2010 LEGISLATIVE PROPOSALS

TITLES

LEGISLATIVE PROPOSAL 10-1
EXECUTIVE SUMMARY

- **Title:** Provide Taxpayers an Electronic Communication Option

- **Problem:** The law requiring the Franchise Tax Board (FTB) to send certain notices to taxpayers by U.S. mail frustrates taxpayers that prefer electronic communication and limits the FTB's ability to use technology to improve efficiencies in tax administration.

- **Proposed Solution:** Amend current law to allow the FTB, at a taxpayer's request, to send a message to the taxpayer that a bill, notice, or statement can be retrieved by the taxpayer through the secure FTB web site in lieu of mailing the notice by U.S. mail. The details of the process would be developed through regulations so that input from taxpayers could be obtained and utilized.

- **Revenue:** This proposal would not impact state income tax revenue.

Title

Provide Taxpayers an Electronic Communication Option

Introduction

This proposal would, at a taxpayer's request, authorize the Franchise Tax Board (FTB) to send a message to the taxpayer that a bill, notice, or statement can be retrieved by the taxpayer through the secure FTB web site in lieu of mailing the notice by U.S. mail.

Current Federal Law

The Fourteenth Amendment to the United States Constitution guarantees to individuals specific rights, including the right to due process of law before property can be taken from the individual by any state. The essential elements of due process include reasonable notice.

Under current federal tax law, the due process element of reasonable notice is met when the IRS mails a required notice to the taxpayer at the taxpayer's last known address. Federal regulations require that unless the IRS has been given clear and concise notice of a different address, the address that appears on the taxpayer's most recently-filed federal tax return is the taxpayer's last known address. The regulation also provides that under certain conditions, updated address information received from the United States Postal Service (USPS) National Change of Address (NCOA) database will be considered the taxpayer's last known address unless the IRS is given clear and concise notification of a different address.

The "last-known-address rule" places responsibility on the taxpayer to notify the IRS of any change of address. The rationale for this rule is that with the transient nature of many taxpayers, the IRS does not have sufficient resources to track the movements of several hundred thousand taxpayers each year. When the IRS has reason to believe that the address previously provided by the taxpayer is no longer correct, the IRS has a duty to exercise reasonable diligence to ascertain the correct address.

While the IRS allows taxpayers to submit returns and payments electronically, the IRS explicitly informs taxpayers that it does not communicate on taxpayer accounts electronically.

Current State Law

Under California tax law, any notice mailed to a taxpayer is sufficient to satisfy the reasonable notice element of due process if it is mailed to the taxpayer's last known address. Last known address is defined as the address that appears on the taxpayer's last return filed with the FTB, unless the taxpayer has provided the FTB clear and concise written or electronic notification of a different address or the FTB has an address it has reason to believe is the most current address for the taxpayer.

Specifically, under California tax law, a Notice of Proposed Assessment (NPA) and final deficiency notice issued after January 1, 2008, require a postmark. A postmark is defined as a postal marking made on a letter, package, or postcard indicating the date the item is delivered to the USPS.

Taxpayers may authorize a person to act on their behalf and authorize the representative, in writing, to do the following through an executed Power of Attorney form:

- Represent the taxpayer in matters involving the FTB,
- Receive, but not endorse, and cash refund checks,
- Sign waivers to extend the statutory period for assessment or determination of taxes,
- Execute closing agreements,
- Delegate authority or substitute another representative,
- Execute settlement agreements, and
- Receive confidential tax information.

Beginning January 1, 2008, the California Rules of Court[1] now provides that a notice may be served via electronic service when a party indicates that the party agrees to accept an electronic service by either filing or serving a notice to that effect or by electronically filing any document with the court. The act of electronic filing is evidence that the party agrees to accept service at the electronic communication address provided. Service is considered complete at the time of transmission and any deadlines explicit in the notice served are extended by two court days if served electronically. Proof of service must state the electronic communication address of the person making the service in addition to the person's residence or business address.

<u>Program History/Background</u>

An individual taxpayer or their designated representative can obtain limited confidential FTB account information through their "MY FTB ACCOUNT" on the department website. To access the MY FTB ACCOUNT, a taxpayer uses his or her social security number (SSN) and the customer service number (CSN) that is issued annually to each taxpayer to authenticate that the person accessing the account is the taxpayer. The taxpayer can access the following information through their MY FTB ACCOUNT:

- Up to 25 estimated tax payments, estimate transfers, and payments under extension waiting to be applied to a tax return,
- Up to 60 of the most recent payments applied to the taxpayer's balance due,
- A summary of up to 10 tax years with a balance and the total amount due,
- A summary of each tax year with a balance due,
- Up to 4 years of California wage and withholding information,
- Up to 3 years of FTB-issued 1099-G and 1099-INT information, and
- Links to other online services offered by the FTB.

[1] California Rules of Court Rule 2.260 Electronic Service.

Currently, taxpayers are sent paper notices and bills by U.S. mail.

Under the Enterprise Data to Revenue Project (EDR), the FTB plans to reconfigure existing computer systems to implement service oriented architecture to improve the efficiency of existing processes. One feature of EDR is the Taxpayer Folder, where all information regarding a taxpayer will be made available to a taxpayer through the Taxpayer Folder. The Taxpayer Folder will contain the account data, address data, and account history data for each taxpayer and include an historical record of every notice or bill issued to the taxpayer. The Taxpayer Folder will be accessible online by all taxpayers or their authorized representative using their SSN and CSN to authenticate the user. At the option of the taxpayer, an electronic communication option would be available that would allow taxpayers to elect to receive electronic communication of notices or bills issued by the FTB. The Taxpayer Folder is scheduled to be completed and available to taxpayers by January 1, 2013.

The FTB issues approximately 17 million bills and notices each year to taxpayers that include notices in response to returns filed, collection notices for unpaid liabilities, filing enforcement notices when the taxpayer fails to file a return, and notices related to audit activities of taxpayer returns. Some are merely correspondence regard a pending matter, but many have legal significance in that consequences can occur if a taxpayer fails to take action or otherwise respond.

Problem

The law requiring the FTB to send certain notices to taxpayers by U.S. mail frustrates taxpayers that prefer electronic communication and limits the FTB's ability to use technology to improve efficiencies in tax administration.

Proposed Solution

Amend current law to allow the FTB, at a taxpayer's request, to send a message to the taxpayer that a bill, notice or statement can be retrieved by the taxpayer through the secure FTB web site in lieu of mailing the notice by U.S. mail. The details of the process would be developed through regulations so that input from taxpayers could be obtained and utilized.

The FTB envisions that an electronic communication would be sent in the manner designated by the taxpayer informing the taxpayer or their authorized representative that a notice, bill, or statement is in their Taxpayer Folder. Using the Taxpayer Folder, the taxpayer would access the FTB's secure website, using secure authentication procedures, and access the notice in the folder. Taxpayers would be able to download a copy of the notice, bill, or statement directly from their Taxpayer Folder. The notice would be considered received by the taxpayer when the communication is transmitted in a manner as designated by the taxpayer. No confidential information would be transmitted electronically in the communication. The specific details would be worked out through the regulatory process to ensure taxpayer input would be obtained to implement this proposal.

Effective/Operative Date of Solution

If enacted in the 2010 legislative session, the provisions of this proposal would be effective on January 1, 2011, and specifically operative beginning January 1, 2013.

Justification

This proposal would do the following:

- Allow taxpayers to, at their own request, take advantage of technological advancements by modernizing the methods the public and the FTB use to communicate,
- Allow the department to service taxpayer preferences,
- Allow the FTB to “go green” while providing greater services to taxpayers interested in receiving the electronic notice,
- Reduce postage and mailing costs, and
- Allow taxpayers that move frequently to avoid notifying the FTB of each change of physical address.

Implementation

Implementing this proposal is contingent upon implementation of the EDR and the featured Taxpayer Folder component of that project.

Fiscal Impact

Costs to provide access to the Taxpayer Folder have been included in the EDR estimates. While the department anticipates there would be some potential postage and mailing savings related to making electronic communication available in lieu of paper notices, the amount of savings is based on the number of taxpayers that choose this option and is not quantifiable at this time. Additionally, the migration to electronic processes in lieu of paper processes would provide savings through the improvement of efficiencies in tax administration workloads.

Economic Impact

This proposal would not impact state income tax revenue. Taxpayers that prefer electronic communication are not expected to remit tax payments any earlier.

Other Agency/Industry Impacted

Because this is an internal solution, no other agency or industry would be impacted by this proposal.

Other States

A review of laws from *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* revealed that while each of these states have electronic filing and payment options available for taxpayers, none use an electronic communication option to service their taxpayers’ income tax needs. These states were chosen due to the similarity to California’s tax laws and economy.

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FRANCHISE TAX BOARD’S
LP 10-1
Electronic Notice Option

SEC. 1. Section 18416.5 of the Revenue and Taxation Code is added to read:

18416.5. (a) The Franchise Tax Board may, by regulation, implement an alternative communication method that, at the request of a taxpayer, would allow the Franchise Tax Board to provide notification to the taxpayer in a preferred electronic communication method designated by the taxpayer that a notice, statement, bill, or other communication required or authorized under Part 10 (commencing with Section 17001), this part, or Part 11 (commencing with Section 23001)is available for viewing in the taxpayer's limited access secure folder on the Franchise Tax Board’s website and would allow the taxpayer to file a protest, notification, and other communication to the Franchise Tax Board in a secure manner.

(b) Sending electronic notification to a taxpayer pursuant to the taxpayer's request made in accordance with regulations authorized under subdivision (a) shall not be considered a violation of Sections 19542 or 19542.1.

(c) The alternative communication method authorized by this section shall not apply to any notice, statement, bill, protest, or other communication between the Franchise Tax Board and a taxpayer prior to January 1, 2013, or successful implementation of the Taxpayer Folder as a component of the Enterprise Data to Revenue project of the Franchise Tax Board, whichever is later.

(d) Notwithstanding any other provision of law regarding the use of U.S. Mail, any notice, statement, bill, protest, and other communication from the Franchise Tax Board to a taxpayer and from a taxpayer to the Franchise Tax Board pursuant to the alternative communication method authorized by this section shall be treated as if it were mailed by U.S. Mail postage prepaid.

LEGISLATIVE PROPOSAL 10-5
EXECUTIVE SUMMARY

- **Title:** Collection of Franchise Tax Board Orders of Restitution

- **Problem:** Because the Franchise Tax Board (FTB) lacks express authority to use existing tax-collection tools to collect orders of restitution awarded in criminal tax cases, the FTB relies on less efficient methods to collect those liabilities.

- **Proposed Solution:** Amend the Revenue and Taxation Code to do the following:

  - Authorize the FTB to collect both state and federal orders of restitution awarded to the FTB in the same manner and with the same priority as state income taxes, and
  - Clarify that voluntary payments made expressly for orders of restitution owed by a taxpayer must be applied as the taxpayer designates.

- **Revenue:**

Estimated Revenue Impact of LP 10-5 Effective for Years Beginning on or After (BOA) January 1, 2011		
2009-10	2010-11	2011-12
0	0	$100,000

Title

Collection of Franchise Tax Board Orders of Restitution

Introduction

This proposal would allow the Franchise Tax Board (FTB) to collect orders of restitution awarded in criminal proceedings in the same manner as tax liabilities.

Program History/Background

The State can seek restitution for economic losses incurred as a result of a crime. The order of restitution provides that the State (as a victim of the crime) receive restitution of the FTB's economic loss from a person convicted of a crime. The FTB's economic loss in these situations is the amount of state income tax (including applicable penalties, interest and costs of investigation or prosecution) that the person failed to pay as a result of the crime for which the person is guilty. Because an order of restitution is not specifically a tax or a tax penalty, when awarded in any criminal case, the FTB's administrative tax collection tools are unavailable for use in collecting restitution orders owed to the State.

Currently, FTB orders of restitution may be collected either through the existing Court-Ordered-Debt (COD) provisions in the Revenue and Taxation Code or as a civil money judgment using collection remedies available under the Code of Civil Procedure. The FTB does not use COD to collect its orders of restitution for the following reasons:

- The billing notices that the FTB issues to taxpayers owing both tax and restitution would be inaccurate because the balances are maintained on two separate systems that do not communicate in either billing or collection processes. The average balance due for an order of restitution is substantially larger and more complex, thereby requiring higher levels of collection expertise to resolve than the average COD account that relies primarily on automated processes.
- The COD system does not assess interest; instead, the client agency that refers the debt to the FTB for collection provides updates for accrued interest. Restitution orders accrue interest until paid.

When the FTB collects an order of restitution as a civil money judgment, the FTB must use the collection remedies available to any creditor under the Code of Civil Procedure, which are generally time consuming and cumbersome. The statutory procedures for obtaining levies can delay the collection of the order of restitution, and the FTB must rely on the availability of external resources to collect amounts owed as a civil money judgment. In general, depending on the nature of the assets involved, the civil process can take anywhere from 90 days to one year from the date of seizure to the date of the auction to complete.

FTB Investigations estimates that orders of restitution are received in approximately 40 criminal cases annually with an estimated value of $15 million that currently cannot be collected using the department's existing administrative tax collection tools.

Current Federal Law

The IRS may pursue criminal prosecution against a taxpayer for certain offenses and the court may award an order of restitution. The offenses that may be pursued criminally include, but are not limited to, the following:

- Willful attempt to evade or defeat tax,
- Willful failure to collect or pay over collected tax, or
- Willful failure to file a return or supply information.

Because the U.S. Department of Justice (DOJ) represents the IRS in the prosecution of criminal cases, verdicts awarded to the IRS are collected by the DOJ staff under the Federal Debt Collection Procedures Act of 1990.[1] Within the US Attorney's office, the Financial Litigation Units are responsible for collection of restitution orders using procedures for enforcing collections—such as filing liens, searching for offender assets, wage garnishments, writs of execution, and demand letters.[2]

Federal law provides restitution pursuant to the Mandatory Victims Restitution Act,[3] which provides that restitution must be made to the victim of certain crimes regardless of the offender's ability to pay. Orders of restitution issued in a federal criminal action for certain crimes are enforceable in the same manner as a civil judgment.

FTB Investigations may obtain federal court orders of restitution for criminal charges referred to a federal court. Charges that can be pursued in federal court include federal offenses such as the following:

- Wire fraud,
- Mail fraud,
- Money laundering, and
- Financial crimes.

Current State Law

Restitution Orders

Victims of crimes are entitled to restitution under the California Constitution.[4] All persons who suffer losses as a result of criminal activity have the right to seek and secure restitution from the persons convicted of the crimes causing the losses they suffer. Courts are required to award an order of restitution from a convicted wrongdoer in every case that a crime victim suffers a loss.

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[1] See Title 28 U.S.C. sections 3001 through 3308.
[2] GAO report-GAO 01-664 Criminal Debt-Oversight and Actions Needed to Address Deficiencies in Collection Processes.
[3] See Title 18 U.S.C. section 3663A.
[4] Article I section 28, subdivision (b).

Under existing law, the FTB may refer cases for criminal prosecution in state courts against a person for certain offenses and the court may award restitution. The offenses that may be referred for criminal prosecution include the following:

- Failure to file returns,
- Forging a spouse's signature,
- False, fraudulent, or deceptive conduct,
- Tax evasion,
- Conversion of a taxpayer refund by a tax preparer, and
- Employer's failure to collect or deposit tax.

Orders of restitution do not expire and are not dischargeable in an individual bankruptcy proceeding.

Collection of Restitution by the FTB through the Court Ordered Debt Program

Under existing state law, the FTB administers COD, where fines, state or local penalties, forfeitures, restitution fines, restitution orders, or any other amounts imposed by a superior court of the State of California on a person that are due and payable in an amount no less than $100 and are at least 90 days delinquent can be referred to the FTB for collection.[5]

Restitution orders may be referred to the FTB only by a governmental entity that meets all of the following criteria:

- The governmental entity has the authority to collect on behalf of the state or the victim.
- The governmental entity is responsible for distributing the restitution order collections, as appropriate.
- The governmental entity ensures that it coordinates with any other related collection activities that may occur regarding that debt.

Restitution orders referred to the FTB for collection by other government entities are collected through an automated collection system and are subject to the limitations of that system. Restitution orders awarded to the FTB in federal cases do not meet the requirements for referral under the COD provisions.

Collection Using the Civil Process

In general, the civil process is the means used by a court to acquire or exercise its jurisdiction over a person or specific property. In California, FTB uses the marshal or the sheriff to serve, execute, or process court notices, writs, orders or other actions as authorized based on judgments received in the court proceedings. The civil process includes both a notice process, where persons that are required to receive notice in certain actions are provided that notice, and the enforcement process, where the sheriff or marshal can seize funds belonging to a debtor on behalf of a judgment creditor. A sheriff or marshal issues garnishments, levies bank accounts, or seizes property in the hands of a third party in the enforcement process. Fees for services are set by statute.

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[5] Revenue and Taxation Code section 19280.

The FTB uses the services of the sheriff or marshal when conducting any of the following collection actions:

- Seizing personal property such as vehicles,
- Seizing cash receipts of a business through till taps or keeper actions,
- Seizing assets in a safe deposit box, or
- Issuing subpoenas to enforce the tax code.

The rate of interest on the unpaid liability is computed in accordance with the Revenue and Taxation Code when using the civil process to collect taxes.

FTB Administrative Collection Authority

The FTB has administrative authority to collect delinquent income tax and other debts referred to the FTB for collection through the issuance of wage garnishments, bank levies, and Notices of State Tax Liens when an amount owed for state income tax is due and payable, and the taxpayer has not complied with their obligation to pay the amount due. The garnishments and levies issued by the FTB are treated like warrants that are issued under the civil process.

Payment Priority

State law establishes a priority for payment of debts when multiple debts are owed by the same debtor and are collected by the FTB. Payments are applied in the following order:

1. Payment of any child support delinquencies transferred for collection.
2. Payment of any taxes, additions to tax, penalties, interest, fees, or other amounts due and payable for Non Admitted Insurance Taxes, Personal Income Taxes, or Corporation Income Taxes.
3. Payment of delinquent wages collected pursuant to the Labor Code.
4. Payment of delinquent vehicle license fees.
5. Payment of any amounts due referred for collection under the Court Ordered Debt Collection.
6. Payment of any amounts that are referred for collection under the Cal-OSHA targeted inspection program.
7. Payment of delinquent penalties collected for the Department of Industrial Relations pursuant to the Labor Code.
8. Payment of delinquent fees collected for the Department of Industrial Relations pursuant to the Labor Code.
9. Payment of delinquencies referred by the Student Aid Commission.

Problem

Because the FTB lacks express authority to use existing tax collection tools to collect orders of restitution awarded the State in criminal tax cases, the FTB relies on less efficient methods to collect those liabilities.

Proposed Solution

The proposed solution would do the following:

- Add Revenue and Taxation Code (R&TC) section 19722 to authorize the FTB to collect its orders of restitution in the same manner and with the same priority as the FTB collects state income tax.
- Amend R&TC section 19533 to clarify that voluntary payments made expressly for orders of restitution owed by a taxpayer must be applied as the taxpayer designates.

In addition, this proposal would permit the FTB to collect orders of restitution awarded in FTB federal criminal cases, which is not currently an available remedy under COD collection.

Effective/Operative Date of Solution

If enacted in the 2010 Legislative Session, this proposal would be effective January 1, 2011, and would be operative for orders of restitution awarded to the FTB in criminal cases before, on, or after that date.

Justification

This proposal would do the following:

- Accelerate the collection process on the awards received in criminal cases,
- Ensure prompt follow up on receivables owed to the state by allowing the system to monitor the account for activity that may lead to collection of the liability, and
- Take advantage of the efficient collection tools available for tax administration thereby improving the process for collecting orders of restitution awarded to the FTB.

The FTB can combine amounts owed for tax debts and amounts owed for orders of restitution into one billing statement to provide a taxpayer with an accurate statement of amounts owed to the FTB.

Implementation

Implementing this proposal would require changes to the accounting and collection systems and changes to collection notices to include amounts owed for restitution.

Fiscal Impact

The department estimates that one-time costs to modify existing systems and processes to incorporate orders of restitution to taxpayer accounts would be approximately $110,000 (1.0 P.Y.).

Economic Impact

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

Estimated Revenue Impact of LP 10-5 Effective for years BOA January 1, 2011		
2009-10	2010-11	2011-12
0	0	$100,000

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

Revenue Discussion:

The revenue attributable to the collection of order-of-restitution debt under the personal income tax collection program would be determined by the amount of additional restitution collected as a result of the efficiencies achieved.

The ability to collect order-of-restitution debt may be limited due to the debtor's incarceration, prior asset forfeiture, or payment of victim restitution. Under this proposal, the same administrative authority to collect delinquent income tax debts would apply to order of restitution debts including filing a state tax lien. The cost of investigation awarded in the orders of restitution for the past three fiscal years averaged $400,000 per year, of which the department expects to collect approximately $100,000 annually.

Other States

A comparison of other states did not identify any states that use administrative collection tools to collect on orders of restitution for criminal tax cases.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS LP 10-5
FTB's Collection of Orders of Restitution

AMENDMENT 1

SEC. 1. Section 19533 of the Revenue and Taxation Code is amended to read:

19533. In the event the debtor has more than one debt being collected by the Franchise Tax Board and the amount collected by the Franchise Tax Board is insufficient to satisfy the total amount owing, the amount collected shall be applied in the following priority:

(a) Payment of any delinquencies transferred for collection under Article 5 (commencing with Section 19270) of Chapter 5.

(b) Payment of any taxes, additions to tax, penalties, interest, fees, or other amounts due and payable under Part 7.5 (commencing with Section 13201), Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), ~~or~~ this part, or amounts authorized to be collected under Section 19722.

(c) Payment of delinquent wages collected pursuant to the Labor Code.

(d) Payment of delinquencies collected under Section 10878.

(e) Payment of any amounts due that are referred for collection under Article 5.5 (commencing with Section 19280) of Chapter 5.

(f) Payment of any amounts that are referred for collection pursuant to Section 62.9 of the Labor Code.

(g) Payment of delinquent penalties collected for the Department of Industrial Relations pursuant to the Labor Code.

(h) Payment of delinquent fees collected for the Department of Industrial Relations pursuant to the Labor Code.

(i) Payment of delinquencies referred by the Student Aid Commission.

(j) Notwithstanding the payment priority established by this section, voluntary payments ~~made by a taxpayer~~ designated by the taxpayer as payment for a personal income tax liability or as a payment on amounts authorized to be collected under section 19722, shall not be applied pursuant to this priority, but shall instead be applied as designated. ~~solely to the personal income tax liability for which the voluntary payment was made.~~

AMENDMENT 2

SEC 2. Section 19722 of the Revenue and Taxation Code is added to read:

19722. (a)(1) Restitution orders, fines, penalties, or any other amounts imposed by a court of competent jurisdiction for criminal offenses upon a person or any other entity that are due and payable to the Franchise Tax Board may be collected by the Franchise Tax Board in any manner provided by law for collection of a delinquent income tax liability, including, but not limited to, issuance of an order and levy under Article 4 (commencing with Section 706.070) of Chapter 5 of Division 2 of Title 9 of Part 2 of the Code of Civil Procedure in the manner provided for earnings withholding orders for taxes.
(2) Amounts imposed by a court of competent jurisdiction as an order of restitution for criminal offenses shall be treated as final and due and payable to the State of California on the date that amount is established on the records of the Franchise Tax Board.

(b) Part 10 (commencing with Section 17001), this part, Part 10.7 (commencing with Section 21001), and Part 11 (commencing with Section 23001) shall apply to amounts collected under this section in the same manner and with the same force and effect and to the full extent as if the language of those laws had been incorporated in full into this section, except to the extent that any provision is either inconsistent with this section or is not relevant to this section.

(c)Notwithstanding Chapter 6 (commencing with Section 19301), no refund or credit may be allowed for any amounts paid or payments applied under this section.

(d) Amounts authorized to be collected pursuant to this section shall accrue interest at the greater of the rate applicable to the amounts being collected or the rate provided under Section 19521 from and after the date such amounts are established on the records of the Franchise Tax Board.

(e) Amounts authorized to be collected pursuant to this section are not subject to section 19255.

(f)Notwithstanding section 19204 or Chapter 14 of Division 7 of Title 1 of the Government Code (commencing with Section 7150), any portion of the amounts authorized to be collected under this section that remains unsatisfied may be collected by the recording of a Notice of State Tax Lien. The Franchise Tax Board may record or extend a recorded Notice of State Tax Lien at any time until the amount due, including any accrued interest, is paid in full.

(g) On a monthly basis, the amounts collected pursuant to subdivision (a) that represent the costs of investigation shall be transferred from the Personal Income Tax Fund and Bank and Corporation Tax Fund to the Franchise Tax Board’s General Fund Appropriation to reimburse the costs of investigation.

(h) This section shall be apply on and after January 1, 2011, to amounts authorized to be collected pursuant to this section that are due and payable to the Franchise Tax Board before, on, or after that date.

LEGISLATIVE PROPOSAL 10-6
EXECUTIVE SUMMARY

- **Title:** Innocent Spouse Law Conformity

- **Problems:**

1. Taxpayers who request innocent spouse relief based solely on “equitable relief” have no appeal rights, while taxpayers whose request includes “equitable relief” as one of several grounds for relief have appeal rights, which results in inconsistent treatment between two similarly situated taxpayers.
2. Taxpayers who have requested federal innocent spouse relief must also request California relief by the stated deadline to avoid being barred from receiving California innocent spouse relief, which forces taxpayers to duplicate effort.
3. Current law contains obsolete language that creates inconsistent references to the deadline to request innocent spouse relief, which results in taxpayer confusion.

- **Proposed Solutions:** Amend Revenue and Taxation Code section 18533 to do each of the following:

1. Allow taxpayers who request innocent spouse relief based solely on “equitable relief” to appeal the Franchise Tax Board’s (FTB’s) determination.
2. Reenact the statutory requirement that the FTB grant innocent spouse relief when the Internal Revenue Service (IRS) has granted relief under the same facts and circumstances.
3. Remove the obsolete transition rule that refers to a four-year period for submitting a request for innocent spouse relief.

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

Estimated Revenue Impact of LP 10-6 Effective January 1, 2011 and Operative for Requests Made on or After January 1, 2009 Enactment Assumed After June 30, 2010		
2009/10	2010/11	2011/12
-$90,000	-$200,000	-$200,000

Title

Innocent Spouse Relief Law Conformity

Introduction

This proposal would make several changes to the innocent spouse relief provisions.

Program History/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:

1. *Understatement/Apportionment.* A spouse may request 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 that lead to the understatement of tax.

   If the taxpayer can show lack of knowledge, as described above, with respect to *a portion of the understatement,* 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 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.

In order for a taxpayer to qualify for relief under either 1 or 2, above, the taxpayer must request relief within two years of the date the Secretary has begun collection activities with respect to the taxpayer making the election.

The federal Tax Relief and Health Care Act of 2006 (the "2006 Act") gave the Tax Court authority to review an IRS denial of equitable innocent spouse relief and suspends the running of the period of limitations while the appeal is pending. The changes made by the 2006 Act apply to requests for equitable relief with respect to liability for taxes arising or unpaid after Dec. 20, 2006.

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.

In addition, California law provides two avenues for innocent spouse relief not available under federal law:

1. A taxpayer may seek a divorce court order relieving the taxpayer of joint and several liability (JSL) for income tax reported on a joint return or additional tax resulting from an audit. The order cannot relieve tax on any income that was earned by or derived from assets under the exclusive control and management of the taxpayer seeking relief.

2. A taxpayer may also seek relief from the FTB on any unpaid self-assessed tax liability on a joint return, including penalties and interest. The tax liability must not be attributable to income that was under the exclusive control and management of the requesting taxpayer.

During the period from January 1, 2004, through December 31, 2008, under changes made by SB 285 (Speier, Stats. 2003, Ch. 370), an individual who had been granted relief from specified joint and several liability provisions under Internal Revenue Code (IRC) section 6015 was also granted relief under California law when the facts and circumstances supporting relief were the same. This provision was repealed by a sunset provision.

California has not conformed to the 2006 Act. As a result, FTB "equitable relief" determinations cannot be appealed.

Problems

This legislative proposal would resolve the following three problems:

1. Taxpayers who request innocent spouse relief based solely on "equitable relief" have no appeal rights, while taxpayers whose request includes "equitable relief" as one of several grounds for relief have appeal rights, which results in inconsistent treatment between two similarly situated taxpayers.

2. Taxpayers who have requested federal innocent spouse relief must also request California relief by the stated deadline to avoid being barred from receiving California innocent spouse relief, which forces taxpayers to duplicate effort.
3. Current law contains obsolete language that creates inconsistent references to the deadline to request innocent spouse relief, which results in taxpayer confusion.

Proposed Solutions

Amend Revenue and Taxation Code (R&TC) section 18533 to do each of the following:

1. Allow taxpayers who request innocent spouse relief based solely on "equitable relief" to appeal the FTB's determination.
2. Reenact the statutory requirement that the FTB grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances.
3. Remove the obsolete transition rule that refers to a four-year period for submitting a request for innocent spouse relief.

Effective/Operative Date of Solution

If enacted in 2010, as a non-urgency matter, the new provisions would become effective and operative January 1, 2011, with the exception of the provision requiring the FTB to rely on an IRS grant of relief which would be operative as of January 1, 2009.

Justification

1. Allowing taxpayers to appeal the FTB's "equitable relief" determinations eliminates disparate treatment of taxpayers and brings state law into conformity with federal law.
2. Reenacting the statutory requirement for the FTB to grant relief based on an IRS innocent spouse determination when the facts and circumstances are the same would eliminate the need for a taxpayer to file a separate request for state relief to prevent being barred from receiving state relief because the two-year application period had expired at the time federal relief was granted.
3. Removing obsolete language prevents confusion for taxpayers and the department when applying state law.

Implementation

Implementing this proposal could occur during the department's normal annual update.

Fiscal Impact

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

Economic Impact

Revenue Estimate:

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

Estimated Revenue Impact of LP 10-6 Effective January 1, 2011 and Operative for Requests Made on or After January 1, 2009 Enactment Assumed After June 30, 2010		
2009/10	2010/11	2011/12
-$90,000	-$200,000	-$200,000

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

Revenue Discussion:

Although the proposal would resolve three problems, the provision that would reenact the requirement that the FTB follow an IRS grant of innocent spouse relief, provision No. 2, is the only one that would impact revenue.

Under current law there are scenarios that result in both spouses being legally relieved of the obligation to pay a joint and several liability. These scenarios include situations where one spouse obtains relief of the tax liability through a bankruptcy ruling or via an Offer in Compromise agreement and the other spouse obtains relief as an innocent spouse. Requiring the FTB to grant innocent spouse relief based on an IRS grant of relief increases the possibility of both spouses obtaining relief from the liability, resulting in the FTB's inability to collect the tax liability.

Although the number of cases where both spouses are legally relieved of their joint and several liability is unknown, based on departmental data for the number and amount of claims, it is estimated that five percent of the liability relieved under former R&TC section 18533(i) that required the FTB to grant relief based on an IRS grant, would become uncollectable against both spouses.

For the period January 1, 2004, through November 30, 2007, the FTB granted relief of an annual average of $3.8 million in joint and several obligations based on IRS grants of relief. Applying the estimated rate of the liability that will become uncollectible against both spouses results in an estimated annual revenue loss of approximately $200,000 ($3.8 million x 5% ≈ $200,000). The 2010/11 loss would be half of that amount because the bill would not go into effect until January 1, 2011. Because accrual rules require that revenue associated with a prior tax year be shifted one year back, the revenue estimate is accrued from fiscal year 2010/11 to 2009/10 resulting in the amounts shown in the table above.

Provisions 1 and 3 are not expected to impact revenue. Provision 1 allows taxpayers to appeal the FTB's "equitable relief" determinations. It is anticipated that situations where a taxpayer would have to pay an assessment and file a claim for refund to continue with their administrative options are rare and would not significantly impact revenue. Provision 3 removes obsolete references to the period a spouse has to request relief. This change would not impact revenue.

Other States

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

Illinois law provides that a federal request for innocent spouse relief constitutes a request for Illinois state tax relief. Under Illinois law, innocent spouse relief from a tax liability arising and paid prior to August 13, 1999, is granted based on proof of IRS relief for the same tax years.

Massachusetts law provides for innocent spouse relief to the extent that a tax liability is attributable to a substantial understatement of tax attributable to grossly erroneous items of the taxpayer's spouse. *Massachusetts* innocent spouse relief provisions do not refer to or conform to IRC section 6015.

Michigan law provides for innocent spouse relief similar to federal relief and adheres to IRS interpretation in matters regarding relief from joint and several liability.

Minnesota grants innocent spouse relief to the extent a liability is due to an understatement. Federal standards as set forth in IRC section 6015(b) determine qualifications. Final denials or grants of relief may be appealed to the Minnesota Tax Court.

New York adopted the federal innocent spouse provisions for tax years beginning on or after January 1, 2009.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO LP 10-6

AMENDMENT 1

SECTION 1. Revenue and Taxation Code Section 18533 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 does 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 purposes 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 or requests equitable relief under subdivision (f)--

(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) or requesting equitable relief under subdivision (f) 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) or requesting equitable relief under subdivision (f) 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) or requesting equitable relief under subdivision (f) 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),~~(c) or requesting equitable relief under subdivision (f), 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 Section 19306 and 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),~~(c) or request for equitable relief under subdivision (f), 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.
(C) No credit or refund shall be allowed as a result of an election under subdivision (c).
(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~~The amendments made by Section 5 of 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 period specified under subparagraph (E) of paragraph (1) of subdivision (b) or subparagraph (B) of paragraph (3) of subdivision (c) does not expire before the date that is four years after the date of the first collection activity after 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) This section shall become operative on January 1, 2009.

~~(i)~~ (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.

~~(j)~~ (m) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any procedure or rule prescribed by the Franchise Tax Board pursuant to this section.
(n) (1) The provisions of subdivision (i) and (j), as amended by the act adding this subdivision, shall apply on and after January 1, 2009.
(2) The amendments made to subdivisions (e), (g), and (h) shall apply to requests for relief received on or after the effective date of the act adding this subdivision.

LEGISLATIVE PROPOSAL 10-7
EXECUTIVE SUMMARY

- **Title:** Voluntary Disclosure Agreements

- **Problems:**

1. Some taxpayers must submit their tax return for the most recent tax year covered by a Voluntary Disclosure Agreement (VDA) before the federal tax return due date, which creates a burden because the state return is based on the federal return.
2. Some taxpayers receive the underpayment-of-estimated-tax penalty for the first taxable year after the VDA period because the VDA is signed after one or more quarterly estimated tax payments are already past due.
3. An applicant must pay all amounts due under a VDA within 120 days, but applicants requesting an Installment Payment Arrangement (IPA) may lose the benefit of the VDA if the IPA application is denied after the 120-day period.

- **Proposed Solutions:**

1. Allow taxpayers to file the current-year tax return as late as the extended due date.
2. Eliminate the underpayment-of-estimated-tax penalty where imposed because the agreement is signed after the quarterly tax payment due date.
3. Allow VDA applicants requesting an IPA additional time to satisfy the VDA if the IPA request is denied after the VDA period ends.

- **Revenue:** This proposal would not impact state income tax revenue.

Title

Voluntary Disclosure Agreements

Introduction

This proposal would make changes to the California Revenue and Taxation Code (R&TC) sections related to participation in what is commonly called a Voluntary Disclosure Agreement (VDA).

Program History/Background

Some out-of-state taxpayers that conduct business in California as defined by the R&TC may not be aware of their California franchise or income tax liability or filing requirements. The Franchise Tax Board (FTB) also may not readily identify such taxpayers through its filing enforcement or other compliance programs. Given the substantial penalties for delinquent filing of returns and payment of taxes, and the open statute to audit all tax years preceding identification, these taxpayers may be reluctant to disclose their California presence and report any tax liability voluntarily.

Current VDA statutes allow qualified entities, qualified shareholders, or qualified beneficiaries to disclose their liability voluntarily through a VDA. The qualified entities, qualified shareholders, or beneficiaries that choose to participate in a VDA may anonymously apply to the FTB and in exchange, if accepted, must disclose their California tax liability for the immediately-preceding six taxable years. The FTB waives its authority to assess taxes, additions to tax, fees, or certain penalties for the taxable years ending more than the six taxable years covered by the VDA.

The Multistate Tax Commission (MTC) has an agreement with 30 states, including California, that provides incentives for taxpayers to request a VDA. The states that participate in MTC's voluntary disclosure program follow guidelines and processes provided by the MTC allowing applicants to request VDAs for multiple states through the MTC. The voluntary disclosure period in these states is the four taxable years ending before the signing date of the VDA.

Each of these states allows the taxpayer to remain anonymous during the application period. As a result, the estimated tax payments due in the year immediately after the voluntary disclosure period may be late, and the taxpayer is penalized for the late payments. The other states in the MTC compact address the penalty on a case-by-case basis.

With the exception of California's six-year VDA period, current state law generally conforms to the MTC's VDA application procedures and guidelines.

Current Federal/State Law

Current federal law has no comparable voluntary disclosure statutes.

Current state law allows the FTB to enter into a VDA with qualified taxpayers and waive the following penalties that would normally apply for the period covered by the VDA:

1. Failure to make and file a return under R&TC section 19131,
2. Failure to pay tax by the due date under R&TC section 19132,
3. Underpayment of estimated tax under R&TC sections 19136 and 19142,
4. Failure to file Corporate Organization Statement under R&TC section 19141,
5. Failure to furnish information or maintain records under R&TC section 19141.5,
6. Failure to file a partnership return under R&TC section 19172,
7. Failure to file information returns under R&TC section 19183, and
8. Any penalty related to relief from contract voidability under R&TC section 23305.1.

Current state law allows a taxpayer requesting a VDA to remain anonymous until the signed agreement is returned to the FTB. Current state law also defines qualified taxpayers for the purposes of a VDA as qualifying business entities, including corporations, certain limited liability companies (LLCs), qualified trusts, qualified shareholders, qualified members of LLCs, and qualified beneficiaries of qualified trusts. These entities are defined as follows:

- A “qualifying business entity” includes any out-of-state corporation or LLC not classified as a corporation that has never filed a California income or franchise tax or LLC return and that voluntarily applies for a VDA prior to any contact from the FTB regarding income, franchise, or LLC tax liability.
- A “qualified shareholder” is a nonresident shareholder of an S corporation that has applied for a VDA and disclosed all material facts pertaining to the shareholder’s liability.
- A “qualified member” is an individual who is a nonresident on the signing date or a corporation or LLC that is not organized in California nor qualified or registered with the office of the Secretary of State. A qualified member in all cases is a member of an LLC that has applied for a VDA and disclosed all material facts pertaining to the member'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 VDA. However, “qualified trust” includes 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 VDA and for each of the preceding six taxable years.

Under the terms of the VDA, the FTB waives certain penalties for noncompliance, including the underpayment-of-estimated-tax penalty, but requires specified reporting and payment requirements for the six taxable years immediately preceding the agreement. For the taxable years ending more than six years prior to the agreement, the applicant's income or franchise tax, additions to tax, fees, or penalties are waived.

To satisfy the terms of the VDA, approved taxpayers must return a signed agreement to the FTB, make all payments, and submit all returns to the FTB within a 120-day statutory deadline that begins upon the signing date of the VDA. Failure to perform timely renders the VDA null and void. An exception to the requirement that complete payment be made within 120 days allows the applicant to enter into an installment payment arrangement (IPA). A taxpayer with a VDA also approved for an IPA would be allowed to make monthly installment payments on the outstanding tax liability for up to 36 months and would still be in compliance with VDA.

The three-member Franchise Tax Board must approve all VDAs.

Problems

The following problems have been identified in current law:

1. Some taxpayers must submit their tax return for the most recent tax year covered by a VDA before the federal tax return due date, which creates a burden because the state return is based on the federal return.

2. Some taxpayers receive the underpayment -of-estimated-tax penalty for the first taxable year after the VDA period because the VDA is signed after one or more quarterly estimated tax payments are already past due.

3. An applicant must pay all amounts due under a VDA within 120 days, but applicants requesting an IPA may lose the benefit of the VDA if the IPA application is denied after the 120-day period.

Proposed Solutions

1. Amend R&TC section 19191(d)(3) to allow taxpayers to file the current-year tax return as late as the extended due date.
2. Add R&TC section 19191(h) to eliminate the underpayment-of-estimated-tax penalty when imposed because the agreement is signed after the quarterly tax payment due date.

3. Amend R&TC section 19194(a)(3)(C) to allow VDA applicants requesting an IPA additional time to satisfy the VDA if the IPA request is denied after the VDA period ends.

Effective/Operative Date of Solutions

If enacted in the 2010 Legislative Session in legislation that is not immediately effective, the provisions of this proposal would become effective and specifically operative January 1, 2011.

Justification

This proposal would make changes to the processes involved with reviewing VDAs, which would help the department achieve greater compliance with state income tax laws. Specifically, the proposal would do the following:

1. Minimize the burden of tax return preparation because a completed federal income tax return is necessary to prepare a California return.

2. Provide a greater incentive for qualified entities to participate in a VDA, thus increasing compliance with state income tax laws.

3. Provide greater assurance to taxpayers seeking to make installment payments that they will not lose the benefit of the VDA due to the FTB's speed in reviewing IPA applications.

Implementation

This proposal could be implemented with minimal impact to the department's operations.

Fiscal Impact

This proposal would not impact the department's costs.

Economic Impact

This proposal would not impact state income tax revenue.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 10-7

AMENDMENT 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 or qualified shareholder, qualified member, or qualified beneficiary 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) Reasonable reliance on the advice of a person in a fiduciary position or other competent advice that the qualified entity or qualified shareholder, qualified member, or qualified beneficiary 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 or qualified shareholder, qualified member, or qualified beneficiary.

(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), (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 a date that is 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 of this code.

(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 25153 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 or to the latest extended due date of the return for a taxable year for which relief is granted, whichever is later.

(e) No addition to tax under sections 19136 or 19142 shall be made for any underpayment of estimated tax attributable to the underpayment of an installment of estimated tax due before the signing date of the voluntary disclosure agreement.

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

~~(g)~~ (h) The amendments to this section made by Chapter 543 of the Statutes of 2001 shall apply to voluntary disclosure agreements entered into on or after January 1, 2005.

(i) 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, 2011.

AMENDMENT 2

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 entity has misrepresented any material fact in applying for the voluntary disclosure agreement or in entering into the agreement.

(2) The qualified 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 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 entity to comply with the terms of the installment payment arrangement shall also render the voluntary disclosure arrangement null and void.

(C) Notwithstanding subparagraphs (A) and (B), an applicant applying for an installment arrangement shall have the same time periods as identified in paragraphs (1) and (2) of subdivision (d) of Section 19008 to pay in full any tax, fee, penalty, or interest due.

(4) The tax shown by the qualified 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 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 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 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) and subdivision (h) of Section 19191 shall not be binding on the Franchise Tax Board.

(c) 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, 2011.

LEGISLATIVE PROPOSAL 10-17
EXECUTIVE SUMMARY

- **Title:** Funding for Transfer Pricing Experts

- **Problem:** The Department lacks the resources necessary to examine numerous transfer pricing cases, resulting in taxpayer noncompliance and potential lost corporation tax revenues from international transactions.

- **Proposed Solution:**

  - Provide legislative findings and declarations discussing transfer pricing schemes and the uniqueness and complexity of transfer pricing examinations.
  - Provide that on qualified issues the Franchise Tax Board (FTB) may enter into a benefit-funded contract with a vendor for purposes of supporting the administrative functions at audit, protest, appeal, settlement, and litigation.
  - Prohibit the benefit-funded contract from causing the displacement of civil service employees.
  - Provide that all transfer pricing examinations assisted by a vendor would be conducted by the FTB in accordance with the existing FTB audit regulations.

- **Revenue:**

Revenue Estimate for LP 10-17
Effective for Examinations Commenced after January 1, 2011
Assumed Enacted after June 30, 2010
($ in Millions)

	2010-11	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Net Revenue	N/A	$4	$16	$20	$33

Title

Funding for Transfer Pricing Experts

Introduction

This proposal would provide a self-funding mechanism so outside vendors with specialized expertise could be utilized to assist with a complex area of tax law.

Transfer Pricing

Corporations that are owned or controlled by the same interests have the ability to structure their intercompany transactions in such a way as to reduce the total tax liability of the related group of corporations through the artificial shifting of income or deductions from one entity to another entity within the controlled group. Intercompany transfer pricing is the method used for tax purposes in determining the arm's-length price to be taken into account as having been paid or charged for property or services transferred from one related corporation to another.

Internal Revenue Code (IRC) section 482, under which transfer pricing audits are conducted, was enacted to allow the federal government to distribute, allocate, or apportion income and deductions between entities owned or controlled by the same interests to prevent evasion of taxes or to clearly reflect income. In general, current state law conforms to IRC section 482.

Current Federal Law

Under federal law, corporations report their income subject to U.S. taxation using a separate accounting method of tax accounting. The use of separate accounting raises issues of potential manipulation of the tax base through use of intercompany transactions between related parties that are not at arm's-length, as such transactions would generally be if between unrelated parties.

In response to this potential manipulation resulting from the use of separate accounting, the Internal Revenue Service (IRS) is authorized to allocate income and deductions among two or more entities owned or controlled by the same interests in order to prevent tax evasion or to reflect the true taxable income of any of those entities. This authority assures taxpayers report and pay the correct amount of tax by preventing improper shifting of income and deductions among related entities.

Under Advance Pricing Agreements (APAs), the IRS and taxpayers agree to a prospective transfer pricing methodology to be applied to specified international transactions between related foreign or domestic entities. APAs memorialize the agreement between the taxpayer and IRS of the transfer pricing methods that should be applied before the tax return is filed. Negotiating an APA prior to tax return filing provides certainty and eliminates the need for intrusive and resource-intensive transfer pricing audits.

Current State Law

Under state law, corporations report their net income subject to California taxation using the unitary method of tax accounting. The use of the unitary method generally avoids the intercompany transactions issues that arise under federal law due to the use of separate accounting. However, in certain circumstances California law allows corporations to elect to determine their business income on a "water's-edge" basis.

In general, the water’s-edge method excludes the income and apportionment factors of foreign corporations from the calculation of a California taxpayer’s taxable income. The effect of a water's-edge election is that some foreign unitary entities are no longer part of the combined reporting group and thus transactions between these entities and related entities within the water's-edge are reflected on a separate-accounting basis, which raises the same transfer pricing audit issues that arise under federal law.

Revenue and Taxation Code (R&TC) section 25114 provides that if the IRS has conducted a detailed transfer pricing audit, whether there are federal adjustments or not, it shall be presumed no additional adjustments are necessary for state purposes. In addition, it has been the Department’s practice to follow federal APA’s.

Current law provides that the FTB may enter into an agreement with a debt collection service and may make collection agreements with one or more persons. The FTB determines the amount of contract costs and notifies the Controller of that amount to be transferred from the Personal Income Tax Fund or the Corporation Tax Fund to the Delinquent Tax Collection Fund. The Controller transfers the contract cost from the Delinquent Tax Collection Fund to the FTB for reimbursement.

Program History/Background

A significant issue for water’s-edge taxpayers is the computation and assignment of income among related entities within and without the water’s-edge group. IRC section 482 requires that all transactions between related entities be accounted for at arm’s-length. “Arm’s-length” refers to the uncontrolled price that would be used in the open marketplace had the entities been unrelated.

International tax sheltering that adds to the tax gap occurs when intercompany transactions between members of the water’s-edge combined group and excluded foreign affiliates are not accounted for using arm's-length standards. For purposes of R&TC section 25114, an intercompany transaction includes the transfer, sale, purchase, or license for use of tangible or intangible property from or by a water’s-edge group member to or from an excluded foreign entity. Prices for the goods and services traded between a domestic corporation and a foreign affiliate may not reflect the actual market prices for the same goods and services. For example, goods sold by a domestic parent to its foreign affiliates may be below the price sold in the U.S., or it may inflate the price of goods imported from its foreign affiliate to shift profits offshore.

A large component of the tax gap at the corporate level, as highlighted in the 2006 Levin-Coleman hearings, is shifting profits offshore. The Multistate Tax Commission in a July 15, 2003, report estimated that California could be losing as much as $1.34 billion annually attributable to all international tax-sheltering strategies.

Historically, the FTB has relied on the IRS to address this issue due to its extreme complexity and significant cost in terms of resources necessary to conduct a transfer pricing audit. The analysis needed for a transfer pricing examination, more specifically, the process of determining an “arm’s-length” price, is extremely time consuming, necessitating not only significant audit hours, but also the skills of economists, attorneys, and industry experts. Historical FTB audit statistics show that an average of 3,000 audit hours, 800 staff economist hours, and 700 legal staff hours are utilized when examining a transfer pricing issue.

In response to the complexity of conducting transfer pricing audits, the IRS has established a program to address transfer pricing issues on a pre-filing basis. The IRS, at the request of a taxpayer, enters into APAs establishing various rules and valuations associated with that taxpayer's asset or inventory items. While not all of the Fortune 500 companies may have APAs, the IRS is reporting a surge in requests for APAs. In 2008, the IRS received 123 APA applications, which is a record high. Three-quarters of these APAs involved inbound transactions between foreign multinationals with U.S. subsidiaries or U.S. branches. The IRS has completed 841 APAs since the program started.[1] The FTB follows these agreements.

Problem

The Department lacks the resources necessary to examine numerous transfer pricing cases, resulting in taxpayer noncompliance and potential lost corporation tax revenues from international transactions.

Proposed Solution

This proposal would accomplish the following:

- Provide legislative findings and declarations that transfer pricing schemes are used by some companies to shift profits overseas and that this proposal would encourage increased tax compliance and help close the state tax gap involving international transactions. In addition, this proposal would declare in legislative findings that transfer pricing examinations are extremely complex, unique, and time consuming and require special expertise and access to specialized industry data.
- Provide that on qualified issues the FTB may enter into a benefit-funded contract with a vendor for purposes of supporting the administrative functions at audit, protest, appeal, settlement, and litigation.
- Prohibit the benefit-funded contract from causing the displacement of civil service employees.
- Provide the following definitions:
  (a) “Benefit funded” would mean that the payments for contract services would be based on a certain percentage of the final tax liability and would only be paid upon the collection of the final tax liability.
  (b) “Final tax liability” would be defined as an amount perfected, including related interest, additions to tax, penalties, or other amounts assessed, and could be enforceable by a state tax lien.[2] In other words, the amount of tax liability is final and may not be reduced by taking any administrative or judicial actions (i.e. protest, litigation, or claim for refund).
  (c) “Qualified issues” would mean issues relating to transfer pricing for a specific taxable year as long as no detailed transfer pricing examination has been conducted by the IRS or no APA has been approved by the IRS for the same taxable period.
  (d) “Displacement” would include layoff, demotion, involuntary transfer to a new class, involuntary transfer to a new location requiring a change in residence, and time base reductions. “Displacement” would exclude changes in shifts or days off, and reassignment to any other position within the same class and general location.

[1] 2008 APA Annual Report.
[2] Revenue & Taxation Code section 19221.

- Provide that the FTB would have the sole discretion in selecting which taxpayers would be subject to the transfer pricing examinations assisted by the vendor and which aspects of the administrative functions the vendor would assist with. In addition, this proposal would provide that all transfer pricing examinations assisted by a vendor would be conducted by the FTB in accordance with the existing FTB audit regulations.[3]
- Provide that after the FTB collects the final tax liability, it would determine the amount of payment owed to the vendor under the benefit-funded contract and notify the Controller of that amount. The Controller would transfer the amount owed from the Corporation Tax Fund to the newly-formed Water's-edge Consultant Fund. The Controller would then transfer the amount of payment from the Water's-edge Consultant Fund to the FTB for reimbursement for the benefit funded contract costs.
- Provide that the amount of monies transferred under these provisions would be continuously appropriated, without regard to fiscal years.
- Provide that the funds generated from the benefit funded contracts would be prohibited from being used in place of funds from other sources that are available for appropriation to the FTB.

Justification

This proposal would allow the FTB to expand the number of transfer pricing examinations it opens, which could result in additional cash revenues to the state, increase fairness and compliance, and assist with closing the tax gap involving international tax-avoidance activities. This proposal would allow the FTB to contract with vendors with extensive transfer pricing expertise and access to industry data not available to the state. This proposal would establish a funding mechanism that would pay for the transfer pricing expert services based on a percentage of the final transfer pricing assessment paid by the taxpayer, resulting in no additional costs to the state.

Background: California Budget Process

The State Constitution requires that the Governor submit a budget to the Legislature by January 10th. It provides for a balanced budget in that, if the proposed expenditures for the budget year exceed estimated revenues, the Governor is required to recommend the sources for the additional funding.

The Director of Finance, as the chief financial advisor to the Governor, directs the effort for preparation of the Governor's Budget. Under the policy direction of the Governor, the Director of Finance issues instructions and guidelines for budget preparation to agencies and departments. This effort typically gets underway even before the Legislature has passed the budget for the current fiscal year.

Although California has utilized concepts such as Zero-Based Budgeting, Management by Objectives, and Total Quality Management, the basic approach utilized is incremental budgeting. This approach uses the current departmental level of funding as a base amount to be adjusted by change proposals.

[3] Cal. Code of Regs. title 18, section 19032.

The Budget Change Proposal (BCP) has been the traditional decision document which proposes a change to the existing budget level. BCPs are submitted by departments to the Department of Finance for review and analysis. A flowchart from the Department of Finance's website illustrating the California Budget Process is included in Appendix A.

After numerous discussions with the Department of Finance, the department was unable to determine how to obtain budget approval for entering into a benefit-funded contract because the amount and timing of the contract payment would be uncertain and conflicts with California's budget process that funds vendor projects that are sum certain.

Effective/Operative Date of Solution

If the proposal were enacted during the 2010 legislative session in non-urgency legislation, it would be effective January 1, 2011, and specifically operative for audits opened on and after January 1, 2011.

Implementation

The Department can implement this proposal with existing processes and resources.

Fiscal Impact

It is estimated that any workload increase due to additional enforcement through audits, contracts with vendor, and accounting for the payment to vendors would be absorbable.

Economic Impact

Revenue Estimates:

Based on the data and assumptions discussed below, this proposal would result in the following revenue gains beginning in fiscal year 2011-12.

Revenue Estimate for LP 10-17
Funding for Transfer Pricing Experts
Effective for Examinations Commenced After January 1, 2011
Assumed Enacted After June 30, 2010
($ in Millions)

	2010-11	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Net Revenue	N/A	$4	$16	$20	$33

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

Revenue Discussion:

The revenue impact is dependent upon the terms of the contract entered into between the FTB and a vendor, the number of audits performed, and the duration of each case. Because it is likely that some taxpayers would protest the deficiency notice, the duration and outcome of each case would vary.

During 2011 and for each year thereafter, it is expected that ten audits would begin and would be anticipated to be completed successively 18 months later. It is estimated that the ten audits started during 2011 would result in transfer pricing adjustments totaling $42 million in tax deficiencies, for an average of $4.2 million per audit. Because the additional tax due exceeds the large corporate understatement penalty (LCUP), the 20 percent penalty would apply. The vendor would be expected to receive a percentage of the paid final assessment. For purposes of this estimate, 16 percent was used as the vendor's contract rate based on department staff's knowledge of vendors that have previously entered into benefit-funded contracts. Based on historical data and departmental input, it is estimated that the first audit cycle would, on average, be resolved as follows for the estimated ten audits:

- One audit in September 2012
- Two protests affirmed at 100 percent in September 2013
- One protest withdrawn in September 2013
- One protest affirmed at 80 percent in September 2013
- One appeal affirmed at 100 percent in September 2014
- Two protests affirmed at 50 percent in September 2015
- Two appeals affirmed at 100 percent in September 2015

It is assumed that the tax and contract fee would be paid in the same fiscal year the case is resolved.

The first audit would be anticipated to be completed during 2012-13. To derive the impact for this fiscal year, the amount received from the Notice of Proposed Assessment ($4.2 million) plus the LCUP of $840,000 (20% X $4.2 million) is reduced by the vendor fee of $806,400 {16% X ($4.2 million + $840,000)} for net revenue of $4.0 million ($4.2 million + $840,000 - $806,400 = $4.23 million rounded to $4.0 million). Because accrual rules require that revenue and expenses associated with a prior tax year be shifted one year back, the revenue is accrued from fiscal year 2012-13 to 2011-12. Subsequent years were similarly calculated and incorporate the second, third, and fourth year audit cycles. Adding subsequent audit cycles consisting of ten audits each cycle cause the revenue to increase until the 2015-16 fiscal year where it levels out at $33 million per fiscal year.

<u>Other Agency/Industry Impacted</u>

The FTB would coordinate with the Controller's office for the reimbursement of contract costs out of the newly-created Water's-Edge Consultant Tax Fund.

Other States

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

Research[4] was conducted to determine 1) if these states employ private contractors to assist in the administration of tax law, 2) how the private contractors are compensated, and 3) what areas of tax law do they assist with.

Florida employs private contractors to assist with audit and tax-collection activities and compensates the contractors by a negotiated contract.

Illinois employs private contractors to assist with tax-collection activities and compensates the contractors through a contingency fee.

Massachusetts employs private contractors for tax-collection activities and uses a variety of methods to compensate the contractors.

Michigan employs private contractors for nexus, audit, and tax-collection activities and compensates the contractors through a contingency fee.

Minnesota employs private contractors to assist with tax-collection activities, but research could not determine the method used to compensate the contractors.

New York does not employ private contractors to assist with the administration of tax law.

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[4] According to the 2009 Multistate Corporate Tax Guide published by CCH.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS
LP 10-17

SECTION 1. The Legislature finds and declares all of the following:

(a) A large component of the tax gap at the corporate level, as highlighted in the 2006 Levin-Coleman hearing, is shifting profits offshore. Some companies have designed transfer pricing schemes to minimize their taxable profits in the United States and shift profits overseas.

(b) In the case of water's-edge taxpayers, the same transfer pricing issues that exist under federal law become issues for California franchise tax purposes due to the separate tax accounting treatment of transactions between affiliated entities, some within and some without, the water's-edge.

(c) Transfer pricing examinations are unique, complex, and time consuming and require special expertise and access to industry data to effectively examine pricing arrangements for goods, services, intangibles, loans, and other financial transactions between United States and foreign related business entities.

(d) The Legislature finds and declares that expanded enforcement and examination of transfer pricing issues will increase tax compliance and help close the state tax gap involving international transactions.

SEC. 2. Section 19032.5 [25114] is added to the Revenue and Taxation Code to read:

Section 19032.5. (a) The Franchise Tax Board may enter into a benefit funded contract with one or more persons for the purpose of supporting the administrative determinations and judicial proceedings identified in Part 10.2 (commencing with Section 18401), including Sections 19032, 19044, 19047, 19442, and Chapter 6 of Part 10.2 (commencing with Section 19301) to identify and substantiate qualified issues.

(b) The benefit funded contract may not cause the net displacement of civil service employees.

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

(1) "Benefit funded" means the payment for such contract services will be based on a percentage of the final tax liability and will only be paid upon the collection of the final tax liability.

(2) "Final tax liability" means any tax liability arising under Part 11 (commencing with Section 23001) that is a perfected and enforceable tax lien pursuant to Section 19221, including related interest, additions to tax, penalties, or other amounts assessed under this part or Part 10.2 (commencing with Section 18401) for a taxable year.

(3) "Qualified issues" means issues identified under Sections 25114 and 24725 with respect to Section 482 of the Internal Revenue Code for a specific taxable year as long as no detailed audit has been conducted by the Internal

Revenue Service or the taxpayer has not entered into Advanced Pricing Agreement with the Internal Revenue Service pursuant to Section 482 of the Internal Revenue Code for the same taxable period.

(4) "Displacement" includes layoff, demotion, involuntary transfer to a new class, involuntary transfer to a new location requiring a change in residence, and time base reductions, but does not include changes in shifts or days off, nor does it included reassignment to any other position within the same class and general location.

(d) The Franchise Tax Board shall have the sole discretion in selecting taxpayers and the administrative determination and judicial proceedings covered by a benefit funded contract, and any person who enters into a contract under this section shall not have any cause of action against the Franchise Tax Board as a result of the exercise of that discretion. In addition, all examinations utilizing benefit funded contracts shall be conducted by the Franchise Tax Board pursuant to Section 19032 and the regulations adopted thereunder.

(e) This section shall apply to audits initiated or claims filed on or after January 1, 2011.

SEC. 3. Section 19608 is added to the Revenue and Taxation Code to read:

Section 19608. (a) The Franchise Tax Board shall determine the amount of contracting costs incurred under Section 19032.5 and notify the Controller of that amount which shall be transferred from the Corporation Tax Fund to the Water's-Edge Consultant Fund, which is hereby created.

(b) The Controller shall transfer the amount determined pursuant to subdivision (a) from the Water's-Edge Consultant Fund to the Franchise Tax Board for reimbursement of its contracting costs. The Controller upon notification by the Franchise Tax Board shall transfer the moneys remaining in the Waters'-Edge Consultant Fund after disbursements to the Corporation Tax Fund. Notwithstanding Section 13340 of the Government Code, the moneys transferred pursuant to this section are hereby continuously appropriated, without regard to fiscal years.

(c) The funds generated through this section shall not be used in place of funds from other sources that are available for appropriation to the Franchise Tax Board.

(d) This section shall become operative January 1, 2011.

APPENDIX A
CALIFORNIA BUDGET PROCESS

(http://www.dof.ca.govHTML/BUD_DOCS/budenact.pdf)