $1,000,000. If an electing individual with more than $1,000,000 in taxable income is included in more than one group nonresident return, the individual's income from each group nonresident return would be assessed at the highest marginal rate plus the additional 1%.

For tax year 2005, the department received approximately 3,300 group nonresident returns on behalf of an estimated 68,000 nonresidents. Currently, per instructions specifically prescribed by FTB, group nonresident returns are not allowed to be filed electronically. After processing group nonresident returns, the department sends these returns to the Filing Enforcement Unit where the member and income information is manually keyed.

Problem

Certain nonresident taxpayers excluded from filing a group nonresident return in some instances avoid both filing a return and enforcement detection thereby contributing to the tax gap.

Proposed Solution

Amend current law to allow the following to be included in a group nonresident return:

- Entities with less than two electing nonresident individuals, and
- Individuals with more than $1,000,000 in California taxable income.

Effective/Operative Date of Solution

If enacted in the 2008 legislative session, this proposal would be effective on January 1, 2008, and operative for returns filed on or after January 1, 2010, for taxable years beginning on or after January 1, 2009.

Justification

This proposal would ease the filing burden for nonresidents with very little connection to California, provide administrative convenience for both individuals and FTB, and help close a part of the tax gap by collecting revenue that may go unreported under the current scheme.

Implementation

Implementing this proposal would have a moderate impact on the department as discussed below under Fiscal Impact. Department staff anticipates implementing the proposal during the normal updates and would apply to returns filed beginning January 1, 2010.

Legislative History

AB 970 (Torrico, Stat. 2006, Ch. 343) authorized nonresident directors that receive California source wages, salaries, fees, or other compensation from that corporation for director services to file a group nonresident return.

SB 298 (Campbell, Stat. 1995, Ch. 475) exempted from withholding income that is paid by a corporation for services performed in California to a nonresident corporate director for services.

AB 129 (Jones, Stat. 1987, Ch. 918) authorized nonresident individuals that receive a distributive share of income from a pass-through entity to file a group nonresident return.

Fiscal Impact

Implementing this proposal would require changes to existing tax forms (Form 540NR, California Part-Year Resident or Nonresident Income Tax Return and Publication 1067, Guidelines for Filing a Group Form 540NR) and instructions, manually validating filed group returns, programming changes to computer systems, and electronic applications. The department would incur one-time costs for these items of approximately $101,000, with absorbable annual ongoing costs.

Economic Impact

Revenue Estimate:

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

The Revenue Estimate for LP 08-09 Effective for Tax Years BOA 1/1/2009 Assumed Enactment Date After 6/30/2008 ($ in Millions)			
	2008/2009	2009/2010	2010/2011
General Fund Revenue	+$2	+$6	+$6
Mental Health Fund Revenue	+$3	+$7	+$7

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

Revenue Discussion:

The revenue impact of this proposal would depend on the following:

1) The extent compliance increases among nonresident non-filers that would generate new revenue.
2) The extent taxpayers switch their method of filing, from filing individual nonresident returns to filing as part of a group return.
3) The extent that taxpayers with income in excess of $1,000,000 no longer erroneously file as part of a group return.

1. Increase in compliance

To the extent this proposal eases the filing process, some non-filing nonresident taxpayers may become compliant. The number of noncompliant nonresident taxpayers and their tax liabilities are unknown.

An estimate of the expected increase in compliance can be made with the amount of tax currently paid by nonresident taxpayers that report partnership income. For taxable year 2005, the amount of tax paid by nonresidents who only report partnership income is estimated to total $280 million.

This includes nonresidents who file a single nonresident return, as well as those who file as part of a group nonresident return. Assuming that nonresident partners are on average 90% compliant regarding the reporting of partnership income to California, approximately $30 million [($280 million ÷ 90%) - $280 million)] in taxes currently go unreported.

This proposal is not anticipated to substantially entice taxpayers to fulfill their filing or reporting requirements. Assuming that unreported tax would be reduced by 1%, this portion of the proposal would result in a minor revenue gain of $300,000 ($30 million x 1%).

<u>2. Change in method of filing</u>

This proposal would expand group return eligibility rules to include:

- Group 1: Single nonresident members of partnerships, LLCs, or corporations, and
- Group 2: Nonresident members of flow-through entities with taxable income in excess of $1 million.

This change is anticipated to ease the filing process and entice nonresidents that file single returns to start filing as part of a group return. Based on a review of nonresident data, taxpayers from Group 1 that would be enticed to switch are estimated to currently report $15 million in adjusted gross income (AGI). Tax liabilities for Group 1 taxpayers would increase because they would be assessed at a higher tax rate and not be allowed to use any exemptions, deductions, or credits. A comparison of data on reported AGI and tax liabilities implies that, on average, taxpayers would be assessed an additional 2.3% that would result in a $350,000 ($15 million x 2.3%) positive revenue impact.

For Group 2, based on a review of tax return data for nonresident taxpayers currently subject to the mental health tax, it is estimated that 305 taxpayers would switch and file as part of a group return.

Taxpayers with more than $1million in taxable income are currently assessed an effective tax rate of 9.4%, of which 8.9% represents revenue attributed to the General Fund and 0.5% represents revenue attributed to the Mental Health Fund. By filing a group return, these taxpayers would not be allowed to use any exemptions, deductions, or credits. Essentially, this proposal would assess these taxpayers at a new effective tax rate of 10.3%, of which 9.3% would be attributed to the General Fund and 1% to the Mental Health Fund. It is estimated that AGI currently reported by these taxpayers approximates $975 million. The difference in tax rates within each fund would generate a $4 million increase in revenue for the General Fund [($975 million x 9.3%) – ($975 million x 8.9%)] and a $5 million increase in revenue for the Mental Health Fund [($975 million x 1%) – ($975 million x 0.5%)].

<u>3. Group returns that currently erroneously include taxpayers subject to the mental health tax</u>

Currently, some group returns erroneously include taxpayers subject to the mental health tax. The taxpayers erroneously filing group returns will be issued a filing enforcement notice and be required to pay the tax calculated on an individual basis, for which the actual tax rate on AGI will likely be between 9.3% and 10.3%.

Assuming the combined tax rate calculated on an individual nonresident return for a particular taxpayer's income is 9.7%, General Fund revenue under current law would be composed of two parts: (1) 9.3% of income would be received by the return filing date, and (2) an additional 0.4% of income would be received after the taxpayer is served with a filing enforcement notice and subsequently files an individual return. For this same taxpayer, under this proposal, the amount of revenue would be 10.3% of income, and it would be received by the return due date. This proposal would, essentially, lead to a trade off; the 0.4% of income that is received into the General Fund with a lag of one to two years after the return due date would be lost, in exchange for a gain of 1% of income for the Mental Health Fund. This revenue would be received by the return filing date.

The revenues generated by allowing these taxpayers to file as part of group returns, rather than file erroneously as part of a group return and then be subject to filing enforcement activity, is estimated to result in an increase in mental health tax revenues of about $1 million. It is also expected to reduce General Fund revenue by an insignificant amount with a year lag.

Summary

Based on taxable year 2005 data, General Fund revenues would increase by approximately $6 million ($300,000 for additional compliance + $350,000 for the single nonresident member for partnership, LLC, or corporation + $5 million for taxpayers with more than $1,000,000 in taxable income) and the Mental Health Fund would increase by approximately $6 million. The revenue estimate in the chart above includes adjustments for projected growth in taxable income and reflects a fiscal year cash flow basis.

Other States

Of the 40 states with a personal income tax, 39 states (Nebraska is the one exception) allow either the filing of group returns or impose an entity level tax similar to the group return concept. Specifically, *New York*, *Delaware, Pennsylvania*, and *Connecticut* allow group nonresident returns to be filed by pass-through entities, and they all require the electing partners to be individuals (the same as current California law). Requirements and criteria such as what entities can file, allowable deductions, exemptions, and tax rates vary widely for each state.

Policy Consideration

Even though individuals with more than $1,000,000 in California taxable income make the election to be included in a group nonresident return, those wanting to participate in group nonresident returns would be taxed at the highest marginal rate plus the additional 1% on their entire income. Thus, under this proposal, some taxpayers would trade convenience and ease of the filing for a higher tax rate.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Nicole Kwon	Stephanie Rios	Franchise Tax Board
(916) 845-7800	(916) 845-4204	(916) 845-6333
haeyoung.kwon@ftb.ca.gov	stephanie.rios@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Nicole Kwon
Telephone # 845-7800
Attorney Douglas Powers

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-09

AMENDMENT 1

Section 18535 of the Revenue and Taxation Code is amended as follows:

18535. (a) In lieu of electing nonresident partners filing a return pursuant to Section 18501~~or 18507~~, the Franchise Tax Board may, pursuant to requirements and conditions set forth in forms and instructions, provide for the filing of a group return for <u>one or more</u> electing nonresident partners by a partnership doing business in, or deriving income from, sources in California. The tax rate or rates applicable to each electing partner's distributive share shall ~~be~~ <u>consist of</u> the highest marginal rate or rates provided by Part 10 (commencing with section 17001<u>), plus, in the case of any electing nonresident partner included on the group return who would be subject to Section 17043 when filing individually, an additional tax rate of 1 percent.</u> Except as provided in subdivision (b), no deductions shall be allowed except those necessary to determine each partner's distributive share, and no credits shall be allowed except those directly attributable to the partnership. As required by the Franchise Tax Board, the partnership as agent for the electing partners shall make the payments of tax, additions to tax, interest, and penalties otherwise required to be paid by the electing partners.

(b) Deductions provided by Chapter 5 (commencing with Section 17501) of Part 10, attributable to earned income of a partner derived from a partnership filing a group return on behalf of electing nonresident partners under subdivision (a), shall be allowed if the partner certifies, in the form and manner as the Franchise Tax Board may prescribe, that he or she has no earned income from any other source.

(c) This section shall also be applicable to a nonresident shareholder of a corporation which is treated as an "S corporation" under Chapter 4.5 (commencing with Section 23800) of Part 11. In that case, the provisions of subdivisions (a) and (b) are modified to refer to "shareholder or shareholders" in lieu of "partners" and to "S corporation" in lieu of "partnership."

(d) This section shall also be applicable to a nonresident ~~person~~ <u>individual</u> with a membership or economic interest in a limited liability company, registered limited liability partnership, or foreign limited liability partnership, which is classified as a partnership for

California tax purposes. In that case, the provisions of subdivisions (a) and (b) are modified to refer to "holders of a membership or economic interest" in lieu of "partners" and to "limited liability companies" in lieu of "partnerships," and "partnerships" shall include registered limited liability partnerships and foreign limited liability partnerships.

(e) The Franchise Tax Board may adjust the income of an electing nonresident taxpayer included in a group return filed under this section to properly reflect income under Part 10 (commencing with Section 17001), including Chapter 11 thereof (commencing with Section 17951), this part (commencing with Section 18401), and Part 11 (commencing with Section 23001), including Chapter 17 thereof (commencing with Section 25101).

Amendment 2

Section 18536 of the Revenue and Taxation Code is amended as follows:

18536. (a) In lieu of electing nonresident directors filing a return pursuant to Section 18501, the Franchise Tax Board may, pursuant to requirements and conditions set forth in applicable forms and instructions, provide for the filing of a group return by a corporation for one or more electing nonresident individuals who receive wages, salaries, fees, or other compensation from that corporation for director services, including attendance of board of directors' meetings that take place in this state. The tax rate or rates applicable to each director's compensation for services performed in this state shall ~~be the~~ consist of the highest marginal rate or rates provided for by Part 10 (commencing with Section 17001) of Division 2), plus, in the case of any electing nonresident director included on the group return who would be subject to Section 17043 when filing individually, an additional tax rate of 1 percent, and no deductions or credits ~~should~~ shall be allowed. As required by the Franchise Tax Board, the corporation, as the agent for the electing nonresident directors, shall make the payments of tax, additions to tax, interest, and penalties otherwise required to be paid by, or imposed on, the electing directors.

(b) The Franchise Tax Board may adjust the income of an electing nonresident taxpayer included in a group return filed under this section to properly reflect the income under Part 10 (commencing with Section 17001) of Division 2.

Amendment 3

Sec. 3. The amendments made by section 1 and 2 of this act shall apply to returns filed on or after January 1, 2010, for taxable years beginning on or after January 1, 2009.

LEGISLATIVE PROPOSAL 08-11
EXECUTIVE SUMMARY

- **Title:** Real Estate Withholding for Certain Non-California Business Entities
- **Problems:**
  1. Non-California partnerships with nonresident partners are not subject to withholding on sales of California real property and thus have a high likelihood of avoiding taxation.
  2. The rate of real property withholding on sales by non-California S corporations is insufficient to approximate the total tax that would be due by both the S corporation and nonresident shareholders on the gain.
  3. Nonresident sellers of California real property pursuant to an installment agreement are not subject to withholding when payments are received in later years unless the buyer elects to do so and thus have a high likelihood of avoiding taxation.
  4. Current withholding sections contain redundancies and technical errors that should be fixed.
- **Proposed Solutions:**
  1. Amend Revenue and Taxation Code (R&TC) section 18662 to require non-California partnerships to be subject to withholding on California real property sales at a rate of 3 1/3% of sales proceeds or 9.3% of gain.
  2. Amend R&TC section 18662 to specify that the entity level and pass-through rates be combined to determine the alternative withholding rate to be applied to the gain on the sale. In other words, the withholding rate would equal the sum of the S corporation rate and the maximum individual rate (1.5% + 9.3% = 10.8%).
  3. Amend R&TC section 18662 to require the buyer to withhold on each installment sale payment if the sale is structured as an installment sale.
  4. Amend R&TC section 18668 to remove redundant language, to clarify that withholding amounts can be collected from the withholding agent if the agent fails to withhold or fails to remit to FTB withheld amounts, and to provide a clear method for assessment and collection of unremitted withholding.
- **Major Concerns/Issues:** Real estate industry representatives have said that mandatory real estate withholding on each installment payment would place a burden on the buyer and may stifle seller-financed transactions.
- **Revenue:** The revenue impact of this proposal is estimated to be as shown in the following table:

Estimated Revenue Impact of LP 08-11 Effective 1/1/2009 Enacted by 6/1/2008 ($ in Millions)				
	2008/09	2009/10	2010/11	2011/12
Non-California S Corporations	+ $1	+ $1	a/	a/
Non-California Partnerships	+ $7	+ $2	+ $2	+ $2
Installment Sales	b/	c/	a/	a/
Total	+ $8	+ $3	+ $2	+ $2

a/ Minor gains of less than $500,000.
b/ Minor loss of less than $500,000.
c/ Insignificant gains of less than $150,000.

Title

Real Estate Withholding for Certain Non-California Business Entities

Introduction

This proposal would ensure that tax is collected on payments to certain nonresident businesses and their owners on the sale of California real property and make technical corrections for the administration of withholding law.

Background

The California tax gap is estimated to be about $6.5 billion per year. Almost 80% of the tax gap is attributable to underreporting of income or overreporting of deductions, primarily by individuals. Studies conducted by the IRS indicate that taxpayers voluntarily report 96% of income that is subject to information reporting. That rate increases to 99% when the income is subject to withholding. That rate decreases to 68% when there is no information reporting or withholding.

California's law requiring withholding on payments to foreign (i.e., non-U.S) partnerships and other persons from sales of California real property was established and modified—generally in conformity to federal rules—over a period of years prior to 1990. Beginning in 1991, these provisions were extended to sales of California property by domestic (i.e., U.S.) nonresidents of California.[1] Sales of real property by <u>all</u> partnerships (California and out-of-state) were excluded from the real estate withholding provisions on the presumption that withholding on distributions of sale proceeds to nonresident partners would cover the amount of tax that could become due on such sales.

Current State Law

Revenue and Taxation Code (R&TC) section 18662 requires withholding at source from payments to nonresident individuals and business entities with no permanent place of business in California.

Real Estate Withholding – Partnerships and S Corporations

Current law generally requires withholding at source at the rates shown in the table that follows. Generally, payments of California source income to nonresident individuals and non-California business entities are subject to withholding at source. For sales of California real property, both resident and nonresident individuals and corporations without permanent place of business following the sale are subject to withholding. Partnerships—regardless of whether California or non-California—are not subject to real estate withholding. Under Franchise Tax Board's (FTB) general withholding authority, partnerships are subject to 7% withholding on California source payments received, but in the case of a payment to a non-California partnership on a real estate sale, FTB has taken the position in its forms and instructions that no withholding is required.

[1] SB 2319 (Stats. 1990, Ch. 464).

For S corporation sellers of real property, California taxes the gain from that sale in two steps. First, the gain is taxed under the corporate franchise tax at the S corporation entity level rate. Second, the income from the sale that is passed through to the shareholders as their pro rata share is taxed to the shareholder, generally at the personal income tax rate. However, as noted in the table, for S corporations that elect the alternative withholding amount based on gain, the applicable withholding rate is limited to the entity-level tax rate.

Transaction	**Resident Individuals Tax rate: 9.3%**	**Nonresident Individuals Tax rate: 9.3%**	**Non-CA Partnerships Tax rate depends on partner entity type**	**Non-CA C Corps Tax rate: 8.84% or 10.84%**	**Non-CA S Corps**	
					Entity-level tax rate—1.5% or 3.5%	**Share-holder tax rate—9.3% of pro rata share**
Payments of CA source income to nonresidents	Not applicable	7% of income	7% of income and 7% of distribution to partners	7% of income	7% of income	7% of distribution
Sale of CA real property						
• Default withholding based on sale proceeds	3 1/3%	3 1/3%	Not applicable	3 1/3%	3 1/3%	
• Taxpayer elects withholding based on gain	9.3%	9.3%	Not applicable	8.84% or 10.84% for financial corps	1.5% or 3.5% for financial corps	

Real Estate Withholding—Installment Sales

In the case of a sale of real property that qualifies as an "installment sale" under the Internal Revenue Code (IRC), current law allows the buyer to elect to withhold on each of the installment payments over the life of the installment contract, rather than withholding and remitting the entire withholding amount at the time of sale.

Withholding Administration

R&TC section 18668 provides additional withholding requirements and administrative procedures, including penalties and interest for failing to withhold or to remit withholding.[2]

[2] Because the withholding statutes were modified over a period of decades, sometimes conforming to federal provisions in piecemeal fashion, a few procedural provisions regarding the assessment and collection of amounts required to be withheld are duplicative, internally inconsistent, and contradictory.

Problems

1. Non-California partnerships with nonresident partners are not subject to withholding on sales of California real property and thus have a high likelihood of avoiding taxation.

2. The rate of real property withholding on sales by non-California S corporations is insufficient to approximate the total tax that would be due by both the S corporation and nonresident shareholders on the gain.

3. Nonresident sellers of California real property pursuant to an installment agreement are not subject to withholding when payments are received in later years unless the buyer elects to do so and thus have a high likelihood of avoiding taxation.

4. Current withholding sections contain redundancies and technical errors that should be fixed.

Proposed Solutions

1. Amend R&TC section 18662 to require non-California partnerships to be subject to withholding on California real property sales at a rate of 3 1/3% of sales proceeds or 9.3% of gain.

2. Amend R&TC section 18662 to specify that the entity level and pass-through rates be combined to determine the alternative withholding rate to be applied to the gain on the sale. In other words, the withholding rate would equal the sum of the S corporation rate and the maximum individual rate (1.5% + 9.3% = 10.8%).

3. Amend R&TC section 18662 to require the buyer to withhold on each installment sale payment if the sale is structured as an installment sale.

4. Amend R&TC section 18668 to remove redundant language, to clarify that withholding amounts can be collected from the withholding agent if the agent fails to withhold or fails to remit to FTB withheld amounts, and to provide a clear method for assessment and collection of unremitted withholding.

The following table illustrates the solution for problems 1 and 2 in large, bold type.

Transaction	**Resident Individuals Tax rate: 9.3%**	**Nonresident Individuals Tax rate: 9.3%**	**Non-CA Partnerships Tax rate depends on partner entity type**	**Non-CA C Corps Tax rate: 8.84% or 10.84%**	**Non-CA S Corps**	
					Entity-level tax rate—1.5% or 3.5%	**Share-holder tax rate—9.3% of pro rata share**
Payments of CA source income to nonresidents	Not applicable	7% of income	7% of income and 7% of distribution to partners	7% of income	7% of income	7% of distribution
Sale of CA real property						
• Default withholding based on sale proceeds	3 1/3%	3 1/3%	**3 1/3%**	3 1/3%	3 1/3%	
• Taxpayer elects withholding based on gain	9.3%	9.3%	**9.3%**	8.84% or 10.84% for financial corporations	**10.8%** or **12.8%** for financial corporations	

Effective/Operative Date of Solution

If enacted in 2008, this proposal would become effective on January 1, 2009, and apply to real property sales that occur on or after that date.

Justification

This proposal would help reduce the tax gap by ensuring collection of tax on California source income due from a narrow set of nonresidents. The proposed withholding would also encourage those taxpayers to file tax returns at the end of the year.

Real Estate Withholding – Partnerships

Under current law, exemption of non-California partnerships from the real estate withholding rules creates loopholes and inequities that this proposal would resolve by eliminating this exemption:

- A sale by an individual is subject to withholding, but if that individual transfers the property to a partnership, the individual can avoid withholding and possibly evade California taxation on their distributive share of the partnership's gain on the sale.

- Non-California partnerships are treated more favorably than other non-California business entities with regard to withholding on sales of California real property. The latter are subject to the withholding requirements if, after the sale, they no longer have a permanent place of business in California.
- If the partnership does not have a permanent place of business in California it is difficult, if not impossible, for FTB to verify that a return is eventually filed by the partners who should be reporting income from the sale.

Real Estate Withholding – S Corporations

Under current law, only the 1.5% entity-level withholding rate applies to sales of real property by S corporations that elect the alternative withholding amount based on gain. Because the tax due on the gain on sale by an S corporation would include both the entity-level tax and the tax—generally at a rate of 9.3%–on the shareholders' pro rata share of the gain, the entity-level rate alone substantially under withholds the total California tax due. This oversight potentially allows nonresident shareholders to evade taxation on the income from the sale. Using a combined (entity-level plus individual) rate for sales by S corporations would resolve this problem.

Real Estate Withholding – Installment Sales

Current law permits the buyer to make an election to withhold on a payment-by-payment basis rather than withholding on the entire sale in the year of sale. Many buyers fail to make such an election, resulting in overwithholding in the year of sale and no withholding in later years as subsequent payments are made and gain on sale is recognized. Mandatory withholding on a payment-by-payment basis would resolve this problem.

Implementation

This proposal would not significantly impact the department's programs or operations. Systems, forms, and instructions would be modified to administer the proposed withholding. In addition, education and outreach efforts would be conducted to inform withholding agents of the new requirements.

Fiscal Impact

Departmental costs associated with this proposal are anticipated to be minor and would be implemented during normal annual forms and systems updates.

Economic Impact

Revenue Estimate

The revenue impact of this proposal is estimated to be as shown in the following table:

Estimated Revenue Impact of LP 08-11 Effective 1/1/2009 Enacted by 6/1/2008 ($ in Millions)				
	2008-09	2009-10	2010-11	2011-12
Non-California S Corporations	+ $1	+ $1	a/	a/
Non-California Partnerships	+ $7	+ $2	+ $2	+ $2
Installment Sales	b/	c/	a/	a/
Total	+ $8	+ $3	+ $2	+ $2

a/ Minor gains of less than $500,000.
b/ Minor loss of less than $500,000.
c/ Insignificant gains of less than $150,000.

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

Revenue Discussion

The revenue impact of this proposal was estimated separately for each of the three real property withholding provisions. Revenue impact was generally estimated as the difference between the cash flow under current law and the cash flow under proposed law. Cash flow includes withheld amounts, both with regard to the time of sales and the time of S corporation and partnership distributions, tax amounts paid subsequent to sales or distributions, and refunds. The general approach was to determine—under both current law and proposed law—how much tax would actually be paid and in what form: withholding, estimated payments, final payments, or refund. Then the approximate timing in which the payments would be received was assigned to those payments.

For non-California S corporations, the withheld amounts at the time of sale under current law were based on actual amounts reported to FTB. The amount of tax paid on shareholders' pass-through income under current law was approximated as the estimated gain from the above withholding times an assumed average tax rate of 7%. The amount of withholding and refunds under proposed law were computed based on the above estimated gains times the proposed withholding rate of 10.8% (1.5% + 9.3%). The net impact was extrapolated to later tax years.

For extrapolation purposes, it was assumed that real estate sales would decline by 10% a year from 2007 to 2009 and would remain flat in 2010 and 2011. The extrapolated results on a tax-year basis were then converted to fiscal-year basis.

Total real estate sales by non-California S corporations were estimated to be $887 million in 2009. The alternative withholding rate would be elected for only $115 million of these sales, the gain on which was estimated to be $38 million. After applying the methodology described in the first paragraph above, this provision would result in revenue increases of $1 million in the 2008/09 and 2009/10 fiscal years, and minor revenue increases of less than $500,000 in the 2010/11 and 2011/12 fiscal years.

For non-California partnerships, real estate withholding is not currently required. The amount of tax paid on partners' pass-through income under current law and the withholding and refund amounts under proposed law were estimated as the product of the estimated real estate gains or sales by non-California partnerships and the applicable tax rates (the assumed tax rate on pass-through income is 7%). The real estate gain of non-California partnerships was assumed to be approximately 63% of real estate gain of non-California S corporations, estimated above. This assumption was based on the ratio of the reported number of partnerships in finance, insurance, and real estate industries in 2004 over the same number for S corporations. Real estate sales of non-California partnerships were then derived from the estimated gain and an assumed profit margin of 33%, resulting in $557 million in 2009. The net impact was extrapolated to later tax years and converted to fiscal-year basis. After applying the methodology described in the first paragraph above, it was estimated this provision would result in revenue increases of $7 million for the 2008/09 fiscal year and $2 million for each of the later fiscal years. The revenue drop after the first year was due to the offset of tax refunds against withholding in the later years that would not occur in the first year.

The total amount of real estate installment sales was estimated from reported real estate withholding data on installment sales. Installment sales without buyer agreement to withhold on each installment payment were assumed to be equal to 25% of all real estate installment sales. From the above data, the amounts of new withholding, refunds, and taxes under proposed and current law were derived. The net impact was then extrapolated to later tax years and converted to fiscal-year basis. Real estate installment sales without buyer agreement were estimated to be $25 million in 2009. After applying the methodology described above, it was estimated this provision would result in minor revenue losses for the 2008/09 fiscal year and insignificant or minor revenue increases in later fiscal years. The revenue loss in the 2008/09 fiscal year was caused by applying the 3 1/3% withholding rate to each installment payment under proposed law, rather than the total sales prices as required under current law. That is, under the proposal, the withholding shifts from year of sale to later years as installment payments are received.

There is no revenue impact resulting from the technical correction provision of this proposal.

Policy Considerations

Installment Sales

Pro: The current law was intentionally drafted to permit an election by—rather than a mandate on—the buyer to withhold on a payment-by-payment basis because of the burden such withholding might place on the buyer. However, where the buyer fails to make such an election, it has become evident that there is such a mismatch of withholding to income recognition, that there is too great an opportunity for nonresident sellers to escape taxation on gain recognized in the years following the sale. Usually, any first-year withholding will greatly exceed the tax due from the transaction for the year of sale and FTB must refund it back to the seller.

Con: Mandatory withholding on each installment payment would place a burden on the buyer and may stifle seller-financed transactions.

Industry Impacted

This proposal would impact the escrow and title industry or any other person—such as an exchange accommodator—facilitating the sale of California real property. The installment provision of the proposal may also tend to have a negative impact on the housing market by, as noted in Policy Considerations above, stifling seller-financed transactions.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Anne Mazur	Hoang Nguyen	Franchise Tax Board
(916) 845-5404	(916) 845-4985	(916) 845-6333
anne.mazur@ftb.ca.gov	hoang.nguyen@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Anne Mazur
Telephone # 916-845-5404
Attorney Douglas Powers

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP 08-11

AMENDMENT 1

SECTION 1. Section 18662 of the Revenue and Taxation Code is amended to read:

18662. (a) The Franchise Tax Board may, by regulation, require any person, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and any officer or department of the state or any political subdivision or agency of the state, or any city organized under a freeholder's charter, or any political body not a subdivision or agency of the state, having the control, receipt, custody, disposal, or payment of items of income specified in subdivision (b), to withhold an amount, determined by the Franchise Tax Board to reasonably represent the amount of tax due when the items of income are included with other income of the taxpayer, and to transmit the amount withheld to the Franchise Tax Board at the time as it may designate.

(b) The items of income referred to in subdivision (a) are interest, dividends, rents, prizes and winnings, premiums, annuities, emoluments, compensation for services, including bonuses, partnership income or gains, and other fixed or determinable annual or periodical gains, profits, and income.

(c) The Franchise Tax Board may authorize the tax under subdivision (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(d) Any person **that fails** ~~failing~~ to withhold from any payments any amounts required **by this section or fails to remit taxes withheld is liable for the amount specified in section 18668** ~~**by subdivision (a) to be withheld is liable for the amount withheld or the amount of taxes due from the person to whom the payments are made to an extent not in excess of the amounts required to be withheld, whichever is greater, unless it is shown that the failure to withhold is due to reasonable cause**~~.

(e) (1) This subdivision applies to any disposition of a California real property interest by:

(A) Any person, other than either of the following:

(i) **Except as otherwise provided in this subdivision, a** ~~A~~ corporation, including an entity classified for tax purposes as a corporation under Part 11 (commencing with Section 23001).

(ii) **Except as otherwise provided in this subdivision, a** ~~A~~ partnership, as determined in accordance with Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code, including an entity classified as a partnership for tax purposes under Part 10 (commencing with Section 17001).

(B) A corporation **or partnership,** if **that** ~~the~~ corporation **or partnership** immediately after the transfer of the title to the California real property has no permanent place of business in California. For purposes of this subdivision, a corporation **or partnership** has no permanent place of business in California if all of the following apply:

(i) It is not organized and existing under the laws of California.

(ii) It does not qualify with the office of the Secretary of State to transact business in California.

(iii) It does not maintain and staff a permanent office in California.

(2) (A) Except as provided in subparagraph (B), in the case of any disposition of a California real property interest by a transferor described in paragraph (1), the transferee, including for this purpose any intermediary or accommodator in a deferred exchange, is required to withhold an amount equal to 3 1/3 percent of the sales price of the California real property conveyed.

(B) If the transferor makes an election under this subparagraph, the transferee, including any intermediary or accommodator in a deferred exchange, is required to withhold an amount equal to an amount certified by the transferor in writing under penalty of perjury. The amount certified shall not be less than the gain required to be recognized under Part 10 (commencing with Section 17001) **and** ~~or~~ Part 11 (commencing with Section 23001) on the disposition of the California real property multiplied by the rate specified in either Section 23151 or Section 23186, as applicable, for transferors that are corporations, or the highest rate specified in Section 17041 for transferors other than corporations. For purposes of applying the previous sentence, **the following shall apply:**

(i) ~~the~~ **The** highest rate specified in Section 17041 is determined without regard to any other tax rate specified under Part 10 (commencing with Section 17001) irrespective of whether the applicable statute provides that tax shall be treated as if imposed under Section 17041.

(ii) For corporations that are “S corporations” subject to the modified tax rate specified in Section 23802, the rate shall be the sum of the rate specified in subdivision (b) of Section 23802 and the highest rate specified in Section 17041, as described in clause (i).

(C) (i) The written certification required by subparagraph (B) shall be in a form, as prescribed by the Franchise Tax Board. The form shall provide as follows:

"Title and escrow persons and exchange accommodators are not authorized to provide legal or accounting advice for purposes of determining withholding amounts. Transferors are strongly encouraged to consult with a competent tax professional for this purpose."

(ii) The Franchise Tax Board shall make this form available electronically on its Web site in a format that allows a transferor to complete and print the form. The Franchise Tax Board shall also provide electronic means to enable the transferor to estimate the amount of gain required to be recognized by the transferor in the transaction. Any form or worksheet, electronic or otherwise, developed for this purpose shall provide as follows:

"Title and escrow persons and exchange accommodators are not authorized to provide legal or accounting advice for purposes of determining withholding amounts. Transferors are strongly encouraged to consult with a competent tax professional for this purpose."

(3) Notwithstanding any other provision of this subdivision, all of the following shall apply:

(A) No transferee is required to withhold any amount under this subdivision unless the sales price of the California real property conveyed exceeds one hundred thousand dollars ($100,000).

(B) No transferee, other than an intermediary or an accommodator in a deferred exchange, is required to withhold any amount under this subdivision unless written notification of the withholding requirements of this subdivision has been provided by the real estate escrow person.

(C) (i) No transferee, trustee under a deed of trust, or mortgagee under a mortgage with a power of sale is required to withhold under this subdivision when the transferee has acquired California real property at a sale pursuant to a power of sale under a mortgage or deed of trust or a sale pursuant to a decree of foreclosure or has acquired the property by a deed in lieu of foreclosure.

(ii) No transferee is required to withhold under this subdivision when the transferor is a bank acting as trustee other than a trustee of a deed of trust.

(D) No transferee, including for this purpose any intermediary or accommodator in a deferred exchange, is required to withhold any amount under this subdivision if the transferee, in good faith and based on all the information of which he or she has knowledge, relies on a written certificate executed by the transferor, certifying, under penalty of perjury, one of the following:

(i) (I) The California real property being conveyed is the seller's or decedent's principal residence, within the meaning of Section 121 of the Internal Revenue Code.

(II) The last use of the property being conveyed was use by the transferor as the transferor's principal residence within the meaning of Section 121 of the Internal Revenue Code.   (ii) (I) The California real property being conveyed is being exchanged, or will be exchanged, for property of like kind, within the meaning of Section 1031 of the Internal Revenue Code, but only to the extent of the amount of the gain not required to be recognized for California income or franchise tax purposes under Section 1031 of the Internal Revenue Code.

(II) Subclause (I) may not apply if an exchange does not qualify for nonrecognition treatment for California income or franchise tax purposes under Section 1031 of the Internal Revenue Code, in whole or in part, due to the failure of the transaction to comply with the provisions of Section 1031(a)(3) of the Internal Revenue Code, relating to the requirement that property be identified and that the exchange be completed not more than 180 days after the transfer of the exchanged property.

(III) In any case where clause (ii) applies, the transferee, including for this purpose any intermediary or accommodator in a deferred exchange, is required to notify the Franchise Tax Board in writing within 10 days of the expiration of the statutory periods specified in Section 1031(a)(3) of the Internal Revenue Code and thereafter remit the applicable withholding amounts determined under this subdivision in accordance with paragraph (4).

(iii) The California real property has been compulsorily or involuntarily converted, within the meaning of Section 1033 of the Internal Revenue Code, and the transferor intends to acquire property similar or related in service or use so as to be eligible for nonrecognition of gain for California income tax purposes under Section 1033 of the Internal Revenue Code.

(iv) The transaction will result in either a net loss or a net gain not required to be recognized for California income or franchise tax purposes.

(v) The transferor is a corporation with a permanent place of business in California.

(E) (i) In the case of any transaction otherwise subject to this subdivision that qualifies as an "installment sale," within the meaning of Section 453(b) of the Internal Revenue Code, for California income tax purposes, the provisions of this subdivision ~~**may, upon the irrevocable written election of the transferee,**~~ **shall** be separately applied to each principal payment to be made under the terms of the installment sale agreement between the parties.

(ii) For purposes of clause (i), subparagraph (A) of paragraph (3) does not apply to each individual payment to be received under the terms of the installment sale agreement.

~~**(iii) The election under this subparagraph shall be made at the time, and in the form and manner, specified by the Franchise Tax Board in forms and instructions, except that the form shall, at a minimum, include the requirement specified in clause (iv) of this subparagraph.**~~

~~**(iv) The election under this subparagraph is valid only if the**~~

~~**transferee agrees to withhold and remit from each installment payment the amount specified under this subdivision in the form and manner, and at the time, specified in paragraph (4).**~~

(4) (A) Amounts withheld and payments made in accordance with this subdivision shall be reported and remitted to the Franchise Tax Board in the form and manner and at the time specified by the Franchise Tax Board. Notwithstanding the foregoing, funds withheld on individual transactions by real estate escrow persons may, at the option of the real estate escrow person, be remitted by the 20th day of the month following the close of escrow for the individual transaction, or may be remitted on a monthly basis in combination with other transactions closed during that month.

(B) The transferor shall submit a copy of the written certificate and supporting documentation for the reduced withholding specified in subparagraph (B) of paragraph (2) or subparagraph (D) of paragraph (3), executed by the transferor, to the Franchise Tax Board upon request.

(5) For purposes of this subdivision, "California real property interest" means an interest in real property located in California and defined in Section 897(c)(1)(A)(i) of the Internal Revenue Code.

(6) For purposes of this subdivision, "real estate escrow person" means any of the following persons involved in the real estate transaction:

(A) The person, including any attorney, escrow company, or title company, responsible for closing the transaction.

(B) If no person described in subparagraph (A) is responsible for closing the transaction, then any other person who receives and disburses the consideration or value for the interest or property conveyed.

(7) (A) Unless the real estate escrow person provides "assistance," it shall be unlawful for any real estate escrow person to charge any customer for complying with the requirements of this subdivision.

(B) For purposes of this paragraph, "assistance" includes, but is not limited to, helping the parties clarify with the Franchise Tax Board the issue of whether withholding is required under this subdivision or, upon request of the parties, withholding an amount under this subdivision and remitting that amount to the Franchise Tax Board.

(C) For purposes of this paragraph, "assistance" does not include providing the written notification of the withholding requirements of this subdivision.

(D) In a case where the real estate escrow person provides "assistance" in complying with the withholding requirements of this subdivision, it shall be unlawful for the real estate escrow person to charge any customer a fee that exceeds forty-five dollars ($45).

(8) For purposes of this subdivision, "sales price" means the sum of all of the following:

(A) The cash paid, or to be paid, but excluding for this purpose any stated or unstated interest or original issue discount, as determined under Sections 1271 through 1275, inclusive, of the Internal Revenue Code.

(B) The fair market value of other property transferred, or to be transferred.

(C) The outstanding amount of any liability assumed by the transferee or to which the California real property interest is subject immediately before and after the transfer.

(9) The Franchise Tax Board may prescribe, by forms, instructions, published notices, or regulations, any requirements necessary for the efficient administration of this subdivision relating to the treatment of "de ~~**minimus**~~ **minimis**" amounts otherwise required under this section.

~~**(f) Whenever any person has withheld any amount pursuant to this section, the amount so withheld shall be held in trust for the State of California. The amount of the fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations, including penalties, as are applicable with respect to the taxes imposed by Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part.**~~

(**f**~~g~~) Withholding is not required under this section with respect to wages, salaries, fees, or other compensation paid by a corporation for services performed in California for that corporation to a nonresident corporate director for director services, including attendance at a board of directors' meeting.

(**g**~~h~~) In the case of any payment described in subdivision (**f** ~~g~~), the person making the payment shall do each of the following:

(1) File a return with the Franchise Tax Board at the time and in the form and manner specified by the Franchise Tax Board.

(2) Provide the payee with a statement at the time and in the form and manner specified by the Franchise Tax Board.

(h~~i~~) (1) The amendments to this section made by Chapter 488 of the Statutes of 2002 apply to dispositions of California real property interests that occur on or after January 1, 2003.

(2) In the case of any payments received on or after January 1,2003, pursuant to an installment sale agreement relating to a disposition occurring before January 1, 2003, the amendments to this section made by Chapter 488 of the Statutes of 2002 do not apply to those payments.

(i) (1) The amendments made to this section by the act adding this subdivision shall apply to dispositions of California real property interests that occur on or after January 1, 2009.

(2) In the case of any payments received on or after January 1, 2009, pursuant to an installment sale agreement relating to a disposition occurring before January 1, 2009, the amendments made to this section by the act adding this subdivision do not apply to those payments.

AMENDMENT 2

SEC. 2. Section 18668 of the Revenue and Taxation Code is amended to read:

18668. (a) Every person required under this article to deduct and withhold any tax is hereby made liable for that tax~~,~~ to the extent provided by this section**.** ~~**and, insofar as they are not inconsistent with this article, all the provisions of this part relating to penalties, interest, assessment, and collections shall apply to persons subject to this part, and for these purposes**~~ **Any** ~~**any**~~ amount required to be deducted and paid to the Franchise Tax Board under this article shall be considered the tax of **that** ~~**the**~~ person. **Unless it is shown that the failure is due to reasonable cause, any** ~~**Any**~~ person who fails to withhold from any payments any amount required to be withheld under this article **or who fails to transmit the withheld amounts to the Franchise Tax Board on or before the due date required by regulations is liable for the amount actually** ~~**is liable for the amount**~~ withheld, or the amount of taxes due from the taxpayer to whom the payments are made**, whichever is greater,** but not in excess of the amount required to be withheld~~**, whichever is more, unless it is shown that the failure to withhold is due to reasonable cause**~~.

(b) If any amount required to be withheld under this article is not paid to the Franchise Tax Board on or before the due date required by regulations, interest shall be assessed at the adjusted annual rate established pursuant to Section 19521, computed from the due date to the date paid.

(c) Whenever any person has withheld any amount pursuant to this article, the amount so withheld shall be held to be a special fund in trust for the State of California.

(d) In lieu of the amount provided for in subdivision (a), unless it is shown that the failure to withhold is due to reasonable cause, whenever any transferee is required to withhold any amount pursuant to subdivision (e) of Section 18662, the transferee is liable for the greater of the following amounts for failure to withhold only after the transferee, as specified, is notified in writing of the requirements under subdivision (e) of Section 18662:

(1) Five hundred dollars ($500).

(2) Ten percent of the amount required to be withheld under subdivision (e) of Section 18662.

(e) (1) Unless it is shown that the failure to notify is due to reasonable cause, the real estate escrow person is liable for the amount specified in subdivision (d), when written notification of the withholding requirements of subdivision (e) of Section 18662 is not provided to the transferee, other than a transferee that is an intermediary or accommodator in a deferred exchange, and the California real property disposition is subject to withholding under subdivision (e) of Section 18662.

(2) The real estate escrow person shall provide written notification to the transferee (other than a transferee that is an

intermediary or accommodator in a deferred exchange) in substantially the same form as follows:

"In accordance with Section 18662 of the Revenue and Taxation Code, a buyer may be required to withhold an amount equal to 3 1/3 percent of the sales price or the amount that is specified in a written certificate executed by the transferor in the case of a disposition of California real property interest by either:

1. A seller who is an individual, trust, or estate or when the disbursement instructions authorize the proceeds to be sent to a financial intermediary of the seller, OR

2. A corporate **or partnership** seller that has no permanent place of business in California immediately after the transfer of title to the California real property.

The buyer may become subject to penalty for failure to withhold an amount equal to the greater of 10 percent of the amount required to be withheld or five hundred dollars ($500).

However, notwithstanding any other provision included in the California statutes referenced above, no buyer will be required to withhold any amount or be subject to penalty for failure to withhold if:

1. The sales price of the California real property conveyed does not exceed one hundred thousand dollars ($100,000), OR

2. The seller executes a written certificate, under the penalty of perjury, certifying that the seller is a corporation **or partnership** with a permanent place of business in California, OR

3. The seller, who is an individual, trust, estate**,** ~~or a~~ corporation**, or a partnership** without a permanent place of business in California executes a written certificate, under the penalty of perjury, of any of the following:

A. The California real property being conveyed is the seller's or decedent's principal residence, within the meaning of Section 121 of the Internal Revenue Code.   B. The last use of the property being conveyed was use by the transferor as the transferor's principal residence within the meaning of Section 121 of the Internal Revenue Code.

C. The California real property being conveyed is or will be exchanged for property of like kind, within the meaning of Section 1031 of the Internal Revenue Code, but only to the extent of the amount of gain not required to be recognized for California income tax purposes under Section 1031 of the Internal Revenue Code.

D. The California real property has been compulsorily or involuntarily converted, within the meaning of Section 1033 of the Internal Revenue Code, and that the seller intends to acquire property similar or related in service or use so as to be eligible for nonrecognition of gain for California income tax purposes under Section 1033 of the Internal Revenue Code.

E. The California real property transaction will result in a loss or a net gain not required to be recognized for California income tax purposes.   The seller is subject to penalty for knowingly filing a fraudulent certificate for the purpose of avoiding the withholding requirement."

(3) The real estate escrow person is not liable under this subdivision if the tax due as a result of the disposition of California real property is paid by the original or extended due date of the transferor's return for the taxable year in which the disposition occurred.

(4) The real estate escrow person or transferee is not liable under paragraph (1) or subdivision (d), if the failure to withhold is the result of his or her reliance, based on good faith and on all the information of which he or she has knowledge, upon a written certificate executed by the transferor under penalty of perjury pursuant to subparagraph (D) of paragraph (3) of subdivision (e) of Section 18662.

(5) Any transferor who for the purpose of avoiding the withholding requirements of subdivision (e) of Section 18662 knowingly executes a false certificate pursuant to that section is liable for twice the amount specified in subdivision (d).

(f) The amount of tax required to be deducted**,** ~~**and**~~ withheld **and remitted** under this article shall be assessed, collected, and paid **upon notice and demand.** ~~**in the same manner and subject to the same provisions and limitations, including penalties, as are applicable with respect to the taxes imposed by Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001).**~~ **Article 3 (commencing with Section 19031), relating to deficiency assessments, shall not apply with respect to the assessment or collection of any amount due under this article.**

LEGISLATIVE PROPOSAL 08-12
EXECUTIVE SUMMARY

- **Title:** Taxpayer Advocate Equity Relief

- **Problem:** The absence of affirmative statutory authority to administratively remedy an error made by FTB staff requires the taxpayer to seek an external remedy.

- **Proposed Solution:** Amend Part 10.7, Division 2 of the Revenue and Taxation Code (Taxpayers' Bill of Rights) to authorize the Advocate to waive penalties or additions to tax, fees, and interest that are a result of an FTB error. In addition, this proposal would do the following:

  - Apply only to instances where no part of the error is attributable to the taxpayer,
  - Preclude judicial or administrative review of the department's exercise of discretion,
  - Limit relief to situations where no other statute can be used to provide relief,
  - Require that for relief for amounts up to $500, a public record of the action taken and reason relief was warranted be placed in the office of the Executive Officer of the Franchise Tax Board,
  - Require that relief granted in excess of $500 be submitted to the Chief Counsel for concurrence,
  - Require that relief in excess of $7,500 be submitted to the Chief Counsel for concurrence and that the Chief Counsel be required to inform the three-member Franchise Tax Board,
  - Require the Advocate to include in its annual report to the Legislature a summary of the instances where relief was granted, the nature of the error or delay, and the steps taken by the department to remedy systemic issues that required relief.

- **Major Concerns/Issues:** None

- **Revenue:** The revenue impact of this proposal would depend on the amounts of relief granted to taxpayers that would otherwise be collected. Based on an estimated volume of less than ten cases per year, the revenue impact is anticipated to be inconsequential. If a system error were to occur that affected numerous taxpayers, the loss could be substantial; however, the magnitude of the impact of a system error cannot be predicted.

Title

Taxpayer Advocate Equity Relief

Introduction

This proposal would give discretionary authority to the Taxpayers' Rights Advocate to grant relief from penalties, fees, additions to tax, or interest imposed on a taxpayer because of erroneous actions of the department.

Current Federal Law

The IRS has authority to abate any unpaid portion of tax or any liability related to tax assessed erroneously. The IRS also has discretion to abate any interest assessed that is attributable to any unreasonable error or delay by the IRS when performing a managerial or ministerial act, but only if no significant aspect of the error or delay can be attributed to the taxpayer involved. The term “managerial act” means an administrative act that occurs during the processing of a taxpayer's case involving the temporary or permanent loss of records or the exercise of judgment or discretion relating to management of personnel. The term “ministerial act” means a procedural or mechanical act that does not involve the exercise of judgment or discretion and that occurs during the processing of a taxpayer’s case after all prerequisites of the act, such as conferences and review by supervisors, have taken place. The error or delay must have occurred before the taxpayer was contacted in writing about the deficiency or payment.

A taxpayer can obtain written advice from the IRS on tax issues by providing a written request with accurate information regarding the tax issue. In response to such requests, the IRS can issue a Private Letter Ruling or a Technical Advice Memorandum, which are taxpayer-specific rulings. If a taxpayer relies on the advice obtained from these documents and it is later found that the tax reported on their return is incorrect because the IRS advice was incorrect, the IRS can abate any portion of any penalty or addition to tax assessed that is attributable to the erroneous written advice furnished to a taxpayer. The taxpayer must have reasonably relied on the advice, and the portion of the penalty or addition to tax must not have resulted from the taxpayer’s failure to provide adequate or accurate information.

Subject to exceptions, the IRS is required to suspend interest on any amounts owed if the IRS fails to provide a notice to the taxpayer stating the amount owed and the basis of the amount owed within 18 months from when the return was filed, or if later, the date it is due without regard to extension. Beginning with notices issued after November 25, 2007, the IRS is required to issue notices stating the amount owed and basis of the amount owed within 36 months from when the return was filed, or if later, the date it is due without regard to extension.

The Treasury Secretary, in consultation with the IRS Oversight Board and the IRS Commissioner, appoints the National Taxpayer Advocate. The National Advocate reports directly to the Commissioner. The National Advocate’s functions are as follows:

- Assist taxpayers in resolving problems with the IRS,
- Identify areas where taxpayers have problems dealing with the IRS,
- Propose changes to IRS administrative practices to mitigate identified problems, and
- Identify potential legislative changes to mitigate identified problems.

The National Advocate can issue Taxpayer Assistance Orders (TAO) if it determines that the taxpayer will suffer a significant hardship because of IRS administration of the tax laws or regulations. A TAO can require the IRS to do the following:

- Release levied property of the taxpayer,
- Cease specified action with respect to the taxpayer, and
- Suspend an applicable statute of limitations while the taxpayer's case is under review by the National Advocate.

Although the National Advocate can make recommendations to the IRS to assist resolving the taxpayer's issue, the National Advocate is unable to adjust a taxpayer's account.

<u>Current State Law</u>

Current law allows FTB staff to abate penalties, fees, additions to tax, or interest in the following narrow circumstances:

- Where interest is attributable to an unreasonable delay by FTB in performing a ministerial or managerial act. Interest abatement is limited to interest that accrues after FTB's first contact with the taxpayer regarding the tax year.
- Where FTB issues an assessment based on an IRS assessment and the IRS abates interest due to an IRS delay.
- Where a taxpayer is experiencing an extreme financial hardship caused by a significant disability or catastrophic circumstance, FTB can abate interest.
- Where a taxpayer reasonably relied on the written advice of a legal ruling by the chief counsel.
- Where penalties carry reasonable cause exceptions. Reasonable cause means generally that despite ordinary business care and prudence, the action that caused the penalty or addition to tax occurred. Not all penalties carry a reasonable cause exception.
- Where FTB fails to provide a notice to the taxpayer stating the amount owed and the basis of the amount owed within 18 months from when the return was filed, or if later, the date it is due without regard to extension.
- Where the Chief Counsel rescinds the application of tax shelter penalties or fees as authorized.

State law authorizes FTB to reimburse taxpayers for bank charges and fees that result from the issuance of an erroneous levy. Reimbursement includes fees and overdraft charges incurred because of the erroneous levy.

Taxpayers can appeal an action of FTB to the State Board of Equalization (BOE). If a taxpayer loses the appeal at BOE, the taxpayer can either file a lawsuit for refund of taxes or file a claim with the Victim Compensation and Government Claims Board (VCGCB). Taxpayers can file claims with VCGCB for refund of tax or losses caused by the action or inaction of a state agency.

The claimant is required to submit a $25 processing fee with the claim form, and if awarded the claim, the responsible state agency is liable for the claim plus an additional 15% surcharge.

Under state law, the Taxpayers' Rights Advocate (Advocate) reports directly to the Executive Officer of FTB and is responsible for coordinating the resolution of taxpayer complaints and problems. The Advocate is empowered to review actions taken on a taxpayer's account and take prompt action including placing a hold on actions where a taxpayer has suffered or will suffer irreparable loss from the board action.

Problem

The absence of affirmative statutory authority to administratively remedy an error made by FTB staff requires the taxpayer to seek an external remedy.

Program History/Background

The occurrences of errors by FTB that this proposal would address are believed to be infrequent--the Advocate estimates less than ten occurrences per year. If a system error were to occur, significant numbers of taxpayers could be affected by the error.

The following situations have been identified as the specific instances where FTB lacks affirmative statutory authority to resolve the consequences of the error.

- FTB lacks the ability to waive interest assessed due to a delay in processing. For example: A taxpayer files an amended return assuming that the tax on the return was paid in full. The return is misplaced within the department and fails to be processed for several years. When the return is discovered and finally processed, it is determined that the taxpayer in fact does owe additional tax. FTB issues a bill to the taxpayer for the unpaid tax and the accrued interest from the original due date of the return to the date of the billing, including the period during which the return was not processed. Because the department lacks authority to waive interest accrued prior to the first billing, the taxpayer is responsible for that interest.

- A taxpayer follows directions provided in FTB forms or publications to prepare his return. Upon audit, it is determined that the taxpayer owes additional tax, penalty or addition to tax, and interest despite following the directions provided by FTB. Despite the FTB error, the taxpayer is responsible for payment of the penalty or addition to tax and interest.

- System limitations or workload constraints prevent FTB from providing timely billing to a taxpayer, resulting in the accrual of additional interest to the taxpayer. Several years ago, FTB implemented a new accounting system for business entities returns. In the process of transitioning from the old system to the new system, numerous accounts remained on the old system, with balances due, but no billing issued. Approximately ten months later, those accounts were incorporated into the new system, and bills were issued for balances due that included the accrued interest. The delayed billings prevented taxpayers from resolving their accounts without accruing interest.

Proposed Solution

Amend Part 10.7, Division 2 of the Revenue and Taxation Code (Taxpayers' Bill of Rights) to authorize the Advocate to waive penalties or additions to tax, fees, and interest that are a result of an FTB error. In addition, this proposal would do the following:

- Apply only to instances where no part of the error is attributable to the taxpayer,
- Preclude judicial or administrative review of the department's exercise of discretion,
- Limit relief to situations where no other statute can be used to provide relief,
- Require that for relief for amounts up to $500, a public record of the action taken and reason relief was warranted be placed in the office of the Executive Officer of the Franchise Tax Board,
- Require that relief in excess of $500 be submitted to the Chief Counsel for concurrence,
- Require that relief in excess of $7,500 be submitted to the Chief Counsel for concurrence, and that the Chief Counsel be required to inform the three-member Franchise Tax Board, and
- Require the Advocate to include in its annual report to the Legislature a summary of the instances where relief was granted, the nature of the error or delay, and the steps taken by the department to remedy systemic issues that required relief.

Effective/Operative Date of Solution

If enacted in the 2008 legislative session, this proposal would be effective January 1, 2009, and be operative on and after that date.

Justification

This proposal would relieve taxpayers from paying increased penalties or additions to tax, interest or fees based on an FTB error. This proposal would reduce the burden for taxpayers seeking relief from certain FTB errors by eliminating the need for the taxpayer to appeal to BOE or VCGCB as the only method to obtain relief. By granting discretionary authority to the Advocate to resolve these cases at the lowest level possible, it would avoid unnecessary expense to both the taxpayer and the department. FTB would be able to correct its own errors and hold taxpayers harmless.

Implementation

Implementing this proposal would not significantly impact the department's programs or operations.

Fiscal Impact

Although FTB is unable to quantify actual case volumes, it is expected that this proposal would ultimately save minor litigation and appeal costs incurred for the issues that the department is unable to resolve under current statutory authority. It is estimated that any workload increases to the Advocate staff created by this proposal would be absorbable.

Economic Impact

The revenue impact of this proposal would depend on the amounts of relief granted to taxpayers that would otherwise be collected. Based on an estimated volume of less than ten cases per year, the revenue impact is anticipated to be inconsequential. If a system error were to occur that affected numerous taxpayers, the loss could be substantial. The magnitude of the impact of a system error cannot be predicted.

Other States

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. These states have interest waiver and reasonable cause exceptions to certain penalty provisions that are similar to the existing federal and California provisions. Statutes granting administrative relief at the tax agency level were not found in the laws of the comparison states.

LEGISLATIVE STAFF CONTACT

Deborah Barrett
Franchise Tax Board
845-4301
Deborah.Barrett@ftb.ca.gov

Janet Jennings
Franchise Tax Board
845-3495
Janet.Jennings@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Deborah Barrett
Telephone # 845-4301
Attorney Douglas Powers

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-12

AMENDMENT 1

SEC. 1. Revenue and Taxation Code Section 21004 is amended to read:

21004. (a) The board shall establish the position of the Taxpayers' Rights Advocate. The advocate or his or her designee shall be responsible for coordinating resolution of taxpayer complaints and problems, including any taxpayer complaints regarding unsatisfactory treatment of taxpayers by board employees or problems identified by board employees. The advocate shall report directly to the executive officer of the board.

(b) The advocate or his or her designee shall give highest priority to reviewing and taking prompt and appropriate action, including staying actions where taxpayers have suffered or will suffer irreparable loss as the result of board action. Applicable statutes of limitation shall be tolled during the pendency of a stay. Any penalties and interest which would otherwise accrue shall not be affected by the granting of a stay.

(c)(1) The advocate may review any application for relief pursuant to this subdivision and abate any penalties, fees, additions to tax, or interest assessed on a taxpayer, if it is determined by the advocate that the penalties, fees, additions to tax, or interest that have been assessed, or any part thereof, is attributable to any of the following:

(A) Erroneous action or erroneous inaction by the Franchise Tax Board in processing documents filed or payments made by taxpayers,

(B) Unreasonable delay caused by the Franchise Tax Board, or,

(C) Erroneous written advice not covered under Section 21012.

(2) Relief may be granted pursuant to this subdivision only if no significant aspect of that error or delay can be attributed to the taxpayer involved and relief is not available under any other provision of this part, Part 10 or Part 11, including any relief granted under any regulation or other administrative pronouncement of the Franchise Tax Board.

(3)(A) (i) Any relief granted pursuant to this subdivision in which the total reduction in penalties, fees, additions to tax, or interest exceeds five hundred dollars ($500) shall be submitted to the Chief Counsel, for concurrence.

(ii) If the total relief granted pursuant to this subdivision (including penalties, fees, additions to tax, and interest) exceeds seven thousand five hundred dollars ($7,500), the Chief Counsel shall notify the Franchise Tax Board, itself.

(B) Whenever the amount of penalties, interest, or fees that are relieved under this subdivision is in excess of five hundred dollars ($500), there shall be placed on file in the office of the executive officer of the Franchise Tax Board a public record with respect to that relief. The public record shall include the following:

(i) Taxpayer's name.

(ii) The total amount involved.

(iii) Amount payable or refundable pursuant to the error or delay.

(iv) A summary of why the relief is warranted.

(4) A refund may be paid as a result of relief granted under this subdivision only if the applicable statute of limitations with respect to filing a claim for refund for amounts paid remains open as of the date that the basis for providing relief, as reflected in subparagraphs (A) through (C) of paragraph (1) of this subdivision, was reflected in a written communication received by the advocate.

(d) No other entity may participate in the grant or denial of relief pursuant to this section.

(e) On January 1 of each calendar year beginning on or after January 1, 2009, the Franchise Tax Board shall increase the amount specified in subparagraph (A) of paragraph (3) of subdivision (c) to the amount computed under this subdivision. That adjustment shall be made as follows:

(1) The 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 homeownership 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 then:

(A) Compute the percentage change in the California Consumer Price Index from the later of June 2008 or June of the calendar year prior to the last increase in the amount specified in paragraph (1).

(B) Compute the inflation adjustment factor by adding 100 percent to the percentage change so computed, and converting the resulting percentage to the decimal equivalent.

(C) Multiply the amount specified in paragraph (1) for the immediately preceding calendar year, as adjusted under this subparagraph, by the inflation adjustment factor determined in subparagraph (B), and round off the resulting product to the nearest one hundred dollars ($100).

(f) Notwithstanding any other law or rule of law, all determinations made under subdivision (c) may not be subject to review in any administrative or judicial proceeding.

Amendment 2

Sec. 2. Revenue and Taxation Code Section 21006 is amended to read:

21006. (a) The board shall perform annually a systematic identification of areas of recurrent taxpayer noncompliance and shall report its findings to the Legislature on December 1 of each year.

(b) As part of the identification process described in subdivision (a), the board shall do both of the following:

(1) Compile and analyze sample data from its audit process, including, but not limited to, all of the following:

(A) The statute or regulation violated by the taxpayer.

(B) The amount of tax involved.

(C) The industry or business engaged in by the taxpayer.

(D) The number of years covered in the audit period.

(E) Whether professional tax preparation assistance was utilized by the taxpayer.

(F) Whether income tax or bank and corporation tax returns were filed by the taxpayer.

(2) Conduct an annual hearing before the board itself where industry representatives and individual taxpayers are allowed to present their proposals on changes to the Personal Income Tax Law or the Corporation Tax Law which may further facilitate achievement of the legislative findings.

(c) The board shall include in its report recommendations for improving taxpayer compliance and uniform administration, including, but not limited to, all of the following:

(1) Changes in statute or board regulations.

(2) Improvement of training of board personnel.

(3) Improvement of taxpayer communication and education.

(4) Increased enforcement capabilities.

(d) The board shall include in its report a summary of cases where relief was granted under subdivision (c) of Section 21004 in the report year, including the nature of the error or delay, and the steps taken by the board to remedy systemic issues that caused the error or delay.

Amendment 3

Sec. 3. The amendments made by Section 1 of this act shall apply to requests for advocate consideration that are received by the advocate on or after January 1, 2009, irrespective of the tax year involved.

LEGISLATIVE PROPOSAL 08-13
EXECUTIVE SUMMARY

- **Title:** Period of Limitations for Other State Tax Credit Claims for Credit or Refund

- **Problem**: A taxpayer who pays income taxes to another state, generally as the result of an audit, after the statute of limitations (SOL) for filing a California claim for refund has expired is barred from claiming an otherwise allowable Other State Tax Credit (OSTC).

- **Major Issues/Concerns**: None

- **Proposed Solution:** Add Revenue and Taxation Code (R&TC) section 19311.5 to provide that if a taxpayer pays tax to another state, the taxpayer has one year from the date the tax is paid to claim an OSTC, notwithstanding any other SOL.

- **Revenue:** The annual revenue loss from this proposal is expected to be less than $1 million.

Title

Period of Limitations for Other State Tax Credit Claims for Credit or Refund

Introduction

This proposal would provide parity in treatment of the Other State Tax Credit (OSTC) by revising the statute of limitations (SOL) period for claiming an OSTC to be the *later* of the normal SOL period or one year after the taxpayer pays tax to the other state.

Background

Taxpayers who pay tax on the same income to more than one state are allowed, under certain circumstances, to claim an OSTC for income tax paid to another state. In general, the purpose of the credit is to provide limited protection from double taxation at the state level. There are some instances where taxpayers are audited by another state, and as a result are required to pay tax to another state after the applicable California SOL expired and are unable to claim an otherwise allowable OSTC on their California income tax return. In the reverse situation, if a taxpayer receives a refund from another state after having claimed an OSTC, the taxpayer is required to report the income immediately to the Franchise Tax Board (FTB). If FTB determines additional tax is due, FTB is not barred by any SOL from assessing additional tax.

There have been two recent State Board of Equalization (BOE) decisions addressing this issue. In the consolidated *Appeals of Timothy Ampe and Tamara Hurley, Stephen Eastin* and *Daniel Hirscher and Kathleen Hirscher*, decided on March 17, 2006, the taxpayers were audited by another state after the California SOL to claim the OSTC expired. FTB determined that the taxpayers' claims for refund for taxes ultimately paid to the other state were barred by R&TC section 19306. The BOE sustained the FTB action.

In the consolidated *Appeals of Christopher Bittman and Kenda Noble, Stephen Cullen, William Jurika and Michelle Jurika,* and *Konrad Rautenberg and Cheryl Noriye*, decided on May 7, 2007, another state began auditing the taxpayers prior to the SOL expiring. The taxpayers filed claims for refund in an attempt to “protect” the SOL for claiming the OSTC; however, the protective claims were filed one month after the SOL expired. FTB determined that the taxpayers' claims for refund were barred by R&TC section 19306. The BOE sustained the FTB action.

Current Federal Law

There is no comparable federal credit for taxes paid at the state level. State income taxes paid by individuals are generally deductible as an itemized deduction. Federal law provides a credit for taxes paid to foreign countries, and the SOL for claiming that credit is ten years.[1]

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[1] The federal foreign tax credit rules are found in IRC § 901-908, while the applicable statute of limitations is found in IRC section 6511(d)(3).

Current State Law

Statute of Limitations (SOL)

In General – California Revenue & Taxation Code (R&TC) section 19306 states that no credit or refund shall be allowed after four years from the original due date of the return, four years from the date the return was filed (if filed within the extension period), or one year from the date of the overpayment, whichever is later, unless before the expiration of that period a claim for refund is filed by the taxpayer.

Special Statutes - Other provisions of the R&TC extend the SOL for filing a claim for refund for specific circumstances, including claims based on federal changes[2], overpaid partnership items[3], bad debts or worthless securities[4], and financially disabled taxpayers[5].

General OSTC Provisions - Subject to certain conditions and limitations:

- A California resident may claim a credit for income taxes paid to another state on income that has a source within the other state and is income that is taxable by California[6];
- An estate or trust treated as a resident of California and also a resident of another state may claim a credit for income taxes paid to another state on income that is taxable by California[7];
- A California resident beneficiary of an estate or trust may claim a credit for income taxes paid to another state on income that is taxable by California[8];
- Partners, S corporation shareholders, or members of a limited liability company classified as a partnership may claim a credit for their share of income taxes paid by the respective entity to another state on income that is taxable by California[9];
- Nonresidents may claim the credit for net income taxes paid to another state if the income being taxed by the other state is also taxable by California, and the state of residence does either of the following[10]:
    1. Does not tax the income of California residents that is derived from sources within that state, or
    2. Allows California residents to claim a credit for taxes paid to California on income that is also being taxed by that state.

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[2] R&TC section 19311.
[3] R&TC section 19313.
[4] R&TC section 19312.
[5] R&TC section 19316.
[6] R&TC section 18001.
[7] R&TC section 18004.
[8] R&TC section 18005.
[9] R&TC section 18006.
[10] R&TC section 18002.

Period Credit May be Claimed and Other Provisions

- Regulation section 18001-1, subsection (b), provides that the credit may be taken either at the time of filing returns or "subsequently." A taxpayer claiming the credit must provide a receipt showing proof of payment of taxes to the other state. A taxpayer must also provide a certified copy of the other state return or a certified copy of the notice assessing or proposing to assess the additional tax.

- Regulation section 18001-1, subsection (c), provides that if the net tax has been paid before a credit is claimed, a taxpayer must file a refund claim in the time and manner provided under Chapter 6 of Part 10.2 of the R&TC.

- R&TC section 18007 provides that if a taxpayer has paid taxes to another state, received a California OSTC based on those taxes, and the other state at any time refunds or credits any of the tax back to the taxpayer, the taxpayer shall immediately report that fact to the FTB. R&TC section 18008 provides that a tax equal to the credit allowed for the taxes credited or refunded by the other state is due and payable upon notice and demand from the FTB.

Problem

A taxpayer who pays income taxes to another state, generally as the result of an audit, after the SOL for filing a California claim for refund has expired is barred from claiming an otherwise allowable OSTC.

Proposed Solution

Add R&TC section 19311.5 to provide that if a taxpayer pays tax to another state, the taxpayer has one year from the date the tax is paid to claim an OSTC, notwithstanding any other SOL.

Effective/Operative Date

If enacted during the 2008 legislative session, this proposal specifically provides that it would apply to OSTC claims for which tax is paid to another state after the date this proposal takes effect.

Justification

This proposal would provide parallel treatment of the OSTC. Under existing law, a taxpayer is required to repay California if an OSTC is determined to be overstated, regardless of whether the SOL has expired, but is barred from receiving a refund or credit if an OSTC is determined to be understated after the SOL has expired.

Implementation

Implementing this proposal would not significantly impact the department’s programs and operations.

Fiscal Impact

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

Economic Impact

The revenue impact of this proposal would depend on the amount of tax paid to California on income that is subsequently taxed by another state after the expiration of the California SOL.

The revenue impact of this proposal is indeterminable because the FTB does not track this issue. That is because either the taxpayer is aware of the expired SOL and does not submit a claim for refund or the taxpayer files a claim for refund after the expiration of the SOL and the claim is denied as barred by the SOL. The only instances that can be tracked are cases with this issue that are appealed to the BOE. Two cases, one totaling $2,300 and the other $900,000, were denied by the BOE during 2006 and 2007, respectively. In any given year, the potential exists for a taxpayer to file a claim with a very large amount at issue, which would result in a significant revenue impact under this proposal. Based on the limited information available, the annual revenue loss from this proposal is expected to be less than $1 million.

Other States

The laws of five states were reviewed because their tax laws are similar to California's income tax laws: Illinois, Massachusetts, Michigan, Minnesota, and New York. All five states provide an OSTC; however, only Minnesota provides an extended SOL for the OSTC, and that extension is one year from the date tax is paid to another state. The other four states have an SOL that is similar to current California law.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Scott McFarlane	Stephanie Rios	Franchise Tax Board
(916) 845-6075	(916) 845-4204	(916) 845-6333
scott.mcfarlane@ftb.ca.gov	stephanie.rios@ftb.ca.gov	brian.putler@ftb.ca.gov

Analyst	Scott McFarlane
Telephone #	845-6075
Attorney	Pat Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-13

AMENDMENT 1

Section 19311.5 is added to the Revenue and Taxation Code to read:

(a) If any taxes paid to another state result in an allowable credit under Sections 18001, 18002, 18003, 18004, 18005, or 18006, a claim for credit or refund of an overpayment of income tax attributable to a credit allowable under any of these sections may be filed within one year from the date tax is paid to the other state or within the period provided in Section 19306, whichever period expires later.

(b) This section shall apply to taxes paid to another state after the effective date of the action adding this section.

LEGISLATIVE PROPOSAL 08-16
EXECUTIVE SUMMARY

- **Title:** Child and Dependent Care (CDC) Expense Credit Fraud

- **Problem:** Current tools available to prevent CDC credit abuse have proven ineffective in deterring the most abusive fraudulent schemes.

- **Proposed Solution:** Amend the CDC provisions to deny the credit unless the service provider license number is included in the CDC form, and if service provider is exempt from licensure, the taxpayer must indicate the basis for the exemption.

  Provide Franchise Tax Board (FTB) authority to promulgate regulations to administer the CDC and establish recordkeeping and substantiation requirements.

  Provide FTB the authority to share information with licensing agencies to validate the license number and to confirm with responsible agency that service provider is following state daycare requirements.

  Further, FTB would disclose to other state, local, and federal agencies that the CDC provider received income for providing child/dependent care.

- **Revenue:**

Estimated Revenue Impact of LP 08-16 Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2008			
CDC Fraud	2008-09	2009-10	2010-11
Cash Saved		$1,500,000	$1,900,000
Additional Cases Worked	$300,000	$650,000	$750,000
Total	+<$500,000	+$2,150,000	+$2,650,000

Title

Child and Dependent Care Expense Credit (CDC) Fraud

Introduction

This proposal would create additional eligibility requirements for the CDC to limit the amount of fraudulent claims filed using falsified supporting documents.

Program History/Background

Assembly Bill 480 (Stats.2000, Ch. 114) enacted California's refundable CDC Expense Credit for taxable years beginning on or after January 1, 2000. The purpose of the CDC is to defray expenses incurred by taxpayers who must pay for child or dependent care so they can seek employment or be gainfully employed.

The CDC has been the subject of fraudulent claims since its inception in 2000. There are many taxpayers who claim the credit when they knowingly do not qualify or claim an amount much greater than the amount to which they are entitled. These individuals intentionally enter false information on their tax returns. Fraud schemes involve unscrupulous tax preparers who either mislead their clients by falsely promising to get them more money or misuse their client's information to benefit themselves and other taxpayers.

The Franchise Tax Board's (FTB's) Fraud Prevention and Detection unit (FPD) works to identify personal income tax fraud schemes and prevent the issuance of fraudulent refunds.

In a 2003 pilot study to measure noncompliance, FPD extracted and analyzed data from filed returns prepared by tax practioners. FPD examined 10,830 tax practioners who prepared returns and found that an average tax practitioner claimed the CDC on 5% of the returns filed. However, tax practioners that were involved in fraud schemes claimed CDC on nearly 75% of returns filed. To confirm the childcare expenses claimed on returns prepared by this small group of practitioners, FPD mailed CDC verification letters to the childcare providers listed on the returns. The responses from these letters identified numerous concerns of fraud.

FPD focused on three concerns:

1. Individuals falsifying verification and/or notarized letters claiming child care expense paid during the taxable year,
2. Service providers verifying false supporting documents for child care expenses, and
3. CDC claimants claiming refunds greater than the entitled amount (claiming the maximum amount when not entitled).

In 2004, FPD identified 79 tax practitioners with a high volume of CDC claims for the 2003 pilot study. The pilot resulted in the detection of 10,663 fraudulent CDC claims, totaling $5.5 million in CDC fraud for 2003. Twenty-four of the 79 tax practitioners selected have been referred to FTB's Investigations Bureau for criminal prosecution. The clients of the remaining 55 tax practioners were assessed civil liabilities or penalties or both due to suspected fraudulent claims.

In addition, the FPD suspect that many of the service providers that participate in fraud schemes are receiving some type of general assistance from state, local, and federal programs. FPD recommends that FTB and the California Department of Social Services and county welfare agencies share information to curtail fraud on both sides.

Much of the FPD's ongoing CDC workload consists of verifying the validity of CDC claims. In 2006, FPD identified approximately $27 million in fraudulent CDC claims.

Current Federal Law

Child and Dependent Care Tax Credit

The Internal Revenue Code has had a child and dependent care tax credit since 1976, usually referred to as the dependent care credit.[1] The credit permits a taxpayer with employment-related child and dependent care expenses to subtract a portion of these expenses from federal tax liability to reduce the amount of tax actually owed the federal government. The federal credit is not refundable.

The federal CDC expense credit has the following key features:

- The federal credit covers employment-related expenses for the care of a dependent child under the age of 13 who lives with the taxpayer and for the care of a disabled dependent that lives with the taxpayer and is incapable of self-care.
- The federal credit permits flexibility in care arrangements, covering both in-home and out-of-home care in a variety of settings. However, care for spouses and dependents age 13 and older who are incapable of self-care is covered only if the spouse or dependent spends at least eight hours a day in the taxpayer's household.
- A taxpayer (and the spouse, if married) may claim employment-related expenses of up to $2,400 annually for one child or dependent and up to $4,800 annually for two or more children or dependents. Any expenses above these amounts are not eligible for the credit. In addition, the expenses may not exceed the earned income of the taxpayer or the taxpayer's spouse, whichever is less.
- The full-time student or disabled spouse is treated as having earned $250 per month if one qualifying person was cared for ($500 for two or more qualifying persons).
- The federal credit is non-refundable.
- The federal credit requires that if the care provider is an individual, a valid social security number or a valid employer identification number must be provided for the care provider.
- The taxpayer must pay the expenses to someone other than:
    - the taxpayer's child under age 19, or
    - the taxpayer's dependent claimed on the return.

[1] The origin of the credit was a 1954 provision establishing a tax deduction for certain employment-related child and dependent care expenses. The deduction was converted to a credit in 1976. The current federal CDC credit is found at 26 U.S.C. §21 (2001), as amended by Pub. L. No. 107-16, title II, §207, 115 Stat. 38 (2001).

Current State Law

Child and Dependent Care Expense Credit

California provides a refundable credit for child and dependent care expenses. The credit is equal to a percentage of the nonrefundable federal credit that IRS allows the taxpayer for the cost of employment-related child and dependent care expenses.

California conforms to federal law with the following modifications:

- Limited to taxpayers with adjusted gross income of $100,000 or less.
- Limited to expense for household services and care provided in California.

Disclosures with Other Agencies

Current state law prohibits the disclosure of any taxpayer information except as specifically authorized by statute.

California law, in limited instances, permits FTB to release individual tax return information under certain limited circumstances to the following entities: legislative committees, Office of the Attorney General, Office of the California Parent Locator Service, directors of Social Services and Health Services, and California tax officials, such as the Board of Equalization or the Employment Development Department, the Controller, and the Department of Motor Vehicles.

Agencies must have a specific reason for requesting the information, including investigating items of income disclosed on any return or report, verifying eligibility for public assistance, locating absent parents to collect child support, or locating abducted children. For some agencies, only limited information may be released, such as the taxpayer's social security number and address.

Problem

Current tools available to prevent CDC credit abuse have proven ineffective in deterring the most abusive fraudulent schemes.

Solution

Amend the CDC provisions to deny the credit unless the following are provided:

- Service provider's license number for the period which the care was provided under the California Health and Safety Code, or
- If the service provider is exempt from licensure, provide the basis of the exemption.

Provide FTB authority to promulgate regulations to administer the CDC and reduce fraud and abuse including regulation establishing recordkeeping and substantiation requirements to establish eligibility of the CDC.

In addition, this proposal would provide FTB with authority to disclose to other state, local, and federal agencies that the CDC service provider received income for providing child/dependent care. This would require FTB to secure a Memorandum of Understanding with the appropriate agencies to transmit the information.

Effective/Operative Date of Solution

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

Justification

The sharing of service provider information to appropriate agencies will help discourage service providers from falsely verifying income. If legislation is not enacted to curtail this behavior by this category of providers, fraudulent CDC claims will continue to grow and resources will be needed to control this escalating trend.

Requiring taxpayers to provide FTB with additional documentation to verify their claims would facilitate identification of fraudulent claims.

Implementation

Implementing this proposal would require some changes to existing tax forms and instructions, establishing a Memorandum of Understanding with applicable agencies, and updating information systems, which could be accomplished during the normal annual update.

Fiscal Impact

FTB estimates that the cost associated with these changes would be absorbable.

Economic Impact

Revenue Estimate

This proposal would result in the following revenue gains:

Estimated Revenue Impact of LP 08-16 Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2008			
CDC Fraud	2008-09	2009-10	2010-11
Cash Saved		$1,500,000	$1,900,000
Additional Cases Worked	$300,000	$650,000	$750,000
Total	+<$500,000	+$2,150,000	+$2,650,000

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

Revenue Discussion

The revenue impact of this proposal would be determined by the number of fraudulent claims for the CDC that would be identified before being allowed and by amounts recovered after being allowed upon subsequent denial.

According to departmental staff working the CDC fraud issue, the staff verified and allowed CDC credits on over 7,000 returns for cash payments to day care providers. Approximately 75% of these returns, or 5,000 returns, would be affected by the proposal to verify payment. Of these 5,000 returns, 90%, or 4,700, would be disallowed for not having verified proof of payment. The average adjustment for each of these claims is approximated at $400. (Claims based on cash payments have higher fraudulent claim amounts.) The impact of these disallowed credits would be $1.9 million (4,700 returns x $400). The $1.9 million is reduced to $1.5 million in the initial year to account for taxpayers developing an awareness of the requirement of substantiating cash payments.

In addition to the revenue savings from enforcement, there would be an additional amount of revenue from staff efficiencies. Because less correspondence will be necessary under the proposal than otherwise under current law, staff will be able to resolve more of these questionable CDC cases. It is estimated that 3,000 additional cases would be worked with an average adjustment per case of $250. (These claims have lower fraudulent claim amounts than the cash payment claims discussed above). The revenue impact would be 3,000 additional cases at $250 each, or $750,000. For the 2009 tax year, revenue impact is reduced to $500,000 because of the time it takes taxpayers to become aware of changes to the law.

The 2008-09 fiscal year for Additional Cases Worked includes only the impact from the first half of the 2009 tax year, when the revenue impact first occurs. The 2009-10 fiscal year is higher because it includes portions of 2009 and 2010.

Other States

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.

Florida, Illinois, Massachusetts, and *Michigan* do not provide a credit comparable to the credit allowed by California. *Minnesota* and *New York* have similar refundable child and dependent care credits. *Minnesota* and *New York* CDC provisions mirror federal CDC law with some modifications; however, the two states' CDC provisions do not indicate requirements for provider statements to be eligible for the CDC expense credit.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Victoria Favorito	Barbara Ellison	Franchise Tax Board
(916) 845-3825	(916) 845-4950	(916) 845-6333
Victoria.Favorito@ftb.ca.gov	Barbara.Ellison@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Victoria Favorito
Telephone # 845-3825
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-16

AMENDMENT 1

SEC. 1. Section 17052.6 of the Revenue and Taxation Code is amended to read:

17052.6. (a) For each taxable year beginning on or after January 1, 2000, there shall be allowed as a credit against the "net tax" , as defined in Section 17039, an amount determined in accordance with Section 21 of the Internal Revenue Code, except that the amount of the credit shall be a percentage, as provided in subdivision (b) of the allowable federal credit without taking into account whether there is a federal tax liability.

(b) For the purposes of subdivision (a), the percentage of the allowable federal credit shall be determined as follows:

(1) For taxable years beginning before January 1, 2003:

If the adjusted gross income is:	The percentage of credit is:
$40,000 or less..............	63%
Over $40,000 but not over $70,000......................	53%
Over $70,000 but not over $100,000.....................	42%
Over $100,000................	0%

(2) For taxable years beginning on or after January 1, 2003:

If the adjusted gross income is:	The percentage of credit is:
$40,000 or less..............	50%
Over $40,000 but not over $70,000......................	43%
Over $70,000 but not over $100,000.....................	34%
Over $100,000................	0%

(c) In the case of a taxpayer whose credits provided under this section exceed the taxpayer's tax liability computed under this part, the excess shall be credited against other amounts due, if any, from the taxpayer and the balance, if any, shall be paid from the Tax Relief and Refund Account and refunded to the taxpayer.

(d) For purposes of this section, "adjusted gross income" means adjusted gross income as computed for purposes of paragraph (2) of subdivision (h) of Section 17024.5.

(e) The credit authorized by this section shall be limited, as follows:

(1) Employment-related expenses, within the meaning of Section 21 of the Internal Revenue Code, shall be limited to expenses for household services and care provided in this state.

(2) Earned income, within the meaning of Section 21(d) of the Internal Revenue Code, shall be limited to earned income subject to tax under this part. For purposes of this paragraph, compensation received by a member of the armed forces for active services as a member of the armed forces, other than pensions or retired pay, shall be considered earned income subject to tax under this part, whether or not the member is domiciled in this state.

(f) For purposes of this section, Section 21(b)(1) of the Internal Revenue Code, relating to a qualifying individual, is modified to additionally provide that a child, as defined in Section 151(c)(3) of the Internal Revenue Code, shall be treated, for purposes of Section 152 of the Internal Revenue Code, as applicable for purposes of this section, as receiving over one-half of his or her support during the calendar year from the parent having custody for a greater portion of the calendar year, that parent shall be treated as a "custodial parent," within the meaning of Section 152(e) of the Internal Revenue Code, as applicable for purposes of this section, and the child shall be treated as a qualifying individual under Section 21(b)(1) of the Internal Revenue Code, as applicable for purposes of this section, if both of the following apply:

(1) The child receives over one-half of his or her support during the calendar year from his or her parents who never married each other and who lived apart at all times during the last six months of the calendar year.

(2) The child is in the custody of one or both of his or her parents for more than one-half of the calendar year.

~~(g) The amendments to this section made by Section 1.5 of Chapter 824 of the Statutes of 2002 shall apply only to taxable years beginning on or after January 1, 2002.~~

(g) The provisions of paragraph (9) of subsection (e) of the Internal Revenue Code Section 21 shall be modified to additionally include the following:

(1) With respect to a service provider that is required to be licensed under Section 1596.80 of the California Health and Safety Code, the taxpayer shall provide the service provider’s license number for the period for which the care was provided and, where appropriate, the county agency that issued the license, or

(2) If a service provider is exempt from licensure under Section 1596.792 of the California Health and Safety Code, the taxpayer shall provide the basis for the exemption.

(h) The Franchise Tax Board may prescribe such regulations and other guidance as may be necessary or appropriate to implement this section and to reduce fraud and abuse, including regulations that establish recordkeeping and substantiation requirements regarding eligibility for the credit authorized by this section.

Amendment 2

SEC. 2. Section 19560 of the Revenue and Taxation Code is added to read:

19560. The Franchise Tax Board may disclose returns and return information of a taxpayer claiming the credit under section 17052.6 and any information received from a service provider related thereto to any federal, state, county health and human assistance agency, Social Security Administration, and Internal Revenue Service.

Amendment 3

SEC. 3. Section 19560.1 of the Revenue and Taxation Code is added to read:

19560.1. (a) Notwithstanding any other provision of law, the Department of Social Services and any county agency that licenses a service provider, within the meaning of Section 17052.6, shall disclose to the Franchise Tax Board licensing information described in subdivision (g) of Section 17052.6.

(b) The Franchise Tax Board may disclose to the Department of Social Services and any applicable county licensing agency information regarding a service provider, within the meaning of Section 17052.6, including information on tax returns and return information received in connection with a claim for credit under Section 17052.6, for purposes of administering the California Child Day Care Act (Chapter 34 (commencing with Section 1596.70) of the Health and Safety Code).

(c) Any information provided to or secured by the Franchise Tax Board by the department and agency described in subdivision (a) maybe used by the Franchise Tax Board for the purposes of administering Section 17052.6.

SEC. 4. (a) The amendments made to Section 17052.6 of the Revenue and Taxation Code by Section 1 of this Act shall apply to taxable years beginning on or after January 1, 2009.

(b) Revenue and Taxation Code Sections 19560 and 19560.1, as added by Section 2 and 3 of this Act, shall apply to disclosures made on or after January 1, 2009.

LEGISLATIVE PROPOSAL 08-18
EXECUTIVE SUMMARY

- **Title:** Direct Deposit Refund (DDR) Errors

- **Problem:** Financial privacy laws limit Franchise Tax Board's (FTB) ability to assist taxpayers that designate an incorrect account for their DDRs, thereby requiring taxpayers to initiate legal action to recover a misdirected DDR.

- **Proposed Solution:** This proposal would provide an avenue to recover misdirected DDRs that currently does not exist in statute by revising the California Right to Financial Privacy Act (CRPA) to provide an express exception allowing financial institutions to provide, upon certification from FTB, limited information to identify the recipient of the misdirected DDR. This proposal would revise the erroneous refund statute to allow FTB to pursue the third-party recipient of the misdirected DDR and provide reimbursement to the taxpayer upon issuance of a Notice and Demand against the third-party recipient of the misdirected DDR.

- **Major Concerns/Issues:** Failure to provide a remedy for misdirected DDRs could deter taxpayers from using the direct deposit feature on their tax returns, thereby increasing operational costs and reducing efficiencies.

- **Revenue:**

Estimated Revenue Impact of LP 08-18 Enactment Assumed for Misdirected DDRs Issued On or After 01/01/2009			
Fiscal Impact	2008-09	2009-10	2010-11
Revenue Loss	< $150,000	< $150,000	< $150,000

Title

Direct Deposit Refund Errors

Introduction

This proposal would provide a method for the Franchise Tax Board (FTB) to recover misdirected direct deposit refunds (DDR) and to return any recovered funds to the proper taxpayer.

Program History/Background

FTB processes approximately 4 million DDR requests each year and receives rejections on approximately 60,000 DDRs due to incorrect routing or account numbers. FTB reissues a rejected DDR to the taxpayer in the form of a paper refund warrant by US Mail. Annually, FTB receives approximately 450 requests to research missing DDRs. These missing deposits generally are found in the taxpayer's bank account; however, some are discovered deposited in a third-party's account--because the taxpayer provided an incorrect routing or account number. This type of errant deposit is called a misdirected DDR.

In some cases, FTB can request a financial institution either to return the DDR to FTB or to move to the correct taxpayer's account, which resolves the issue. FTB is unable to resolve approximately 20 cases of misdirected DDR each year. Less than $50,000 is involved on a yearly basis. The dollar amount will grow each year with greater public use of DDRs.

Federal and state laws allow the government to recover an erroneous refund—a refund where due to an error made by the government a refund is made in the wrong amount or to the wrong person; however, a misdirected DDR is not an erroneous refund because the taxing agencies followed the taxpayer's instructions.

The department only has account and routing information and has no statutory authority to obtain the identity of the third-party account holder from a financial institution. Current subpoena powers are ineffective to learn the identity of the third-party because the account holder is required to be served with the subpoena before the financial institution can honor the subpoena; however, FTB lacks the identity of the account holder and thus cannot issue an effective subpoena.

Current Federal Law

Under federal law, taxpayers may select one or more accounts for purposes of directly depositing their federal tax refunds; however, the IRS assumes no responsibility in the event the taxpayer or their preparer puts an incorrect account or routing number on a return.

Under the federal Electronic Funds Transfer Act, financial institutions are not required to match taxpayer names with the names on an account designated for direct deposit. Financial institutions are required to resolve problems related to electronic funds transfer (EFT) errors in instances where the error is attributable to the financial institution or a failure within the Fedwire system. Federal law specifies what constitutes an error; a misdirected DDR does not qualify as an EFT error. With limited exceptions, federal financial privacy laws prohibit a financial institution from divulging the personal information of account holders without a civil or criminal subpoena or court order.

Current State Law

Current state law allows a taxpayer to designate one or more accounts at a financial institution for direct deposit of their state tax refund. FTB can recover an erroneous refund if FTB issues a notice and demand for repayment of the erroneous refund within two years from when the refund is made or during the period within which FTB may mail a notice of proposed deficiency assessment, whichever period expires later. FTB may recover any erroneous refund, including accrued interest, in an action brought in a court of competent jurisdiction in the County of Sacramento.

Except under specified conditions, the California Right to Financial Privacy Act (CRPA) prohibits an officer, employee, or agent of a state agency or department from requesting or receiving from a financial institution the financial information of a customer. The CRPA generally requires that a consumer notice be sent to the account holder prior to the delivery of an administrative subpoena before the financial institution can release account information, including the name of the account holder.

One express exception to the CRPA requires a financial institution to provide specified public retirement systems with the names and addresses of accounts of a customer who received direct deposit transfers from the retirement system after the date of his or her death.

Taxpayers can exercise a civil remedy on their own to recover their misdirected deposits through civil litigation in small claims or superior courts. Once the taxpayer receives a judgment, the taxpayer can execute the judgment through warrants, as provided in the California Code of Civil Procedure.

Problem

Financial privacy laws limit FTB's ability to assist taxpayers that designate an incorrect account for their DDRs, thereby requiring taxpayers to initiate legal action to recover a misdirected DDR.

Proposed Solution

Revise the CRPA to provide an express exception allowing financial institutions to provide, upon certification from FTB, limited information to identify the recipient of the misdirected DDR. This proposal would also revise the erroneous refund statute to allow FTB to pursue the third-party recipient of the misdirected DDR and provide reimbursement to the taxpayer upon issuance of a Notice and Demand against the recipient of the misdirected DDR. FTB would also have the option to pursue the third-party through a civil action.

Implementation

Implementing this proposal would provide an avenue to recover misdirected DDRs that currently does not exist in statute. FTB would issue a certification to the bank to obtain the name and address of the account owner. Once FTB is able to identify the person, FTB would issue a Notice and Demand, and if the third-party recipient fails to return the misdirected DDR, FTB would issue an assessment. When FTB issues the assessment, FTB would reimburse the taxpayer for the misdirected DDR and would collect the amounts due through normal collection processes.

Effective/Operative Date of Solution

If enacted in the 2008 legislative session, this proposal would be effective January 1, 2009, and be operative for misdirected payments made on or after that date.

Justification

This proposal would enhance FTB's ability to collect misdirected DDRs on behalf of taxpayers by the following:

- Provide reimbursement to taxpayers for the misdirected DDR at the earliest point possible.
- Eliminate undue enrichment by the third-party by charging back the misdirected funds.
- Provide FTB the same limited information that financial institutions provide to public retirement systems to recover funds placed in the hands of someone who is not entitled to the funds.

Fiscal Impact

This proposal would take advantage of current assessment and collection processes, resulting in absorbable costs to FTB to implement.

Economic Impact

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

Estimated Revenue Impact of LP 08-18 Enactment Assumed for Misdirected DDRs Issued On or After 01/01/2009			
Fiscal Impact	2008-09	2009-10	2010-11
Revenue Loss	< $150,000	< $150,000	< $150,000

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

The revenue impact would depend on the number of misdirected DDRs where the third-party fails to return the funds and that are reimbursed to the taxpayer. With an annual universe of misdirected DDRs of approximately $50,000, FTB anticipates the volume of remaining DDRs after collection efforts to be less than that amount. The $50,000 estimate would grow over time with the increase in the use of DDRs. Estimating annual growth rate of 10% in DDRs, this option would have an inconsequential effect on state revenue.

Agency/Industry Pro & Con Arguments

This proposal could provide a solution for financial institutions that must also handle dissatisfied customers due to the absence of available remedies. Further, the financial institutions would bear no additional liability with this proposal.

Other States/IRS

A review of *Illinois, Massachusetts, Michigan*, *Minnesota*, and *New York* laws found no comparable provisions that would assist a taxpayer in recovering the funds from a misdirected direct deposit. These states were reviewed because of the similarities between California income tax laws and their tax law.

The IRS assumes no responsibility in the event the taxpayer or their preparer puts an incorrect account or routing number on a return.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Deborah Barrett	Janet Jennings	Franchise Tax Board
(916) 845-4301	(916) 845-3495	(916) 845-6333
Deborah.Barrett@ftb.ca.gov	Janet.Jennings@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Deborah Barrett
Telephone# 845-4301
Attorney Tommy Leung

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 08-18

Amendment 1

SEC 1. Section 7480 of the Government Code, as amended by Section 1 of Chapter 705 of the Statutes of 2005, is amended to read:

7480. Nothing in this chapter shall prohibit any of the following:

(a) The dissemination of any financial information that is not identified with, or identifiable as being derived from, the financial records of a particular customer.

(b) When any police or sheriff's department or district attorney in this state certifies to a bank, credit union, or savings association in writing that a crime report has been filed that involves the alleged fraudulent use of drafts, checks, access cards, or other orders drawn upon any bank, credit union, or savings association in this state, the police or sheriff's department or district attorney may request a bank, credit union, or savings association to furnish, and a bank, credit union, or savings association shall furnish, a statement setting forth the following information with respect to a customer account specified by the police or sheriff's department or district attorney for a period 30 days prior to, and up to 30 days following, the date of occurrence of the alleged illegal act involving the account:

(1) The number of items dishonored.

(2) The number of items paid that created overdrafts.

(3) The dollar volume of the dishonored items and items paid which created overdrafts and a statement explaining any credit arrangement between the bank, credit union, or savings association and customer to pay overdrafts.

(4) The dates and amounts of deposits and debits and the account balance on these dates.

(5) A copy of the signature card, including the signature and any addresses appearing on a customer's signature card.

(6) The date the account opened and, if applicable, the date the account closed.

(7) Surveillance photographs and video recordings of persons accessing the crime victim's financial account via an automated teller machine (ATM) or from within the financial institution for dates on which illegal acts involving the account were alleged to have occurred. Nothing in this paragraph does any of the following:

(A) Requires a financial institution to produce a photograph or video recording if it does not possess the photograph or video recording.

(B) Affects any existing civil immunities as provided in Section 47 of the Civil Code or any other provision of law.

(8) A bank, credit union, or savings association that provides the requesting party with copies of one or more complete account statements prepared in the regular course of business shall be deemed to be in compliance with paragraphs (1), (2), (3), and (4).

(c) When any police or sheriff's department or district attorney in this state certifies to a bank, credit union, or savings association in writing that a crime report has been filed that involves the alleged fraudulent use of drafts, checks, access cards, or other orders drawn upon any bank, credit union, or savings association doing business in this state, the police or sheriff's department or district attorney may request, with the consent of the accountholder, the bank, credit union, or savings association to furnish, and the bank, credit union, or savings association shall furnish, a statement setting forth the following information with respect to a customer account specified by the police or sheriff's department or district attorney for a period 30 days prior to, and up to 30 days following, the date of occurrence of the alleged illegal act involving the account:

(1) The number of items dishonored.

(2) The number of items paid that created overdrafts.

(3) The dollar volume of the dishonored items and items paid which created overdrafts and a statement explaining any credit arrangement between the bank, credit union, or savings association and customer to pay overdrafts.

(4) The dates and amounts of deposits and debits and the account balance on these dates.

(5) A copy of the signature card, including the signature and any addresses appearing on a customer's signature card.

(6) The date the account opened and, if applicable, the date the account closed.

(7) Surveillance photographs and video recordings of persons accessing the crime victim's financial account via an automated teller machine (ATM) or from within the financial institution for dates on which illegal acts involving this account were alleged to have occurred. Nothing in this paragraph does any of the following:

(A) Requires a financial institution to produce a photograph or video recording if it does not possess the photograph or video recording.

(B) Affects any existing civil immunities as provided in Section 47 of the Civil Code or any other provision of law.

(8) A bank, credit union, or savings association doing business in this state that provides the requesting party with copies of one or more complete account statements prepared in the regular course of business shall be deemed to be in compliance with paragraphs (1), (2), (3), and (4).

(d) For purposes of subdivision (c), consent of the accountholder shall be satisfied if an accountholder provides to the financial institution and the person or entity seeking disclosure, a signed and dated statement containing all of the following:

(1) Authorization of the disclosure for the period specified in subdivision (c).

(2) The name of the agency or department to which disclosure is authorized and, if applicable, the statutory purpose for which the information is to be obtained.

(3) A description of the financial records that are authorized to be disclosed.

(e) (1) The Attorney General, a supervisory agency, the Franchise Tax Board, the State Board of Equalization, the Employment Development Department, the Controller or an inheritance tax referee when administering the Prohibition of Gift and Death Taxes (Part 8 (commencing with Section 13301) of Division 2 of the Revenue and Taxation Code), a police or sheriff's department or district attorney, a county welfare department when investigating welfare fraud, a county auditor-controller or director of finance when investigating fraud against the county, or the Department of Corporations when conducting investigations in connection with the enforcement of laws administered by the Commissioner of Corporations, from requesting of an office or branch of a financial institution, and the office or branch from responding to a request, as to whether a person has an account or accounts at that office or branch and, if so, any identifying numbers of the account or accounts.

(2) No additional information beyond that specified in this section shall be released to a county welfare department without either the accountholder's written consent or a judicial writ, search warrant, subpoena, or other judicial order.

(3) A county auditor-controller or director of finance who unlawfully discloses information he or she is authorized to request under this subdivision is guilty of the unlawful disclosure of confidential data, a misdemeanor, which shall be punishable as set forth in Section 7485.

(f) The examination by, or disclosure to, any supervisory agency of financial records that relate solely to the exercise of its supervisory function. The scope of an agency's supervisory function shall be determined by reference to statutes that grant authority to examine, audit, or require reports of financial records or financial institutions as follows:

(1) With respect to the Commissioner of Financial Institutions by reference to Division 1 (commencing with Section 99), Division 1.5 (commencing with Section 4800), Division 2 (commencing with Section 5000), Division 5 (commencing with Section 14000), Division 7 (commencing with Section 18000), Division 15 (commencing with Section 31000), and Division 16 (commencing with Section 33000), of the Financial Code.

(2) With respect to the Controller by reference to Title 10 (commencing with Section 1300) of Part 3 of the Code of Civil Procedure.

(3) With respect to the Administrator of Local Agency Security by reference to Article 2 (commencing with Section 53630) of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code.

(g) The disclosure to the Franchise Tax Board of (1) the amount of any security interest that a financial institution has in a specified asset of a customer or (2) financial records in connection with the filing or audit of a tax return or tax information return that are required to be filed by the financial institution pursuant to Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or Part 18 (commencing with Section 38001), of the Revenue and Taxation Code.

(h) The disclosure to the State Board of Equalization of any of the following:

(1) The information required by Sections 6702, 6703, 8954, 8957, 30313, 30315, 32383, 32387, 38502, 38503, 40153, 40155, 41122, 41123.5, 43443, 43444.2, 44144, 45603, 45605, 46404, 46406, 50134, 50136, 55203, 55205, 60404, and 60407 of the Revenue and Taxation Code.

(2) The financial records in connection with the filing or audit of a tax return required to be filed by the financial institution pursuant to Part 1 (commencing with Section 6001), Part 2 (commencing with Section 7301), Part 3 (commencing with Section 8601), Part 13 (commencing with Section 30001), Part 14 (commencing with Section 32001), and Part 17 (commencing with Section 37001), of Division 2 of the Revenue and Taxation Code.

(3) The amount of any security interest a financial institution has in a specified asset of a customer, if the inquiry is directed to the branch or office where the interest is held.

(i) The disclosure to the Controller of the information required by Section 7853 of the Revenue and Taxation Code.

(j) The disclosure to the Employment Development Department of the amount of any security interest a financial institution has in a specified asset of a customer, if the inquiry is directed to the branch or office where the interest is held.

(k) The disclosure by a construction lender, as defined in Section 3087 of the Civil Code, to the Registrar of Contractors, of information concerning the making of progress payments to a prime contractor requested by the registrar in connection with an investigation under Section 7108.5 of the Business and Professions Code.

(l) Upon receipt of a written request from a local child support agency referring to a support order pursuant to Section 17400 of the Family Code, a financial institution shall disclose the following information concerning the account or the person named in the request, whom the local child support agency shall identify, whenever possible, by social security number:

(1) If the request states the identifying number of an account at a financial institution, the name of each owner of the account.

(2) Each account maintained by the person at the branch to which the request is delivered, and, if the branch is able to make a computerized search, each account maintained by the person at any other branch of the financial
institution located in this state.

(3) For each account disclosed pursuant to paragraphs (1) and (2), the account number, current balance, street address of the branch where the account is maintained, and, to the extent available through the branch's computerized search, the name and address of any other person listed as an owner.

(4) Whenever the request prohibits the disclosure, a financial institution shall not disclose either the request or its response, to an owner of the account or to any other person, except the officers and employees of the financial institution who are involved in responding to the request and to attorneys, employees of the local child support agencies, auditors, and regulatory authorities who have a need to know in order to perform their duties, and except as disclosure may be required by legal process.

(5) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for (A) disclosing information in response to a request pursuant to this subdivision, (B) failing to notify the owner of an account, or complying with a request under this paragraph not to disclose to the owner, the request or disclosure under this subdivision, or (C) failing to discover any account owned by the person named in the request pursuant to a computerized search of the records of the financial institution.

(6) The local child support agency may request information pursuant to this subdivision only when the local child support agency has received at least one of the following types of physical evidence:

(A) Any of the following, dated within the last three years:

(i) Form 599.

(ii) Form 1099.

(iii) A bank statement.

(iv) A check.

(v) A bank passbook.

(vi) A deposit slip.

(vii) A copy of a federal or state income tax return.

(viii) A debit or credit advice.

(ix) Correspondence that identifies the child support obligor by name, the bank, and the account number.

(x) Correspondence that identifies the child support obligor by name, the bank, and the banking services related to the account of the obligor.

(xi) An asset identification report from a federal agency.

(B) A sworn declaration of the custodial parent during the 12 months immediately preceding the request that the person named in the request has had or may have had an account at an office or branch of the financial institution to which the request is made.

(7) Information obtained by a local child support agency pursuant to this subdivision shall be used only for purposes that are directly connected with the administration of the duties of the local child support agency pursuant to Section 17400 of the Family Code. (m) (1) As provided in paragraph (1) of subdivision (c) of Section 666 of Title 42 of the United States Code, upon receipt of an administrative subpoena on the current federally approved interstate child support enforcement form, as approved by the federal Office of Management and Budget, a financial institution shall provide the information or documents requested by the administrative subpoena.

(2) The administrative subpoena shall refer to the current federal Office of Management and Budget control number and be signed by a person who states that he or she is an authorized agent of a state or county agency responsible for implementing the child support enforcement program set forth in Part D (commencing with Section 651) of Subchapter IV of Chapter 7 of Title 42 of the United States Code. A financial institution may rely on the statements made in the subpoena and has no duty to inquire into the truth of any statement in the subpoena.

(3) If the person who signs the administrative subpoena directs a financial institution in writing not to disclose either the subpoena or its response to any owner of an account covered by the subpoena, the financial institution shall not disclose the subpoena or its response to the owner.

(4) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for (A) disclosing information or providing documents in response to a subpoena pursuant to this subdivision, (B) failing to notify any owner of an account covered by the subpoena or complying with a request not to disclose to the owner, the subpoena or disclosure under this subdivision, or (C) failing to discover any account owned by the person named in the subpoena pursuant to a computerized search of the records of the financial institution.

(n) The dissemination of financial information and records pursuant to any of the following:

(1) Compliance by a financial institution with the requirements of Section 2892 of the Probate Code.

(2) Compliance by a financial institution with the requirements of Section 2893 of the Probate Code.

(3) An order by a judge upon a written ex parte application by a peace officer showing specific and articulable facts that there are reasonable grounds to believe that the records or information sought are relevant and material to an ongoing investigation of a felony violation of Section 186.10 or of any felony subject to the enhancement set forth in Section 186.11.

(A) The ex parte application shall specify with particularity the records to be produced, which shall be only those of the individual or individuals who are the subject of the criminal investigation.

(B) The ex parte application and any subsequent judicial order shall be open to the public as a judicial record unless ordered sealed by the court, for a period of 60 days. The sealing of these records may be extended for 60-day periods upon a showing to the court that it is necessary for the continuance of the investigation. Sixty-day extensions may continue for up to one year or until termination of the investigation of the individual or individuals, whichever is sooner.
(C) The records ordered to be produced shall be returned to the peace officer applicant or his or her designee within a reasonable time period after service of the order upon the financial institution.

(D) Nothing in this subdivision shall preclude the financial institution from notifying a customer of the receipt of the order for production of records unless a court orders the financial institution to withhold notification to the customer upon a finding that the notice would impede the investigation.

(E) Where a court has made an order pursuant to this paragraph to withhold notification to the customer under this paragraph, the peace officer or law enforcement agency who obtained the financial information shall notify the customer by delivering a copy of the ex parte order to the customer within 10 days of the termination of the investigation.

(4) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for any of the following:

(A) Disclosing information to a probate court pursuant to Sections 2892 and 2893.

(B) Disclosing information in response to a court order pursuant to paragraph (3).

(C) Complying with a court order under this subdivision not to disclose to the customer, the order, or the dissemination of information pursuant to the court order.

(o) Disclosure by a financial institution to a peace officer, as defined in Section 830.1 of the Penal Code, pursuant to the following:

(1) Paragraph (1) of subdivision (a) of Section 1748.95 of the Civil Code, provided that the financial institution has first complied with the requirements of paragraph (2) of subdivision (a) and subdivision (b) of Section 1748.95 of the Civil Code.

(2) Paragraph (1) of subdivision (a) of Section 4002 of the Financial Code, provided that the financial institution has first complied with the requirements of paragraph (2) of subdivision (a) and subdivision (b) of Section 4002 of the Financial Code.

(3) Paragraph (1) of subdivision (a) of Section 22470 of the Financial Code, provided that any financial institution that is a finance lender has first complied with the requirements of paragraph (2) of subdivision (a) and subdivision (b) of Section 22470 of the Financial Code.

(p) When the governing board of the Public Employees' Retirement System or the State Teachers' Retirement System certifies in writing to a financial institution that a benefit recipient has died and that transfers to the benefit recipient's account at the financial institution from the retirement system occurred after the benefit recipient's date of death, the financial institution shall furnish the retirement system with the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of the benefit recipient's death, or if the account has been closed, the name and address of the person who closed the account.

(q) When the retirement board of a retirement system established under the County Employees Retirement Law of 1937 certifies in writing to a financial institution that a retired member or the beneficiary of a retired member has died and that transfers to the account of the retired member or beneficiary of a retired member at the financial institution from the retirement system occurred after the date of death of the retired member or beneficiary of a retired member, the financial institution shall furnish the retirement system with the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of death of the retired member or beneficiary of a retired member, or if the account has been closed, the name and address of the person who closed the account.

(r) When the Franchise Tax Board certifies in writing to a financial institution that:

(1) A taxpayer filed a tax return that authorized a direct deposit refund with incorrect financial institution account or routing number which resulted in all or a portion of the refund not being received, directly or indirectly, by the taxpayer;

(2) The direct deposit refund was not returned to the Franchise Tax Board; and

(3) The refund was deposited directly on a specified date into the account of an accountholder of the financial institution, who was not entitled to receive the refund,then the financial institution shall furnish to the Franchise Tax Board the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of direct deposit refund, or if the account has been closed, the name and address of the person who closed the account.

AMENDMENT 2

SEC 2. Section 7480 of the Government Code as amended by Section 3 of Chapter 140 of the Statutes of 2005 is amended to read:

7480. Nothing in this chapter prohibits any of the following:

(a) The dissemination of any financial information that is not identified with, or identifiable as being derived from, the financial records of a particular customer.

(b) When any police or sheriff's department or district attorney in this state certifies to a bank, credit union, or savings association in writing that a crime report has been filed that involves the alleged fraudulent use of drafts, checks, or other orders drawn upon any bank, credit union, or savings association in this state, the police or sheriff's department or district attorney may request a bank, credit union, or savings association to furnish, and a bank, credit union, or savings association shall furnish, a statement setting forth the following information with respect to a customer account specified by the police or sheriff's department or district attorney for a period 30 days prior to, and up to 30 days following, the date of occurrence of the alleged illegal act involving the account:

(1) The number of items dishonored.

(2) The number of items paid that created overdrafts.

(3) The dollar volume of the dishonored items and items paid which created overdrafts and a statement explaining any credit arrangement between the bank, credit union, or savings association and customer to pay overdrafts.

(4) The dates and amounts of deposits and debits and the account balance on these dates.

(5) A copy of the signature card, including the signature and any addresses appearing on a customer's signature card.

(6) The date the account opened and, if applicable, the date the account closed.

(7) A bank, credit union, or savings association that provides the requesting party with copies of one or more complete account statements prepared in the regular course of business shall be deemed to be in compliance with paragraphs (1), (2), (3), and (4).

(c) When any police or sheriff's department or district attorney in this state certifies to a bank, credit union, or savings association in writing that a crime report has been filed that involves the alleged fraudulent use of drafts, checks, or other orders drawn upon any bank, credit union, or savings association doing business in this state, the police or sheriff's department or district attorney may request, with the consent of the accountholder, the bank, credit union, or savings association to furnish, and the bank, credit union, or savings association shall furnish, a statement setting forth the following information with respect to a customer account specified by the police or sheriff's department or district attorney for a period 30 days prior to, and up to 30 days following, the date of occurrence of the alleged illegal act involving the account:

(1) The number of items dishonored.

(2) The number of items paid that created overdrafts.

(3) The dollar volume of the dishonored items and items paid which created overdrafts and a statement explaining any credit arrangement between the bank, credit union, or savings association and customer to pay overdrafts.

(4) The dates and amounts of deposits and debits and the account balance on these dates.

(5) A copy of the signature card, including the signature and any addresses appearing on a customer's signature card.

(6) The date the account opened and, if applicable, the date the account closed.

(7) A bank, credit union, or savings association doing business in this state that provides the requesting party with copies of one or more complete account statements prepared in the regular course of business shall be deemed to be in compliance with paragraphs (1), (2), (3), and (4).

(d) For purposes of subdivision (c), consent of the accountholder shall be satisfied if an accountholder provides to the financial institution and the person or entity seeking disclosure, a signed and dated statement containing all of the following:

(1) Authorization of the disclosure for the period specified in subdivision (c).

(2) The name of the agency or department to which disclosure is authorized and, if applicable, the statutory purpose for which the information is to be obtained.

(3) A description of the financial records that are authorized to be disclosed.

(e) (1) The Attorney General, a supervisory agency, the Franchise Tax Board, the State Board of Equalization, the Employment Development Department, the Controller or an inheritance tax referee when administering the Prohibition of Gift and Death Taxes (Part 8 (commencing with Section 13301) of Division 2 of the Revenue and Taxation Code), a police or sheriff's department or district attorney, a county welfare department when investigating welfare fraud, a county auditor-controller or director of finance when investigating fraud against the county, or the Department of Corporations when conducting investigations in connection with the enforcement of laws administered by the Commissioner of Corporations, from requesting of an office or branch of a financial institution, and the office or branch from responding to a request, as to whether a person has an account or accounts at that office or branch and, if so, any identifying numbers of the account or accounts.

(2) No additional information beyond that specified in this section shall be released to a county welfare department without either the accountholder's written consent or a judicial writ, search warrant, subpoena, or other judicial order.

(3) A county auditor-controller or director of finance who unlawfully discloses information he or she is authorized to request under this subdivision is guilty of the unlawful disclosure of confidential data, a misdemeanor, which shall be punishable as set forth in Section 7485.

(f) The examination by, or disclosure to, any supervisory agency of financial records that relate solely to the exercise of its supervisory function. The scope of an agency's supervisory function shall be determined by reference to statutes that grant authority to examine, audit, or require reports of financial records or financial institutions as follows:

(1) With respect to the Commissioner of Financial Institutions by reference to Division 1 (commencing with Section 99), Division 1.5 (commencing with Section 4800), Division 2 (commencing with Section 5000), Division 5 (commencing with Section 14000), Division 7 (commencing with Section 18000), Division 15 (commencing with Section 31000), and Division 16 (commencing with Section 33000) of the Financial Code.

(2) With respect to the Controller by reference to Title 10 (commencing with Section 1300) of Part 3 of the Code of Civil Procedure.

(3) With respect to the Administrator of Local Agency Security by reference to Article 2 (commencing with Section 53630) of Chapter 4 of Part 1 of Division 2 of Title 5 of the Government Code.

(g) The disclosure to the Franchise Tax Board of (1) the amount of any security interest that a financial institution has in a specified asset of a customer or (2) financial records in connection with the filing or audit of a tax return or tax information return that are required to be filed by the financial institution pursuant to Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or Part 18 (commencing with Section 38001) of the Revenue and Taxation Code.

(h) The disclosure to the State Board of Equalization of any of the following:

(1) The information required by Sections 6702, 6703, 8954, 8957, 30313, 30315, 32383, 32387, 38502, 38503, 40153, 40155, 41122, 41123.5, 43443, 43444.2, 44144, 45603, 45605, 46404, 46406, 50134, 50136, 55203, 55205, 60404, and 60407 of the Revenue and Taxation Code.

(2) The financial records in connection with the filing or audit of a tax return required to be filed by the financial institution pursuant to Part 1 (commencing with Section 6001), Part 2 (commencing with Section 7301), Part 3 (commencing with Section 8601), Part 13 (commencing with Section 30001), Part 14 (commencing with Section 32001), and Part 17 (commencing with Section 37001) of Division 2 of the Revenue and Taxation Code.

(3) The amount of any security interest a financial institution has in a specified asset of a customer, if the inquiry is directed to the branch or office where the interest is held.

(i) The disclosure to the Controller of the information required by Section 7853 of the Revenue and Taxation Code.

(j) The disclosure to the Employment Development Department of the amount of any security interest a financial institution has in a specified asset of a customer, if the inquiry is directed to the branch or office where the interest is held.

(k) The disclosure by a construction lender, as defined in Section 3087 of the Civil Code, to the Registrar of Contractors, of information concerning the making of progress payments to a prime contractor requested by the registrar in connection with an investigation under Section 7108.5 of the Business and Professions Code.

(l) Upon receipt of a written request from a local child support agency referring to a support order pursuant to Section 17400 of the Family Code, a financial institution shall disclose the following information concerning the account or the person named in the request, whom the local child support agency shall identify, whenever possible, by social security number:

(1) If the request states the identifying number of an account at a financial institution, the name of each owner of the account.

(2) Each account maintained by the person at the branch to which the request is delivered, and, if the branch is able to make a computerized search, each account maintained by the person at any other branch of the financial institution located in this state.

(3) For each account disclosed pursuant to paragraphs (1) and (2), the account number, current balance, street address of the branch where the account is maintained, and, to the extent available through the branch's computerized search, the name and address of any other person listed as an owner.

(4) Whenever the request prohibits the disclosure, a financial institution shall not disclose either the request or its response, to an owner of the account or to any other person, except the officers and employees of the financial institution who are involved in responding to the request and to attorneys, employees of the local child support agencies, auditors, and regulatory authorities who have a need to know in order to perform their duties, and except as disclosure may be required by legal process.

(5) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for (A) disclosing information in response to a request pursuant to this subdivision, (B) failing to notify the owner of an account, or complying with a request under this paragraph not to disclose to the owner, the request or disclosure under this subdivision, or (C) failing to discover any account owned by the person named in the request pursuant to a computerized search of the records of the financial institution.

(6) The local child support agency may request information pursuant to this subdivision only when the local child support agency has received at least one of the following types of physical evidence:

(A) Any of the following, dated within the last three years:

(i) Form 599.

(ii) Form 1099.

(iii) A bank statement.

(iv) A check.

(v) A bank passbook.

(vi) A deposit slip.

(vii) A copy of a federal or state income tax return.

(viii) A debit or credit advice.

(ix) Correspondence that identifies the child support obligor by name, the bank, and the account number.

(x) Correspondence that identifies the child support obligor by name, the bank, and the banking services related to the account of the obligor.

(xi) An asset identification report from a federal agency.

(B) A sworn declaration of the custodial parent during the 12 months immediately preceding the request that the person named in the request has had or may have had an account at an office or branch of the financial institution to which the request is made.

(7) Information obtained by a local child support agency pursuant to this subdivision shall be used only for purposes that are directly connected with the administration of the duties of the local child support agency pursuant to Section 17400 of the Family Code.

(m) (1) As provided in paragraph (1) of subdivision (c) of Section 666 of Title 42 of the United States Code, upon receipt of an administrative subpoena on the current federally approved interstate child support enforcement form, as approved by the federal Office of Management and Budget, a financial institution shall provide the information or documents requested by the administrative subpoena.

(2) The administrative subpoena shall refer to the current federal Office of Management and Budget control number and be signed by a person who states that he or she is an authorized agent of a state or county agency responsible for implementing the child support enforcement program set forth in Part D (commencing with Section 651) of Subchapter IV of Chapter 7 of Title 42 of the United States Code. A financial institution may rely on the statements made in the subpoena and has no duty to inquire into the truth of any statement in the subpoena.

(3) If the person who signs the administrative subpoena directs a financial institution in writing not to disclose either the subpoena or its response to any owner of an account covered by the subpoena, the financial institution shall not disclose the subpoena or its response to the owner.

(4) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for (A) disclosing information or providing documents in response to a subpoena pursuant to this subdivision, (B) failing to notify any owner of an account covered by the subpoena or complying with a request not to disclose to the owner, the subpoena or disclosure under this subdivision, or (C) failing to discover any account owned by the person named in the subpoena pursuant to a computerized search of the records of the financial institution.

(n) The dissemination of financial information and records pursuant to any of the following:

(1) Compliance by a financial institution with the requirements of Section 2892 of the Probate Code.

(2) Compliance by a financial institution with the requirements of Section 2893 of the Probate Code.

(3) An order by a judge upon a written ex parte application by a peace officer showing specific and articulable facts that there are reasonable grounds to believe that the records or information sought

are relevant and material to an ongoing investigation of a felony violation of Section 186.10 or of any felony subject to the enhancement set forth in Section 186.11.

(A) The ex parte application shall specify with particularity the records to be produced, which shall be only those of the individual or individuals who are the subject of the criminal investigation.

(B) The ex parte application and any subsequent judicial order shall be open to the public as a judicial record unless ordered sealed by the court, for a period of 60 days. The sealing of these records may be extended for 60-day periods upon a showing to the court that it is necessary for the continuance of the investigation. Sixty-day extensions may continue for up to one year or until termination of the investigation of the individual or individuals, whichever is sooner.

(C) The records ordered to be produced shall be returned to the peace officer applicant or his or her designee within a reasonable time period after service of the order upon the financial institution.

(D) Nothing in this subdivision shall preclude the financial institution from notifying a customer of the receipt of the order for production of records unless a court orders the financial institution to withhold notification to the customer upon a finding that the notice would impede the investigation.

(E) Where a court has made an order pursuant to this paragraph to withhold notification to the customer under this paragraph, the peace officer or law enforcement agency who obtained the financial information shall notify the customer by delivering a copy of the ex parte order to the customer within 10 days of the termination of the investigation.

(4) No financial institution, or any officer, employee, or agent thereof, shall be liable to any person for any of the following:

(A) Disclosing information to a probate court pursuant to Sections 2892 and 2893.

(B) Disclosing information in response to a court order pursuant to paragraph (3).

(C) Complying with a court order under this subdivision not to disclose to the customer, the order, or the dissemination of information pursuant to the court order.

(o) Disclosure by a financial institution to a peace officer, as defined in Section 830.1 of the Penal Code, pursuant to the following:

(1) Paragraph (1) of subdivision (a) of Section 1748.95 of the Civil Code, provided that the financial institution has first complied with the requirements of paragraph (2) of subdivision (a) and subdivision (b) of Section 1748.95 of the Civil Code.

(2) Paragraph (1) of subdivision (a) of Section 4002 of the Financial Code, provided that the financial institution has first complied with the requirements of paragraph (2) of subdivision (a) and subdivision (b) of Section 4002 of the Financial Code.

(3) Paragraph (1) of subdivision (a) of Section 22470 of the Financial Code, provided that any financial institution that is a finance lender has first complied with the requirements of paragraph

(2) of subdivision (a) and subdivision (b) of Section 22470 of the Financial Code.

(p) When the governing board of the Public Employees' Retirement System or the State Teachers' Retirement System certifies in writing to a financial institution that a benefit recipient has died and that transfers to the benefit recipient's account at the financial institution from the retirement system occurred after the benefit recipient's date of death, the financial institution shall furnish the retirement system the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of the benefit recipient's death, or if the account has been closed, the name and address of the person who closed the account.

(q) When the retirement board of a retirement system established under the County Employees Retirement Law of 1937 certifies in writing to a financial institution that a retired member or the beneficiary of a retired member has died and that transfers to the account of the retired member or beneficiary of a retired member at the financial institution from the retirement system occurred after the date of death of the retired member or beneficiary of a retired member, the financial institution shall furnish the retirement system the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of death of the retired member or beneficiary of a retired member, or if the account has been closed, the name and address of the person who closed the account.

(r) When the Franchise Tax Board certifies in writing to a financial institution that:

(1) A taxpayer filed a tax return that authorized a direct deposit refund with incorrect financial institution account or routing number which resulted in all or a portion of the refund not being received, directly or indirectly, by the taxpayer;

(2) The direct deposit refund was not returned to the Franchise Tax Board; and

(3) The refund was deposited directly on a specified date into the account of an accountholder of the financial institution, who was not entitled to receive the refund,

then the financial institution shall furnish to the Franchise Tax Board the name and address of any co-owner, cosigner, or any other person who had access to the funds in the account following the date of direct deposit refund, or if the account has been closed, the name and address of the person who closed the account.

(~~r~~ s) This section shall become operative on January 1, 2013.

AMENDMENT 3

SEC. 3 Section 19368 of the Revenue and Taxation Code is amended to read:

19368. (a) If the Franchise Tax Board makes or allows a refund or credit that it determines to be erroneous, in whole or in part, the amount erroneously made or allowed may be assessed and collected after notice and demand pursuant to Section 19051 (pertaining to mathematical errors), except that the rights of protest and appeal shall apply with respect to amounts assessable as deficiencies without regard to the running of any period of limitations provided elsewhere in this part. Notice and demand for repayment must be made within two years after the refund or credit was made or allowed, or during the period within which the Franchise Tax Board may mail a notice of proposed deficiency assessment, whichever period expires the later. Abatement of interest on an amount due under this section is governed by subdivision (c) of Section 19104.

(b)(1) This section shall also apply to a misdirected refund. For purposes of this subdivision, a “misdirected refund” means a direct deposit refund that was deposited in the account of a person other than the taxpayer entitled to that refund. A misdirected refund does not include any refund caused by Franchise Tax Board error, which is an erroneous refund under subdivision (a).

(2) This subdivision shall only apply if the Franchise Tax Board determines that all of the following conditions have been satisfied:

(A) A taxpayer filed a tax return that designated one or more direct deposit refunds.

(B) The taxpayer, tax preparer, or electronic return originator entered incorrect financial institution account or routing number that resulted in all or a portion of the refund not being received, directly or indirectly, by the taxpayer due the refund.

(C) The taxpayer did not receive the refund; and

(D) The recipient of the misdirected refund was not entitled to the refund.

(3) Before any credit of the misdirected refund is allowed to the taxpayer, the taxpayer shall provide one or more of the following, upon written request by the Franchise Tax Board:

(A) An affidavit from the taxpayer that the taxpayer notified the financial institution that the taxpayer, tax preparer, or electronic return originator entered incorrect financial institution account or routing number and that the state-issued refund was directly deposited into an account not owned, indirectly or directly, by the taxpayer entitled to the refund.

(B) An affidavit from the taxpayer indicating that neither the taxpayer nor the taxpayer’s representative has custody or control, directly or indirectly, over the account at the financial institution that received the direct deposit refund.

(C) An affidavit from the taxpayer indicating that neither the taxpayer nor the taxpayer’s representative has received reimbursement of the refund monies from any source.

(4) The Franchise Tax Board shall mail notice and demand for repayment as prescribed in subdivision (a) to the recipient of the misdirected refund at the last known address.

(5) Effective on the date of the notice and demand for repayment to the recipient is mailed to the recipient, the taxpayer's account shall be credited with the amount of the misdirected refund.
(6) This subdivision shall apply to misdirected refunds deposited on or after the effective date of the act adding this subdivision.

AMENDMENT 4

SEC. 4 Section 19411 of the Revenue and Taxation Code is amended to read:

19411. (a) The Franchise Tax Board may recover any refund or credit or any portion thereof that is erroneously made or allowed to the taxpayer or any third-party, including where the taxpayer or a related party caused in any way that erroneous refund, together with interest at the adjusted annual rate established pursuant to Section 19521, in an action brought in a court of competent jurisdiction in the County of Sacramento in the name of the people of the State of California within whichever of the following periods expires the later:
(1) Two years after the refund or credit was made.
(2) During the period within which the Franchise Tax Board may mail a notice of proposed deficiency assessment.
(b) Abatement of interest under this section is governed by subdivision (c) of Section 19104.

AMENDMENT 5

SEC.5 It is the intent of the Legislature that the procedures identified in Government Code Section 7480 that provide an exception to the California Right to Financial Privacy Act for purposes of the Franchise Tax Board to obtain the name and address of a recipient of a misdirected refund from a financial institution be exercised by the Franchise Tax Board only after all other avenues to recover the misdirected refund have been exhausted.

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

Suggested By: **Roland Boucher, United Californians for Tax Reform**

Title

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

Introduction

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.

Current Federal Law

Personal Exemption

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).

Standard Deduction

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 gain 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.

LEGISLATIVE STAFF CONTACT

Analysis prepared by:	Revenue estimated by:	Brian Putler
Nicole Kwon	Jay Chamberlain	Franchise Tax Board
(916) 845-7800	(916) 845-4204	(916) 845-6333
haeyoung.kwon@ftb.ca.gov	jay.chamberlain@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Nicole Kwon
Telephone # 845-7800
Attorney Patrick Kusiak

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)~~ <u>seven thousand four hundred six dollars ($7,406).</u>

(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)~~ <u>fourteen thousand eight hundred twelve dollars ($14,812).</u>

(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).