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# LEGISLATIVE PROPOSAL 04-03
# EXECUTIVE SUMMARY

**Title:** Modify The Penalty For Failing To Withhold At Source

- **Problem Statement:**

The penalty for failure to withhold at source is generally ineffective for three reasons:

- Assessing the penalty is dependent on the actions of persons other than the withholding agent.
- Determining the penalty amount requires substantial FTB resources.
- Assessing the penalty occurs only once a substantial amount of time passes after the failure to withhold.

- **Proposed Solution:**

Amend the law to make any withholding agent liable for the failure to withhold penalty in an amount equal to $500 or 10% of the amount required to be withheld with a maximum penalty of $5,000. Assess the penalty immediately after the failure to withhold occurs. Thus, the penalty would be based solely on the actions of the withholding agent; the penalty could be assessed without contacting the taxpayer recipient; and the penalty would be applied to all withholding agents in a uniform manner.

- **Major Concerns/Issues:**

Real estate escrow persons (REEPs), entertainment promoters, attorneys, brokers, partnerships, or other intermediaries who act as withholding agents would be impacted by this proposal.

- **Revenue:**

Based on limited information, the potential revenue enhancement of this proposal is estimated to be on the order of $1 million annually and is due primarily to a projected increase in compliance as a result of this proposal.

**2004 Departmental Legislative Proposal**
**LP 04-03**

## Title

Modify The Penalty For Failing To Withhold At Source

## Introduction

This legislative proposal would increase the effectiveness of the failure to withhold penalty.

## Background

The department's withhold at source program requires withholding of tax for income derived from California sources received by nonresident contractors, beneficiaries of estates and trusts, partners, and individual resident and nonresident sellers of California real property. The obligation to withhold is generally borne by the party paying the item of income to the taxpayer. This program is distinct from withholding on regular wages, which is administered by the Employment Development Department (EDD).

## Current Federal Law

Generally, a percentage of income paid to a nonresident alien or a foreign corporation for services or sale of real property must be withheld. The withholding obligation is imposed on the “withholding agent.” A “withholding agent” means the person that is normally responsible for the disbursement of the funds. The withholding agent is frequently the person paying for the services or purchasing the property, but can also be an attorney, escrow person, broker, or other intermediary.

A penalty is imposed if the withholding agent fails to withhold from, for purposes of this proposal, a nonresident alien or foreign corporation. The amount of the federal penalty is equal to the amount of tax the taxpayer ultimately fails to pay, but cannot exceed the amount that should have been withheld. Therefore, the penalty can be assessed only once the Internal Revenue Service (IRS) determines the amount of tax the taxpayer failed to pay. The penalty is excused if the failure to withhold is due to reasonable cause.

## Current State Law

California law is similar to federal law except California law expands withholding to the sale of California real property by any individual. The withholding rate for California source income paid to a nonresident or corporation with no presence in California is 7%. For real property, the withholding rate is $3^{1/3}$% of the sales price of California real property. Like federal law, the withholding agent is normally the person paying for the services or purchasing the realty.

The amount of the penalty imposed is calculated in a method similar to federal law, namely the amount of tax the taxpayer failed to pay, but not greater than the amount that should have been withheld. The penalty can be assessed only after the department determines the amount of tax the taxpayer failed to pay.

The penalty amount for buyers of real property located in California is calculated in a different manner. The penalty is the greater of $500 or 10% of the amount required to be withheld. The penalty may be assessed immediately after the failure to withhold.

**Administration of the Penalty**

The primary purpose of the penalty is to ensure compliance with the withholding requirement. There are three weaknesses in the effectiveness of this penalty:

- Whether the penalty is imposed is dependent on both the withholding agent's failure to withhold and the taxpayer's failure to pay the tax; however, the penalty amount is based solely on the amount of tax owed by the taxpayer, rather than the withholding agent's failure. This weakens the effectiveness of the penalty because the penalty is for failure to withhold, not for the failure of the taxpayer to pay the taxes.

- The department must have the taxpayer's return to determine the amount of the penalty. If the taxpayer's return combines the payment of income in question with other income, the department has to contact the taxpayer to determine if both the payment was reported as income and the corresponding tax was paid. This is ineffective because it effectively requires the audit of every taxpayer that may have a withholding at source requirement.

- The time between the failure to withhold and the assessment of the penalty can be 22 months. This lag discourages timely compliance.

The penalty is calculated differently for buyers of real estate. A buyer of California real property is routinely the withholding agent for the seller of the real property. If the buyer fails to withhold on the seller, the buyer is immediately liable for the failure to withhold penalty in an amount equal to the greater of $500 or 10% of the amount required to be withheld. Regardless of whether the seller reports the sale of the real property on their return and pays the proper amount of tax, the buyer is liable for the penalty.

Withholding agents for out-of-state taxpayers (e.g., promoters of entertainment events and escrow persons) are aware of the weaknesses in the failure to withhold penalty resulting in withholding agents that fail to withhold diligently or refuse to withhold altogether.

**Problem**

The penalty for failure to withhold at source is generally ineffective for three reasons:

- Assessing the penalty is dependent on the actions of persons other than the withholding agent.
- Determining the penalty amount requires substantial FTB resources.
- Assessing the penalty occurs only once a substantial amount of time passes after the failure to withhold.

**Proposed Solution**

Amend the law to make any withholding agent liable for the failure to withhold penalty in an amount equal to the greater of $500 or 10% of the amount required to be withheld to a maximum penalty amount of $5,000. Assess the penalty immediately after the failure to withhold occurs. Thus, the penalty would be based solely on the actions of the withholding agent; the penalty could be assessed without contacting the taxpayer recipient; and the penalty would be applied to all withholding agents in a uniform manner.

**Effective/Operative Date of Solution**

If enacted in the 2004 legislative session, the provision would be effective and operative beginning January 1, 2005.

**Justification**

The department's withhold at source program administers withholding on out-of-state contractors, partners, and dispositions of real estate. For the 2003 calendar year, the department will collect approximately $1.2 billion through its withholding at source program. This proposal would ensure continuing compliance with the withholding requirements and would increase compliance above existing levels.

**Implementation**

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

**Fiscal Impact**

**Departmental Costs**

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

**Tax Revenue Estimate**

Based on limited information and the discussion below, the potential revenue enhancement of this proposal is estimated to be on the order of $1 million annually, and is due primarily to a projected increase in compliance as a result of this proposal.

Revenue Discussion:

Based on departmental data, approximately $35 million in personal income tax (PIT) withholding for the tax year 2001 remains unclaimed. These unclaimed tax payments represent amounts withheld by withholding agents and remitted to the department but were unclaimed as a tax payment on any tax return. Significantly, all of the taxpayers representing this $35 million in withholding failed to file a return. It is estimated that the $35 million represents 80% of the tax that would have been due if the taxpayers properly reported the income received. Thus, the total tax due on the income received is estimated to be $44 million ($35 million / 80%). The difference between the amounts withheld and tax due on the income is attributable to the withholding rates of either 7% or $3^{1/3}$% and the highest marginal tax rate of 9.3%.

Unclaimed corporate withholding is estimated to represent 22% of the PIT unclaimed amount or $8 million. Assuming corporate withholding behavior is similar to that of PIT, it is estimated that total tax due on the income is $10 million.

The above yields approximately $54 million ($44 million + $10 million) in total taxes due from the income for a difference of $11 million ($54 million – ($35 million + $8 million) attributable to non-compliance. This number was then grown to approximate 2004 levels ($12 million). Assuming an improved compliance rate of 10%, estimated revenue would be on the order of $1 million annually.

**Policy Considerations**

As discussed above, it is inequitable to have the failure to withhold penalty apply differently for the same failure. The penalty should be applied uniformly among buyers, Real Estate Escrow Person's (REEPs), concert promoters and other withholding agents.

**Other Agency/Industry Impacted**

REEPs, entertainment promoters, attorneys, brokers, partnerships, or other intermediaries who act as withholding agents would be impacted by this proposal.

**Other States**

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were surveyed because their tax laws are similar to California's income tax laws. *Illinois*, *Massachusetts, Michigan,* and *Minnesota* require withholding at source on various entities. While it is clear that penalties exist for failure to file withholding taxes, it is unclear if a specific withholding at source penalty is collected in these states. Information regarding withholding at source was not readily located for *New York.*

**LEGISLATIVE STAFF CONTACT**

Kristina E. North
Franchise Tax Board
845-6978
Kristina.North@ftb.ca.gov

Jeff Garnier
Franchise Tax Board
845-5322
Jeff.Garnier@ftb.ca.gov

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

Analyst Jeff Garnier &
Kristina North
Telephone # 845-5322/845-6978
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 04-03

**AMENDMENT 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) Unless it is shown that the failure to withhold is due to reasonable cause, ~~Any~~any person failing to withhold from any payments any amounts required by subdivision (a) to be withheld is subject to ~~liable for~~ a penalty ~~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~~ equal to the greater of:

(1) Five hundred dollars ($500), or

(2) Ten percent of the difference between the amount withheld and submitted to the Franchise Tax Board and the amount required to be withheld and submitted to the Franchise Tax Board, but not to exceed $5,000.

(e) (1) In the case of any disposition of a California real property interest by an individual, the transferee (including for this purpose any intermediary or accommodator in a deferred exchange) shall be required to withhold an amount equal to 3 1/3 percent of the sales price of the California real property conveyed.

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

(A) No transferee shall be 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) shall be 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) No transferee shall be required to withhold under this subdivision when the transferee is a corporate beneficiary under a mortgage or beneficiary under a deed of trust and the California real property is acquired in judicial or nonjudicial foreclosure or by a deed in lieu of foreclosure.

(D) No transferee shall be required to withhold any amount under this subdivision if the transferee, in good faith and based upon all the information of which he or she has knowledge, relies on a written certificate executed by the transferor, certifying under penalty of perjury, that the California real property being conveyed is the principal residence of the transferor (within the meaning of Section 121 of the Internal Revenue Code).

(E) (i) No transferee (including for this purpose any intermediary or accommodator in a deferred exchange) shall be 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, that the California real property being conveyed is 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 tax purposes under Section 1031 of the Internal Revenue Code.

(ii) Clause (i) shall not apply to the extent that any exchange does not qualify for nonrecognition treatment for California income 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 requirement that property be identified and that exchange be completed not more than 180 days after 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) shall be 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 shall thereafter remit the applicable withholding amounts determined under this subdivision in accordance with paragraph (4).

(F) No transferee shall be 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, that the California real property has been compulsorily or involuntarily converted (within the meaning of Section 1033 of the Internal Revenue Code) and that 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.

(G) No transferee shall be required to withhold any amount under this subdivision if the transferee, in good faith and based on all the information which he or she has knowledge, relies on a written certificate executed by the transferor, certifying under penalty of perjury, that the transaction will result in a loss for California income tax purposes.

(3) (A) 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 payment to be made under the terms of the installment sale agreement between the parties.

(B) For purposes of subparagraph (A), subparagraph (A) of paragraph (2) shall not apply to each individual payment to be received under the terms of the installment sale agreement.

(C) The election under this paragraph 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 subparagraph (D) of this paragraph.

(D) The election under this paragraph shall only be valid 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) 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.

(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 other 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.

(f) (1) In the case of any disposition of a California real property interest by a person (but not a partnership as determined in accordance with Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code, or a corporation, or an individual), when the return required to be filed with the Secretary of the Treasury under Section 6045(e) of the Internal Revenue Code indicates, or the authorization for the disbursement of the transaction's funds instructs, that the funds be disbursed either to a transferor with a last known street address outside the boundaries of this state at the time of the transfer of the title to the California real property or to the financial intermediary of the transferor, the transferee shall be required to withhold an amount equal to 3 1/3 percent of the sales price of the California real property conveyed.

(2) In the case of any disposition of a California real property interest by a corporation, the transferee shall be required to withhold an amount equal to 3 1/3 percent of the sales price of the California real property conveyed, 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:

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

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

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

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

(A) No transferee shall be required to withhold any amount under this subdivision if the sales price of the California real property conveyed does not exceed one hundred thousand dollars ($100,000).

(B) No transferee shall be 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) No transferee shall be 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 shall be required to with hold under this subdivision when the transferee is a corporate beneficiary under a mortgage or beneficiary under a deed of trust and the California real property is acquired in judicial or nonjudicial foreclosure or by a deed in lieu of foreclosure.

(E) No transferee shall be 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 that the transferor is a corporation with a permanent place of business in California.

(4) (A) At the request of the transferor, the Franchise Tax Board may authorize that a reduced amount or no amount be withheld under this subdivision if the Franchise Tax Board determines that to substitute a reduced amount or no amount shall not jeopardize the collection of tax imposed by Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). If the transferor provides documentation sufficient for the Franchise Tax Board to determine the actual gain required to be recognized on the transaction, the Franchise Tax Board may authorize a reduced amount based on the amount of the gain, as determined, which will result in a sum which is substantially equivalent to the amount of tax reasonably estimated to be due under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) from the inclusion of the gain in the gross amount of the transferor.

(B) Within 45 days after receiving a request that a reduced amount or no amount be withheld, the Franchise Tax Board shall either authorize a reduced amount or no amount, or deny the request.

(C) In the case where the parties to the transaction are requesting that a reduced amount or no amount be withheld and the response by the Franchise Tax Board to the request has not been received at the time title to the California real property is transferred, the parties may direct the real estate escrow person to hold in trust for 45 days the amount required to be withheld under this subdivision. The parties shall instruct the real estate escrow person that at the end of 45 days the real estate escrow person shall remit the amount withheld to the Franchise Tax Board in accordance with this section, unless the Franchise Tax Board has authorized that a reduced amount or no amount be withheld.

(5) Amounts withheld and payments made in accordance with this subdivision shall be reported and remitted to the Franchise Tax Board in the form and at the time as the Franchise Tax Board shall determine.

(6) "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.

(7) For purposes of this subdivision, "financial intermediary" means an agent for the purpose of receiving and transferring funds to a principal.

(8) 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 other 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.

(9) (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, helping the parties request that the Franchise Tax Board authorize a reduced amount or no amount be withheld under this subdivision, or, upon request of the parties, withholding an amount under this subdivision and remitting the 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, or providing the certification that the transferor is a corporation with a permanent place of business in California.

(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).

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

(A) The cash paid, or to be paid. The term "cash paid, or to be paid" does not include stated or unstated interest or original issue discount (as determined by Sections 1271 to 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.

(g) 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.

(h) Withholding shall not be 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.

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

(j) (1) The amendments to this section made by ~~the act adding this subdivision shall only~~ <u>Chapter 488 of the Statutes of 2002</u> 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 ~~the act adding this subdivision~~ <u>Chapter 488 of the Statutes of 2002</u> shall not apply to those payments.

**AMENDMENT 2**

Section 18666 of the Revenue and Taxation Code is amended to read:

18666. (a) Section 1446 of the Internal Revenue Code shall apply to the extent that the amounts represent income from California sources, except as otherwise provided.

(b) (1) The rate of tax referred to in Section 1446(b)(2)(A) of the Internal Revenue Code shall be the maximum tax rate specified in Section 17041, rather than the rate specified in Section 1 of the Internal Revenue Code.

(2) The rate of tax referred to in Section 1446(b)(2)(B) of the Internal Revenue Code shall be the rate specified in Section 23151, 23181, or 23183, as applicable, rather than the rate specified in Section 11 of the Internal Revenue Code.

(c) The penalty for failure to withhold any amount required by this section shall be determined in accordance with subdivision (a) of Section 18668.

**AMENDMENT 3**

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. Unless it is shown that the failure to withhold is due to reasonable cause any ~~Any~~ person who fails to withhold from any payments any amount required to be withheld under this article is ~~liable for~~ subject to a penalty, ~~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.~~ equal to the greater of:

(1) Five hundred dollars ($500), or

(2) Ten percent of the difference between the amount withheld and submitted to the Franchise Tax Board and the amount required to be withheld and submitted to the Franchise Tax Board, but not to exceed $5,000.

(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~~ 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) or (f) 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) or (f) of Section 18662:~~

~~(1) Five hundred dollars ($500).~~

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

~~(e)~~(1) Unless it is shown that the failure to notify is due to reasonable cause, the real estate escrow person shall be subject to the ~~amount~~ penalty specified in subdivision ~~(d)~~(a), when written notification of the withholding requirements of subdivision (e) or (f) 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) or (f) of Section 18662, and the required amount is not withheld by the real estate escrow person.

(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 in the case of a disposition of California real property interest by either:

1. A seller who is an individual 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.

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, executes a written certificate, under the penalty of perjury, of any of the following:

A. That the California real property being conveyed is the seller's principal residence (within the meaning of Section 121 of the Internal Revenue Code).

B. That 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.

C. That 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.

D. That the California real property transaction will result in a loss 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.

The California statutes referenced above include provisions which authorize the Franchise Tax Board to grant reduced withholding and waivers from withholding on a case-by-case basis for corporations or other entities."

(3) ~~The real estate escrow person shall not be 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 and the transferee shall not be liable under ~~paragraph (1) or~~ subdivision ~~(d)~~ <u>(a)</u>, if the failure to withhold is the result of the real estate escrow person's 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 certifying to any of the following:

(A) Where the transferor is an individual:

(i) That the California real property being conveyed is the principal residence of the transferor within the meaning of Section 121 of the Internal Revenue Code.

(ii) That 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.

(iii) That 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.

(iv) That the California real property transaction will result in a loss for California income tax purposes.

(B) Where the transferor is a corporation, that the transferor is a corporation with a permanent place of business in California.

~~(5)~~ (4) Any transferor who for the purpose of avoiding the withholding requirements of subdivision (e) or (f) of Section 18662 knowingly executes a false certificate pursuant to this subdivision shall be liable for a penalty twice the amount specified in subdivision ~~(d)~~ (a).

~~(6) Unless the failure to notify is due to willful disregard of the withholding requirements of subdivision (e) or (f) of Section 18662, the real estate escrow person shall not be liable under this subdivision if the disposition of California real property occurs prior to July 1, 1991.~~

~~(f)~~ (e) 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 04-7
# EXECUTIVE SUMMARY

**Title:** Taxation of Nonresidents: Federal Preemption

- **Problem Statement:**

  California law regarding the taxation of nonresidents on income from California sources could be interpreted to conflict with federal statutes that limit or preempt a state's authority to tax certain nonresidents, i.e., those employed in interstate commerce and members of the armed forces.

- **Proposed Solution:**

  The proposed solution is to amend the Revenue and Taxation Code to provide expressly that California is conformed to federal statutes that limit or preempt California's ability to tax the California source income of nonresidents. This proposal would prevent a possible interpretation of existing law that could require lengthy and expensive litigation to validate the preeminence of federal law.

- **Major Concerns/Issues:**

  Tax practitioners and their clients would most likely support this proposal as it would prevent unnecessary audits from being conducted by the department and the need for lengthy and expensive litigation of those actions by their clients were a conflicting interpretation under Section 3.5 of Article III of the California Constitution to be made.

- **Revenue:**

  This proposal would not impact the state's income tax revenue. An examination of actual state tax returns did not show any claiming this exclusion. It is assumed that, in general, the pro-rata share of income of nonresident interstate commerce employees who travel into California and provide a service is below the filing threshold.

**2004 Departmental Legislative Proposal**
**LP 04-7**

## Title

Taxation of Nonresidents: Federal Preemption

## Introduction

This proposal would prevent an interpretation of existing law that could require lengthy and expensive litigation to validate the preeminence of federal law.

## Current Federal Law

The federal Constitution is the "supreme law of the land" and provides that federal constitutional provisions "trump" conflicting provisions of any state's laws or constitution.[1]

There are a number of federal statutes that limit or preempt California's ability to tax the California source income of nonresidents:[2]

> In the case of a nonresident employee of an air carrier (airline), California can tax a nonresident employee's California source income from that employment only if more than 50 percent of the pay received by the employee is earned in California.[3]
>
> In the case of a nonresident employee of a railroad who performs services in two or more states, California cannot tax any of the income from that employment. Only the state of residence may tax this income.[4]
>
> In the case of a nonresident employee of an interstate motor carrier (truck or bus driver) who performs services in two or more states, California cannot tax any of the income from that employment. Only the state of residence may tax this income.[5]
>
> In the case of a nonresident member of the armed forces stationed in California, California may not tax any of the income from military service performed in California.[6] Only the state of residence may tax this income.

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[1] U.S. Const., art. VI, section 2.
[2] It is noted the federal statutes considered deal with interstate commerce (see U.S. Const., art. I, section 8, cl. 3) and the military (see U.S. Const., art. I, section 8, cl. 11-13).
[3] 49 U.S.C. section 40116(f)(2)(B).
[4] 49 U.S.C. section 11502(a).
[5] 49 U.S.C. section 14503(a)(1).
[6] 50 U.S.C. Appen. Section 574.

**Current State Law**

The California Constitution provides that a California administrative agency may not fail to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation.[7]

The California Attorney General has stated, in another context, that, with respect to federal preemption of conflicting State statutes, Article III, section 3.5 of the California constitution must fail because of federal supremacy.[8]

The California Constitution also provides that a California court may not take any action to prevent or enjoin the collection of tax. Only after payment of tax may a court action be maintained to recover tax and interest paid.[9]

California taxes nonresidents only on income from California sources.[10] However, no California statute explicitly establishes rules to source income. Instead, the relevant California statute delegates to the Franchise Tax Board authority to prescribe sourcing rules by regulation.[11]

These regulations provide that services are sourced to California to the extent the services are performed in this State.[12] When nonresidents perform services in California and other states, compensation for these services is sourced to California by using various apportionment methods that reasonably reflect the value of the California services as compared to the total services performed. These regulations are interpreted by department staff to be consistent with federal statutes that limit or preempt California's ability to tax the California source income of nonresidents.[13]

With respect to a nonresident member of the armed forces stationed in California, the California Legislature confirmed by statute in 1986[14] that none of the income from military service performed in California is included in gross income even with respect to a resident spouse under community property law or rules.

In 1996, Section 114 of Title 4 of the United States Code was enacted to limit state income taxation on a source basis with respect to certain pension income. During that same year, California enacted a conforming provision[15] that, for 1996 and later years, specifically provides that gross income of a nonresident from sources within this state does not include "qualified retirement income." This conforming section applies only during the period that the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income, are effective.

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[7] Cal. Const., art. III, section 3.5.
[8] 68 Ops.Cal.Att.Gen. 209, 219-222 (1985).
[9] Cal. Const., art. XIII, sec. 32. Revenue and Taxation Code section 19381 provides for suit in Superior Court to determine residency without payment of tax.
[10] Revenue and Taxation Code section 17951.
[11] Revenue and Taxation Code section 17954.
[12] Cal. Code. Regs., tit. 18, section 17951-5.
[13] *Id*. Various apportionment methods are used.
[14] Revenue and Taxation Code section 17140.5.
[15] Revenue and Taxation Code section 17952.5.

## Problem

California law regarding the taxation of nonresidents on income from California sources could be interpreted to conflict with federal statutes that limit or preempt a state's authority to tax certain nonresidents, i.e., those employed in interstate commerce and members of the armed forces.

## Proposed Solution

The proposed solution is to amend the Revenue and Taxation Code to provide expressly that California is conformed to federal statutes that limit or preempt California's ability to tax the California source income of nonresidents. This proposal would prevent a possible interpretation of existing law that could require lengthy and expensive litigation to validate the preeminence of federal law.

## Effective/Operative Date of Solution

This proposal, if enacted in 2004, would become effective January 1, 2005, and would apply to taxable years beginning on or after that date.

## Justification

The proposed solution will ensure that the department is in full compliance with the requirements of the Federal and California Constitutions.

## 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

### Revenue Estimate

This proposal would not impact the state's income tax revenue. An examination of actual state tax returns did not show any claiming this exclusion. It is assumed that, in general, the pro-rata share of income of nonresident interstate commerce employees who travel into California and provide a service is below the filing threshold.

## Agency/Industry Pro & Con Arguments

Tax practitioners and their clients would most likely support this proposal as it would prevent unnecessary audits from being conducted by the department and the need for lengthy and expensive litigation of those actions by their clients were a conflicting interpretation under Section 3.5 of Article III of the California Constitution to be made.

**<u>Other States</u>**

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

None of these state's constitutions contain any provision comparable to the California Constitution's provision that a California administrative agency may <u>not</u> fail to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation. (Cal. Const., art. III, section 3.5.)

**LEGISLATIVE STAFF CONTACT**

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

Analyst John Pavalasky
Telephone # 845-4335
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS - LP 04-7

AMENDMENT 1

SEC. . Section 17951 of the Revenue and Taxation Code is amended to read:

17951. (a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, in the case of nonresident taxpayers the gross income includes only the gross income from sources within this state.

(b) Notwithstanding subdivision (a), the gross income of a nonresident taxpayer does not include income not subject to state taxation by operation of the following federal laws:

(1) Section 11108 of Title 46, United States Code, relating to compensation for the performance of duties of certain merchant seamen.

(2) Section 11502 of Title 49, United States Code, relating to compensation of an employee of a rail carrier.

(3) Section 14503 of Title 49, United States Code, relating to compensation of an employee of a motor carrier.

(4) Section 40116 of Title 49, United States Code, relating to the pay of an employee of an air carrier.

(5) Section 574 of Title 50 Appendix, United States Code, relating to compensation for military or naval service.

# LEGISLATIVE PROPOSAL 04-08
# EXECUTIVE SUMMARY

**Title:** Disclosure of Return and Return Information for Personnel Matters

- **Problem Statement:**

  State tax agencies and public entities that receive confidential taxpayer information from FTB are currently unable to disclose those records when necessary to prosecute disciplinary actions involving inappropriate browsing or disclosure.

- **Proposed Solution:**

  Amend Revenue &Taxation Code Section 19556 to authorize other state tax agencies and public entities to disclose confidential taxpayer information received from FTB in disciplinary actions.

- **Major Concerns/Issues:**

  This proposal expands the exceptions to the general rule that taxpayer information is confidential.

- **Revenue:**

  This proposal would not impact state income tax revenue.

**2004 Departmental Legislative Proposal**
**LP 04-08**

## Title

Disclosure of Return and Return Information for Personnel Matters

## Introduction

This proposal would allow any state agency or public entity that receives confidential taxpayer information from the Franchise Tax Board (FTB) to disclose that information as evidence in a personnel disciplinary action.

## Program History/Background

Under prior law, FTB faced a number of instances regarding personnel disciplinary actions where the interests of taxpayer privacy resulted in depriving a present or former department employee of due process rights or in limiting the ability of the department to prosecute those actions successfully. In some cases, the facts underlying the disciplinary action necessitate the disclosure of confidential taxpayer information.

State Personnel Board (SPB) case law requires that a Notice of Adverse Action served on an employee against whom a disciplinary action is taken under the Civil Service Act include copies of all documents relied upon by the department in taking the action. This step is required to satisfy the employee's due process rights. After the disciplinary action is served, the employee is given the opportunity to discuss the action with the appointing authority (state agency) in what is called a Skelly hearing. After a Skelly hearing, the employee may file an administrative appeal with SPB. Decisions of the SPB may be appealed to the Superior Court.

## Current Federal Law

Current federal law allows disclosure of tax return and return information for use in federal personnel matters. Upon written request, the Secretary of the Treasury (Secretary) is authorized to disclose confidential taxpayer information to an employee or former employee of the Department of the Treasury or his or her authorized legal representative solely for use in the preparation of or in a disciplinary action affecting the personnel rights of an employee. The Secretary is authorized to disclose the confidential taxpayer information to the extent the Secretary determines that such confidential taxpayer information is or may be relevant to the action. The Secretary also is authorized to disclose the confidential taxpayer information to officers and employees of the Department of the Treasury for use in those administrative actions. Federal law also authorizes the Department of Treasury to disclose the relevant confidential taxpayer information to other specified recipients, including the Department of Justice, for prosecution and other purposes.

## Current State Law

State law prohibits the disclosure or unauthorized inspection of any confidential taxpayer information, except as specifically authorized by statute. Any FTB employee responsible for the unauthorized disclosure or inspection of state or federal tax information is subject to criminal prosecution. Improper disclosure or inspection of state tax information is a misdemeanor and improper disclosure or inspection of federal tax information is a felony.

Under Revenue & Taxation Code (R&TC) Section 19556, the department has authority to disclose confidential taxpayer information to an employee or former employee of FTB, a representative of an employee or former employee, an administrative law judge, SPB members, and Superior Court judges for purposes of disciplinary actions.

## Problem

State tax agencies and public entities that receive confidential FTB taxpayer information are currently unable to disclose those records when necessary to prosecute disciplinary actions involving inappropriate browsing or disclosure.

## Proposed Solution

Amend R&TC Section 19556 to authorize other state tax agencies and public entities to disclose confidential FTB taxpayer information in disciplinary actions.

## Effective/Operative Date of Solution

If adopted in the 2004 legislative session, this proposal would be effective and operative January 1, 2005.

## Justification

This proposal would assist a state tax agency or public entity to prosecute disciplinary actions successfully by allowing the careful and sensible disclosure of confidential FTB taxpayer information while satisfying an employee's due process rights. This expansion of current law would help to ensure the privacy of taxpayer records by deterring employees from illegally browsing and disclosing confidential FTB taxpayer information.

## Implementation

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

## Fiscal Impact

No departmental costs are associated with this proposal.

## Economic Impact

This proposal would not impact state income tax revenue.

**Other Agency/Industry Impacted**

This proposal would initially impact the Board of Equalization and the Employment Development Department by allowing both departments to disclose confidential FTB taxpayer information in disciplinary actions against their employees as both agencies currently have access to the department's income tax databases. Any state tax agency or public entity granted access to confidential FTB taxpayer information in the future would also be allowed to disclose those records for purposes of disciplinary actions. For example, once the automated statewide system for child support is available, the Department of Child Support Services and its local child support agencies would have access to confidential FTB taxpayer information for the collection of child support.

**Other States**

Unlike California that has three distinct taxing agencies, other states have a single department of revenue that maintains all taxpayer information. While those departments of revenue may have the authority to share taxpayer information with other state agencies and local public entities, it is not clear if that information can be disclosed as evidence during personnel disciplinary matters.

**LEGISLATIVE STAFF CONTACT**

Darrine Distefano
Franchise Tax Board
845-6458
Darrine.Distefano2@ftb.ca.gov

Rachel Coco
Franchise Tax Board
845-4328
Rachel.Coco@ftb.ca.gov

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

| | |
|---|---|
| Analysts | Darrine Distefano |
| | Rachel Coco |
| Telephone # | 845-6458 |
| | 845-4328 |
| Attorney | Patrick Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 04-08

AMENDMENT 1

Section 19556 of the Revenue and Taxation Code is amended as follows:

19556. (a)(1) A state agency or a local public entity (~~The Franchise Tax Board~~ may disclose to persons described in paragraphs (1) to (4), inclusive, of subdivision (b) tax return and return information solely for use in an action or proceeding affecting the personnel rights of an employee or former employee of the state agency or local public entity, or in preparation of the action or proceeding, but only to the extent the state agency or local public entity ~~Franchise Tax Board~~ determines that the tax return or return information is, or may be, relevant and material to the action or proceeding.

(b) Tax return and return information may be disclosed pursuant to this section to any of the following persons:

(1) An employee or former employee of the state agency or local public entity ~~the Franchise Tax Board~~ who is, or may be, a party to an administrative action or proceeding affecting the personnel rights of that employee or former employee.

(2) Upon written request by the employee or former employee of the state agency or local public entity, to the employee's or former employee's duly authorized legal representative.

(3) Officers and employees of the state agency or local public entity ~~the Franchise Tax Board~~ for use in any action or proceeding affecting the rights of an employee or former employee of the state agency or local public entity, to the extent necessary to advance or protect the interests of the State of California.

(4) An administrative law judge, administrative board member, judge, or justice, or authorized officer or employee thereof, in connection with an administrative hearing, adjudication, or appeal thereof, related to an action or proceeding affecting the personnel rights of an employee or former employee of the state agency or local public entity.

(c) The disclosure by a state agency or local public entity, as authorized by this section, is limited to those state agencies and local public entities where officers, employees, agents, deputies, clerks, or other persons of the agency or entity have access to tax return or return information pursuant to some other provision of law. ~~For purposes of this section an action or proceeding affecting the personnel right of an employee or former employee of the Franchise Tax Board means an action proceeding arising under either of the following:~~

~~(1) The State Civil Service Act (Part 2 (commencing with Section 18500) of Division 5 of the Government Code).~~

~~(2) The Ralph C. Dills Act (Chapter 10.3 (commencing with Section 3512) of Division 4 of Title 1 of the Government Code).~~

(d) Any unauthorized disclosure by a person described in paragraphs (1) to (4), inclusive, of subdivision (b) of any tax return or return information disclosed to that person pursuant to this section shall be subject to criminal penalty and civil liability under this part for that unauthorized disclosure.

(e)(1) For purposes of this section, "state agency" has the same meaning as under Government Code section 11000, et. seq.

(2) For purposes of this section, “local public entity” includes a county, city, district, public authority, public agency, and any other political subdivision or public corporation in the State.

# LEGISLATIVE PROPOSAL 04-10
# EXECUTIVE SUMMARY

**Title:** Extend Voluntary Disclosure Program to Limited Liability Companies

- **Problem Statement:** This proposal addresses two problems:

  1. FTB staff must decline offers to enter the voluntary disclosure program from LLCs taxed as partnerships or where the entity is disregarded for tax purposes causing the state to forgo tax revenue from non-filers.

  2. The voluntary disclosure statutes contain definitions and terminology that are inconsistent within the Revenue and Taxation Code (RTC), which can confuse taxpayers and department staff.

- **Proposed Solution:**

  1. Amend the RTC Sections 19191 and 19192 to extend the voluntary disclosure program to LLCs and their corporate and nonresident individual members.

  2. Amend RTC Sections 19191, 19192, and 19194 to make minor and technical changes to reduce taxpayer and department staff confusion.

- **Major Concerns/Issues:**

  This proposal would reduce the "tax gap" by obtaining compliance and collecting taxes from those that currently have a California tax liability but otherwise would not file and pay.

- **Revenue:**

  This proposal potentially would generate minor revenue gains annually, probably not exceeding $500,000 in any given year.

**2004 Departmental Legislative Proposal**
**LP 04-10**

## Title

Extend Voluntary Disclosure Program to Limited Liability Companies

## Introduction

This proposal would:

1. Encourage limited liability companies (LLCs) and their owners to comply voluntarily with California income tax laws.
2. Make minor and technical changes to clarify the voluntary disclosure statute.

## Background

Nexus is a constitutional prerequisite that must be satisfied before any state can exercise its power to tax. Nexus is generally defined as a level of presence or activity within the state that creates a legally sufficient connection between the state and the business or individual so that it is constitutionally permissible for the state to impose a tax.

Certain out-of-state businesses may not be aware of their California franchise or income tax liability or filing requirements, and the Franchise Tax Board (FTB) may not readily identify them through its filing enforcement or other compliance programs. These businesses' franchise or income tax liability may be "discovered" by FTB only after years of presence or activity in California or not at all, if their presence or activities occurred only for a few years. Because of the substantial penalties that apply to the delinquent filing of returns and payment of taxes and the potential for audit by FTB for all years preceding "discovery," these taxpayers may be reluctant to come forward and voluntarily disclose their California presence or activities and report any tax liability.

AB 2880 (Caldera, Stats. 1994, Ch. 367), a Franchise Tax Board sponsored bill, established a California Voluntary Disclosure Program for certain out-of-state banks and corporations.

In addition to corporations, AB 2880, as introduced, applied to limited partnerships, certain trusts, and certain partners and beneficiaries. During the legislative process, however, because concern was expressed that waiver of penalties for flow-through entities and their partners/beneficiaries might be viewed as amnesty for a small group of individuals, these entities were eliminated from the bill. S corporations, which are also pass-through entities, were included in the bill as corporate entities, but the status of their shareholders was not addressed.

SB 38 (Lockyer, Stats. 1996, Ch. 954) added S corporation shareholders to California's voluntary disclosure program. To limit the concern that applying the waiver authority to S corporation shareholders could be viewed as amnesty for these individuals, participation in the California voluntary disclosure program was limited to those S corporation shareholders who were nonresidents on the day that the agreement was signed.

SB 1185 (Senate Revenue & Taxation Committee, Stats. 2001, Ch. 543), a Franchise Tax Board sponsored bill, added trusts and nonresident beneficiaries to California's voluntary disclosure program.

## **Current Federal/State Law**

### Voluntary Disclosure

Federal tax law does not contain the same nexus complexities as state law, thus federal law does not provide a voluntary disclosure program.

Under state law, FTB is authorized to enter into voluntary disclosure agreements with:

- qualifying business entities,
- qualified shareholders,
- qualified trusts, and
- qualified beneficiaries.

A “qualifying business entity” includes any out-of-state or nonexempt corporation that has never filed a California income tax return and that voluntarily applies to the program prior to any contact from FTB regarding income or franchise tax liability.

A “qualified shareholder” is a nonresident shareholder of an S corporation that has applied for a voluntary disclosure agreement and disclosed all material facts pertaining to the shareholder’s liability.

A “qualified trust” is a trust that has never been administered in California and that has had no resident beneficiaries in California for six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement. However, “qualified trust” would include a trust with a resident beneficiary whose interest in the trust is contingent and who has never received a distribution from the trust.

A “qualified beneficiary” is an individual who is a beneficiary of a qualified trust and is a nonresident on the signing date of the voluntary disclosure agreement and for each of the preceding six taxable years.

Under the terms of the voluntary disclosure agreement, FTB waives penalties for noncompliance with specified reporting and payment requirements for the six taxable years immediately preceding FTB’s signing of the agreement. For taxable years ending more than six years prior to the agreement, the business’s income or franchise taxes, additions to tax, fees, or penalties also are waived. The three-member Franchise Tax Board must approve all voluntary disclosure agreements.

### Limited Liability Companies

Current state law authorizes the creation of a business entity known as an LLC. An LLC consists of one or more members that may be individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, other LLCs, or other business entities. The members of an LLC are afforded limited liability similar to shareholders of a corporation but have pass-through treatment for taxes comparable to the tax treatment of a partnership.

Under federal and state tax law, an LLC may elect to be treated as a corporation or a partnership. An LLC with a single member may be treated as a corporation or disregarded for income tax purposes.

When an entity is “disregarded,” its activities are deemed to be the activities of the owner (e.g., a sole proprietorship or a division of a parent company).

Existing state law requires an LLC not classified as a corporation for tax purposes to pay both an annual tax and an annual fee. The annual tax is an amount equal to the minimum franchise tax and is paid annually until the effective date of cancellation or, if later, the date the LLC ceases to do business within the state. The annual fee is based on the LLC’s total income from all sources reportable to this state for the taxable year.

An LLC classified as a corporation is eligible to participate in the voluntary disclosure program. However, an LLC taxed as either a partnership or an entity disregarded for tax purposes is not allowed to participate even though the LLC pays an entity level tax and fee.

**Problem**

This proposal addresses two problems:

1. FTB staff must decline offers to enter the voluntary disclosure program from LLCs taxed as partnerships or where the entity is disregarded for tax purposes causing the state to forgo tax revenue from non-filers.

2. The voluntary disclosure statutes contain definitions and terminology that are inconsistent within the Revenue and Taxation Code (RTC), which can confuse taxpayers and department staff.

**Proposed Solution**

1. Amend RTC Sections 19191 and 19192 to extend the voluntary disclosure program to LLCs and their corporate and nonresident individual members. This would be accomplished by:

    - Expanding the definition of qualified entity eligible to participate in the voluntary disclosure program to include an LLC as defined in RTC Section 17941.
    - Adding a definition for “qualified member” consistent with the types of entities eligible to participate in the voluntary disclosure program and with the definition of a “qualified shareholder.”
    - Clarifying that “fees,” as well as tax and interest must be paid. This change is necessary since LLCs pay “fees” in addition to “taxes.”

2. Amend RTC Sections 19191, 19192, and 19194 to make the following minor and technical changes:

    - Clarify that qualified entities subject to the franchise tax must pay at least the minimum franchise tax for each of the six taxable years.
    - Clarify that a “contingent beneficiary” is a beneficiary that has not received *any* distribution from the trust within the six taxable years preceding the signing date of the voluntary disclosure agreement.
    - Change the term “qualified business entity” to “qualified entity” for consistency in the voluntary disclosure provisions.
    - Change the term “reliance” to “reasonable reliance” for consistency within the RTC.

## Effective/Operative Date of Solution

This proposal includes language that would make it applicable to voluntary disclosure agreements entered into on or after January 1, 2005.

## Justification

This proposal would encourage multi-jurisdictional LLCs and their owners to comply with the California tax law thereby advancing the objectives of California's voluntary compliance program. This proposal also would clarify the voluntary disclosure statutes to reduce confusion for taxpayers and department staff.

## Implementation

This proposal would be implemented within FTB's existing voluntary disclosure program and would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

## Fiscal Impact

### Departmental Costs

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

### Tax Revenue Estimate

This proposal potentially could generate minor revenue gains annually, probably not exceeding $500,000 in any given year. The number of multi-jurisdictional LLCs (that elect to be treated as partnerships or are disregarded) and nonresident members that voluntarily enter into a disclosure agreement and the amount of taxes paid by these entities and members would determine the revenue impact of this proposal.

Although department staff has received inquiries from representatives of multi-jurisdictional LLCs about entering the tax system, the department is presently compelled to decline these offers because of statutory restrictions. The volume of voluntary disclosure agreements for LLCs and the amount of tax revenue generated is expected to be less than that of corporations under the current program. Under the current program, it is estimated that about 20 applications are received each year from corporations resulting in revenue collections of approximately $2 million annually.

## Policy Considerations

This proposal would reduce the "tax gap" by obtaining compliance and collecting taxes from those that currently have a California tax liability but otherwise would not file and pay.

**<u>Other States</u>**

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* laws found that each state other than *Massachusetts* and *New York* has a voluntary disclosure program. *Michigan's* program specifically includes LLCs. The laws of these states were reviewed because of similarities to California's economy, business entity types, and tax laws.

The Multistate Tax Commission has a National Nexus Program that allows businesses to resolve potential state sales and use or income and franchise tax liabilities voluntarily. The program acts as a coordinator for businesses to approach the 40 participating states anonymously to seek resolution. California participates in this program.

**LEGISLATIVE STAFF CONTACT**

| | |
|---|---|
| Marion Mann DeJong | Brian Putler |
| Franchise Tax Board | Franchise Tax Board |
| 845-6979 | 845-6333 |
| marion.dejong@ftb.ca.gov | brian.putler@ftb.ca.gov |

Analyst Marion Mann DeJong
Telephone # 845-6979
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 04-10

AMENDMENT 1

SECTION 1. Section 19191 of the Revenue and Taxation Code is amended to read:

19191. (a) The Franchise Tax Board may enter into a voluntary disclosure agreement with any qualified entity, qualified shareholder, qualified member, or qualified beneficiary as defined in Section 19192, that is binding on both the Franchise Tax Board and the qualified entity, qualified shareholder, qualified member, or qualified beneficiary.

(b) The Franchise Tax Board shall do all of the following:

(1) Provide guidelines and establish procedures for qualified entities and their qualified shareholders, qualified members, or qualified beneficiaries to apply for voluntary disclosure agreements.

(2) Accept applications on an anonymous basis from qualified entities and their qualified shareholders, qualified members, or qualified beneficiaries for voluntary disclosure agreements.

(3) Implement procedures for accepting applications for voluntary disclosure agreements through the National Nexus Program administered by the Multistate Tax Commission.

(4) For purposes of considering offers from qualified entities and their qualified shareholders, qualified members, or qualified beneficiaries to enter into voluntary disclosure agreements, take into account the following criteria:

(A) The nature and magnitude of the qualified entity's previous presence and activity in this state and the facts and circumstances by which the nexus of the qualified entity was established.

(B) The extent to which the weight of the factual circumstances demonstrates that a prudent business person exercising reasonable care would conclude that the previous activities and presence in this state were or were not immune from taxation by this state by reason of Public Law 86-272 or otherwise.

(C) ~~Reliance~~ Reasonable reliance on the advice of a person in a fiduciary position or other competent advice that the qualified entity's activities were immune from taxation by this state.

(D) Lack of evidence of willful disregard or neglect of the tax laws of this state on the part of the qualified entity.

(E) Demonstrations of good faith on the part of the qualified entity.

(F) Benefits that will accrue to the state by entering into a voluntary disclosure agreement.

(5) Act on any application of a voluntary disclosure agreement within 120 days of receipt.

(6) Enter into voluntary disclosure agreements with qualified entities, qualified shareholders, qualified members, or qualified beneficiaries, as authorized in subdivision (a) and based on the criteria set forth in paragraph (4).

(c) Before any voluntary disclosure agreement becomes binding, the Franchise Tax Board, itself, shall approve the agreement in the following manner:

(1) The Executive Officer and Chief Counsel of the Franchise Tax Board shall recommend and submit the voluntary disclosure agreement to the Franchise Tax Board for approval.

(2) Each voluntary disclosure agreement recommendation shall be submitted in a manner as to maintain the anonymity of the taxpayer applying for the voluntary disclosure agreement.

(3) Any recommendation for approval of a voluntary disclosure agreement shall be approved or disapproved by the Franchise Tax Board, itself, within 45 days of the submission of that recommendation to the board.

(4) Any recommendation of a voluntary disclosure agreement that is not either approved or disapproved by the board within 45 days of the submission of that recommendation shall be deemed approved.

(5) Disapproval of a recommendation of a voluntary disclosure agreement shall be made only by a majority vote of the Franchise Tax Board.

(6) The members of the Franchise Tax Board shall not participate in any voluntary disclosure agreement except as provided in this subdivision.

(d) The voluntary disclosure agreement entered into by the Franchise Tax Board and the qualified entity, qualified shareholder, qualified member, or qualified beneficiary as provided for in subdivision (a) shall to the extent applicable specify that:

(1) The Franchise Tax Board shall with respect to a qualified entity, qualified shareholder, qualified member, or qualified beneficiary, except as provided in ~~paragraph (4) or (7)~~ paragraphs (4), (6), or (9) of subdivision (a) of Section 19192:

(A) Waive its authority under this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001) to assess or propose to assess taxes, additions to tax, fees, or penalties with respect to each taxable year ending prior to six years from the signing date of the voluntary disclosure agreement.

(B) With respect to each of the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement, based on its discretion, agree to waive any or all of the following:

(i) Any penalty related to a failure to make and file a return, as provided in Section 19131.

(ii) Any penalty related to a failure to pay any amount due by the date prescribed for payment, as provided in Section 19132.

(iii) Any addition to tax related to an underpayment of estimated tax, as provided in Section 19136.

(iv) Any penalty related to Section 6810 or subdivision (a) of Section 8810 of the Corporations Code, as provided in Section 19141.

(v) Any penalty related to a failure to furnish information or maintain records, as provided in Section 19141.5.

(vi) Any addition to tax related to an underpayment of tax imposed under Part 11 (commencing with Section 23001), as provided in Section 19142.

(vii) Any penalty related to a partnership required to file a return under Section 18633, as provided in Section 19172.

(viii) Any penalty related to a failure to file information returns, as provided in Section 19183.

(ix) Any penalty related to relief from contract voidability, as provided in Section 23305.1.

(2) The qualified entity, qualified shareholder, qualified member, or qualified beneficiary shall:

(A) With respect to each of the six taxable years ending immediately preceding the signing date of the written agreement:

(i) Voluntarily and fully disclose on the qualified entity's application all material facts pertinent to the qualified entity's, shareholder's, member's, or beneficiary's liability for any taxes imposed under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001).

(ii) Except as provided in paragraph (3), within 30 days from the signing date of the voluntary disclosure agreement:

(I) File all returns required under this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001).

(II) Pay in full any tax, interest, fee, and penalties (other than those penalties specifically waived by the Franchise Tax Board under the terms of the voluntary disclosure agreement) imposed under this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001) in a manner as may be prescribed by the Franchise Tax Board. Paragraph (1) of subdivision (f) of Section 23153 shall not apply to qualified entities admitted into the voluntary disclosure program.

(B) Agree to comply with all franchise and income tax laws of this state in subsequent taxable years by filing all returns required and paying all amounts due under this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001).

(3) The Franchise Tax Board may extend the time for filing returns and paying amounts due to 120 days from the signing date of the voluntary disclosure agreement.

(e) The amendments to this section made by Chapter 954 of the Statutes of 1996 shall apply to taxable years beginning on or after January 1, 1997.

(f) The amendments to this section made by ~~the act adding this subdivision~~ Chapter 543 of the Statutes of 2001 shall apply to voluntary disclosure agreements entered into on or after January 1, 2002.

(g) The amendments to this section made by the act adding this subdivision shall apply to voluntary disclosure agreements entered into on or after January 1, 2005.

SEC. 2. Section 19192 of the Revenue and Taxation Code is amended to read:

19192. For purposes of this article:

(a)(1) "Qualified entity" means an entity that is all of the following:

(A) A corporation, as defined in Section 23038, a limited liability company, as defined in subdivision (d) of Section 17941, or a qualified trust, as defined in paragraph ~~(5)~~ (7).

(B) An entity, including any predecessors to the entity, that previously has never filed a return with the Franchise Tax Board pursuant to this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23011).

(C) An entity, including any predecessors to the entity, that previously has not been the subject of an inquiry by the Franchise Tax Board with respect to liability for any of the taxes imposed under Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001).

(D) An entity that voluntarily comes forward prior to any unilateral contact from the Franchise Tax Board, makes application for a voluntary disclosure agreement in a form and manner prescribed by the Franchise Tax Board, and makes a full and accurate statement of its activities in this state for the six immediately preceding taxable years.

(2)(A) Notwithstanding paragraph (1), a qualified entity does not include any of the following:

(i) ~~A corporation~~ An entity that is organized ~~and existing~~ under the laws of this state.

(ii) ~~A corporation~~ An entity that is qualified or registered with the office of the Secretary of State.

(iii) An entity that maintains and staffs a permanent facility in this state.

(B) For purposes of this paragraph, the storing of materials, goods, or products in a public warehouse pursuant to a public warehouse contract does not constitute maintaining a permanent facility in this state.

(3) "Qualified shareholder" means an individual that is all of the following:

(A) A nonresident on the signing date of the voluntary disclosure agreement.

(B) A shareholder of an S corporation (defined in Section 23800) that has applied for a voluntary disclosure agreement under this article under which all material facts pertinent to the shareholder's liability would be disclosed on that S corporation's voluntary disclosure agreement as required under clause (i) of subparagraph (A) of paragraph (2) of subdivision (d) of Section 19191.

(4) Notwithstanding paragraph (3), subparagraph (B) of paragraph (1) of subdivision (d) of Section 19191 shall not apply to any of the six taxable years immediately preceding the signing date that the qualified shareholder was a California resident required to file a California tax return, nor to any penalties or additions to tax attributable to income other than the California source income from the S corporation that filed an application under this article.

(5) “Qualified member” means an individual, corporation, or limited liability company that is all of the following:

(A)(i) In the case of an individual, is a nonresident on the signing date of the voluntary disclosure agreement.

(ii) In the case of a corporation or limited liability company, is not either of the following:

(I) Organized under the laws of this state.

(II) Qualified or registered with the office of the Secretary of State.

(B) A member of a limited liability company that has applied for a voluntary disclosure agreement under this article under which all material facts pertinent to the member’s liability would be disclosed on that limited liability company’s voluntary disclosure agreement as required under clause (i) of subparagraph (A) of paragraph (2) of subdivision (d) of Section 19191.

(6) Notwithstanding paragraph (5), in the case of a qualified member who is an individual, subparagraph (B) of paragraph (1) of subdivision (d) of Section 19191 shall not apply to any of the six taxable years immediately preceding the signing date that the qualified member was a California resident required to file a California tax return, nor to any penalties or additions to tax attributable to income other than the California source income from the limited liability company that filed an application under this article.

(7) "Qualified trust" means a trust that meets both of the following:

(A)(i) The administration of the trust has never been performed in California.

(ii) For purposes of this subparagraph, administrative activities performed in California would be deemed to be performed outside of California if those activities were inconsequential to the overall administration of the trust.

(B) For six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement, the trust has had no resident beneficiaries (other than a beneficiary whose interest in that trust is contingent. A beneficiary's trust interest is not contingent if the trust has made any distribution to the resident beneficiary at any time during the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement).

~~(6)~~ (8) "Qualified beneficiary" means an individual who is all of the following:

(A) A nonresident on the signing date of the voluntary disclosure agreement and a nonresident during each of the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement.

(B) A beneficiary of a qualified trust that has applied for a voluntary disclosure agreement under this article under which all material facts pertinent to the beneficiary's liability would be disclosed on that trust's voluntary disclosure agreement as required under clause (i) of subparagraph (A) of paragraph (2) of subdivision (d) of Section 19191.

~~(7)~~ (9) Notwithstanding paragraph ~~(6)~~ (8), subparagraph (B) of paragraph (1) of subdivision (d) of Section 19191 shall not apply to any penalties or additions to tax attributable to income other than income from the trust that filed an application under this article.

(b) "Signing date" of the voluntary disclosure agreement means the date on which a person duly authorized by the Franchise Tax Board signs the agreement.

(c) The amendments to this section made by Chapter 954 of the Statutes of 1996 shall apply to taxable years beginning on or after January 1, 1997.

(d) The amendments to this section made by ~~the act adding this subdivision~~ Chapter 543 of the Statutes of 2001 shall apply to voluntary disclosure agreements entered into on or after January 1, 2002.

(e) The amendments to this section made by the act adding this subdivision shall apply to voluntary disclosure agreements entered into on or after January 1, 2005.

SEC. 3. Section 19194 of the Revenue and Taxation Code is amended to read:

19194. (a) Notwithstanding any other provision of this article, a voluntary disclosure agreement shall be null and void in the event that the Franchise Tax Board finds that with respect to the agreement any of the following circumstances exist:

(1) The qualified ~~business~~ entity has misrepresented any material fact in applying for the voluntary disclosure agreement or in entering into the agreement.

(2) The qualified ~~business~~ entity fails to file any returns for any taxable year covered by the voluntary disclosure period agreed upon on or before the due date prescribed under the terms of the agreement in accordance with paragraph (2) of subdivision (d) of Section 19191.

(3)(A) The qualified ~~business~~ entity fails to pay in full any tax, fee, penalty, or interest due within the time prescribed under the terms of the voluntary disclosure agreement in accordance with paragraph (2) of subdivision (d) of Section 19191 or to pay any installments thereof due within the time prescribed under the terms of an installment payment arrangement in accordance with subparagraph (B).

(B) The Franchise Tax Board may enter into an installment payment arrangement, which shall include provisions for interest, in lieu of the full payment required under paragraph (2) of subdivision (d) of Section 19191. Failure by the qualified ~~business~~ entity to comply with the terms of the installment payment arrangement shall also render the voluntary disclosure arrangement null and void.

(4) The tax shown by the qualified ~~business~~ entity on its tax return filed for any taxable year covered by the voluntary disclosure agreement, including any amount shown on a qualified amended return, as defined in Section 1.6664-2(c)(3) of Title 26 of the Code of Federal Regulations, understates by 10 percent or more the tax imposed under either Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) and the qualified ~~business~~ entity cannot demonstrate to the satisfaction of the Franchise Tax Board that a good-faith effort was made to accurately compute the tax.

(5) The qualified ~~taxpayer~~ entity fails to begin to prospectively comply with all franchise and income tax laws of this state as agreed upon under the terms of the voluntary disclosure agreement in accordance with paragraph (2) of subdivision (d) of Section 19191.

(b) In the event that the Franchise Tax Board finds that the qualified ~~business~~ entity has failed to comply under any of the circumstances which render the voluntary disclosure agreement null and void as set forth in subdivision (a), the limitation on assessment for any taxable years and the waiver of any penalties as provided for in paragraph (1) of subdivision (d) of Section 19191 shall not be binding on the Franchise Tax Board.

# LEGISLATIVE PROPOSAL 04-12
# EXECUTIVE SUMMARY

**Title:** Coordination of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

- **Background:**

This proposal is basically the same as LP 03-22. The three-member board instructed staff to work with industry to develop a mutually acceptable solution to the whole range of water's-edge, controlled foreign corporation (CFC), and Subpart F subjects. Staff has met with industry representatives. Industry representatives did not express concerns with this proposal, but clearly prefer for staff to develop a broader proposal. Staff believes a comprehensive proposal can be developed after final resolution of pending litigation regarding the dividends received deduction (*Farmer Bros.*). Staff believes this proposal should move forward without regard to *Farmer* Bros in order to close what staff considers a loophole.

- **Problem Statement:**

1. Due to an inconsistency in the statute, taxpayers have argued that a CFC that is a California taxpayer is included in the water's-edge combined report only to the extent of its U.S.-source income. Thus, the CFC's Subpart F income is excluded from a water's-edge combined report.
2. Unlike federal law, the water's-edge statute does not coordinate the U.S.-source income and Subpart F rules for an item of income that qualifies under both rules. Taxpayers have argued that the lack of coordination between the rules allows the Subpart F income to escape taxation.

- **Proposed Solution:**

Modify the law to specify that a CFC that is a California taxpayer or has income from a U.S. source cannot exclude its Subpart F income from a water's-edge combined report. Also, coordinate the U.S.-source income and the Subpart F income rules to operate simultaneously. Thus, like federal law, 100% of the corporation's income that is U.S.-source and 100% of its Subpart F income would be considered in the combined report for California tax purposes. The rules would apply regardless of whether the entity is a California taxpayer. Allow FTB prescribe regulations to prevent the double counting of such income.

- **Major Concerns/Issues:**

Opponents will argue this is a tax increase because they have been allowed to either qualify as a foreign-affiliate or create sufficient nexus for that affiliate to cause their CFCs to become California taxpayers and thereby exclude Subpart F income. Alternatively, opponents may argue that the mere presence of U.S.-source income would prevent the application of the Subpart F rules.

- **Revenue:**

If this proposal simply clarifies the application of the law, as staff believes, there would be no revenue impact. If taxpayers are successful in arguing that Subpart F income should not be taxed, the total revenue at risk is uncertain, perhaps up to $50 million annually.

**2004 Departmental Legislative Proposal**
**LP 04-12**

## Title

Coordination of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

## Introduction

This proposal would modify the statutes regarding Subpart F and U.S.-source income to:

- specify that a controlled foreign corporation (CFC) that is a California taxpayer or that has income from a U.S. source cannot exclude its Subpart F income from a water's-edge combined report;
- coordinate existing laws so that the U.S.-source income rules and the Subpart F income rules would operate simultaneously and apply consistently to corporations regardless of whether they are California taxpayers; and
- permit the Franchise Tax Board (FTB) to issue regulations to resolve problems relating to potential double taxation of U.S.-source and Subpart F income.

## Background

AB 1469 (Ortiz, 1997/1998) contained proposed amendments to existing water's-edge provisions to address the first problem described, below, in this proposal. Governor Wilson vetoed AB 1469 because of that provision. In his veto message, Governor Wilson stated that the water's-edge provision was added to the bill late in the legislative session with little or no policy debate, it could have a negative effect on the California business community, and it had the potential to result in a tax increase.

Analyses of AB 1469 by Capitol staff described the bill as addressing an unintended "loophole" in existing law. Department staff assigned no revenue gain to AB 1469 since, at the time, no taxpayer had been identified utilizing the interpretation of law that the bill would have precluded. Opponents of AB 1469 asserted that the bill would change an agreed-upon compromise made when the water's-edge election was adopted and that the bill would result in a tax increase.

Last year department staff developed a legislative proposal, LP 03-22, which was almost identical to this proposal. At its November 26, 2002, hearing, the Franchise Tax Board took no action on LP 03-22. Controller Connell suggested that the department work with industry to develop a mutually acceptable solution to the whole range of water's-edge, CFC (LP 03-23), and Subpart F subjects.

Department staff held a meeting with industry representatives in October 2003. Industry representatives did not express concerns with the substance of LP 03-22, but stated a preference for staff to develop a broader proposal, namely changing the conceptual approach from California's method of taxing a CFC to one conforming to federal law that would treat Subpart F income as a deemed divided distribution. They also recommended that such an approach include a revenue neutral dividends received deduction.

Department staff agrees that a change in the conceptual approach to the federal method of treating Subpart F income as a deemed dividend with a revenue neutral dividends received deduction is appropriate. However, because of the uncertainty relating to the dividends received deduction created by the *Farmer Bros* litigation (108 Cal App 4th 976) and the fact that a Petition for Certiorari will be filed with the United States Supreme Court; staff believes that such a proposal should be deferred until final resolution of that litigation. Once the issue of the dividends received deduction is resolved, department staff will work with industry on a proposal to change the conceptual approach of taxing CFCs.

Staff believes that this proposal (LP 04-12) is necessary because there is indication that taxpayers are beginning to use the inconsistency within the statute to avoid including CFCs with Subpart F income in the water's-edge combined report. Further, even if the conceptual approach of taxing CFCs were changed, it would occur over a period of up to seven years to allow a taxpayer currently filing on a water's-edge basis to file under existing rules until the term of the contract expires. Thus, the issue in this proposal would still need resolution during that seven-year period.

**Current Federal Law**

To understand this proposal it is necessary to understand the general federal rules for taxing corporations. Under current federal law, a corporation organized in the U.S. is taxed on all its income, regardless of source, and is allowed a credit for any taxes paid to a foreign country on its foreign source income.

A foreign corporation engaged in a U.S. trade or business is taxed applying U.S. graduated corporate income tax rates on the net income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income (ECI). In addition, a foreign corporation is generally taxed at a flat 30% rate on specified types of fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources. The income of a foreign corporation can be composed of either U.S.-source income or foreign-source income or both.

A U.S. corporation can operate in foreign countries itself, through branches, or through foreign subsidiaries. These foreign subsidiaries are known as CFC's. A CFC's income would normally not be taxed by the U.S. until it flows back to the U.S. parent corporation through dividends. In the 1960's it was determined by Congress that CFC's were being used to shield certain income, called "tax haven income," from U.S. taxation. As a result, Subpart F was added to the Internal Revenue Code. Under Subpart F, certain income is treated as being paid to the U.S. shareholders as a deemed dividend immediately upon being earned, which allows the U.S. to immediately tax the income when the CFC earns it and prevents deferral of tax.

A foreign corporation that is a CFC can be engaged in a U.S. trade or business or hold securities issued by a U.S. corporation. In such circumstances, a foreign corporation has both U.S.-source income and Subpart F income. In addition, some items of income (e.g., interest from U.S. Treasury Bonds) can qualify both as U.S.-source and Subpart F income. To the extent that a foreign corporation has an item of income that is both U.S.-source and Subpart F income, the income generally will be subject to both the U.S.-source rules and the Subpart F income rules.

It is important to note that effectively, 100% of a foreign corporation's income that meets the definitions of either U.S.-source income or Subpart F income is taxed. This is accomplished because the federal statutes coordinate the U.S.-source and Subpart F income rules so that both sets of rules operate simultaneously and apply to a single corporation. However, the same item of income is taxed only once.

**Current State Law**

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Generally, under water's-edge an entity incorporated in the U.S. is included in the combined report while a foreign entity is excluded. The law also provides specific rules about whether certain types of entities are included in or excluded from the water's-edge combined report, including the following two rules.

1. Any affiliated corporation that is a CFC for federal tax purposes is partially included in the water's-edge combined report. In general, the income and apportionment factors of the CFC are included based on the ratio of the CFC's Subpart F income for federal purposes for the current year to the CFC's earnings and profits (E&P) for the current year. The ratio can be 0% or higher. However, it cannot exceed 100%.
2. Foreign corporations with less than 20% of their activities in the U.S. and foreign banks are included in the water's-edge combined report, but only to the extent of their U.S.-source income.

This proposal deals with two problems in current state law regarding the taxation of CFCs. First, there is a possible inconsistency in the statute that could be interpreted to exclude certain CFCs from the water's-edge group. (See Appendix I.).

Generally, CFCs are not California taxpayers. However, a water's-edge group could cause its CFC to become a California taxpayer by either qualifying with the Secretary of State or establishing minimal ties in California sufficient to create nexus and a minimum tax liability. While department staff interprets the statute to require any CFC to be partially included in the water's-edge combined report under rule No. 1[1], some taxpayers argue that if a CFC is a California taxpayer, the income is limited to its U.S.-source income under rule No. 2. Thus, some taxpayers argue that such a CFC should pay only the $800 minimum franchise tax and consequently exclude Subpart F income from the water's-edge combined report.

In addition, some taxpayers argue that even a small amount of U.S.-source income (e.g. stock or a debt instrument of a U.S. corporation) causes its included income in the combined report to be limited under rule No. 2 "to the extent of" its U.S.-source income and apportionment factors.

Second, current law does not specify whether the U.S.-source income rules (rule No. 2) or the Subpart F income rules (rule No.1) are applied to income of a CFC that qualifies as both U.S.-source income and Subpart F income (e.g. interest income). However, California Code of Regulations Section 25110(d)(2)(H) provides that the U.S.-source income rules apply when both rules could apply. If the same income item were both Subpart F income and U.S.-source income, the regulation would treat that *item* of income as U.S.-source income rather than Subpart F income.

Since the U.S.-source and Subpart F rules are not coordinated as they are under federal law, some taxpayers have argued that California law and the regulation provide that if a CFC has an item of U.S.-source income and a separate item of Subpart F income, that the U.S.-source income causes the Subpart F rules to no longer apply and the Subpart F income escapes taxation.

For example, assume a CFC had total net income of $4 million. Of the $4 million, $200,000 is U.S.-source income and $3 million is Subpart F income. Assume that the $200,000 U.S.-source income also qualifies as Subpart F income. Taxpayers have argued that the Subpart F income rules would not apply and only the $200,000 U.S.-source income would be included in the water's-edge combined report. Department staff has interpreted the law and regulation to work to prevent double taxation of

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1 It is department staff's opinion that the provisions of Section 25110(a)(6), which include "any" affiliated CFC, is broad enough to require inclusion of all CFCs in the combined report, regardless of whether they are California taxpayers. Further, the rules of statutory construction would favor the inclusion of CFCs because presumably the legislature would not create a law including CFCs in the water's-edge group that could be avoided simply by becoming a California taxpayer or generating a minimal amount of U.S. source income.

the income so that $2,800,000 ($3 million Subpart F income less the amount included under the U.S.-source income rules) would be included under the Subpart F rules and $200,000 would be included under the U.S.-source rules.

## Problem

This proposal addresses two problems:

1. Because of an inconsistency in the statute, taxpayers have argued that a CFC that is a California taxpayer is included in the water's-edge combined report only to the extent of its U.S.-source income. Thus, the CFC's Subpart F income is excluded from a water's-edge combined report.

2. Unlike federal law, the water's-edge statute does not coordinate the U.S.-source income and Subpart F rules for an item of income that qualifies under both rules. Taxpayers have argued that the lack of coordination between the rules allows the Subpart F income to escape taxation.

## Proposed Solution

1. Amend RTC Section 25110 to specify that a CFC that is a California taxpayer or has income from a U.S. source cannot exclude its Subpart F income from a water's-edge combined report. Although some taxpayers may disagree, department staff believes this is a clarification of existing law.

2. Coordinate the U.S.-source income and the Subpart F income rules to operate simultaneously. Thus, like federal law, 100% of the corporation's income that is U.S.-source and 100% of its Subpart F income would be considered in the combined report for California tax purposes. The rules would apply regardless of whether the entity is a California taxpayer. In addition, add a requirement that FTB prescribe regulations to prevent the double counting of income and factors when a corporation has both U.S.-source and Subpart F income.

## Effective/Operative Date of Solution

This proposal specifies that it would apply to taxable years beginning on or after January 1, 2004.

The proposal also contains uncodified language expressing that "no inference" should be drawn between the modifications made by this proposal and the law for taxable years beginning before January 1, 2004. This language is intended to allow both taxpayers and the department to litigate their respective positions without prejudice from this proposal.

**Justification**

This proposal would eliminate taxpayer confusion and eliminate unintended opportunities for tax avoidance.

In 1986, when defining the water's-edge group, the federal working group, which included legislative, government, and corporate participants, agreed that an effort should be made to (1) maintain a water's-edge group that was at least congruent with the federal consolidated return, and (2) include those activities and income which were generally recognized as tax-advantaged devices. An underlying principle was that to the extent possible, states should conform to the federal international taxation rules. This was generally to ensure that if the income of an entity was required to be taxed for federal purposes, the income and factors of that entity should also be included in the state return. In addition, conformity with federal law reduces the taxpayer's compliance burden. There is little rationale to justify circumventing the law requiring partial inclusion of a CFC merely because that CFC also has U.S. source income or is a California taxpayer.

**Implementation**

The proposal could be implemented in the department's annual program updates.

**Fiscal Impact**

No departmental costs are associated with this proposal.

**Economic Impact**

Tax Revenue Estimate

If this proposal simply clarifies existing law, there would be no revenue impact. However, taxpayers assert that under their interpretation of existing law, they have been allowed since 1988 to create sufficient nexus to cause their CFCs to become California taxpayers and avoid including otherwise includible Subpart F income. To date, relatively few taxpayers have been identified as asserting a nexus or other position for excluding Subpart F income. The total revenue at risk is uncertain, perhaps a few million annually currently, but could reach $50 million annually in the near future if the taxpayer's position is sustained. This projection is based on a prior examination by audit staff of corporations with prominent CFCs.

Tax Revenue Discussion

Under the taxpayers' interpretation, the number of CFCs that establish ties in California sufficient to create nexus, and any otherwise includible Subpart F income and apportionment factors, would determine the revenue impact of this proposal. Removing CFC dividends from the calculation of the inclusion ratio (used to determine includable Subpart F income) has been previously estimated, through an examination of tax returns, at $25 million annually. Departmental staff estimates that this loss is roughly half of the loss attributed to excluding all Subpart F income.

## Policy Considerations

The underlying principle of the water's-edge legislation was, to the extent possible, that California should conform to the federal international taxation rules and be able to rely upon federal audit activities and filings.  Therefore, the U.S.-source income and Subpart F income partial inclusion rules should be coordinated to include all such income of a foreign corporation, regardless of whether that corporation is a taxpayer, in the California apportionable income base.  This coordination is consistent with federal treatment.

Under the opponents' view, the legislature's addition of income and apportionment factors attributable to Subpart F income of a CFC to the water's-edge combined report would be nullified by relatively simple tax planning.  If so, the Subpart F provisions would be effective only as a tax trap for the unwary.

## Agency/Industry Pro & Con Arguments

Some taxpayers may actively oppose this proposal.  Opponents have contended that since the enactment of the water's-edge legislation they have been allowed either to qualify as a foreign affiliate or to create sufficient nexus for that affiliate to cause a CFC to become a California taxpayer and thereby avoid the inclusion of Subpart F income.  Under this interpretation, as a California taxpayer, the CFCs were liable for and paid only the $800 minimum corporation franchise tax and were not required to include Subpart F income within the water's-edge apportionable income base.  Alternatively, taxpayers may argue that the mere presence of U.S.-source income would prevent the application of the Subpart F partial inclusion rule.  Thus, they would argue, this proposal results in a tax increase.

## Other States

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries.  However, no other state taxes on a water's-edge basis similar to California.  Thus, it does not appear that these issues apply to other states.

## Additional Comments

Previously staff was only aware of a handful of taxpayers that were using the argument that their CFCs, although not incorporated in California, had nexus in California and were taxpayers in the year at issue and not required to include Subpart F income.  Staff is now aware of a taxpayer that has actually registered its CFCs through the Secretary of State.  This indicates that taxpayers may be beginning to register or qualify their CFCs in California in an attempt to avoid inclusion of their Subpart F income in the apportionable base.  Staff is also aware of a taxpayer that included their CFCs with Subpart F income in their original return, but has filed a claim for refund to remove their CFCs with Subpart F income because the CFCs had U.S.-source income.

## LEGISLATIVE STAFF CONTACT

| | |
|---|---|
| Marion Mann DeJong | Brian Putler |
| Franchise Tax Board | Franchise Tax Board |
| 845-6979 | 845-6333 |
| Marion.DeJong@ftb.ca.gov | Brian.Putler@ftb.ca.gov |

Analyst Marion Mann DeJong
Telephone # 845-6979
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 04-12

AMENDMENT 1

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

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

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

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

~~(2)~~ (B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

~~(3)~~ (C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code~~, of which more than 50 percent of their voting stock is owned or controlled directly or indirectly by the same interests~~.

~~(4) A corporation that is not described in paragraphs (1) to (3), inclusive, or paragraph (5), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the United States.~~

~~(5)~~ (D) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(2) With respect to a corporation that is not described in subparagraphs (A), (B), or (C) of paragraph (1), as follows:

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

(B) The income and apportionment factors of such a corporation that ~~(6) Any affiliated corporation which~~ is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, ~~if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be~~ to the extent determined by multiplying the income and apportionment factors of that ~~affiliate without~~ corporation (without application of this ~~paragraph~~ subparagraph) by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable ~~year, as defined in Section 964 of the Internal Revenue Code.~~ year. For purposes of this subparagraph:

(i) "Subpart F income" means "subpart F income" within the meaning of Section 952 of the Internal Revenue Code.

(ii) "Earnings and profits" means "earnings and profits" within the meaning of Section 964 of the Internal Revenue Code.

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

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

~~(7)(A) The income and factors of the above-enumerated corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.~~

~~(B) The income and factors of a corporation that is not described in paragraphs (1) to (3), inclusive, and paragraph (5) and that is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (4).~~

(b) For purposes of this article and Section 24411:

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

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

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

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

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

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

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

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

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

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

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

SEC 2. (a) The amendments made to Section 25110 of the Revenue and Taxation Code by this act shall be applied to taxable years beginning on or after January 1, 2004.

(b) It is the intent of the Legislature that no inference be drawn in connection with any matter governed by Section 25110 of the Revenue and Taxation Code for any taxable year beginning before January 1, 2004, with respect to the amendments made to Section 25110 of the Revenue and Taxation Code by this act.

# Appendix I

A literal application of two different provisions of Revenue and Taxation Code Section 25110, subdivision (a)(6) and subdivision (a)(7)(B), yields two mutually inconsistent results. Under subdivision (a)(6), the income and factors of a Controlled Foreign Corporation (CFC) that is an affiliated corporation of a taxpayer that made a water's-edge election is included (to the extent of the Subpart F ratio) in the combined report of a taxpayer making a water's-edge election. Subdivision (a)(6), by its terms, applies regardless of whether the CFC is a taxpayer. Under subdivision (a)(7)(B), the income and factors of a CFC that is an electing taxpayer are included in the combined report for water's-edge purposes, but only to the extent of its income and factors attributable or assignable to U.S. sources, thereby arguably excluding Subpart F income from the income and factors of a water's-edge group.

As originally enacted in 1986 (operative for income years beginning on or after January 1, 1988), Section 25110(a)(7)(B) applied only to foreign banks and was included in the water's-edge legislation to clarify that a foreign bank would be included in a water's-edge combined report only to the extent of its U.S.-source income. Further, the ordering of the statute was such that the language of Section 25110(a)(7)(B) immediately followed the paragraph describing the U.S.-source income partial inclusion rules and before the paragraph describing the Subpart F income partial inclusion rules.

In 1988, the section was amended to change the term "bank" to "bank and corporation" so that if either a foreign bank or a foreign corporation had U.S.-source income, it could elect water's-edge and include income and factors in the combined report only to the extent of the U.S.-source income. In addition, the statute was renumbered so that Section 25110(a)(7)(B) now follows the paragraphs describing both the U.S.-source and the Subpart F partial inclusion rules.

A cardinal principle of statutory construction is to give effect to all of the provisions of a statute. Pursuant to the current provisions of Section 25110(a)(6), the income and factors of a CFC that is an affiliated corporation must be included to the extent of the Subpart F ratio within the combined report of a taxpayer making a water's-edge election. It is also clear that the provisions of subdivision (a), paragraphs (1) through (6) are limited to taxpayers with affiliated corporations. Subparagraph (7)(B), on the other hand, was enacted to permit a foreign taxpayer with no water's-edge affiliates to make a water's-edge election, taking into account its income and factors only to the extent of income derived from or attributable to sources within the U.S. and its factors assignable to a location in the U.S. Subparagraph (7)(B) was not intended to permit a CFC with Subpart F income to make an election and, for all practical and legal purposes, write the inclusion rules of paragraph (6) out of existence.

Nothing in the legislative record indicates intent to include CFCs to the extent of their Subpart F income while simultaneously allowing the same CFCs to shelter that income from inclusion in the combined report by becoming taxpayers.

# LEGISLATIVE PROPOSAL 04-14
# EXECUTIVE SUMMARY

**Title:** Innocent Spouse/Election Period Technical Clean-Up

- **Problem Statement:**

  The statute providing innocent spouse relief erroneously references a "*four-year* period" for making an election; however, the referenced sections actually provide *two years* to make the election.

- **Proposed Solution:**

  Amend the Revenue and Taxation Code to remove the erroneous "four-year" reference so that only the correct two-year period is referenced.

- **Major Concerns/Issues:**

  None.

- **Revenue:**

  This proposal would not impact the state's income tax revenue or the department's current programs or practices.

**2004 Departmental Legislative Proposal**
**LP 04-14**

## Title

Innocent Spouse/Election Period Technical Clean Up

## Introduction

This proposal would remove an erroneous statutory reference relating to relief from joint and several liability so the law is clear that taxpayers must request innocent spouse relief within two years from the date the Franchise Tax Board (FTB) begins collection activities.

## Background

Under federal and state income tax law, spouses who file a joint tax return are individually responsible for the accuracy of the return and for the full tax liability for that tax year. These obligations apply regardless of which spouse earns the income. The concept of obligating each spouse individually for all of the tax liability is called joint and several liability. Joint and several liability can result in inequitable consequences to one spouse in certain circumstances. Consequently, the federal government and California enacted “innocent spouse” legislation, which may allow a spouse to be relieved of some or all of the responsibility of a joint tax debt.

## Current Federal Law

The federal Internal Revenue Restructuring and Reform Act of 1998 (the "1998 Act") made innocent spouse relief easier to obtain. The 1998 Act allows an innocent spouse to qualify for relief under one of the following three provisions. In order for a taxpayer to qualify for relief under either 1 or 2 below, the taxpayer must elect relief within two years of the date the Secretary has begun collection activities with respect to the taxpayer making the election.

1. *Understatement/Apportionment.* A spouse may elect to be relieved of a tax liability for a taxable year to the extent the liability is attributed to an assessment of tax exceeding the amount reported on the return (also called “understatement of tax”). Generally, the requesting spouse must show that the understatement of tax is a result of an erroneous item, such as an omission of income or an overstatement of deductible expenses, which results in an understatement of tax. In addition, the taxpayer must show that at the time the return was signed he or she did not know and had no reason to know of the erroneous item, as described above, that lead to the understatement of tax.

   A taxpayer who would qualify for relief but for the knowledge requirement of the full amount of the understatement of tax, as described above, may be allowed relief for a portion of the understatement. If the taxpayer can show lack of knowledge, as described above, with respect to *a portion of the understatement,* then the taxpayer may be relieved of liability for the tax that is attributable to that portion of the understatement.

2. *Separate liability election.* A requesting spouse may elect to be taxed as though he or she filed a *married filing separate* tax return. Any tax liability for any deficiency that is assessed on the return, interest, and penalties will be limited to the amount attributable to the income the individual spouse actually earned. This relief is available to taxpayers who are no longer married, are legally separated, or have lived apart from their spouse for 12 months prior to requesting relief. At the time the joint return was signed, the requesting spouse must have lacked actual knowledge of the item resulting in the tax deficiency.

3. *Equitable relief.* If the Internal Revenue Service (IRS) determines from a review of all the facts and circumstances that the requesting taxpayer would not qualify for relief under either 1 or 2, above, the IRS may determine that it would not be equitable to hold the requesting spouse liable for any unpaid tax or any deficiency.

**Current State Law**

In 1999 California conformed to portions of the 1998 Act by enacting the Taxpayers' Bill of Rights Act of 1999, which revised and expanded state innocent spouse relief to be similar to the federal provisions outlined above. Like federal law, the taxpayer must make the election within two years of the date that the FTB begins collection activities.

**Problem**

The statute providing innocent spouse relief erroneously references "the *four-year* period" required for making an election as described under two specific subparagraphs; however, these subparagraphs actually provide only *two years* to make the election.

**Proposed Solution**

Amend subdivision (h) of R&TC Section 18533 to remove the erroneous reference to the *four-year* period for making an election so that the correct two-year period is referenced.

**Effective/Operative Date of Solution**

If enacted in the 2004 legislative session as a technical measure, this proposal would be operative January 1, 2005.

**Justification**

Erroneous references should be corrected to ensure the provisions of law are consistent and to prevent confusion for taxpayers and the department when applying state law. Specifically, this proposal would make existing law clear that an election to request relief must be made within *two years* of the date the department begins collection activities with respect to the taxpayer making the election.

**Implementation**

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

**Fiscal Impact**

This proposal would not impact the state's income tax revenue or the department's current programs or practices.

**Other States**

Information on other states is not relevant as this proposal makes a minor technical change for code maintenance purposes to California statutes.

**LEGISLATIVE STAFF CONTACT**

LuAnna Hass
Franchise Tax Board
845-7478
LuAnna.Hass@ftb.ca.gov

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

Analyst LuAnna Hass
Telephone # 845-7478
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 04-14

AMENDMENT 1

@@@@ Section 18533 of the Revenue and Taxation Code is amended to read:

18533. (a) (1) Notwithstanding subdivision (a) and the first sentence of subdivision (b) of Section 19006:

(A) An individual who has made a joint return may elect to seek relief under the procedures prescribed under subdivision (b), and

(B) If the individual is eligible to elect the application of subdivision (c), the individual may, in addition to any election under subparagraph (A), elect to limit the individual's liability for any deficiency with respect to the joint return in the manner prescribed under subdivision (c).

(2) Any determination under this section shall be made without regard to community property laws.

(b) (1) Under procedures prescribed by the Franchise Tax Board, if—

(A) A joint return has been made under this chapter for a taxable year,

(B) On that return there is an understatement of tax attributable to erroneous items of one individual filing the joint return,

(C) The other individual filing the joint return establishes that in signing the return he or she did not know of, and had no reason to know of, that understatement,

(D) Taking into account all facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax for that taxable year attributable to that understatement, and

(E) The other individual elects (in the form and manner as the Franchise Tax Board may prescribe) the benefits of this subdivision not later than the date that is two years after the date the Franchise Tax Board has begun collection activities with respect to the individual making the election, then the other individual shall be relieved of liability for tax (including interest, penalties, and other amounts) for that taxable year to the extent that the liability is attributable to that understatement.

(2) If an individual who, but for subparagraph (C) of paragraph (1), would be relieved of liability under paragraph (1), establishes that in signing the return the individual did not know, and had no reason to know, the extent of the understatement, then the individual shall be relieved of liability for tax (including interest, penalties, and other amounts) for that taxable year to the extent that the liability is attributable to the portion of the understatement of which that individual did not know and had no reason to know.

(3) For purposes of this subdivision, the term "understatement" has the meaning given to that term by Section 6662(d)(2)(A) of the Internal Revenue Code.

(c) (1) Except as provided in this subdivision, if an individual who has made a joint return for any taxable year elects the application of this subdivision, the individual's liability for any deficiency that is assessed with respect to the return may not exceed the portion of the deficiency properly allocable to the individual under subdivision (d).

(2) Except as provided in clause (ii) of subparagraph (A) of paragraph (3) or subparagraph (C) of paragraph (3), each individual who elects the application of this subdivision shall have the burden of proof with respect to establishing the portion of any deficiency allocable to that individual.

(3) (A) (i) An individual shall only be eligible to elect the application of this subdivision if—

(I) At the time the election is filed, that individual is no longer married to, or is legally separated from, the individual with whom that individual filed the joint return to which the election relates, or

(II) That individual was not a member of the same household as the individual with whom the joint return was filed at any time during the 12-month period ending on the date the election is filed.

(ii) If the Franchise Tax Board demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme by those individuals, an election under this subdivision by either individual shall be invalid (and subdivision (a) and the first sentence of subdivision (b) of Section 19006 shall apply to the joint return).

(B) An election under this subdivision for any taxable year shall be made not later than two years after the date on which the Franchise Tax Board has begun collection activities with respect to the individual making the election.

(C) If the Franchise Tax Board demonstrates that an individual making an election under this subdivision had actual knowledge, at the time the individual signed the return, of any item giving rise to a deficiency (or portion thereof) that is not allocable to the individual under subdivision (d), that election may not apply to that deficiency (or portion). This subparagraph does not apply where the individual with actual knowledge establishes that the individual signed the return under duress.

(4) (A) Notwithstanding any other provision of this subdivision, the portion of the deficiency for which the individual electing the application of this subdivision is liable (without regard to this paragraph) shall be increased by the value of any disqualified asset transferred to the individual.

(B) For purposes of this paragraph--

(i) The term "disqualified asset" means any property or right to property transferred to an individual making the election under this subdivision with respect to a joint return by the other individual filing the joint return if the principal purpose of the transfer was the avoidance of tax or payment of tax.

(ii) (I) For purposes of clause (i), except as provided in subclause (II), any transfer that is made after the date that is one year before the date on which the first notice of proposed assessment under Article 3 (commencing with Section 19031) of Chapter 4 is sent shall be presumed to have as its principal purpose the avoidance of tax or payment of tax.

(II) Subclause (I) does not apply to any transfer pursuant to a decree of divorce or separate maintenance or a written instrument incident to that decree or to any transfer that an individual establishes did not have as its principal purpose the avoidance of tax or payment of tax.

(d) For purpose of subdivision (c)--

(1) The portion of any deficiency on a joint return allocated to an individual shall be the amount that bears the same ratio to the deficiency as the net amount of items taken into account in computing the deficiency and allocable to the individual under paragraph (3) bears to the net amount of all items taken into account in computing the deficiency.

(2) If a deficiency (or portion thereof) is attributable to--

(A) The disallowance of a credit, or

(B) Any tax (other than tax imposed by Section 17041 or 17062) required to be included with the joint return, and the item is allocated to one individual under paragraph (3), that deficiency (or portion) shall be allocated to that individual. Any item so allocated may not be taken into account under paragraph (1).

(3) For purposes of this subdivision--

(A) Except as provided in paragraphs (4) and (5), any item giving rise to a deficiency on a joint return shall be allocated to individuals filing the return in the same manner as it would have been allocated if the individuals had filed separate returns for the taxable year.

(B) Under rules prescribed by the Franchise Tax Board, an item otherwise allocable to an individual under subparagraph (A) shall be allocated to the other individual filing the joint return to the extent the item gave rise to a tax benefit on the joint return to the other individual.

(C) The Franchise Tax Board may provide for an allocation of any item in a manner not prescribed by subparagraph (A) if the Franchise Tax Board establishes that the allocation is appropriate due to fraud of one or both individuals.

(4) If an item of deduction or credit is disallowed in its entirety solely because a separate return is filed, the disallowance shall be disregarded and the item shall be computed as if a joint return had been filed and then allocated between the spouses appropriately.

(5) If the liability of a child of a taxpayer is included on a joint return, that liability shall be disregarded in computing the separate liability of either spouse and that liability shall be allocated appropriately between the spouses.

(e) (1) In the case of an individual who elects to have subdivision (b) or (c) apply--

(A) (i) The determination of the Franchise Tax Board as to whether the liability is to be revised as to one individual filing the joint return shall be made not less than 30 days after notification of the other individual filing the joint return.

(ii) Any action taken under this section shall be treated as though it were action on a protest taken under Section 19044 and shall become final upon the expiration of 30 days from the date that notice of the action is mailed to both individuals filing the joint return, unless, within that 30-day period, the individual making the election under subdivision (b) or (c) appeals the determination to the board as provided in clause (iii) or the other individual filing the joint return appeals the determination to the board as provided in Section 19045.

(iii) The individual making the election under subdivision (b) or (c) may appeal the determination of the Franchise Tax Board of the appropriate relief available to the individual under this section if that appeal is filed during the 30-day period prescribed in clause (ii) and the appeal shall be treated as an appeal to the board under Section 19045. Notwithstanding the preceding sentence, the individual making the election under subdivision (b) or (c) may appeal to the board at any time after the date that is six months after the date the election is filed with the Franchise Tax Board and before the close of the 30-day period prescribed in clause (ii).

(B) Except as otherwise provided in Section 19081 or 19082, no levy or proceeding in court shall be made, begun, or prosecuted against the individual making an election under subdivision (b) or (c) for collection of any assessment to which the election relates until the expiration of the 30-day period described in clause (ii) of subparagraph (A), or, if an appeal to the board has been filed under clause (iii) or Section 19045, until the decision of the board has become final.

(2) The running of the period of limitations in Section 19371 on the collection of the assessment to which the petition under subparagraph (A) of paragraph (1) relates shall be suspended for the period during which the Franchise Tax Board is prohibited by subparagraph (B) of paragraph (1) from collecting by levy or a proceeding in court and for 60 days thereafter.

(3) (A) Except as provided in subparagraph (B), notwithstanding any other law or rule of law (other than Article 6 (commencing with Section 19441) of Chapter 6), a credit or refund shall be allowed or made to the extent attributable to the application of this section.

(B) In the case of any election under subdivision (b) or (c), if a decision of the board in any prior proceeding for the same taxable year has become final, that decision shall be conclusive except with respect to the qualification of the individual for relief that was not an issue in that proceeding. The exception contained in the preceding sentence does not apply if the board determines that the individual participated meaningfully in the prior proceeding.

(f) Under procedures prescribed by the Franchise Tax Board, if taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either), and relief is not available to the individual under subdivision (b) or (c), the Franchise Tax Board may relieve the individual of that liability.

(g) (1) The Franchise Tax Board may prescribe regulations providing methods for allocation of items other than the methods under paragraph (3) of subdivision (d).

(2) It is the intent of the Legislature that, in construing this section and any other sections that are specifically cross-referenced in this section, any regulations that may be promulgated by the Secretary of the Treasury under Section 6015 of the Internal Revenue Code, as amended by Public Law 105-206, shall apply to the extent that those regulations do not conflict with this section or with any regulations that may be promulgated by the Franchise Tax Board.

(h) (1) Except as provided in paragraph (2), the amendments made by ~~the act adding this subdivision~~ Chapter 931, Statutes 1999, shall apply to any liability for tax arising after ~~the effective date of the act adding this subdivision~~ October 10, 1999, and any liability for tax arising on or before that date but remaining unpaid as of that date.

(2) The ~~four-year~~ period under subparagraph (E) of paragraph (1) of subdivision (b) or subparagraph (B) of paragraph (3) of subdivision (c) shall not expire before the date which is four years after the date of the first collection activity after ~~the effective date of the act adding this subdivision~~ October 10, 1999.

(i) (1) An individual who has made a joint return and has been granted relief under Section 6015 of the Internal Revenue Code, relating to joint and several liability with respect to a federal joint income tax return, shall be eligible for relief under this section if all of the following conditions are satisfied:

(A) The individual requests relief under this section.

(B) The facts and circumstances that apply to the understatement and liabilities for which the relief is requested are the same facts and circumstances that applied to the understatement and liabilities for which that individual was granted relief under Section 6015 of the Internal Revenue Code.

(C) The individual requesting relief under this subdivision furnishes the Franchise Tax Board with a copy of the federal determination granting that individual relief under Section 6015 of the Internal Revenue Code. If the federal determination does not clearly identify the issues and liabilities for which the individual was granted relief under Section 6015 of the Internal Revenue Code, the Franchise Tax Board may request, from the individual requesting relief, any supporting documentation reasonably necessary to substantiate that the issues and liabilities for which relief is requested under this section are the same as the issues and liabilities for which the individual received relief under Section 6015 of the Internal Revenue Code.

(2) This subdivision does not apply if, prior to the expiration of the 30-day period described in clause (i) of subparagraph (A) of paragraph (1) of subdivision (e), the other individual that filed the joint return for which the relief is requested under this subdivision submits information to the Franchise Tax Board that indicates that relief should not be granted. For purposes of this paragraph, "information that indicates that relief should not be granted" is limited to the following:

(A) Information that indicates that the facts and circumstances that apply to the understatement and liabilities for which the relief is requested are not the same facts and circumstances that applied to the understatement and liabilities for which that individual was granted relief under Section 6015 of the Internal Revenue Code.

(B) Information that indicates that there has not been a federal determination granting relief under Section 6015 of the Internal Revenue Code or that the federal determination granting relief under Section 6015 of the Internal Revenue Code has been modified, altered, withdrawn, canceled, or rescinded.

(C) Information indicating that the other individual, as described in the first sentence of this paragraph, did not have the opportunity to participate, within the meaning of Section 6015 of the Internal Revenue Code and the regulations thereunder, in the federal administrative or judicial proceeding that resulted in relief under Section 6015 of the Internal Revenue Code.

(j) If, prior to the date the Franchise Tax Board issues its determination with respect to a request for relief under this section, the individual requesting relief demonstrates to the Franchise Tax Board that a request for relief has been filed with the Internal Revenue Service pursuant to Section 6015 of the Internal Revenue Code and demonstrates that the request for relief involves the same facts and circumstances as the request for relief that is pending before the Franchise Tax Board, the Franchise Tax Board may not deny relief with respect to that request, in whole or in part, until federal action on the request for relief under Section 6015 of the Internal Revenue Code is final.

(k) The provisions of subdivisions (i) and (j) shall apply to both of the following:

(1) Any tax liability that becomes final on or after the effective date of the act adding subdivisions (i) and (j) to this section.

(2) Any unpaid tax liability that became final prior to the effective date of the act adding subdivisions (i) and (j) to this section.

(l) An individual may not be granted relief under this section if a court has revised the tax liability in a proceeding for dissolution of the marriage in accordance with subdivision (b) of Section 19006.

(m) This section shall cease to be operative on January 1, 2009, and as of that date is repealed.

AMENDMENT 2

@@@@ Section 18533 of the Revenue and Taxation Code as added by Chapter 370 of the Statutes of 2003 is amended to read:

18533. (a) (1) Notwithstanding subdivision (a) and the first sentence of subdivision (b) of Section 19006:

(A) An individual who has made a joint return may elect to seek relief under the procedures prescribed under subdivision (b), and (B) If the individual is eligible to elect the application of subdivision (c), the individual may, in addition to any election under subparagraph (A), elect to limit the individual's liability for any deficiency with respect to the joint return in the manner prescribed under subdivision (c).

(2) Any determination under this section shall be made without regard to community property laws.

(b) (1) Under procedures prescribed by the Franchise Tax Board, if—

(A) A joint return has been made under this chapter for a taxable year,

(B) On that return there is an understatement of tax attributable to erroneous items of one individual filing the joint return,

(C) The other individual filing the joint return establishes that in signing the return he or she did not know of, and had no reason to know of, that understatement,

(D) Taking into account all facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax for that taxable year attributable to that understatement, and

(E) The other individual elects (in the form and manner as the Franchise Tax Board may prescribe) the benefits of this subdivision not later than the date that is two years after the date the Franchise Tax Board has begun collection activities with respect to the individual making the election, then the other individual shall be relieved of liability for tax (including interest, penalties, and other amounts) for that taxable year to the extent that the liability is attributable to that understatement.

(2) If an individual who, but for subparagraph (C) of paragraph (1), would be relieved of liability under paragraph (1), establishes that in signing the return the individual did not know, and had no reason to know, the extent of the understatement, then the individual shall be relieved of liability for tax (including interest, penalties, and other amounts) for that taxable year to the extent that the liability is attributable to the portion of the understatement of which that individual did not know and had no reason to know.

(3) For purposes of this subdivision, the term "understatement" has the meaning given to that term by Section 6662(d)(2)(A) of the Internal Revenue Code.

(c) (1) Except as provided in this subdivision, if an individual who has made a joint return for any taxable year elects the application of this subdivision, the individual's liability for any deficiency which is assessed with respect to the return shall not exceed the portion of the deficiency properly allocable to the individual under subdivision (d).

(2) Except as provided in clause (ii) of subparagraph (A) of paragraph (3) or subparagraph (C) of paragraph (3), each individual who elects the application of this subdivision shall have the burden of proof with respect to establishing the portion of any deficiency allocable to that individual.

(3) (A) (i) An individual shall only be eligible to elect the application of this subdivision if--

(I) At the time the election is filed, that individual is no longer married to, or is legally separated from, the individual with whom that individual filed the joint return to which the election relates, or

(II) That individual was not a member of the same household as the individual with whom the joint return was filed at any time during the 12-month period ending on the date the election is filed.

(ii) If the Franchise Tax Board demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme by those individuals, an election under this subdivision by either individual shall be invalid (and subdivision (a) and the first sentence of subdivision (b) of Section 19006 shall apply to the joint return).

(B) An election under this subdivision for any taxable year shall be made not later than two years after the date on which the Franchise Tax Board has begun collection activities with respect to the individual making the election.

(C) If the Franchise Tax Board demonstrates that an individual making an election under this subdivision had actual knowledge, at the time the individual signed the return, of any item giving rise to a deficiency (or portion thereof) which is not allocable to the individual under subdivision (d), that election shall not apply to that deficiency (or portion). This subparagraph shall not apply where the individual with actual knowledge establishes that the individual signed the return under duress.

(4) (A) Notwithstanding any other provision of this subdivision, the portion of the deficiency for which the individual electing the application of this subdivision is liable (without regard to this paragraph) shall be increased by the value of any disqualified asset transferred to the individual.

(B) For purposes of this paragraph--

(i) The term "disqualified asset" means any property or right to property transferred to an individual making the election under this subdivision with respect to a joint return by the other individual filing the joint return if the principal purpose of the transfer was the avoidance of tax or payment of tax.

(ii) (I) For purposes of clause (i), except as provided in subclause (II), any transfer that is made after the date that is one year before the date on which the first notice of proposed assessment under Article 3 (commencing with Section 19031) of Chapter 4 is sent shall be presumed to have as its principal purpose the avoidance of tax or payment of tax.

(II) Subclause (I) shall not apply to any transfer pursuant to a decree of divorce or separate maintenance or a written instrument incident to that decree or to any transfer that an individual establishes did not have as its principal purpose the avoidance of tax or payment of tax.

(d) For purpose of subdivision (c)--

(1) The portion of any deficiency on a joint return allocated to an individual shall be the amount which bears the same ratio to the deficiency as the net amount of items taken into account in computing the deficiency and allocable to the individual under paragraph (3) bears to the net amount of all items taken into account in computing the deficiency.

(2) If a deficiency (or portion thereof) is attributable to--

(A) The disallowance of a credit, or

(B) Any tax (other than tax imposed by Section 17041 or 17062) required to be included with the joint return, and the item is allocated to one individual under paragraph (3), that deficiency (or portion) shall be allocated to that individual. Any item so allocated shall not be taken into account under paragraph (1).

(3) For purposes of this subdivision--

(A) Except as provided in paragraphs (4) and (5), any item giving rise to a deficiency on a joint return shall be allocated to individuals filing the return in the same manner as it would have been allocated if the individuals had filed separate returns for the taxable year.

(B) Under rules prescribed by the Franchise Tax Board, an item otherwise allocable to an individual under subparagraph (A) shall be allocated to the other individual filing the joint return to the extent the item gave rise to a tax benefit on the joint return to the other individual.

(C) The Franchise Tax Board may provide for an allocation of any item in a manner not prescribed by subparagraph (A) if the Franchise Tax Board establishes that the allocation is appropriate due to fraud of one or both individuals.

(4) If an item of deduction or credit is disallowed in its entirety solely because a separate return is filed, the disallowance shall be disregarded and the item shall be computed as if a joint return had been filed and then allocated between the spouses appropriately.

(5) If the liability of a child of a taxpayer is included on a joint return, that liability shall be disregarded in computing the separate liability of either spouse and that liability shall be allocated appropriately between the spouses.

(e) (1) In the case of an individual who elects to have subdivision (b) or (c) apply--

(A) (i) The determination of the Franchise Tax Board as to whether the liability is to be revised as to one individual filing the joint return shall be made not less than 30 days after notification of the other individual filing the joint return.

(ii) Any action taken under this section shall be treated as though it were action on a protest taken under Section 19044 and shall become final upon the expiration of 30 days from the date that notice of the action is mailed to both individuals filing the joint return, unless, within that 30-day period, the individual making the election under subdivision (b) or (c) appeals the determination to the board as provided in clause (iii) or the other individual filing the joint return appeals the determination to the board as provided in Section 19045.

(iii) The individual making the election under subdivision (b) or (c) may appeal the determination of the Franchise Tax Board of the appropriate relief available to the individual under this section if that appeal is filed during the 30-day period prescribed in clause (ii) and the appeal shall be treated as an appeal to the board under Section 19045. Notwithstanding the preceding sentence, the individual making the election under subdivision (b) or (c) may appeal to the board at any time after the date which is six months after the date the election is filed with the Franchise Tax Board and before the close of the 30-day period prescribed in clause (ii).

(B) Except as otherwise provided in Section 19081 or 19082, no levy or proceeding in court shall be made, begun, or prosecuted against the individual making an election under subdivision (b) or (c) for collection of any assessment to which the election relates until the expiration of the 30-day period described in clause (ii) of subparagraph (A), or, if an appeal to the board has been filed under clause (iii) or Section 19045, until the decision of the board has become final.

(2) The running of the period of limitations in Section 19371 on the collection of the assessment to which the petition under subparagraph (A) of paragraph (1) relates shall be suspended for the period during which the Franchise Tax Board is prohibited by subparagraph (B) of paragraph (1) from collecting by levy or a proceeding in court and for 60 days thereafter.

(3) (A) Except as provided in subparagraph (B), notwithstanding any other law or rule of law (other than Article 6 (commencing with Section 19441) of Chapter 6), a credit or refund shall be allowed or made to the extent attributable to the application of this section.

(B) In the case of any election under subdivision (b) or (c), if a decision of the board in any prior proceeding for the same taxable year has become final, that decision shall be conclusive except with respect to the qualification of the individual for relief which was not an issue in that proceeding. The exception contained in the preceding sentence shall not apply if the board determines that the individual participated meaningfully in the prior proceeding.

(f) Under procedures prescribed by the Franchise Tax Board, if taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either), and relief is not available to the individual under subdivision (b) or (c), the Franchise Tax Board may relieve the individual of that liability.

(g) (1) The Franchise Tax Board may prescribe regulations providing methods for allocation of items other than the methods under paragraph (3) of subdivision (d).

(2) It is the intent of the Legislature that, in construing this section and any other sections which are specifically cross-referenced in this section, any regulations that may be promulgated by the Secretary of the Treasury under Section 6015 of the Internal Revenue Code, as amended by Public Law 105-206, shall apply to the extent that those regulations do not conflict with this section or with any regulations that may be promulgated by the Franchise Tax Board.

(h) (1) Except as provided in paragraph (2), the amendments made by Chapter 931 of the Statutes of 1999 shall apply to any liability for tax arising after October 10, 1999, and any liability for tax arising on or before that date but remaining unpaid as of that date.

(2) The ~~four-year~~ period under subparagraph (E) of paragraph (1) of subdivision (b) or subparagraph (B) of paragraph (3) of subdivision (c) shall not expire before the date which is four years after the date of the first collection activity after October 10,1999.

(i) An individual may not be granted relief under this section if a court has revised the tax liability in a proceeding for dissolution of the marriage in accordance with subdivision (b) of Section 19006.

(j) This section shall become operative on January 1, 2009.