2005 Legislative Proposals		
Item No.	**Proposal**	**Title**
1	LP 05-06	Disallowance Of Interest Suspension On Tax Positions Resulting in Gross Understatement Of Taxable Income
2	LP 05-08	Earnings Withholding Orders For Taxes (EWOT) For Liability With No Lien
3	LP 05-09	Securities Liquidation Upon Receipt Of Order To Withhold (OTW)
4	LP 05-11	Filing Enforcement Cost Recovery Fee/Apply Fee To All Nonfilers
5	LP 05-13	Repeal Section 24348.5/Bids On Foreclosure By Savings And Loan Associations/Gains
6	LP 05-14	Franchise Tax Board Meetings/Distribution Of CertainWritten Materials
7	LP 05-15	FTB Authority To Reimburse Taxpayers For Third Party Fees
8	LP 05-16	Department Of Justice/Franchise Tax Board Addresses For Non-Registered Sex Offenders
9	LP 05-17	Withholding On California Real Estate To 9.3% Of Profit
10	LP 05-19	Reporting Federal RAR Adjustments - Ordlock
11	LP 05-20	Allow Business Entities To Enter Into Installment Agreements
2004 Taxpayer Bill Of Rights Proposals		
Item No.	**Proposal**	**Title**
12	TP 04-01	Limited Liability Company Double Withholding
13	TP 04-02	Relief From Annual Tax For Limited Partnerships
14	TP 04-04	Restructuring Of Home Owners & Renters Assistance Program

LEGISLATIVE PROPOSAL 05-06
EXECUTIVE SUMMARY

- **Title:**

Disallowance of Interest Suspension on Tax Positions Resulting in Gross Understatement of Taxable Income

- **Problem Statement:**

Present law that suspends the accrual of interest on underpayments of tax where Franchise Tax Board (FTB) issues an assessment 18 months after a return was filed encourages some taxpayers to take filing positions that may be in bad faith to benefit from the use of the money on an interest-free basis while waiting to see if FTB discovers the abuse and proposes an adjustment.

- **Proposed Solution:**

For taxpayers with taxable income greater than $200,000, eliminate interest suspension on assessments, determined at audit, that meet either of the following conditions:

- The taxpayer under-reported income by more than 25%, and the face of the return lacks an adequate disclosure of why the income was under-reported, or
- The taxpayer overstated a tax credit and the overstated amount exceeds 25% of the total credit allowed.

- **Revenue:**

The revenue gain from this proposal is as follows:

Estimated Revenue Impact of LP 05-06 Effective 1/1/2006 (Rounded to the nearest million)		
2005-06	**2006-07**	**2007-08**
$1	**$2**	**$2**

2005 Departmental Legislative Proposal
LP 05-06

Title

Disallowance of Interest Suspension on Tax Positions Resulting in Gross Understatement of Taxable Income

Introduction

Current law suspends the accrual of interest on tax deficiencies if it takes longer than 18 months for the department both to find and to notify the taxpayer of a deficiency. For taxpayers with taxable income greater than $200,000, this proposal would allow interest to continue to accrue where the underpayment of tax is due to an excessively aggressive tax position resulting in a gross understatement.

Current Federal Law

With certain exceptions, federal law provides that the accrual of interest on assessments be suspended if, before the end of an 18-month period, the Internal Revenue Service fails to notify the taxpayer of the assessment. The provision only applies to individuals and to timely filed returns. The suspension starts 18 months after either the original due date of the return, determined without regard to extensions, or the date the return was filed, whichever is later. The suspension ends 21 days after the Internal Revenue Service mails a deficiency notice to the taxpayer. The notice must contain the taxpayer's liability and the basis for the liability.

The interest suspension provision was added to the Internal Revenue Code in 1998. For taxable years beginning after 2003, the 18-month notification period was shortened to 12 months.

Current State Law

California law is the same as federal, but with the following modifications:

- The suspension ends 15 days after notice of assessment is mailed.
- The period for notice is not shortened to 12 months so that it remains 18 months.
- Special rules apply to assessment notices based on a final federal determination after a federal audit.
- For taxpayers involved in a potentially abusive tax shelter, the suspension of interest does not apply to taxpayers with taxable income greater than $200,000.

Problem

Present law that suspends the accrual of interest on underpayments of tax where Franchise Tax Board (FTB) issues an assessment 18 months after a return was filed encourages some taxpayers to take filing positions that may be in bad faith to benefit from the use of the money on an interest-free basis while waiting to see if FTB discovers the abuse and proposes an adjustment.

Proposed Solution

For taxpayers with taxable income greater than $200,000, eliminate interest suspension on assessments, determined at audit, that meet either of the following conditions:

- The taxpayer under-reported income by more than 25%, and the face of the return lacks an adequate disclosure of why the income was under-reported, or
- The taxpayer overstated a tax credit and the overstated amount exceeds 25% of the total credit allowed.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session, the provision would be effective and operative for notices of proposed assessment that are mailed on or after January 1, 2006.

Justification

This proposal is needed because:

- There has been an escalation in excessively aggressive tax return positions related both to underreporting of income and to overstatement of expenses and credits. These taxpayers make up a significant portion of the income tax gap. The department assesses approximately $13 million in tax deficiencies each year for excessively aggressive return positions. Excessively aggressive tax positions are difficult to detect and audit.
- In the risk analysis for whether a taxpayer will take an excessively aggressive filing position, the suspension of interest is sometimes enough of an economic benefit to make the position economically viable.

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

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

Economic Impact

Revenue Estimate

Based on the discussion below, the revenue gain from this proposal is as follows:

Estimated Revenue Impact of LP 05-06 Effective 1/1/2006 (Rounded to the nearest million)		
2005-06	**2006-07**	**2007-08**
$1	**$2**	**$2**

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

Revenue Discussion

The revenue estimate contains two components. The first component is the amount of interest that will be imposed because the taxpayer meets the provisions of this proposal. Based on departmental data, it is projected that $7.8 million will be subject to interest suspension for fiscal year 05/06. It is projected that total interest subject to suspension will increase annually by 5%. It is assumed that 10% ($780,000) will fall under the new proposed criteria to disallow interest suspension. This proposal will only be effective for a portion of the first fiscal year. Based on departmental data, 60% of suspended interest occurs in this part of the year, therefore the gain for 05/06 is $468,000 ($780,000 x 60%).

The second component relates to taxpayer behavior. As a result of this proposal, some taxpayers would choose to not engage in aggressive filing positions, and due to this behavior change, revenues will be subject to acceleration. For the purpose of a revenue estimate, it is assumed that 10% of taxpayers would change their behavior, accelerating revenue on the order of $1 million annually for the first three years only.

Policy Considerations

The interest suspension provisions were originally enacted to grant relief to taxpayers with little means of hiring a tax professional or for taxpayers that make clerical or other common errors. A majority of the taxpayers who would be affected by this proposal obtain professional advice.

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. All these states charge interest on underpayments. None of these states have any interest suspension rules similar to federal or California law.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO LP 05-06

AMENDMENT 1

Section 19116 of the Revenue and Taxation Code is amended to read:

19116. (a) In the case of an individual who files a return of tax imposed under Part 10 (commencing with Section 17001) for a taxable year on or before the due date for the return, including extensions, if the Franchise Tax Board does not provide a notice to the taxpayer specifically stating the taxpayer's liability and the basis of the liability before the close of the notification period, the Franchise Tax Board shall suspend the imposition of any interest, penalty, addition to tax, or additional amount with respect to any failure relating to the return which is computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period.

(b) For purposes of this section:

(1) Except as provided in subdivision (e), "notification period" means the 18-month period beginning on the later of either of the following:

(A) The date on which the return is filed.

(B) The due date of the return without regard to extensions.

(2) "Suspension period" means the period beginning on the day after the close of the notification period and ending on the date which is 15 days after the date on which notice described in subdivision (a) is provided by the Franchise Tax Board.

(c) This section shall be applied separately with respect to each item or adjustment.

(d) This section shall not apply to any of the following:

(1) Any penalty imposed by Section 19131.

(2) Any penalty imposed by Section 19132.

(3) Any interest, penalty, addition to tax, or additional amount involving fraud.

(4) Any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return.

(5) Any criminal penalty.

(e) For taxpayers required by subdivision (a) of Section 18622 to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority the following rules shall apply:

(1) The notification period under subdivision (a) shall be

either of the following:

(A) One year from the date the notice required by Section 18622 is filed with the Franchise Tax Board by the taxpayer or the Internal Revenue Service, if the taxpayer or the Internal Revenue Service reports that change or correction within six months after the final federal determination.

(B) Two years from the date when the notice required by Section 18622 is filed with the Franchise Tax Board by the taxpayer or the Internal Revenue Service, if after the six-month period required in Section 18622, a taxpayer or the Internal Revenue Service reports a change or correction.

(2) The suspension period under subdivision (a) shall mean the period beginning on the day after the close of the notification period under paragraph (1) and ending on the date which is 15 days after the date on which notice described in subdivision (a) is provided by the Franchise Tax Board.

(f) For notices sent after January 1, 2004, this section does not apply to taxpayers with taxable income greater than two hundred thousand dollars ($200,000) that have been contacted by the Franchise Tax Board regarding the use of a potentially abusive tax shelter (within the meaning of Section 19777).

(g) For notices sent after January 1, 2006, this section does not apply to taxpayers with taxable income greater than $200,000 where either of the following conditions apply:

(1) The taxable income reported by the taxpayer on the taxpayer’s original or amended return is less than 75 percent of the taxable income that is required to be reported on that return. In determining the amount of taxable income required to be reported on the return, no amount shall be included for purposes of this subdivision if that amount was disclosed on the taxpayer’s return, or in a statement attached to the return, in a manner adequate to apprise the Franchise Tax Board of the nature and the amount of the item resulting in the understatement of taxable income.

(2) If the taxpayer overstates any credit computed under Part 10 or Part 11 by 25% or more of the total credit allowed under Part 10 or Part 11.

(f) This section shall apply to taxable years ending after October 10, 1999.

LEGISLATIVE PROPOSAL 05-08
EXECUTIVE SUMMARY

- **Title:**

  Earnings Withholding Orders For Liability With An Expired Lien

- **Problem Statement:**

  The current limitation on the use of Earnings Withholding Orders for Taxes (EWOTs) where a state tax lien exists results in the department utilizing less effective, manual methods to collect delinquent tax liabilities.

- **Proposed Solution:**

  Amend section 706.074 of the Code of Civil Procedure to allow the department to use an EWOT until the tax liability is satisfied, regardless of whether a state tax lien is in effect.

- **Major Concerns/Issues:**

  None.

- **Revenue:**

Estimated Revenue Impact of LP 05-08 Expanded Use of EWOTs			
Fiscal Years	2005-06	2006-07	2007-08
Revenue Impact	+$500,000	+$500,000	+$500,000

2005 Departmental Legislative Proposal
LP 05-08

Title

Earnings Withholding Orders For Taxes For Liabilities With An Expired Lien

Introduction

This proposal would eliminate a manual workload by expanding the use of Earnings Withholding Orders for Taxes (EWOTs) to collect on cases where a state tax lien has expired, thereby allowing the automated collection system to continue collection until the liability is satisfied.

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 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 debt arising by operation of law. For federal purposes, the statutory tax lien exists as long as the delinquency exists or until it is unenforceable by reason of lapse of time.

For state purposes, a statutory tax lien arises on the date of an assessment and exists for 10 years, unless the liability becomes satisfied or a Notice of State Tax lien is recorded. The recording of the notice establishes a public record of the existence of the state tax lien against all real and personal property belonging to the taxpayer and located in the county. The recording of a state tax lien is considered on a case-by-case basis and is done by recording a Notice of State Tax Lien in a county recorder's office or with the Secretary of State. Once a state tax lien has been recorded, it can be renewed in 10-year increments, for a maximum of up to 30 years.

Current state law authorizes Franchise Tax Board (FTB) to use several collection tools in order to collect delinquent tax liabilities.

FTB may issue Orders to Withhold Personal Income Tax (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 entity notified is required to submit to the department all cash or cash equivalent due the debtor that will satisfy the amount of the OTW after a 10 day waiting period. If the entity is in possession of any assets other than cash or cash equivalent, they must hold that item, notify FTB, and await further instructions. An OTW can be served by personal delivery, by first class mail, or by fax.

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. An EWOT can be issued by first class mail or personal service.

Program History/Background

The department uses an automated tax collection system to collect delinquent taxes as follows:

- The system automatically issues a Notice of State Tax Lien to the county recorder's office in the county containing the account address when several conditions are met, namely locating a valid address for the debtor and a billable balance exceeding established thresholds. The department will issue a Notice of State Tax Lien to extend a tax lien beyond the existing 10-year expiration date on accounts that meet certain criteria established by the department.

- The department's 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.

The automated system lacks the ability to release EWOTs once taxpayer accounts no longer meet the criteria established by the department for recording a Notice of State Tax Lien. As a result, department staff must manually identify taxpayer accounts no longer meeting the criteria and release the EWOT.

Problem

The current limitation on the use of EWOTs where a state tax lien exists results in the department utilizing less effective, manual methods to collect delinquent tax liabilities.

Proposed Solution

Amend section 706.074 of the Code of Civil Procedure to allow the department to use an EWOT until the tax liability is satisfied, regardless of whether a state tax lien is in effect.

Effective/Operative Date of Solution

If enacted during the 2005 legislative session, this proposal would be effective and operative January 1, 2006.

Justification

This proposal would enable the department to eliminate the need to process taxpayer accounts manually and to use the most cost-effective and efficient collection method available. When issuing EWOTs, the department uses automated processes, thus increasing the net amount of revenue generated due to the low cost to administer. While the department does have other collection tools, such as OTWs and warrants, these tools are less cost-effective in comparison to an EWOT.

Implementation

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

Fiscal Impact

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

Economic Impact

This proposal would result in the following revenue gains:

Estimated Revenue Impact of LP 05-08 Expanded Use of EWOTs			
Fiscal Years	2005-06	2006-07	2007-08
Revenue Impact	+$500,000	+$500,000	+$500,00

This proposal would allow the department to use EWOTs to collect delinquent tax liabilities until the liability has been satisfied. While there are currently a large number of taxpayer accounts in which the use of an EWOT is limited by the 10-year statute of limitation, the majority of those tax debts appear to be collectable through other means, such as an OTW or warrant. Of the accounts no longer meeting the criteria for the continuation of an EWOT, it is estimated that approximately 650 accounts per year would not be collectable without an EWOT. Assuming those accounts have an average balance of $800, there would be approximately $500,000 in uncollectible tax liabilities (650 accounts x $800 average account balance) without this proposal. As a result of allowing the EWOT to continue until the liability is satisfied, it is estimated that this proposal would result in a revenue gain of $500,000, annually.

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 state law provides that once a lien arises, the lien may continue for a period of 20 years. With a lien in place, a levy can be placed upon the wages of a taxpayer and continues until the amount of the liability is paid, unless the employment is terminated or the notice of levy is rescinded or modified.

Massachusetts state law provides that once a lien arises, a levy may be placed on the salary or wages of a taxpayer and shall continue from the date the levy is first made until the liability is satisfied or becomes unenforceable by reason of lapse of time. Current Massachusetts law provides that liens are valid for six years from the date of creation. However, beginning January 1, 2005, liens will be valid for 10 years. It does not appear that the lien can be extended.

Michigan state law provides that the effect of a levy on salary or wages is continuous from the date the levy is first made until the liability is satisfied. It does not appear that a lien must be in place in order to levy wages.

Minnesota state law allows a levy to be filed upon a taxpayer's wages for which a lien is in effect and specifies that the levy shall continue until the liability is satisfied or unenforceable by law. A lien is enforceable for 10 years from the time the lien is filed, and may be renewed for an additional 10 years.

New York state law provides that once a tax warrant (similar to CA state tax lien) has been filed to publicly record the debt, an Income Execution may be issued and continues until the liability has been satisfied. An Income Execution allows for wage deductions not to exceed 10% of gross income.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-08

AMENDMENT 1

Section 706.074 of the Code Of Civil Procedure is modified as follows:

Sec. 706.074 (a) The state may itself issue a withholding order for taxes under this section to collect a state tax liability. The order shall specify the total amount required to be withheld pursuant to the order (unpaid tax liability including any penalties, accrued interest, and costs).

(b) Unless a lesser amount is specified in the order, the amount to be withheld by the employer each pay period pursuant to an order issued under this section is the amount required to be withheld under Section 1673(a) of Title 15 of the United States Code, and is not subject to the exception provided in Section 1673(b) of Title 15 of the United States Code.

<u>(c) For purposes of this article, notwithstanding Section 7172 of the Government Code, a state tax lien continues in effect until the amount due and payable has been paid.</u>

LEGISLATIVE PROPOSAL 05-09
EXECUTIVE SUMMARY

- **Title:**

Liquidation of Securities Upon Receipt Of Order To Withhold

- **Problem Statement:**

For purposes of liquidating securities, the existing warrant process of seizing and selling non-cash assets is generally inefficient, costly, and time-consuming and results in the department missing revenue opportunities.

- **Proposed Solution:**

Amend Revenue and Taxation Code Section 18670 to require financial institutions, or those that maintain, administer, or manage an asset, to fulfill the terms of an FTB OTW by liquidating a taxpayer's non-cash assets, including security holdings that are either certificated or uncertificated, within 30 days of receiving an OTW from FTB.

- **Major Concerns/Issues:**

None.

- **Revenue:**

Estimated Revenue Impact of LP 05-09 Accelerated Collection for Securities Liquidation ($ Millions)			
Fiscal Years	2005-06	2006-07	2007-08
	+$3.6	+$1.0	+$1.0

2005 Departmental Legislative Proposal
LP 05-09

Title

Liquidation of Securities Upon Receipt Of Order To Withhold

Introduction

This proposal would require financial institutions, including brokerage firms that receive a levy for a taxpayer's delinquent taxes from Franchise Tax Board (FTB), to liquidate any securities held by the financial institution to satisfy the levy.

Current Federal Law

If any person liable to pay any tax neglects or refuses to pay the tax within 10 days after notice and demand, the Secretary of the Treasury may collect the tax by levy upon property and rights to property, which is called levy and distraint. The property seized may be real, personal, tangible, or intangible, including receivables, evidences of debt, securities, and to the extent they exceed a specified amount, present and future wages. This means that generally, the IRS may seize any real or personal property of a delinquent taxpayer, whether the taxpayer or an agent holds the property. The IRS may sell the property and apply the proceeds to the unpaid taxes. There are exemptions to seizure for certain kinds of income and property, such as unemployment benefits, clothes, and tools.

Although current law is similar to state law below regarding the seizure and sale of non-cash assets, IRS staff indicated that financial institutions generally respond to an IRS levy for non-cash assets such as uncertificated securities by liquidating the asset and forwarding the proceeds to the IRS. However, certificated securities must be seized and sold through the process described above.

Current State Law

State tax law authorizes FTB to issue levies called orders to withhold (OTWs) to various financial institutions, including brokerage firms, that have in their possession or control personal property or other things of value that belong to a debtor. The financial institution is required to transmit an amount not to exceed the amount specified in the levy to FTB not less than 10 business days after receiving the OTW.

If the assets consist of non-cash items, such as stock or securities held in "street name" in a brokerage account, the financial institution must notify FTB that the account is "frozen" pending further action. The financial institution freezes enough securities to cover the OTW. Since FTB lacks the authority to require the financial institution to liquidate the security to satisfy an OTW, FTB has these types of assets liquidated through a warrant seizure and auction process.

FTB is authorized to issue a warrant to a levying officer such as the California Highway Patrol (CHP) to seize property and convert it to cash to satisfy a tax debt. The taxpayer is afforded an administrative due process hearing with FTB. The levying officer, in conjunction with FTB, sets a specified reserve price and holds a public auction. Generally, the most common use of the warrant is to seize and sell vehicles; however, warrants can also be used to seize, real property, boats, stocks, bonds, mutual funds, and cash from a debtor's business.

Recently enacted legislation, AB 1752 (Assembly Budget Committee, Stats. 2003, Ch. 225), requires a financial institution, person, or securities intermediary to liquidate the financial assets, including securities, of an individual obligor who owes child support when a local child support agency or FTB issues a levy for child support obligations.

Under the California Uniform Commercial Code Investment Securities provisions of state law, for collection purposes, security holdings can be generally classified as certificated and uncertificated securities.

- Generally, a certificated security would include those holdings where an actual paper certificate exists or can be reproduced for seizure with a warrant, such as stocks. Generally, FTB's practice is to release an OTW if liquidation of the security holdings are not cost effective to pursue or the security holdings are worth less than an administrative minimum threshold. As a result, staff estimates that FTB releases approximately 88% of securities that are frozen.
- Uncertificated securities are holdings where no paper record is readily accessible, such as mutual funds. Under current state law, a creditor such as FTB may only reach an uncertificated security by legal process on the issuer of the security at the issuer's executive office. Such information is often unavailable to FTB or if information shows that the issuer's executive office is outside California, FTB would be unable to issue a warrant for seizure and sale. As a result, FTB generally does not pursue the seizure and sale of uncertificated securities.

Program History/Background

See Appendix A at the end of this document for information regarding department administrative procedure and practices.

Problem

For purposes of liquidating securities, the existing warrant process of seizing and selling non-cash assets is generally inefficient, costly, and time-consuming and results in the department missing revenue opportunities.

Proposed Solution

Amend Revenue and Taxation Code Section 18670 to require financial institutions, or those that maintain, administer, or manage an asset, to fulfill the terms of an FTB OTW by liquidating a taxpayer's non-cash assets, including security holdings that are either certificated or uncertificated, within 30 days of receiving an OTW from FTB.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as an administrative measure, this proposal would be effective and operative January 1, 2006, and apply to all OTW's issued for securities after that date.

Justification

This proposal would allow FTB to utilize the OTW as the method to have security holdings liquidated, resulting in the following improvements for the department.

- The department would efficiently pursue 100% of the securities that are located. As stated above, the department typically releases 88% of the securities that are located due to the administrative minimum threshold or because the security is not cost effective to pursue.
- Staff estimates that approximately 36,000 taxpayer accounts currently have a securities asset associated with the account. These accounts represent approximately $500 million in accounts receivable obligations.
- Requiring a financial institution to liquidate security holdings would allow FTB to pursue uncertificated securities. Currently the department does not pursue these types of securities because it requires FTB to serve process on the issuer of the security at the executive office. As stated above, this information is often not available to FTB or the executive office is out of state.
- Requiring financial institutions to liquidate security holdings would allow FTB to improve relationships with those financial institutions that have expressed a desire in the past to liquidate securities, if only the law allowed FTB to request the liquidation.
- Allowing the department to use an OTW to pursue the liquidation of securities would be more cost effective than the current warrant process. Issuing the OTW allows FTB to use an automated process to generate the OTW, as opposed to the staff hours used to pursue the securities using the warrant process.
- If the financial institution liquidates the securities through the OTW process, then FTB would receive the full market value of the security instead of the discounted rate received by FTB through the current auction process.
- In 2003, similar legislation was enacted to require the liquidation of the financial assets of an individual obligor who owes child support when a local child support agency or FTB issues a levy for child support obligations. So far, this provision is working well for the department with a few exceptions regarding contact from financial institutions questioning their possession of uncertificated securities.

Implementation

Department staff anticipates that implementing this proposal would not have a significant impact on the department. This proposal would allow the department to automate the OTW and liquidation process for certain non-cash assets such as securities.

Fiscal Impact

The department anticipates minor costs to implement this proposal and it is anticipated the department would implement any changes during normal annual updates. The costs would include the revision of the OTW forms and minor programming of the collections computer system.

In addition, staff anticipates a cost savings as a result of this proposal since staff would no longer be required to pursue the costly warrant process to liquidate securities. This would allow staff to focus their collection efforts on pursuing other taxpayer accounts.

Economic Impact

Collections Estimate:

Estimated Revenue Impact of LP 05-09 Accelerated Collection for Securities Liquidation ($ Millions)			
Fiscal Yeai	2005-06	2006-07	2007-08
	+$3.6	+$1.0	+$1.0

Collections Discussion:

Currently, FTB collects approximately $3 million annually from the liquidation of securities from over 400 accounts above the administrative threshold. The total annual cost for liquidating these securities is approximately $350,000, which reduces the proceeds of security liquidations that FTB receives. This proposal would eliminate those costs, thereby increasing collections from liquidations by $350,000 annually. In addition, over 550 accounts annually are released because they are below the administrative threshold and it is not cost effective to liquidate those securities. Liquidation of those securities under this proposal would increase collection revenue by over $650,000 annually (550 accounts x $1,200 average account balance).

Currently there is $600,000 in mutual fund accounts that cannot be liquidated under present law and $500,000 in stocks for which investment firms will not issue a certificate. This legislation would make those securities collectable for a total of $1.1 million.

In addition, since the current liquidation process takes from 12 to 18 months to complete, there would be an acceleration of six months of collection revenue or $1.5 million in the first year.

In total there would be an increase in collection of $3.6 million in the first year ($350,000 in reduced costs + $650,000 in collections from smaller accounts + $1.1 million collection of mutual fund liquidations+ $1.5 million in acceleration) and $1 million annually thereafter ($350,000 in reduced costs + $650,000 in collections from smaller accounts).

Other States

Phone calls were made to collection representatives with the Department of Revenue (DOR) for *Illinois, Michigan, Massachusetts, Minnesota,* and *New York* and found the following:

- In the states of *Massachusetts, Minnesota,* and *New York* the financial institution liquidates non-cash assets and forwards the proceeds to the DOR.
- *Illinois* believes they may already have the legal authority to require liquidation by brokerage firms, however they have yet to test the process and are currently creating a plan to do so.
- Similar to California, *Michigan* administratively seizes the asset, and converts the asset into cash. However, an auction is not required.

Other Agency/Industry Impacted

FTB child support collections staff has received communication from an investment company regarding the recently enacted legislation requiring the liquidation of security holdings for the payment of child support obligations. Specifically, this particular company states that since neither the mutual fund nor the mutual fund's transfer agent have actual possession or control of the uncertificated security, then neither the funds nor the transfer agent are able to liquidate that security. As a result of this contact, the attached proposed language would address this problem for FTB purposes by expanding the liquidation requirement to those that maintain, administer, or manage an asset, or possess the legal authority to accept instructions from the taxpayer regarding the disposition of an asset.

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APPENDIX A
Program Background and Department Procedure

Uncertificated Securities

As stated above, FTB is authorized to use the warrant process to seize and sell security holdings. This process is adequate for certificated securities (stocks) because a paper certificate exists or can be reproduced for the seizure. However, for uncertificated securities (stocks or securities or mutual funds held in "street name") for which no paper certificate exists, a creditor such as FTB may only reach an uncertificated security by legal process on the issuer of the security at the issuer's executive office. Such information is often unavailable to FTB or if information shows that the issuer's executive office is outside California, FTB would be unable to issue a warrant for seizure and sale. Use of uncertificated securities is increasing, and feedback from mutual funds or the fund transfer agents regarding whether those parties have actual possession or control of the security and whether FTB can then seize the security. As a result, FTB generally does not pursue the seizure and sale of uncertificated securities.

Certificated Securities

While the warrant process is adequate for the seizure and sale of certificated securities, the process is time-consuming and costly. FTB staff must spend considerable resources on the taxpayer account to do the following:

- Send an OTW;
- Follow-up on the success of the OTW;
- Respond to a financial institution that has frozen a taxpayer's securities;
- Analyze the frozen securities to determine the cost effectiveness of liquidation;
- Send a voluntary liquidation letter to the taxpayer;
- Issue a warrant for law enforcement to seize the securities; and
- Monitor the sale of the securities at auction.

Generally, FTB's practice is to release an OTW if liquidation of the security holdings are not cost effective to pursue or the security holdings are worth less than an administrative minimum threshold. As a result, staff estimates that FTB releases approximately 88% of securities that are frozen, which means FTB only liquidates approximately 12% of the securities located. Of those that are liquidated, FTB discounts the securities to attract buyers to the auction. The final auction bids typically fall below market value. As a result, FTB typically only conducts auctions a couple of times a year when the department has seized enough securities from various taxpayers to justify the expense.

In the past year, FTB has held three stock auctions in the northern region to liquidate 15 individual's securities holdings. For example, at one stock auction conducted through the Oakland district office in March 2004, FTB liquidated 15 securities. The total cost to FTB was approximately $4,106, which included:

- 37 FTB staff hours for a total of $966;
- Advertising costs of $990;
- Law enforcement fees of $1,400; and
- Financial institution fees of $750**.

**For example, Charles Schwab recently began charging FTB $50 for each security certificate that it must prepare and print.

However, for the three stock auctions conducted in the past year, FTB received a total of $415,000, which is an average of $27,000 per taxpayer account. Thus, the average cost per taxpayer's account to conduct these auctions is $785.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-09

AMENDMENT 1

SECTION 1. Section 18670 of the Revenue and Taxation Code is amended to read:

SEC. 1. 18670. (a) The Franchise Tax Board may by notice, served personally or by first-class mail, require any employer, person, officer or department of the state, political subdivision or agency of the state, including the Regents of the University of California, a city organized under a freeholders' charter, or a political body not a subdivision or agency of the state, having in their possession, or under their control, any credits or other personal property or other things of value, belonging to a taxpayer or to an employer or person who has failed to withhold and transmit amounts due pursuant to this article, to withhold, from the credits or other personal property or other things of value, the amount of any tax, interest, or penalties due from the taxpayer or the amount of any liability incurred by that employer or person for failure to withhold and transmit amounts due from a taxpayer under this part and to transmit the amount withheld to the Franchise Tax Board at the times that it may designate. However, in the case of a depository institution, as defined in Section 19(b) of the Federal Reserve Act (12 U.S.C.A. Sec. 461(b)(1)(A)), amounts due from a taxpayer under this part shall be transmitted to the Franchise Tax Board not less than 10 business days from receipt of the notice. To be effective, the notice shall state the amount due from the taxpayer and shall be delivered or mailed to the branch or office reported in information returns filed with the Franchise Tax Board, or the branch or office where the credits or other property is held, unless another branch or office is designated by the employer, person, officer or department of the state, political subdivision or agency of the state, including the Regents of the University of California, a city organized under a freeholders' charter or a political body not a subdivision or agency of the state.

(b) (1) At least 45 days before sending a notice to withhold to the address indicated on the information return, the Franchise Tax Board shall request a depository institution to do either of the following:

(A) Verify that the address on its information return is its designated address for receiving notices to withhold.

(B) Provide the Franchise Tax Board with a designated address for receiving notices to withhold.

(2) Once the depository institution has specified a designated address pursuant to paragraph (1), the Franchise Tax Board shall send all notices to that address unless the depository institution provides notification of another address. The Franchise Tax Board shall send all notices to withhold to a new designated address 30 days after notification.

(3) Failure to verify or provide a designated address within 30 days of receiving the request shall be deemed verification of the address on the information return as the depository institution's designated address.

(c) (1) Notwithstanding Section 8112 of the Commercial Code and Section 700.130 of the Code of Civil Procedure, when the Franchise Tax Board, pursuant to this section or Section 18670.5, issues a levy upon, or requires by notice, any person, financial institution, or securities intermediary, as applicable, to withhold all, or a portion of, a financial asset for the purpose of collecting a delinquent tax liability, the person, financial institution, or securities intermediary (as defined in Section 8102 of the Commercial Code) which maintains, administers, or manages that asset on behalf of the taxpayer, or has the legal authority to accept instructions from the taxpayer as to the disposition of that asset, shall liquidate the financial asset in a commercially reasonable manner within 30 days of the issuance of the order to withhold. Within five days of liquidation, the person, financial institution, or securities intermediary, as applicable, shall remit to the Franchise Tax Board the proceeds of the liquidation, less any reasonable commissions or fees, or both, which are charged in the normal course of business.

(2) If the value of the financial assets to be liquidated exceed the tax liability, the taxpayer may, within 10 days after the service of the order to withhold upon the person, financial institution, or securities intermediary, instruct the person, financial institution, or securities intermediary as to which financial assets are to be sold to satisfy the tax liability. If the taxpayer does not provide instructions for liquidation, the person, financial institution, or securities intermediary shall liquidate the financial assets in a commercially reasonable manner and in an amount sufficient to cover the tax liability, and any reasonable commissions or fees, or both, which are charged in the normal course of business, beginning with the financial assets purchased most recently.

(3) For purposes of this section, a financial asset shall include, but not be limited to, an uncertificated security, certificated security, or security entitlement (as defined in Section 8102 of the Commercial Code), security (as defined in Section 8103 of the Commercial Code), or a securities account (as defined in Section 8501 of the Commercial Code).

(d) Any corporation or person failing to withhold the amounts due from any taxpayer and transmit them to the Franchise Tax Board after service of the notice shall be liable for those amounts. However, in the case of a depository institution, if a notice to withhold is mailed to the branch where the account is located or principal banking office, the depository institution shall be liable for a failure to withhold only to the extent that the accounts can be identified in information normally maintained at that location in the ordinary course of business.

LEGISLATIVE PROPOSAL 05-11
EXECUTIVE SUMMARY

- **Title:**

  Filing Enforcement Cost Recovery Fee/Apply Fee To All Nonfilers

- **Problem Statement:**

  The Filing Enforcement Cost Recovery Fee (FECR fee) is imposed only on repeat nonfilers, rather than all nonfilers, resulting in an inequitable application of the FECR fee.

- **Proposed Solution:**

  Amend Revenue & Taxation Code Section 19254 to allow FTB to impose the FECR fee on all nonfilers who are issued a filing enforcement Notice of Proposed Assessment (FE NPA) after failing to respond in a timely manner to either a Demand for Tax Return letter or a Request for Tax Return notice.

- **Revenue:**

  This proposal is not anticipated to impact income tax revenue. This proposal would simply redistribute the costs of the filing enforcement program among all nonfilers, rather than only repeat nonfilers.

2005 Departmental Legislative Proposal
LP 05-11

Title

Filing Enforcement Cost Recovery Fee/Apply Fee To All Nonfilers

Introduction

This proposal would allow the Franchise Tax Board (FTB) to impose the filing enforcement cost recovery (FECR) fee on all nonfilers.

Current Federal Law

Federal law does not impose a FECR fee.

Current State Law

Current state law authorizes FTB to notify an individual taxpayer for whom FTB has no record of a tax return having been filed for a particular taxable year.

When the taxpayer is a first time nonfiler, the department implements this statute by issuing a Request for Tax Return. A first time nonfiler is a taxpayer that failed to file a tax return and has not been issued a Filing Enforcement Notice of Proposed Assessment (FE NPA) within the previous four years.

When the taxpayer is a repeat nonfiler, the department implements this statute by issuing a Demand for Tax Return. A repeat nonfiler is a taxpayer that failed to file a tax return and has been issued an FE NPA within the previous four years.

If a taxpayer fails to comply with the Request for Tax Return or Demand for Tax Return, a FE NPA is issued to the taxpayer. The FE NPA proposes to impose a demand penalty and FECR.

The demand penalty and FECR fee is imposed on the FE NPA as a result of the repeat nonfiler's failure to comply with the Demand for Tax Return letter. No demand penalty or FECR fee is imposed for the first time nonfiler FE NPA.

If a taxpayer either (1) fails to furnish any information requested by FTB or (2) fails to file a required tax return upon receiving the Demand for Tax Return letter, also known as a "notice and demand letter," the department may impose a demand penalty. The amount of the demand penalty is 25% of the taxpayer's total tax.

Current state law allows FTB to impose an FECR fee if the taxpayer fails to file a tax return within 25 days after FTB mails a Demand for Tax Return letter. The amount of the FECR fee is based on the actual cost of the program. The FECR fee is set in the annual Budget Act. For fiscal year 2004-05, the FECR fee will be $90 for individuals and $129 for corporations.

Problem

The FECR fee is imposed only on repeat nonfilers, rather than all nonfilers, resulting in an inequitable application of the FECR fee.

Proposed Solution

Amend Revenue & Taxation Code Section 19254 to allow FTB to impose the FECR fee on all nonfilers who are issued an FE NPA after failing to respond in a timely manner to either a Demand for Tax Return letter or a Request for Tax Return notice.

Effective/Operative Date of Solution

If adopted in the 2005 legislative session, this proposal would be effective and operative January 1, 2007. The Integrated Nonfiler Compliance (INC) Section has requested that the proposal become effective and operative in 2007 so that department costs for this proposal may be absorbed into another project (Bowen, SB 25, Stats. 2003, Ch. 907) scheduled during that timeframe.

Justification

Adopting this proposal would do the following:

- Equally distribute the FECR fee among all nonfilers since the FE program is in place to enforce filing for all nonfilers, not just repeat nonfilers.
- Decrease the amount of the FECR fee imposed on all nonfilers since the cost of the program would be spread out over a larger group of taxpayers.

Implementation

Implementing this proposal would be 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. Thereafter, any changes would be included in the department's normal annual update.

Economic Impact

This proposal is not anticipated to impact the state's income tax revenue. This proposal would simply redistribute the costs of the filing enforcement program among all nonfilers rather than only repeat nonfilers.

Other States

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* were reviewed because their tax laws are similar to California's income tax laws. Each state imposes a penalty equal to a specified percentage of the amount of tax due for failure to file. None of these states impose a FECR fee.

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Current State Law
Taxpayer fails to file a return.

First-Time Nonfiler:
Defined as a taxpayer that has not been issued an FE NPA for previous 4 years but the current year return is past due.

Repeat Nonfiler:
Defined as a taxpayer that has received an FE NPA within past 4 years and the current year return is past due.

- First-time nonfilers sent Request For Tax Return; demand penalty and FECR fee not imposed.
- Repeat nonfilers sent Demand for Tax Return; demand penalty and FECR fee imposed.

Problem
The FECR fee is imposed only on repeat nonfilers, rather than all nonfilers, resulting in an inequitable application of the FECR fee.

Proposed Solution
Impose FECR fee on all nonfilers who are issued an FE NPA for failure to respond timely to either the Demand for Tax Return or the Request for Return.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-11

AMENDMENT 1

Section 19254 of the Revenue & Taxation Code is amended as follows:

19254. (a) (1) If any person, other than an organization exempt from taxation under Section 23701, fails to pay any amount of tax, penalty, addition to tax, interest, or other liability imposed and delinquent under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part, a collection cost recovery fee shall be imposed if the Franchise Tax Board has mailed notice to that person for payment that advises that continued failure to pay the amount due may result in collection action, including the imposition of a collection cost recovery fee. The collection cost recovery fee shall be in the amount of:

(A) In the case of an individual, partnership, limited liability company classified as a partnership for California income tax purposes, or fiduciary, eighty-eight dollars ($88) or an amount as adjusted under subdivision (b).

(B) In the case of a corporation or limited liability company classified as a corporation for California income tax purposes, one hundred sixty-six dollars ($166) or an amount as adjusted under subdivision (b).

(2) If any person, other than an organization exempt from taxation under Section 23701, fails or refuses to make and file a tax return required by Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part, ~~within 25 days after formal legal demand to file the tax return is mailed to that person by the Franchise Tax Board~~and the Franchise Tax Board issues an assessment pursuant to Section 19087, the Franchise Tax Board shall impose a filing enforcement cost recovery fee in the amount of:

(A) In the case of an individual, partnership, limited liability company classified as a partnership for California income tax purposes, or fiduciary, fifty-one dollars ($51) or an amount as adjusted under subdivision (b).

(B) In the case of a corporation or limited liability company classified as a corporation for California income tax purposes, one hundred nineteen dollars ($119) or an amount as adjusted under subdivision (b).

(b) For fees imposed under this section during the fiscal year 1993-94 and fiscal years thereafter, the amount of those fees shall be set to reflect actual costs and shall be specified in the annual Budget Act.

(c) Interest shall not accrue with respect to the cost recovery fees provided by this section.

(d) The amounts provided by this section are obligations imposed by this part and may be collected in any manner provided under this part for the collection of a tax.

(e) (1) Subdivision (a) is operative with respect to the notices for payment or formal legal demands to file, either of which is mailed on or after September 15, 1992.

(2) The amendments made to this section by the act adding this paragraph are operative with respect to an assessment issued on and after the effective date of this act.

(f) The Franchise Tax Board shall determine the total amount of the cost recovery fees collected or accrued through June 30, 1993, and shall notify the Controller of that amount. The Controller shall transfer that amount to the Franchise Tax Board, and that amount is hereby appropriated to the ~~board~~ Franchise Tax Board for the 1992-93 fiscal year for reimbursement of its collection and filing enforcement efforts.

LEGISLATIVE PROPOSAL 05-13
EXECUTIVE SUMMARY

- **Title:**

  Repeal Section 24348.5/Bids on Foreclosure by Savings and Loan Associations/Gains or Losses/AB 2065 Cleanup

- **Problem Statement:**

  R&TC Section 24348.5 was rendered obsolete by the enactment of conformity to federal bad debt deduction rules for savings and loan associations in AB 2065 (Stats. 2002, Ch. 488), but was not repealed.

- **Proposed Solution:**

  Repeal R&TC Section 24348.5 as obsolete (deadwood) to conform fully to the federal repeal of IRC Section 595.

- **Major Concerns/Issues:**

Obsolete provisions should be eliminated to prevent confusion for taxpayers and the department when applying state law.

- **Revenue:**

  This proposal would not affect state tax revenues.

2005 Departmental Legislative Proposal
LP 05-13

Title

Repeal Section 24348.5/Bids on Foreclosure by Savings and Loan Associations/Gains or Losses/ AB 2065 Cleanup

Introduction

AB 2065 (Stats. 2002, Ch. 488) conformed California law to federal bad debt deduction rules for savings and loan associations as well as banks. That bill, however, failed to repeal Revenue and Taxation Code (R&TC) Section 24348.5, a provision made obsolete by that bill, relating to special rules a savings and loan association used in computing its bad debt deduction with respect to the foreclosure of property securing its loans. See Attachment I for a detailed discussion of federal and state law bad debt deduction rules.

Problem

R&TC Section 24348.5 was rendered obsolete by the enactment of conformity to federal bad debt deduction rules for savings and loan associations in AB 2065 (Stats. 2002, Ch. 488), but was not repealed.

Proposed Solution

Repeal R&TC Section 24348.5 as obsolete (deadwood) to conform fully to the federal repeal of IRC Section 595.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session, this proposal would be operative January 1, 2006.

Justification

Obsolete provisions should be eliminated to prevent confusion for taxpayers and the department when applying state law.

Implementation

Implementation of this proposal would not significantly impact the department.

Fiscal Impact

This proposal would not impact the department's costs.

Economic Impact

This proposal would not affect state tax revenues.

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ATTACHMENT I

FEDERAL AND CALIFORNIA BAD DEBT DEDUCTION RULES

Program History/Background

Generally, under both federal and California law a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the “specific charge-off” method).

Federal Law

Savings and Loan Associations

Under federal law, for years before 1996, certain thrift institutions (savings and loan associations, mutual savings banks, or cooperative banks) were allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to banks). All qualified thrift institutions were allowed to compute deductions for bad debts using either the specific charge-off method or a reserve for bad debts based upon their own loss experience, commonly called the “reserve method of accounting.”

Federal law repealed the special reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under that change, the bad debt deduction rules for banks were made applicable to thrift institutions. This was accomplished by modifying the definition of banks to include these thrift institutions. Thus, a thrift institution that would be treated as a small bank (assets under $500 million) would be allowed to utilize the experience method applicable to banks, while any thrift institution that would be treated as a large bank (assets exceeding $500 million) would be required to use only the specific charge-off method.

The changed federal law also repealed the pre-1996 special rules with respect to the foreclosure of property securing loans of a thrift institution, effective for property acquired in taxable years beginning after December 31, 1995. (Internal Revenue Code (IRC) Section 595.)

State Law

AB 2065 (Stats. 2002, Ch. 488) conformed California law to federal bad debt deduction rules for banks as well as savings and loan associations. Thus, for taxable years beginning on or after January 1, 2002:

- Bad debts would be deducted in the year they become worthless, unless the taxpayer is allowed to use the reserve for bad debt method under IRC Section 585.
- Banks (including thrift institutions such as savings and loan associations, mutual savings
- banks, or cooperative banks) are the only taxpayers allowed to use that method and only if they are not “large banks (including large thrift institutions).” A large bank (including a large thrift institution) is one where the average of all its assets is greater than $500 million during any taxable year beginning after December 31, 1986.
- This Act did not provide any carryback rules, nor conform to any election options contained in federal 1986 or 1995 transitional rules under IRC Section 585 or IRC Section 593, or any changes to the net operating loss rules. Instead, it goes directly to the rules contained in IRC Section 585.
- However, this Act allowed the bad debt reserves of large banks, large savings and loan associations, and all financial corporations, at the beginning of 2002, to be taken into income in

the amount of 50% of the applicable excess reserve (as defined) at the end of the first tax year beginning on or after January 1, 2002. A small bank would not have to bring any excess reserves into income.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-13

AMENDMENT 1

SEC. . Section 24348.5 of the Revenue and Taxation Code is repealed.

~~24348.5. (a) Notwithstanding the provisions of Section 24952, in the case of a state or federal savings and loan association, no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as a result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.~~

~~(b) For purposes of Section 24348, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subdivision (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated for purposes of this chapter as a bad debt to which the provisions of Section 24348 (relating to allowance of a deduction for bad debts) apply.~~

~~(c) The basis of any property to which subdivision (a) applies shall be the basis of the indebtedness for which such property was security (determined as of the date of the acquisition of such property) properly increased for costs of acquisition.~~

~~(d) The Franchise Tax Board shall prescribe such regulations as it may deem necessary to carry out the purposes of this section.~~

LEGISLATIVE PROPOSAL 05-14
EXECUTIVE SUMMARY

- **Title:**

  Franchise Tax Board (FTB) Meetings/Distribution Of Certain Documents

- **Problem Statement:**

  Current law regarding documents that may be considered by the three-member FTB before taking final action on an agenda item places a needless limit on documents offered by the public during the meeting.

- **Proposed Solution:**

  Amend Government Code Section 11125.1 to remove the distribution requirement for documents prepared and submitted by the public.

- **Major Concerns/Issues:**

  While this proposal would allow documents to be prepared and distributed for FTB meetings similar to Board Of Equalization meetings, this proposal would not alleviate the situation where documents drafted by a member of the public during a meeting before the three-member FTB are distributed to all interested parties in a timely manner.

- **Revenue:**

  This proposal would not impact the state's income tax revenue or FTB's administration of state income tax.

2005 Departmental Legislative Proposal
LP 05-14

Title

Franchise Tax Board Meetings/Distribution Of Certain Documents

Introduction

This proposal would assist the public with the submission of documents for meetings of the three-member Franchise Tax Board (FTB).

Program Background/History

SB 445 (Burton, Stat. 2001, Ch. 670) requires FTB to distribute certain documents in a specified manner before a final action can be taken at a meeting of the three-member FTB. SB 445 was enacted to address situations where documents are presented or drafted during a meeting of the three-member FTB, read orally to the public, and voted on by the three-member FTB before the public has an opportunity to review the documents.

Current State Law

The Bagley-Keene Open Meeting Act requires all meetings of a state body to be open and public and grants the right to attend such meetings to all persons, with certain exceptions.

A state body conducting a meeting is required to:

- Provide an agenda and specified notice of its public meetings at least 10 days in advance of the meeting,
- Make available to the public, either at the meeting or after the meeting, any public records relating to any agenda item that will be considered at the meeting.

Public records distributed to members of a state body prior to or during a public meeting must be made available for public inspection *at* the meeting. If the writing is prepared by other than the governmental body or a member of the governmental body, it must be made available for public inspection upon request without delay *after* the meeting.

Under current law, documents pertaining to an agenda item distributed to the three-member FTB by FTB staff or individual FTB members prior to or during an FTB meeting must be distributed in three ways to the public before the three-member FTB may take any final action on that item. The documents must be: (1) distributed to all persons requesting notice of meetings; (2) made available on the Internet; and (3) made available for public inspection at the meeting. These documents must be distributed in the above manner regardless of who prepared the documents.

Following enactment of SB 445, similar amendments were made to the laws with respect to Board of Equalization (BOE) meetings. The BOE provisions are much narrower than those applicable to FTB and are limited to those documents prepared by BOE staff or members of the BOE.

Problem

Current law regarding documents that may be considered by the three-member FTB before taking final action on an agenda item places a needless limit on documents offered by the public during the meeting.

Proposed Solution

Amend Government Code Section 11125.1 to remove the distribution requirement for documents prepared and submitted by the public.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as an administrative measure, this proposal would be effective and operative January 1, 2006, and apply to FTB meetings after that date.

Justification

Limiting the distribution requirement to documents prepared by FTB staff or individual FTB members would allow the public to present relevant documents during a meeting without delaying a final action on an agenda item.

This proposal also would allow FTB to have procedures identical to BOE for conducting public meetings.

Implementation

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

Fiscal Impact

No departmental costs are associated with this proposal.

Economic Impact

This proposal would not impact the state's income tax revenue or FTB's administration of state income tax.

Other States

A search for similar laws of six of the larger states was made: *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. For these states, the taxing authorities are part of their Administration instead of under the authority of a multi-member governmental body. Therefore, the preparation and distribution requirements for an open meeting act would not apply in these states, so a meaningful comparison could not be made.

Policy Concern

While this proposal would allow documents to be prepared and distributed for FTB meetings similar to BOE meetings, this proposal would not alleviate the situation where documents drafted by a member of the public during a meeting before the three-member FTB are distributed to all interested parties in a timely manner.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-14

AMENDMENT 1

Section 11125.1 of the Government Code is amended as follows:

11125.1. (a) Notwithstanding Section 6255 or any other provisions of law, agendas of public meetings and other writings, when distributed to all, or a majority of all, of the members of a state body by any person in connection with a matter subject to discussion or consideration at a public meeting of the body, are disclosable public records under the California Public Records Act (Chapter 3.5(commencing with Section 6250) of Division 7 of Title 1), and shall be made available upon request without delay. However, this section shall not include any writing exempt from public disclosure under Section 6253.5, 6254, or 6254.7 of this code, or Section 489.1 or 583 of the Public Utilities Code.

(b) Writings that are public records under subdivision (a) and that are distributed to members of the state body prior to or during a meeting, pertaining to any item to be considered during the meeting, shall be made available for public inspection at the meeting if prepared by the state body or a member of the state body, or after the meeting if prepared by some other person. These writings shall be made available in appropriate alternative formats, as required by Section 202 of the Americans with Disabilities Act of 1990 (42 U.S.C. Sec. 12132), and the federal rules and regulations adopted in implementation thereof, upon request by a person with a disability.

(c) In the case of the Franchise Tax Board, prior to that state body taking final action on any item, writings pertaining to that item that are public records under subdivision (a) that are <u>prepared and </u>distributed <u>by Franchise Tax Board staff or individual members </u>to members of the state body ~~by board staff or individual members~~ prior to or during a meeting shall be:

(1) Made available for public inspection at that meeting.

(2) Distributed to all persons who request notice in writing pursuant to subdivision (a) of Section 11125.

(3) Made available on the Internet.

(d) Prior to the State Board of Equalization taking final action on any item that does not involve a named tax or fee payer, writings pertaining to that item that are public records under subdivision (a) that are prepared and distributed by board staff or individual members to members of the state body prior to or during a meeting shall be:

(1) Made available for public inspection at that meeting.

(2) Distributed to all persons who request or have requested copies of these writings.

(3) Made available on the Internet.

(e) Nothing in this section shall be construed to prevent a state body from charging a fee or deposit for a copy of a public record pursuant to Section 6253, except that no surcharge shall be imposed on persons with disabilities in violation of Section 202 of the Americans with Disabilities Act of 1990 (42 U.S.C. Sec. 12132), and the federal rules and regulations adopted in implementation thereof. The writings described in subdivision (b) are subject to the requirements of the California Public Records Act (Chapter 3.5 (commencing with Section 6250) of Division 7 of Title 1), and shall not be construed to limit or delay the public's right to inspect any record required to be disclosed by that act, or to limit the public's right to inspect any record covered by that act. This section shall not be construed to be applicable to any writings solely because they are properly discussed in a closed session of a state body. Nothing in this article shall be construed to require a state body to place any paid advertisement or any other paid notice in any publication.

(f) "Writing" for purposes of this section means "writing" as defined under Section 6252.

LEGISLATIVE PROPOSAL 05-15
EXECUTIVE SUMMARY

- **Title:**

  Exception to Estimated Tax Underpayment Penalty/Reimburse Persons For Charges And Fees Incurred Due To Erroneous Action By FTB

- **Problem Statement:**

  If erroneous actions by FTB result in the imposition of an estimate tax underpayment penalty or a third-party charge or fee, the person must file an appeal or claim with another state agency for relief, which subjects the person and state to additional burdens and expenses.

- **Proposed Solution:**

  Add Revenue and Taxation Code (R&TC) Section 19136.7 to provide that the estimate tax underpayment penalty would not apply if an underpayment of tax was created or increased as the direct result of an erroneous levy, erroneous processing action, or erroneous collection action by FTB.

  Amend R&TC Section 21018 to allow greater authority for FTB to reimburse persons for a third-party charge or fee imposed as the direct result of an erroneous levy, erroneous processing action, or erroneous collection action by FTB.

- **Major Concerns/Issues:**

  None.

- **Revenue:**

  This proposal would result in revenue losses of less than $150,000 for the 2004/2005, 2005/2006, and 2006/2007 fiscal years. A greater revenue loss could result in any year due to an isolated incident, for example, a large computer malfunction affecting multiple taxpayers. Based on discussion with departmental staff, this situation could possibly occur, yet, historically is classified as the exception.

2005 Departmental Legislative Proposal
LP 05-15

Title

FTB Authority To Waive Estimated Tax Underpayment Penalty/Reimburse Persons For Charges And Fees Incurred Due To Erroneous Action By FTB

Introduction

This proposal would provide the authority of the Franchise Tax Board (FTB) to waive the estimated tax underpayment penalty and broaden FTB's authority to reimburse persons for external charges and fees in certain circumstances.

Current Federal Law

The IRS may compromise taxpayer tax liabilities, penalties, interest, and additional amounts 1) if doubt as to collectibility exists; 2) if doubt as to liability exists; 3) in cases of economic hardship; and 4) for extraordinary events beyond the taxpayer's control.

The IRS is authorized to abate the unpaid portion of the assessment of any tax or any liability that 1) is excessive in amount; 2) is assessed after the expiration of the applicable period of limitations; or 3) is erroneously or illegally assessed. In addition, the IRS has discretion to abate any interest assessed due to a deficiency or payment attributable to any unreasonable error or delay by an IRS officer or employee acting in his or her official capacity. Further, the IRS is required to abate any portion of any penalty or addition to tax attributable to erroneous written advice given by an IRS officer or employee acting in his or her official capacity in response to a specific written request.

Under federal law, an individual taxpayer generally is subject to an addition to tax (a penalty) for any underpayment of estimated tax. Income tax withholding from wages is considered a payment of estimated taxes. An individual generally does not have an underpayment of estimated tax if the required estimated tax for the year is less than $1,000 or if he or she makes timely estimated tax payments (required payments) at least equal to:

1) 90% of the tax shown on the return for the current year, or
2) 110% of the tax shown on the return of the individual for the preceding year. A special rule affecting high-income taxpayers with AGI over $150,000 ($75,000 if married filing a separate return) applies.

A corporation that underpays its estimated tax must add a penalty to its income tax in an amount equal to the underpayment interest rate times the amount of the underpayment for the period of the underpayment. No estimated tax payment penalty is imposed for any tax year if the tax shown on the return for that tax year is less than $500.

Current State Law

A person may file a claim with FTB for reimbursement of bank charges incurred by the taxpayer as the direct result of an erroneous levy by FTB. Bank charges include a financial institution's customary charge for complying with the levy and reasonable charges for overdrafts that are a direct consequence of the levy. The charges must have been paid by the person and not waived or reimbursed by the financial institution.

Under current law, a taxpayer may file a claim with the Victims Compensation and Government Claims Board (VCGCB) for monetary losses believed to have been caused by the action or inaction of any state agency. Claims may include, but not be limited to, a refund of a tax, fee, or penalty. Effective August 2004, the taxpayer must pay a fee of $25 with a claim that is filed for money or damages against the state. In addition, there is a surcharge of 15% on any claim that is granted by VCGCB. This surcharge, along with the claimant's filing fee, is to be paid by the governmental agency against which the claim was made.

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals with the following general exceptions:

- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than $200 as opposed to the federal $1,000.
- California allows a waiver of estimated tax underpayment penalties created or increased by certain specified legislative changes.

Corporations with an underpayment or late payment of estimated tax may be subject to a penalty for the period from the due date of each installment until it is paid or until the due date of the tax return, whichever is earlier. Generally, an underpayment of any installment is defined as the amount required to have been paid if the estimated tax were equal to the percentage of the tax shown on the tax return. The applicable percentage for taxable years beginning on or after January 1, 1998 is 100%.

Program History/Background

Occasionally, an erroneous FTB action has resulted in the imposition of an estimated tax penalty by FTB or the imposition of additional charges or fees by a third party. In addition, the increase in identity theft, and through no fault of the person, money may be incorrectly debited to or from incorrect taxpayer accounts (see example below). No statutory authority exists for FTB to abate or waive the estimated tax penalty or reimburse the person for imposition of such charges or fees. Currently, the person must either file an appeal with the Board of Equalization (BOE) or file a claim with VCGCB to seek relief.

The following examples illustrate incidents where relief would be unavailable under current law.

1. System errors have resulted in the following actions:
    a. FTB double debiting a taxpayer that has money electronically transferred as part of an installment agreement with FTB. While FTB is able to reverse the erroneous debit, FTB has no statutory authority to reimburse the taxpayer for any bank-imposed fees or charges the taxpayer may have incurred due to the error.
    b. FTB imposing an estimated tax penalty where the taxpayer has an agreement with FTB to have money electronically transferred to pay the estimated tax payments.

2. Many unique examples exist with respect to taxpayer identity theft. For example, assume Mr. Smith lives overseas but maintains bank accounts in California to pay the living expenses of an elderly relative. Unbeknownst to FTB, an individual begins using Mr. Smith's name and social security number (SSN) for employment purposes and the income is reported to FTB under Mr. Smith's name and SSN, but no tax return is filed. FTB is unsuccessful at contacting Mr. Smith and eventually issues an assessment, files a lien, and levies Mr. Smith's bank account for the tax assessment. As a result, Mr. Smith bounces numerous checks and incurs bank fees and other third party fees from those that received the dishonored checks (i.e., a private company that provides oxygen to Mr. Smith's elderly relative). Current law allows for the reimbursement of the bank fees due to the erroneous levy, but does not allow FTB to reimburse Mr. Smith for the fees he incurred from the oxygen company as a result of the dishonored check.

Problem

If FTB takes an erroneous action that results in the imposition of an estimate tax underpayment penalty or charges or fees, the person must file an appeal or claim with another state agency for relief, which subjects the person and state to additional burdens and expenses.

Proposed Solution

Add Revenue and Taxation Code (R&TC) Section 19136.7 to allow FTB to waive the estimate tax underpayment penalty under certain circumstances. In addition, amend R&TC Section 21018 to allow greater authority for FTB to reimburse persons under certain circumstances.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as an administrative measure, this proposal would be effective January 1, 2006, and apply to relief provided by FTB for erroneous actions that occur on or after that date.

Justification

This proposal would ease the administrative burden for persons seeking relief for erroneous actions taken by FTB by allowing the department to reimburse persons where appropriate. As a result, persons would be spared the extra time and money generally spent pursuing an appeal with BOE or filing a claim with VCGCB.

In addition, in the event a person files a claim and receives relief from VCGCB, the department would be required under current law to pay the claimant's filing fee and a 15% surcharge. Broadening the authority of the FTB to reimburse taxpayers would save the department 1) resources spent pursuing this workload, and 2) amounts potentially paid to the claimant in the form of fees and surcharges.

This proposal could increase the fairness of California's tax system by not penalizing taxpayers for actions over which they had no control, such as identity theft or FTB computer malfunctions.

Implementation

Implementing this proposal would not have a significant impact on the department since FTB currently has a process in place to identify persons who incur financial harm due to erroneous FTB action or due to circumstances beyond taxpayer control. It is anticipated that FTB could handle these functions with current staff.

Fiscal Impact

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

Economic Impact

This proposal would result in the following revenue losses:

Estimated Revenue Impact of LP 05-15 Fiscal Year Impact		
2004/2005	2005/2006	2006/2007
a ***/***	a ***/***	a ***/***

a/ losses less than $150,000

Based on departmental information over a five-year period it is estimated that 5,000 persons or taxpayers would have been eligible for relief of charges, fees, and penalties under this proposal. The total amount of relief over the five-year period is estimated to be approximately $500,000. Therefore, the average of $100,000 ($0.5 million/5) per year is deemed as insignificant. A greater revenue loss could result in any year due to an isolated incident, for example, a large computer malfunction affecting multiple taxpayers. Based on discussion with departmental staff, this situation could possibly occur, yet, historically is classified as the exception.

Policy Considerations

This proposal would allow FTB to reimburse a person for bank fees or charges incurred by the person due to an error on the part of FTB, such as the double debiting of a taxpayer bank account. Such reimbursement may not be necessary in these circumstances if the taxpayer informs the bank that the double debit was unauthorized and therefore the bank should reverse any fees or charges. However, the department's experience with various banks while correcting double debit errors shows that some banks will not reverse the fees and charges. Therefore, this proposal would allow FTB to reimburse the taxpayer in those limited instances.

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 similar provisions to FTB's or IRS's existing provisions. However, none of these states appear to have a reimbursement program similar to this proposal.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-15

AMENDMENT 1

SEC. 1. Section 19136.7 is added to the Revenue and Taxation Code to read:

19136.7. (a) No additions to tax shall be made under Section 19136 or Section 19142 with respect to any underpayment of an installment for a taxable year, to the extent that the underpayment was created or increased as the direct result of an erroneous levy, erroneous processing action, or erroneous collection action by the Franchise Tax Board.

(b) The Franchise Tax Board shall implement this section in a reasonable manner.

AMENDMENT 2

SEC. 2. Section 21018 of the Revenue and Taxation Code is amended to read as follows:

21018. (a) A person may file a claim with the board for reimbursement of ~~bank~~charges or fees imposed on ~~incurred by~~ the person by an unrelated business entity ~~taxpayer~~ as the direct result of an erroneous levy, erroneous processing action, or erroneous collection action by the board. ~~Bank charges~~Charges that may be reimbursed include ~~a~~ an unrelated business entity's ~~financial institution's~~ usual and customary charge for complying with the levy instructions and reasonable charges for overdrafts that are a direct consequence of the erroneous levy, erroneous processing action, or erroneous collection action, and are paid by the person and not waived by the unrelated business entity or otherwise reimbursed ~~by the financial institution~~. Each claimant applying for reimbursement shall file a claim with the board which shall be in such form as may be prescribed by the board. In order for the board to grant a claim, the board shall determine that both of the following conditions have been satisfied:

(1) The erroneous levy, erroneous processing action, or erroneous collection action was caused by an error made by the board.

(2) Prior to the erroneous levy, erroneous processing action, or erroneous collection action, the person~~taxpayer~~ responded to all contacts by the board and provided the board with any requested information or documentation sufficient to establish the person's~~taxpayer's~~ position. This provision may be waived by the board for reasonable cause.

(3) The charge or fee has not been waived by the unrelated business entity or otherwise reimbursed.

(b) Claims pursuant to this section shall be filed within 90 days from the date of the erroneous levy, erroneous processing action, or erroneous collection action. Within 30 days from the date the claim is received, the board shall respond to the claim. If the board denies a claim, the claimant~~taxpayer~~

shall be notified in writing of the reason or reasons for the denial of the claim. The board may extend the period for filing a claim under this section.

(c) Charges and fees that may be reimbursed under the authority of the section are limited to usual and customary charges and fees imposed by a business entity in the ordinary course of business.

LEGISLATIVE PROPOSAL 05-16
EXECUTIVE SUMMARY

- **Title:**

  Conformed Revenue And Taxation Code To Existing California Law Regarding Addresses For Unregistered Sex Offenders

- **Problem Statement:**

  Unless all exceptions to the general disclosure law that taxpayer information is confidential are contained within the Revenue and Taxation Code (R&TC), the code becomes unnecessarily complicated to administer.

- **Proposed Solution:**

  Add to the R&TC a recently enacted provision of the Penal Code that operates as an exception to the general disclosure law of the R&TC that taxpayer information is confidential. This addition would expressly state that the Franchise Tax Board shall provide Department Of Justice with address information requested for unregistered sex offenders.

- **Major Concerns/Issues:**

  None**.**

- **Revenue:**

  None**.**

2005 Departmental Legislative Proposal
LP 05-16

Title

Conformed Revenue And Taxation Code To Existing California Law Regarding Addresses For Unregistered Sex Offenders

Introduction

This proposal would incorporate a recently enacted provision of the Penal Code, which operates as an exception to the general disclosure law that taxpayer information is confidential, into the Revenue and Taxation Code (R&TC) as a matter of code maintenance.

Current Federal/State Law

Generally, the Franchise Tax Board (FTB) is prohibited under federal law and an interagency agreement with the Internal Revenue Service (IRS) from disclosing taxpayer information that FTB receives from the IRS, which may include a taxpayer's address.

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.

Recently enacted legislation (AB 1937, Stats. 2004, Ch. 127) added a provision to the Penal Code that requires state agencies, including FTB, to disclose address information to the Department of Justice (DOJ) for purposes of locating unregistered sex offenders. This requirement is without regard to any other provision of state law, including the taxpayer information disclosure law discussed above.

In addition, other recently enacted legislation (AB 488, Stats. 2004, Ch. 745) requires DOJ to make specified information, including home addresses, about certain sex offenders available to the public via the Internet.

Problem

Unless all exceptions to the general disclosure law that taxpayer information is confidential are contained within the R&TC, the code becomes unnecessarily complicated to administer.

Proposed Solution

Add to the RT&C a recently enacted provision of the Penal Code that operates as an exception to the general disclosure law of the R&TC that taxpayer information is confidential. This addition would expressly state that FTB shall provide DOJ with address information requested for unregistered sex offenders.

Effective/Operative Date of Solution

If enacted during the 2005 legislative session, this proposal would be effective January 1, 2006, and operative for disclosures made pursuant to provisions of the Penal Code that are operative on or after January 1, 2005.

Justification

Placing all exceptions to the general disclosure law that taxpayer information is confidential within the R&TC simplifies the administration of the code, thus helping to assure that confidential taxpayer information is handled as required by law.

Implementation

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

Fiscal Impact

This proposal would not impact the department's costs.

Economic Impact

This proposal would not impact state revenue.

Other States

This proposal is essentially a matter of code maintenance; therefore, a comparison of other states would not be relevant.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP 05-16

AMENDMENT 1

SEC. 1. Section 19550 of the Revenue and Taxation Code is amended to read:

(a) Pursuant to Section 817.5 of the Penal Code, the Franchise Tax Board, upon request from the Department of Justice, a court, or any California law enforcement agency and in a form and manner prescribed by the ~~board~~ Franchise Tax Board, shall provide to the Department of Justice, a court, or the law enforcement agency the address of any person represented to be a person for whom there is an outstanding arrest warrant.

(b) Pursuant to Section 290.9 of the Penal Code, the Franchise Tax Board, upon request from the Department of Justice, shall provide to the Department of Justice the address of any person represented to be a person who is in violation of his or her duty to register under Section 290 of the Penal Code.

AMENDMENT 2

SEC. 2. Subdivision (b) of Section 19550 shall be operative with respect to requests made on or after January 1, 2005, pursuant to Section 290.9 of the Penal Code, as added by Stats. 2004, Ch. 127.

LEGISLATIVE PROPOSAL 05-17
EXECUTIVE SUMMARY

- **Title:**

Withholding on California Real Estate Limited to Gain on Sale

- **Problem Statement:**

Withholding on the sale of California real estate fails to match closely the actual tax due on the sale of the property, resulting in over-withholding of tax in many cases.

- **Proposed Solution:**

Allow the seller to elect to have the maximum tax rate, presently 9.3% for individuals and trusts and 8.84% for corporations, applicable to the *gain* on the sale withheld instead of $3^{1/3}$% of the *sales price*, provided that the seller certifies under penalty of perjury that the amount of the gain reported to the buyer or escrow person is correct.

- **Revenue:**

This proposal would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of LP 05-17 Effective for tax years BOA 1/1/2006 Enacted after 1/1/2005 $ Millions			
	2005-06	2006-07	2007-08
3.3% W/H or 9.3% on Gains	-$35	-$4	-$4

* Ultimate tax liabilities are not affected, only the timing of payments.

2005 Departmental Legislative Proposal
LP 05-17

Title

Withholding on California Real Estate Limited to Gain on Sale

Introduction

This legislative proposal would correct most of the current over-withholding on the sale of California real estate.

Background

Prior to 2002, withholding on the sale of California real property applied only to nonresident individuals and certain corporations. AB 2065 (Stats. 2002, Ch. 488) expanded real estate withholding requirements to residents.

Current Federal Law

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of real property interest. This withholding obligation is generally imposed on either the buyer or the withholding agent, who must report the amounts withheld and pay them to the IRS.

Current State Law

Under state law, when California real estate is sold, buyers are required to withhold 3 ⅓% of the total sales price if certain conditions are met.

Generally, California law requires the buyer to withhold when the buyer is purchasing California real property and either of the following conditions are met:

- The seller is an individual or a trust, or
- The seller is a corporation that has no permanent place of business in California immediately after the sale of the real property.

Withholding is not required if any of the following conditions are met:

1. The total sales price of the California real property is $100,000 or less,
2. The buyer did not receive written notification of the withholding requirements. [1]
3. A trustee or a beneficiary under a deed of trust is acquiring the property in foreclosure,
4. The seller certifies under penalty of perjury that:
   - The property conveyed was his or her principal residence,
   - The property is being exchanged under the like-kind exchange provisions of IRC Section 1031,
   - The property was involuntarily converted or sold as defined under IRC Section 1033, or
   - The sale results in a loss to the seller.

[1] In which case, the real estate escrow person (REEP) is responsible for a failure to notify penalty. A REEP is defined as the person (including but not limited to an attorney, escrow company, or intermediary) responsible for closing the transaction or is the person in control of payment. California law requires the REEP to inform the buyer of the withholding requirements.

The withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

Problem

Withholding on the sale of California real estate fails to match closely the actual tax due on the sale of the property, resulting in over-withholding of tax in many cases.

Proposed Solution

Allow the seller to elect to have the maximum tax rate, presently 9.3% for individuals and trusts and 8.84% for corporations, applicable to the *gain* on the sale withheld instead of $3^{1/3}$% of the *sales price*, provided that the seller certifies under penalty of perjury that the amount of the gain reported to the buyer or REEP is correct.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session, the provision would be effective and operative for sales occurring on or after January 1, 2006.

Justification

The withholding rate of $3^{1/3}$% of the sales price was based on the average tax rate of the total estimated real property sales affected by the withholding provisions. Since the withholding rate is based on an average, approximately one-third of the taxpayers are being over-withheld. Allowing the taxpayer to elect between having $3^{1/3}$% of the sales price or 9.3% of the gain withheld will eliminate most instances of over withholding.

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

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

Economic Impact

Tax Cash-flow Estimate:

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of LP 05-17
Effective for tax years BOA 1/1/2006
Enacted after 1/01/2005
$ Millions

	2005-06	2006-07	2007-08
3.3% W/H or 9.3% on Gains	-$35	-$4	-$4

* Ultimate tax liabilities are not affected, only the timing of payments.

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

Cash-flow Estimate Discussion:

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

The cash-flow impact was estimated as follows. The current $3^{1/3}$% withholding requirement is expected to result in $1.5 billion in withholding in 2004. This withholding is projected to reach $1.7 billion in 2006. Simulations using the department's 2001 and 2002 capital gains samples indicate that allowing taxpayers the 9.3%-of-gains option would reduce the withholding by 12%, to $1.5 billion. This cash-flow decrease is further reduced by the following factors:

- Withholding on real estate sales in first six months of 2006 (50%)
- Estimated payments for current law (50%)
- Prepayment offset (30%)

The final estimated impact for fiscal year 2006/07 is a cash-flow loss of $35 million. This cash-flow loss is largely a one-time event. The term "cash-flow" loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

<u>Other States</u>

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to California's present real estate withholding law.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 05-17

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 failing to withhold from any payments any amounts required 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) A corporation, including an entity classified for tax purposes as a corporation under Part 11 (commencing with Section 23001).

(ii) 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, if the corporation 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 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 ~~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) In the case where the transferor makes an election under this subparagraph, the transferee (including for this purpose any intermediary or accommodator in a deferred exchange) is required to withhold an amount equal to the amount the transferor specifies in a written certificate. The written certificate shall be executed by the transferor under penalty of perjury and shall certify the amount specified is not less than the gain required to be recognized under Part 10 or Part 11 on the disposition of the California real property multiplied by the rate specified in either Section 23151 (or Section 23186 for financial corporations) for transferors that are corporations or the highest rate specified in Section 17041 for transferors other than corporations.

(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, 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" 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.

(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.

(h) In the case of any payment described in subdivision (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.

(i) (1) The amendments to this section made by Chapter 488 of theStatutes 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.

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 amount required to be deducted and paid to the Franchise Tax Board under this article shall be considered the tax of the person. Any person who fails to withhold from any payments any amount required to be withheld under this article is liable for the amount withheld or the amount of taxes due from the taxpayer to whom the payments are made 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 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 with a permanent place of business in California, OR

3. The seller, who is an individual, trust, estate or a corporation 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 under this article 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) or Part 11 (commencing with Section 23001).

LEGISLATIVE PROPOSAL 05-19
EXECUTIVE SUMMARY

- **Title:** Reporting Federal Income Tax Adjustments

- **Problem Statement:** A recent decision of the California Court of Appeal, *Ordlock v. FTB,* held that a taxpayer had not failed to notify the FTB of a federal change in the case where the general four-year statute of limitations had expired at the time of the final federal determination so the extended statute of limitations that comes into play where a taxpayer fails to report a federal adjustment did not apply.

- **Proposed Solution:** Amend R&T Code Section 18622(a) & (b) to provide that taxpayers must report federal adjustments that occur after the normal four-year statute of limitations for mailing proposed assessments has expired. Amend R&T Code Section 19057, relating to the normal four-year statute of limitations, to specifically cross-reference Sections 19059 and 19060, relating to the extended statute of limitations for federal adjustments. Also provide that the amendments are found and declared not to constitute a change in, but are declaratory of, existing law and apply to any taxable year beginning before, on, or after the date the act takes effect.

- **Major Concerns/Issues:** This proposal would make changes, declaratory of existing law, to preserve the current statute's requirement for taxpayers to report federal adjustments that become final after the normal four-year state statute of limitations (SOL) has expired.

- **Revenue:** The effect of this proposal is to reverse the Ordlock decision. As this proposal would be declaratory of existing law, the proposal has no revenue effect. However, if this proposal is not enacted and the California Supreme Court eventually upholds the Ordlock decision, it would result in the following revenue losses:

LP 05-19 Not Enacted and Ordlock Decision Upheld [$ In Millions]		
	Taxable Years	
	1999 and Before	2000 and After
PIT	-$10.8	-$10.0 annually
CTL Non-apportioning apportioning	 -$0.2 Negligible Loss	 No Impact No Impact
Total Tax	-$11.0	-$10 annually
Interest	-$21.8	
TOTAL	-$32.8	
Negligible loss is less than $150,000. For apportioning corporations, cases would be very limited as nearly all assessments are issued with the statute of limitations held open by a federal waiver.		

2005 Departmental Legislative Proposal
LP 05-19

Title

Reporting Federal Income Tax Adjustments

Introduction

This proposal would make changes, declaratory of existing law, to preserve the current statute's requirement for taxpayers to report federal adjustments that become final after the normal four-year state statute of limitations (SOL) has expired.

Program History/Background

A recent decision of the California Court of Appeal, *Ordlock v. Franchise Tax Board (FTB)*[1], a case relating to the 1998 tax year, ruled that once the normal four-year SOL expires, the tax payable cannot be "increased." The lynchpin of California tax administration in cases where the Internal Revenue Service (IRS) audits a taxpayer is the provision that allows FTB an unlimited time (SOL) to issue a proposed assessment increasing state tax on the basis of the final federal determination and the taxpayer's failure to notify FTB of that change.

Current State Law

Current law requires that if the amount of gross income or deductions reported on an individual's federal return filed with the IRS for any taxable year is changed, either by the taxpayer or the IRS, the taxpayer must notify the FTB of the change within six months of the "final determination" of that change, unless it does not increase the California income tax payable.

Since the statute requiring the reporting of federal changes exempted federal changes that did not increase tax payable, the Ordlock court reasoned that there was no reporting requirement and so the extended statute of limitations that comes into play where a taxpayer fails to report a federal adjustment did not apply[2].

Problem

A recent decision of the California Court of Appeal, *Ordlock v. FTB,* held that a taxpayer had not failed to notify the FTB of a federal change in the case where the general four-year statute of limitations had expired at the time of the final federal determination so the extended statute of limitations that comes into play where a taxpayer fails to report a federal adjustment did not apply.

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[1] This case has been appealed by the Franchise Tax Board and its status could change based on that appeal.

[2] The Ordlock court stated that "because significance must be given to the statutory framework as a whole, section 19060 must be read in conjunction with section 18622. Under section 19060, subdivision (a), FTB may issue a notice of proposed deficiency assessment only when the taxpayer fails to report a change or correction by the IRS or fails to file an amended return "as required by Section 18622." Because section 19060 incorporates the provisions of section 18622, the last sentence of section 18622, subdivision (a) is applicable. That sentence permits the taxpayer to apply the four-year statute of limitations in determining whether the federal changes increase the amount of tax payable. In short, Taxpayers need not have performed an idle act, namely, reporting to FTB the change or correction by the federal government when the statute of limitations barred FTB from assessing any tax deficiency. Because FTB's 1998 notice of a proposed deficiency assessment was barred by the four-year statute of limitations, the trial court should have granted taxpayers' motion for summary judgment on its complaint for a refund." (Ordlock v. FTB)

Proposed Solution

Amend R&T Code Section 18622(a) & (b) to provide that taxpayers must report federal adjustments that occur after the normal four-year statute of limitations for mailing proposed assessments has expired. Amend R&T Code Section 19057, relating to the normal four-year statute of limitations, to specifically cross-reference Sections 19059 and 19060, relating to the extended statute of limitations for federal adjustments. Also provide that the amendments are found and declared not to constitute a change in, but are declaratory of, existing law and apply to any taxable year beginning before, on, or after the date the act takes effect.

Effective/Operative Date of Solution

The proposed language specifically provides that the amendments are declaratory of existing law and apply to any taxable year beginning before, on, or after the date the act takes effect.

Justification

This change, declaratory of existing law, is necessary to preserve the current statute's requirement for taxpayers to report federal adjustments that become final after the normal four-year state statute of limitations has expired.

Fiscal Impact

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

Economic Impact

The effect of this proposal is to reverse the Ordlock decision. As this proposal would be declaratory of existing law, the proposal has no revenue effect. However, if this proposal is not enacted and the California Supreme Court eventually upholds the Ordlock decision, income/franchise tax collections would be eroded. Based on audit data, if this proposal was not enacted and the California Supreme Court were to eventually uphold the Ordlock decision, it would result in the following revenue losses:

LP 05-19 Not Enacted and Ordlock Decision Upheld [$ In Millions]		
	Taxable Years	
	1999 and Before	2000 and After
PIT	-$10.8	-$10.0 annually
CTL		
Non-apportioning	-$0.2	No Impact
apportioning	Negligible Loss	No Impact
Total Tax	-$11.0	-$10 annually
Interest	-$21.8	
TOTAL	-$32.8	
Negligible loss is less than $150,000. For apportioning corporations, cases would be very limited as nearly all assessments are issued with the statute of limitations held open by a federal waiver.		

Note that the $10 million annual revenue loss under the PITL for years 2000 and subsequent is the net of foregone assessments totaling $12 million and refunds of approximately $2 million that the FTB could not refund to taxpayers due to the expired four-year statute.

Estimates are based on an analysis of audit data and final federal determination data. Approximately 12% of Personal Income Tax (PIT) final federal determinations would meet Ordlock facts and circumstances (i.e., final federal determination received after the normal four-year statute has expired).

Policy Considerations

While for apportioning corporations nearly all assessments are issued based upon the statute of limitations being held open by a federal waiver, this is not the case with respect to individuals. Based on an analysis of audit data and final federal determination data, approximately 12% of PIT final federal determinations would meet Ordlock facts and circumstances (i.e., final federal determination received after the normal four-year statute has expired).

If this proposal is not enacted and the California Supreme Court were to eventually uphold the Ordlock decision, then taxpayers that were audited by the IRS could fail to report the result to the FTB, hoping that the FTB would not be notified of the results by the IRS before the normal statute of limitations had expired (a form of "audit lottery").

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.

All of these states substantially conform to the federal tax base and follow federal rulings if not in conflict with state law. Florida's conformity, however, applies only to corporations as that state has no personal income tax. Each of these states also require that the taxpayer report changes to the federal return by the IRS within a specified period of time, ranging from as few as 60 days to as long as one year, after the federal determination is final. In addition, all of the states surveyed have entered into reciprocity agreements with the IRS that make it possible to compare federal and state returns and to obtain notification of adjustments made to those returns.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS LP 05-19

AMENDMENT 1

SECTION 1. Section 18622 of the Revenue and Taxation Code, is amended to read:

18622. (a) If any item required to be shown on a federal tax return, including any gross income, deduction, penalty, credit, or tax for any year of any taxpayer is changed or corrected by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or where a renegotiation of a contract or subcontract with the United States results in a change in gross income or deductions, that taxpayer shall report each change or correction, or the results of the renegotiation, within six months after the date of each final federal determination of the change or correction or renegotiation, or as required by the Franchise Tax Board, and shall concede the accuracy of the determination or state wherein it is erroneous. For any individual subject to tax under Part 10 (commencing with Section 17001), changes or corrections need not be reported unless they increase the amount of tax ~~payable~~ under Part 10 (commencing with Section 17001) for any ~~year~~ year, determined without regard to the application of any statute of limitations for mailing any notice of proposed deficiency assessment.

(b) Any taxpayer filing an amended return with the Commissioner of Internal Revenue shall also file within six months thereafter an amended return with the Franchise Tax Board which shall contain any information as it shall require. For any individual subject to tax under Part 10 (commencing with Section 17001), an amended return need not be filed unless the change therein would increase the amount of tax ~~payable~~ under Part 10 (commencing with Section 17001) for any ~~year~~ year, determined without regard to the application of any statute of limitations for mailing any notice of proposed deficiency assessment.

(c) Notification of a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or renegotiation of a contract or subcontract with the United States that results in a change in any item or the filing of an amended return must be sufficiently detailed to allow computation of the resulting California tax change and shall be reported in the form and manner as prescribed by the Franchise Tax Board.

(d) For purposes of this part, the date of each final federal determination shall be the date on which each adjustment or resolution resulting from an Internal Revenue Service examination is assessed pursuant to Section 6203 of the Internal Revenue Code.

SEC. 2. Section 19057 of the Revenue and Taxation Code is amended to read:

19057. (a) Except in the case of a false or fraudulent return and except as otherwise expressly provided in this ~~part~~ part (including the provisions of Sections 19059 and 19060, relating to federal adjustments), every notice of a proposed deficiency assessment shall be mailed to the taxpayer within four years after the return was filed. No deficiency shall be assessed or collected with respect to the year for which the return was filed unless the notice is mailed within the later of the four-year period or the period otherwise provided (including the extended periods provided by Sections 19059 and 19060, relating to federal adjustments). For purposes of this chapter, the term "return" means the return required to be filed by the taxpayer and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

(b) The running of the period of limitations provided in subdivision (a) on mailing a notice of proposed deficiency assessment shall, in a case under Title 11 of the United States Code, be suspended for any period during which the Franchise Tax Board is prohibited by reason of that case from mailing the notice of proposed deficiency assessment and for 60 days thereafter.

(c) Where, within the 60-day period ending on the day on which the time prescribed in this section for the assessment of any tax imposed under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) for any taxable year would otherwise expire, the Franchise Tax Board receives a written document, other than an amended return or a report required by Section 18622, signed by the taxpayer showing that the taxpayer owes an additional amount of that tax for that taxable year, the period for the assessment of an additional amount in excess of the amount shown on either an original or amended return shall not expire before the day 60 days after the day on which the Franchise Tax Board receives that document.

(d) If a taxpayer determines in good faith that it is an exempt organization and files a return as an exempt organization under Section 23772, and if the taxpayer is thereafter held to be a taxable organization for the taxable year for which the return is filed, that return shall be deemed the return of the organization for the purposes of this section.

(e) Where the date of a final federal determination or the date of filing an amended return with the Commissioner of Internal Revenue occurs after the expiration of the period prescribed in other subdivisions of this section for mailing a notice of proposed deficiency assessment, a notice of proposed deficiency assessment resulting from the change may be mailed to the taxpayer within the period specified in Section 19059, in the case where the change, correction, or amended return is timely reported, or Section 19060, in the case where the change, correction, or amended return is either not reported or reported after the required reporting period, notwithstanding that the application of other subdivisions of this section would otherwise bar the mailing of the notice of the proposed deficiency assessment.

SEC. 3. The Legislature finds and declares that the amendments to Sections 18622 and 19057 made by this act do not constitute a change in, but are declaratory of, existing law and shall apply to any taxable year beginning before, on, or after the date this act takes effect. The Legislature further finds and declares that the amendments made by this act are necessary for the public purpose of effectuating the Legislatures intent that taxpayers must report federal adjustments that occur after the normal statute of limitations for mailing any notice of proposed deficiency assessments has expired.

LEGISLATIVE PROPOSAL 05-20
EXECUTIVE SUMMARY

- **Title:**

  Allow Business Entities To Enter Into Installment Agreements

- **Problem Statement:**

  Business entities suffering a financial hardship lack options to satisfy their tax liability.

- **Proposed Solution:**

  Amend Section 19008 of the Revenue and Taxation Code (R&TC) to permit business entities to enter into installment agreements.

- **Major Concerns/Issues:**

  None.

- **Revenue:**

Enhancement of BE I/A Program			
Fiscal Year	2005-06	2006-07	2007-08
	+*Minor	+*Minor	+*Minor

*Minor equals a gain of less than $500,000

2005 Departmental Legislative Proposal
LP 05-20

Title

Allow Business Entities to Enter Into Installment Agreements

Introduction

This proposal would permit business entities to enter into installment agreements to satisfy tax liabilities.

Current Federal Law

Current federal law allows installment agreements for all taxpayers. For individuals only, current federal law requires the IRS to approve an installment agreement in certain circumstances. Specifically, the IRS must approve an installment agreement for an individual with a liability of less than $10,000 who agrees to pay the liability in full within 36 months and files all past income tax returns. The fee to enter into an installment agreement is $43.

Current State Law

Current state tax law allows installment agreements for Personal Income Tax (PIT) taxpayers only. Like federal law, state law requires FTB staff to approve an installment agreement for an individual with a liability of less than $10,000 who agrees to pay the liability in full within 36 months and files all past income tax returns.

Recently enacted legislation (SB 1100, Stats. 2004, Ch. 226) permits all taxpayers, including business entities, to enter into an installment agreement during the tax amnesty period from February 1, 2005, through March 31, 2005.

In addition, SB 1100 authorizes the department to charge a fee to a taxpayer that enters into an installment agreement. The authority to charge the fee is not limited to an installment agreement made during amnesty. It is anticipated that the fee will be $20.

Problem

Business entities suffering a financial hardship lack options to satisfy their tax liability.

Proposed Solution

Amend Section 19008 of the Revenue and Taxation Code (R&TC) to permit business entities to enter into installment agreements.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as an administrative measure, this proposal would be operative January 1, 2006.

Justification

Allowing business entities to enter into installment agreements would conform to federal law, would treat business entity taxpayers the same as individual taxpayers, and would help business entity taxpayers experiencing financial hardship satisfy their tax debt.

Implementation

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

Fiscal Impact

The department estimates the costs to implement this proposal to be approximately $200,000 for the enhancement of the current business entity systems. The department would pursue this funding through the normal budgetary process.

Economic Impact

This proposal would result in the following revenue gains:

Estimated Revenue Impact of LP 05-20 Enhancement of BE I/A Program			
Fiscal Yea	2005-06	2006-07	2007-08
	+*Minor	+*Minor	+*Minor

*Minor equals a gain of less than $500,000

The number of business entities that would potentially benefit from entering into installment agreements range from 1,500 to 2,000 accounts. The total tax due on these accounts varies from $3 to $4.5 million.

The current payment default rate for personal income taxpayers in an installment agreement is equal to less than 3%. Assuming that allowing business entities to enter into installment agreements would realize a similar default rate, it is estimated that business entity collections would see a $370,000 annual increase in collections from installment agreement accounts. ($3.75 million in account balances x 37% default rate x 80% business participation rate in EFT divided by the 3 year payment period = approximately $370,000 annually).

Other States

Review of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* tax laws found that all of these states offer installment payment plans to both PIT and business entity taxpayers. The laws of these states were reviewed because their economy, business entity types, and tax laws are similar to California.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS

AMENDMENT 1

Section 19008 of the Revenue and Taxation Code is amended:

(a) The Franchise Tax Board may, in cases of financial hardship, as determined by the Franchise Tax Board, allow ~~an individual or fiduciary~~ taxpayers to enter into installment payment agreements with the Franchise Tax Board to pay taxes due, plus applicable interest and penalties over the life of the installment period. Failure by ~~an individual or fiduciary~~ a taxpayer to comply fully with the terms of the installment payment agreement shall render the agreement null and void, unless the Franchise Tax Board determines that the failure was due to a reasonable cause, and the total amount of tax, interest, and all penalties shall be immediately due and payable.

(b) In the case of a liability for tax of an individual under Part 10 (commencing with Section 17001) or this part, the Franchise Tax Board shall enter into an agreement to accept the payment of the tax in installments if, as of the date the individual offers to enter into the agreement, all of the following apply:

(1) The aggregate amount of the liability (determined without regard to interest, penalties, additions to the tax and additional amounts) does not exceed ten thousand dollars ($10,000).

(2) The taxpayer (and, if the liability relates to a joint return, the taxpayer's spouse) has not during any of the preceding five taxable years done any of the following:

(A) Failed to file any return of tax imposed under Part 10 (commencing with Section 17001) or this part.

(B) Failed to pay any tax required to be shown on the return.

(C) Entered into an installment agreement under this section for payment of any tax imposed by Part 10 (commencing with Section 17001) or this part.

(3) The Franchise Tax Board determines that the taxpayer is financially unable to pay the liability in full when due (and the taxpayer submits any information as the Franchise Tax Board may require to make this determination).

(4) The agreement requires full payment of the liability within three years.

(5) The taxpayer agrees to comply with the provisions of this part and Part 10 (commencing with Section 17001) for the period the agreement is in effect.

(c) Except in any case where the Franchise Tax Board finds collection of the tax to which an installment payment agreement relates to be in jeopardy, or there is a mutual consent to terminate, alter, or modify the agreement, the agreement shall not be considered null and void, or otherwise terminated, unless both of the following occur:

(1) A notice of termination is provided to the ~~individual or fiduciary~~ taxpayer not later than 30 days before the date of termination.

(2) The notice includes an explanation of why the Franchise Tax Board intends to terminate the agreement.

(d) No levy may be issued on the property or rights to property of any person with respect to any unpaid tax:

(1) During the period that an offer by the taxpayer for an installment agreement under this section for payment of the unpaid tax is pending with the Franchise Tax Board.

(2) If the offer is rejected by the Franchise Tax Board, during the 30 days thereafter (and, if a request for review of the rejection is filed within the 30 days, during the period that the review is pending).

(3) During the period that the installment agreement for payment of the unpaid tax is in effect.

(4) If the agreement is terminated by the Franchise Tax Board, during the 30 days thereafter (and, if a request for review of the termination is filed within the 30 days, during the period that the review is pending).

(5) This subdivision shall not apply with respect to any of the following:

(A) Any unpaid tax if either of the following occurs:

(i) The taxpayer files a written notice with the Franchise Tax Board that waives the restriction imposed by this subdivision on levy with respect to the tax.

(ii) The Franchise Tax Board finds that the collection of that tax is in jeopardy.

(B) Any levy that was first issued before the date that the applicable proceeding under this subdivision commenced.

(C) At the discretion of the Franchise Tax Board, any unpaid tax for which the taxpayer makes an offer of an installment agreement subsequent to a rejection of an offer of an installment agreement with respect to that unpaid tax (or to any review thereof).

(D) The period of limitation under Section 19371 shall be suspended for the period during which the Franchise Tax Board is prohibited under this subdivision from making a levy.

(e) The Taxpayers' Rights Advocate shall establish procedures for an independent departmental administrative review for the rejection of the offer of an installment payment and for installment payment agreements that are rendered null and void, or otherwise terminated under this section, for ~~individuals or fiduciaries~~taxpayers who request that review. This administrative review shall not be subject to Chapter 4.5 (commencing with Section 11400) of Part 1 of Division 3 of the Government Code. Unless review is requested by the taxpayer within 30 days of the date of rejection of the offer of an installment agreement or termination of the installment agreement, this administrative review shall not stay collection of the tax to which the installment payment agreement relates.

~~(f) The amendments made by the act adding this subdivision are operative on the effective date of that act, except subdivision (d) shall be operative for any proposed installment agreement submitted after December 31, 2000.~~

TAXPAYER BILL OF RIGHTS PROPOSAL 04-01
EXECUTIVE SUMMARY

- **Title:**

  Limited Liability Company Double Withholding

- **Problem Statement:**

  The application of several provisions of California law results in unnecessary double withholding on certain taxable income of nonresident members of Limited Liability Companies (LLCs), placing unnecessary administrative burdens on affected LLCs, LLC members, and the Franchise Tax Board (FTB).

- **Proposed Solution:**

  Provide FTB with authority to reduce the amount of the NCNR tax to eliminate duplicate withholding on the same taxable income.

- **Major Concerns/Issues:**

  None.

- **Revenue:**

  This proposal would result in an insignificant revenue loss (less than $150,000).

2004 Taxpayer Bill of Rights Legislative Proposal
TP 04-01

Taxpayer Bill of Rights Hearing:

December 2, 2003

Suggested By:

Spidell Publishing, Inc.

Title

Limited Liability Company Double Withholding

Introductory Sentence

This proposal would coordinate the tax payment and withholding requirements applicable to nonresident members of limited liability companies (LLCs).

Current State and Federal Law

Current federal law requires a partnership (foreign or domestic), including an LLC taxable as a partnership, that has income effectively connected with a U.S. trade or business to pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners. Effectively connected taxable income is generally the gross income minus the allowable deductions related to the partnership's U.S. business activities. A publicly traded partnership (a partnership whose interest is regularly traded on an established securities market) not treated as a corporation under section 7704 of the IRC must withhold tax on actual distribution of effectively connected income, unless it chooses to withhold under these rules. The rate of withholding is 35% of the effectively connected income allocable to the foreign partners for the partnership's tax year. A partnership must make installment payments of withholding tax whether or not distributions are made during the partnership's tax year.

This withholding tax does not apply to income that is not effectively connected with the partnership's U.S. trade or business. This type of income is usually interest, dividends, or capital gains and is generally subject to withholding at a rate of 30%.

California law has three withholding regimes for noncorporate LLCs:

- Domestic nonresident member withholding,
- Foreign (non-U.S.) nonresident member withholding, and
- Nonconsenting nonresident (NCNR) member's tax.

Domestic nonresident members are subject to a 7% withholding rate against the actual distribution of California source income that has not been reported to California and is in excess of $1,500. Foreign (non-U.S.) nonresident members are subject to withholding at the member's applicable tax rate on the member's share of California source income, with no minimum threshold.

The NCNR members' tax and consent regime was created in response to a concern about the state being able to collect tax from nonresident members. At the time, there was a concern that nonresident taxpayers may argue that states lack "nexus" (i.e., the constitutional authority to tax nonresident LLC members). The NCNR regime was developed as an alternative if an appellate court endorsed that argument. The tax is applied at the nonconsenting member's applicable tax rate on the member's share of California source income, with no minimum threshold.

A nonresident member is subject either to domestic nonresident withholding or to foreign (non-U.S. nonresident withholding, but not to both at the same time. However, each may also be subject to the NCNR member's tax if they do not timely sign the required consent.

Problem

The application of several provisions of California law results in unnecessary double withholding on certain taxable income of nonresident members of LLCs, placing unnecessary administrative burdens on affected LLCs, LLC members, and Franchise Tax Board (FTB).

Proposed Solution

Provide FTB with authority to reduce the amount of the NCNR tax to eliminate duplicate withholding on the same taxable income.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as a tax levy, this proposal would apply to taxable years beginning on or after January 1, 2005.

Justification

This legislative proposal provides FTB with the tools to reduce an NCNR member's tax in situations that would clearly result in overwithholding, thereby minimizing taxpayer contact and simplifying administrative requirements.

Implementation

This legislative proposal would require changes to existing departmental forms and instructions during the normal review cycles.

Fiscal Impact

Departmental Costs

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

Tax Revenue Estimate

The revenue impact from this proposal to grant FTB the authority to reduce the NCNR members' tax is projected to result in an insignificant loss. An insignificant loss does not exceed $150,000.

Industry Pro Arguments

The granting of authority to FTB to reduce the NCNR tax by the amount of taxes withheld would alleviate the double withholding.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO TP 04-01

AMENDMENT 1

SEC. XX. Section 18633.5 of the Revenue and Taxation Code is amended to read:

18633.5. (a) Every limited liability company which is classified as a partnership for California tax purposes that is doing business in this state, organized in this state, or registered with the Secretary of State shall file its return on or before the fifteenth day of the fourth month following the close of its taxable year, shall make a return for that taxable year, stating specifically the items of gross income and the deductions allowed by Part 10 (commencing with Section 17001). The return shall include the names, addresses, and taxpayer identification numbers of the persons, whether residents or nonresidents, who would be entitled to share in the net income if distributed and the amount of the distributive share of each person. The return shall contain or be verified by a written declaration that it is made under penalty of perjury, signed by one of the limited liability company members. In the case of a limited liability company not doing business in this state, and subject to the tax imposed by subdivision (b) of Section 17941, the Franchise Tax Board shall, for returns required to be filed on or after January 1, 1998, prescribe the manner and extent to which the information identified in this subdivision shall be included with the return required by this subdivision.

(b) Each limited liability company required to file a return under subdivision (a) for any limited liability company taxable year shall, on or before the day on which the return for that taxable year was required to be filed, furnish to each person who holds an interest in that limited liability company at any time during that taxable year a copy of that information required to be shown on that return as may be required by forms and instructions prescribed by the Franchise Tax Board.

(c) Any person who holds an interest in a limited liability company as a nominee for another person shall do both of the following:

(1) Furnish to the limited liability company, in the manner prescribed by the Franchise Tax Board, the name, address, and taxpayer identification number of that person, and any other information for that taxable year as the Franchise Tax Board may prescribe by forms

and instructions.

(2) Furnish to that other person, in the manner prescribed by the Franchise Tax Board, the information provided by that limited liability company under subdivision (b).

(d) The provisions of Section 6031(d) of the Internal Revenue Code, relating to the separate statement of items of unrelated business taxable income, shall apply.

(e) (1) A limited liability company shall file with its return required under subdivision (a), in the form required by the Franchise Tax Board, the agreement of each nonresident member to file a return pursuant to Section 18501, to make timely payment of all taxes imposed on the member by this state with respect to the income of the limited liability company, and to be subject to personal jurisdiction in this state for purposes of the collection of income taxes, together with related interest and penalties, imposed on the member by this state with respect to the income of the limited liability company. If the limited liability company fails to timely file the agreements on behalf of each of its nonresident members, then the limited liability company shall, at the time set forth in subdivision (f), pay to this state on behalf of each nonresident member of whom an agreement has not been timely filed an amount equal to the highest marginal tax rate in effect under Section 17041, in the case of members which are individuals, estates, or trusts, and Section 23151, in the case of members that ~~which~~ are corporations, multiplied by the amount of the member's distributive share of the income source to the state reflected on the limited liability company's return for the taxable period, reduced by the amount of tax previously withheld and paid by the limited liability company pursuant to Section 18662 and the regulations there under with respect to each nonresident member. A limited liability company shall be entitled to recover the payment made from the member on whose behalf the payment was made.

(2) If a limited liability company fails to attach the agreement or to timely pay the payment required by paragraph (1), the payment shall be considered the tax of the limited liability company for purposes of the penalty prescribed by Section 19132 and interest prescribed by Section 19101 for failure to timely pay the tax. Payment of the penalty and interest imposed on the limited liability company for failure to timely pay the amount required by this subdivision shall extinguish the liability of a nonresident member for the penalty and interest for failure to make timely payment of all taxes imposed on that member by this state with respect to the income of the limited liability company.

(3) No penalty or interest shall be imposed on the limited liability company under paragraph (2) if the nonresident member timely files and pays all taxes imposed on the member by this state with respect to the income of the limited liability company.

(f) Any agreement of a nonresident member required to be filed pursuant to subdivision (e) shall be filed at either of the following times:

(1) The time the annual return is required to be filed pursuant to this section for the first taxable period for which the limited liability company became subject to tax pursuant to Chapter

10.6 (commencing with Section 17941).

(2) The time the annual return is required to be filed pursuant to this section for any taxable period in which the limited liability company had a nonresident member on whose behalf an agreement described in subdivision (e) has not been previously filed.

(g) Any amount paid by the limited liability company to this state pursuant to paragraph (1) of subdivision (e) shall be considered to be a payment by the member on account of the income tax imposed by this state on the member for the taxable period.

(h) Every limited liability company that is classified as a corporation for California tax purposes shall be subject to the requirement to file a tax return under the provisions of Part 10.2 (commencing with Section 18401) and the applicable taxes imposed by Part 11 (commencing with Section 23001). ~~including Section 23221 relating to the prepayment of the minimum tax to the Secretary of State.~~

(i) (1) Every limited liability company doing business in this state, organized in this state, or registered with the Secretary of State, that is disregarded pursuant to Section 23038 shall file a return that includes information necessary to verify its liability under Sections 17941 and 17942, provides its sole owner's name and taxpayer identification number, includes the consent of the owner to California tax jurisdiction, and includes other information necessary for the administration of this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001).

(2) If the owner's consent required under paragraph (1) is not included, the limited liability company shall pay on behalf of its owner an amount consistent with, and treated the same as, the amount to be paid under subdivision (e) by a limited liability company on behalf of a nonresident member for whom an agreement required by subdivision (e) is not attached to the return of the limited liability company.

(3) The return required under paragraph (1) shall be filed on or before the fifteenth day of the fourth month after the close of the taxable year of the owner subject to tax under Part 10 (commencing with Section 17001) of Division 2 or on or before the fifteenth day of the third month after the close of the taxable year of the owner subject to tax under Chapter 2 (commencing with Section 23101) of Part 11 of Division 2, whichever is applicable.

(4) For limited liability companies disregarded pursuant to Section 23038, "taxable year of the owner" shall be substituted for "taxable year" in Sections 17941 and 17942.

TAXPAYER BILL OF RIGHTS PROPOSAL 04-02
EXECUTIVE SUMMARY

- **Title:**

  Relief From Annual Tax For Limited Partnerships (LP)

- **Problem Statement:**

  Many LP partners erroneously believe that merely ceasing to do business in California or filing a final tax return with the Franchise Tax Board (FTB) terminates an entity's liability for the annual tax.

- **Proposed Solution:**

  A. Provide relief from the annual tax for taxable years beginning on or after January 1, 2005, to an LP that has filed a final return with FTB for taxable years that have ended before January 1, 2005, if the LP files a certificate of cancellation with Secretary of State (SOS) within 12 months of the effective date.

  2. Provide that the annual tax would not be assessed for an LP that does all three of the following for taxable years beginning on or after January 1, 2005:

     A. files a timely final return with FTB;

     B. files a certificate of cancellation with the SOS within 12 months of the due date of the return for the preceding taxable year, without regard to extension, and

     C. does not do business in California during the period from the end of the taxable year for which the final return was filed until the certificate of cancellation was filed with SOS by the time prescribed.

- **Major Concerns/Issues:**

  None

- **Revenue:**

  This proposal would result in revenue losses $250,000 or less for each of the 2004/2005, 2005/2006, and 2006/2007 fiscal years.

2004 Taxpayer Bill of Rights Legislative Proposal
TP 04-02

Taxpayer Bill of Rights Hearing:

December 2, 2003

Suggested By:

Spidell Publishing, Inc.

Title

Relief From Annual Tax For Limited Partnerships

Introduction

This proposal would provide relief from the requirement to pay an annual tax for specified limited partnerships (LP).

Current State and Federal Law

An LP is formed by two or more individuals or entities and must have one or more general partners and one or more limited partners. A general partner manages the business and is personally liable for the partnership debts. A limited partner does not participate in the control of the partnership, but may, among other things, consult or advise a general partner, act as a surety for the partnership or a general partner, approve or disapprove changes to the partnership agreement, and call meetings. The LP is formed when organizational documents are filed with the Secretary of State (SOS). LPs formed in other states (foreign LPs) are required to register with the SOS to transact business in this state.

Current California tax law requires that an annual tax be paid by every LP 1) doing business in this state; 2) organized under the laws of this state; or 3) registered with SOS to transact business in this state. The amount of the annual tax is equal to the minimum franchise tax, currently $800. The tax is required to be paid for each taxable year, or portion thereof, until a certificate of cancellation is filed with SOS. The certificate of cancellation terminates the existence of a domestic LP and cancels the registration for a foreign LP to do business in California.

When an LP designates a tax return as its "final return," current state tax law requires the Franchise Tax Board (FTB) to notify the LP that the annual tax continues to be due until the LP files a certificate of cancellation with SOS.

Problem

Many LP partners erroneously believe that merely ceasing to do business in California or filing a final tax return with the FTB terminates an entity's liability for the annual tax.

Proposed Solution

1. Provide relief from the annual tax for taxable years beginning on or after January 1, 2005, to an LP that has filed a final return with FTB for taxable years that have ended before January 1, 2005, if the LP files a certificate of cancellation with SOS within 12 months of the effective date.

2. Provide that the annual tax would not be assessed for an LP that does all three of the following for taxable years beginning on or after January 1, 2005:

A. files a timely final return with FTB;

B. files a certificate of cancellation with SOS within 12 months of the due date of the return for the preceding taxable year, without regard to extension, and

C. does not do business in California during the period from the end of the taxable year for which the 'final return' was filed until the certificate of cancellation was filed with the SOS by the time prescribed.

Effective/Operative Date of Solution

If enacted in the 2005/2006 legislative session, this proposal would be effective for taxable years beginning on or after January 1, 2005.

Justification

Some taxpayers perceive the current statutes for canceling an LP and imposing the annual tax as burdensome and rigid, and as a result, unfair to the unwary. Enacting the proposed amendments, as well as including a form for the certificate of cancellation in FTB's 565 Partnership Tax Booklet (see Implementation), could enable FTB and SOS to make the cancellation process for LPs simpler and more flexible to apply. It would provide an opportunity for taxpayers to cancel their LPs without incurring additional taxes, penalties, and interest. Therefore, this measure could provide an incentive for LPs to seek proper cancellation of their entities.

Implementation

In an effort to increase educational awareness of the affected taxpayers, FTB could add the Certificate of Cancellation (Form LP 4/7) and instructions to the 565 Partnership Tax Booklet for easy access and filing.

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.

Legislative History

AB 547 (Maldonado, 2001/2002) would have provided that an annual tax would not be imposed in the year that a timely final return is filed with FTB, if the LP did not do business in California in the taxable year, and filed a certificate of cancellation with SOS within 12 months of the due date of the return for the preceding taxable year, without regard to extension. This bill was an FTB sponsored bill. The prospective solution of this proposal is based on the provisions of this bill. The bill failed passage out of its house of origin.

SB 2170 (Senate Revenue and Taxation Committee, Stats. 2000, Ch. 647) provided relief to those LPs that had ceased operation, filed a timely final return with FTB, and filed a certificate of dissolution with the SOS prior to January 1, 1997, and subsequently filed a certificate of cancellation with the SOS. FTB refunded taxes, penalties, and interest to qualifying LPs for taxable years beginning January 1, 1997. This bill corrected the erroneous limitation contained in SB 1229 (described below).

SB 1229 (Senate Revenue and Taxation Committee, Stats. 1999, Ch. 987) provided relief from the tax for LPs that ceased doing business prior to January 1, 1997, that filed a final tax return with FTB, and that filed a certificate of dissolution with the SOS. However, as drafted, SB 1229 erroneously limited the relief to LPs that filed a certificate of cancellation with the SOS on or after October 10, 1999. A substantial number of LPs filed certificates of cancellation with the SOS prior to October 10, 1999, and would have been inadvertently excluded from relief.

SB 707 (Greene, Stats. 1994, Ch. 948) revised the basis for imposing the tax on LPs and provided transitional relief from the annual tax for LPs that ceased doing business before January 1, 1993, filed a final return with FTB, and subsequently filed a certificate of dissolution *or* cancellation with the Secretary of State by December 31, 1994.

Fiscal Impact

Departmental Costs

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

Tax Revenue Estimate

This proposal would result in the following franchise and income tax revenue losses.

Revenue Impact of TP 04-02 Tax Years Beginning On or After January 1, 2005 Enactment Assumed After June 30, 2005			
	2005/06	2006/07	2007/08
Revenue Impact	–$250,000 or less	-$250,000 or less	-$250,000 or less

The revenue impact of this proposal would be determined by the amount of taxes, penalties, and interest that LPs would be relieved of under the proposal that would be otherwise paid under current law. This proposal would result in negligible revenue losses of less than $250,000 annually beginning in 2005/06. Currently, only under limited circumstances are assessments issued and collected for the $800 annual tax when limited partnerships do not formally cancel by filing appropriate forms with SOS.

For the 2002 taxable year, approximately 3,100 limited partnerships indicated the return filed was the final tax return. Under current departmental procedures, a general partner of each of these limited partnerships was notified of the cancellation filing requirements with SOS, and that it is the filing of the certificate of cancellation with SOS that stops the assessment of the $800 annual tax for future years. It is assumed that no more than 10% of these entities paid the $800 annual tax after ceasing to do business. Thus, this proposal would result in a revenue impact of less than $250,000 [3,100 x .10 = 310 x $800 = $248,000].

Other Agency/Industry Impacted

Secretary of State

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO TP 04-02

Section 17935 of the Revenue and Taxation Code is amended to read:

17935. (a) For each taxable year beginning on or after January 1, 1997, every limited partnership doing business in this state (as defined by Section 23101) and required to file a return under Section 18633 shall pay annually to this state a tax for the privilege of doing business in this state in an amount equal to the applicable amount specified in Section 23153.
(b) (1) In addition to any limited partnership that is doing business in this state and therefore is subject to the tax imposed by subdivision (a), for each taxable year beginning on or after January 1, 1997, every limited partnership that has executed, acknowledged, and filed a certificate of limited partnership with the Secretary of State pursuant to Section 15621 of the Corporations Code, and every foreign limited partnership that has registered with the Secretary of State pursuant to Section 15692 of the Corporations Code, shall pay annually the tax prescribed in subdivision (a). The tax shall be paid for each taxable year, or part thereof, until a certificate of cancellation is filed on behalf of the limited partnership with the office of the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code.
(2) If a taxpayer files a return with the Franchise Tax Board that is designated its final return, that board shall notify the taxpayer that the tax imposed by this chapter is due annually until a certificate of cancellation is filed with the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code.
(c) The tax imposed by this chapter shall be due and payable on the date the return is required to be filed under former Section 18432 or 18633.
(d) For purposes of this section, "limited partnership" means any partnership formed by two or more persons under the laws of this state or any other jurisdiction and having one or more general partners and one or more limited partners.
(e) Notwithstanding subdivision (b), any limited partnership that ceased doing business prior to January 1, 1997, filed a final return with the Franchise Tax Board for a taxable year ending before January 1, 1997, and filed a certificate of dissolution with the Secretary of State pursuant to Section 15623 of the Corporations Code prior to January 1, 1997, shall not be subject to the tax imposed by this chapter for any period following the date the certificate of dissolution was filed with the Secretary of State, but only if the limited partnership files a certificate of cancellation with the Secretary of State pursuant to Section 15623 of the Corporations Code. In the case where a notice of proposed deficiency assessment of tax or a notice of tax due (whichever is applicable) is mailed after January 1, 2001, the first sentence of this subdivision shall not apply unless the certificate of cancellation is filed with

the Secretary of State not later than 60 days after the date of the mailing of the notice.

(f) Notwithstanding subdivision (b), any limited partnership that ceased doing business prior to January 1, 2005, and filed a final return with the Franchise Tax Board for a taxable year ending before January 1, 2005, shall not be subject to the tax imposed by this chapter for any period beginning on or after January 1, 2005, but only if it files a certificate of cancellation with the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code before the end of the 12-month period beginning with the effective date of the act adding this subdivision.

AMENDMENT 2

Section 17937 is added to the Revenue and Taxation Code:

17937. (a) A limited partnership shall not be subject to the taxes imposed by this chapter if all of the following conditions are satisfied:

(1) The limited partnership files a timely final return.

(2) The limited partnership ceases doing business in this state no later than the close of the taxable year for which the return described in paragraph (1) was filed.

(3) A certificate of cancellation is filed on behalf of the limited partnership with the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code before the end of the 12-month period beginning with the due date of the return for the preceding taxable year (determined without regard to extension).

(b) For purposes of this section, a “final return” is a return filed pursuant to Section 18633 on or before the due date of the return (including extensions) that is designated in a manner prescribed by the Franchise Tax Board.

TAXPAYER BILL OF RIGHTS PROPOSAL 04-04
EXECUTIVE SUMMARY

- **Title:**

  Restructuring Of Homeowners and Renters Assistance Program

- **Problem Statement:**

  The proponent of this proposal suggests there would be administrative cost savings associated with integrating the Homeowners and Renters Assistance (HRA) program into the Personal Income Tax (PIT) program.

- **Proposed Solution:**

  Change the HRA program from a property tax assistance program to a Senior/Disabled Housing refundable credit and integrate it with the PIT program. Upon direction of the Franchise Tax Board, department staff will work with the proponent of this proposal to draft the necessary amendments.

- **Major Concerns/Issues:**

  Historically, refundable credits, such as the former state Renter's credit and the federal Earned Income credit, have had significant problems with invalid and fraudulent returns.

  Currently, renters receive an average payment of $311 and homeowners receive an average payment of $242. In order to make this proposal revenue neutral, the amount of the benefit would be reduced to $175 for each claimant. Reducing the benefit amount would allow the revenue needed to fund the program to remain unchanged, while providing the benefit to the significantly larger population of claimants expected.

  The California Performance Review observed that the HRA program no longer meets the original legislative intent and as a result, has made a recommendation to the Governor that the program be revised to phase out homeowners.

- **Revenue:**

  The substitution of a refundable tax credit for the current HRA program could be revenue neutral by creating a single payment structure of $175 per claimant.

2004 Taxpayer Bill of Rights Legislative Proposal
TP 04-04

Taxpayer Bill of Rights Hearing:

December 2, 2003

Suggested By:

Spidell Publishing, Inc.

Title

Restructuring Of Homeowners and Renters Assistance Program

Introductory Sentence

This proposal would change the existing Homeowners and Renters Assistance (HRA) program into a Senior/Disabled Housing refundable credit and incorporate it into the Personal Income Tax (PIT) program.

Program Background

Since HRA is based on property tax, the Franchise Tax Board (FTB) administers HRA as a program separate from the PIT program, including maintaining a separate computer system on which HRA claims are processed. The rules for qualifying for HRA are separate and distinct from income tax, including differences in qualifications related to age and income. FTB receives approximately 750,000 HRA claims annually. Senior citizens (age 62 and older) represent 69% of the claimant population; blind and disabled citizens represent the remaining 31% of the population. While this represents a relatively small workload, in comparison to the processing of 14 million PIT returns, the program is more expensive to administer on a per claim basis, due to the complexity of the rules, the current HRA system limitations, and the communication difficulties of many of the claimants. The administrative budget for this program was $6 million in fiscal year 2002-03. The budget was reduced to $5.1 million in fiscal year 2003-04 due to the financial situation of the state.

Current State Law

Current state tax law authorizes FTB to administer California's PIT laws. Generally, PIT returns are filed on a calendar-year basis with returns and payments due April 15th following the close of the calendar year, or with an extension the returns are due October 15th.

Current state tax law requires FTB to administer the HRA program. The HRA program was implemented in order to provide property tax relief to lower-income California senior citizens. The program currently provides reimbursements to offset property taxes property owners pay directly on their personal residences and renters pay indirectly through their rental payments. Eligibility for reimbursement is limited to United States citizens or certain designated aliens who are 62 years of age or older, blind, or disabled, and who also meet certain household income limitations. Claimants may file for assistance from July 1st through October 15th, inclusive. However, FTB may accept claims through June 30th of the year following the year for which assistance is claimed.

Problem

The proponent of this proposal suggests there would be administrative cost savings associated with integrating the HRA program into the PIT program.

Proposed Solution

Change the HRA program from a property tax assistance program to a Senior/Disabled Housing refundable credit and integrate it with the PIT program. Upon direction of the Franchise Tax Board, department staff will work with the proponent of this proposal to draft the necessary amendments.

Effective/Operative Date of Solution

If enacted in the 2005 legislative session as an administrative measure, this proposal would be operative January 1, 2006, and apply to all HRA claims made on or after that date.

Justification

By changing the current HRA program into a PIT credit, the department would be able to use existing PIT processing procedures, systems, and other resources to process HRA claims. As a result, the department would recognize a reduction in costs associated with the administration of HRA.

Implementation

A new form or schedule would need to be developed for the purpose of claiming the Senior/Disabled Housing refundable credit. The form would include all of the required questions related to residence, age, citizenship, income, and disability/blindness (if any). If the claimant is a taxpayer, the schedule would be attached to the tax return and the amount of the claim would be carried over to the credit line on the Form 540, Form 540A, or Form 540NR[1]. If the claimant is not a taxpayer, the claim could be submitted separately for processing and payment, but this would effectively create a new return type and cause additional processing costs. It may be more cost effective to require the schedule to be filed with a return that has just the minimal entity information and the signature.

The tax booklet would need to be expanded to accommodate the new schedule and instructions (an additional eight pages) or the department could continue to develop the schedule and instructions as a separate stand-alone product. In either case, the new product would be mailed directly to claimants who had filed previously and made available to others via public distribution. In addition, the schedule and instructions would be made available directly to computer tax preparation software developers along with the other tax forms and instructions for inclusion in their annual tax software updates.

In order for the HRA program to exist within the PIT program, the department would abolish the current HRA program and convert it to a PIT credit. Further, once converted, the new Senior/Disabled Housing refundable credit would need to conform to the general parameters of other types of tax credits. At a minimum, the current distinctions made between renters and homeowners would have to be minimized or eliminated so that there would be a single set of business rules and documentation requirements for anyone claiming the credit.

[1] The credit could not be claimed on a Form 5402EZ due to the limitations of that return type.

Other States' Information

Twenty-one other states provide property tax relief, as cash assistance, in the form of a payment (refund) or a refundable tax credit. Thirteen of these states provide assistance to both homeowners and renters; eight limit the assistance to either homeowners or renters. Ten states (Arizona, Illinois, Massachusetts, Michigan, Missouri, Montana, New Jersey, New Mexico, Oklahoma, and Rhode Island) coordinate the claim process with their PIT process. Each of these states requires that some type of form be filed to claim the credit. Half of them require the claimant to file a tax return in order to claim the credit. In the remaining states, individuals with a filing requirement attach a claim form to their tax return; individuals with no filing requirement can file a separate claim form.

Fiscal Impact

Departmental Costs

In the first year of implementation, costs are estimated to equal or exceed the current annual budget for HRA administration of $5.1 million. Subsequently, both the elimination of the dated HRA system and the separate processing of HRA claims could reduce the current budget by over $3.1 million dollars starting in the second year of administration and all future years. Ongoing costs of approximately $2 million would still be needed to cover the costs of the additional pages in the PIT booklet or a separate publication, processing the new schedule with the tax return, customer contacts related to the credit, and increased fraud prevention activity.

Revenue Estimate

Based on available data and assumptions, the substitution of a refundable tax credit for the current HRA program could be revenue neutral by creating a single payment structure of $175 per claimant. This estimate allows for an anticipated 60% increase, (See Pro and Con Arguments, below), in the volume of qualified claimants (up from 605,000 to roughly 1.1 million) and uses a projected 2005 HRA program budget allocation of roughly $200 million ($200 million HRA budget divided by 1.1 million claimants = $175 refundable credit). In addition, there would be an estimated revenue gain of $3.5 million starting in the 2005/06 fiscal year due to better tax liability offset capabilities now that taxpayers will be required to file a return in order to claim the credit.

Based on the 2002 HRA claim year, roughly $178 million in assistance payments were made to 605,000 qualified individuals at an overall average claim of $295. Further breakdown of the figures show renters received an average payment of $311, while homeowners received an average payment of $242. Because the proposed single credit of $175 would apply to all claimants based on a single household income threshold, this proposal would effectively redistribute payments made under current law.

Policy Consideration

Historically, refundable credits, such as the former state Renter's credit and the federal Earned Income credit, have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent. In such cases, the refund commonly cannot be recovered.

Pro & Con Arguments

Pro:

The newly developed Senior/Disabled Housing refundable credit schedule would be available to tax preparation software companies and professional tax preparers when they receive the other income tax forms. The schedule could be e-filed, claimants would be able to check on the status of their refunds through existing electronic applications available on the Internet and telephone, and refunds could be directly deposited into claimants checking or savings accounts. None of these improvements are possible within the current dated HRA system environment.

Con:

Currently, renters receive an average payment of $311 and homeowners receive an average payment of $242. In order to make this proposal revenue neutral, the amount of the benefit would be reduced to $175 for each claimant. Reducing the benefit amount would allow the revenue needed to fund the program to remain unchanged, while providing the benefit to the significantly larger population of claimants expected.

Additional Comments

By Executive Order on February 10, 2004, the Governor created the California Performance Review (CPR) to conduct a focused examination and assessment of California state government. The CPR's mandate was to formulate and recommend practical changes to government agencies, programs, and operations to reduce total costs of operations, increase productivity, improve services, and make government more responsible and accountable to the public.

On August 4, 2004, the CPR provided the Governor with their government reform plan. Contained within the report was the discussion of two tax relief programs to assist low-income seniors and people with disabilities: the property tax postponement program (PTP), administered by the State Controller's Office and the HRA program administered by the department.

It was the opinion of the CPR that the HRA program no longer fulfills the original legislative intent and that the PTP should be expanded. As a result, the CPR recommended a revision of the HRA program. The CPR recommends phasing out the homeowner portion of the program because Proposition 13 reduced and stabilized property taxes. The CPR further recommends increasing the threshold amount for the PTP to meet the anticipated increase in demand, as a result of the homeowner phase out of the HRA program. These recommendations would result in a general fund savings of $174.1 million beginning in fiscal year 2005/2006.