FTB Staff
2007 Legislative Proposals

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LEGISLATIVE PROPOSAL 07-01
EXECUTIVE SUMMARY

- **Title:** Revenue and Taxation Code Misdemeanor Provision/AB 139 Clean-Up

- **Problem:** Limitations amended into the failure to file or filing false return misdemeanor statute in the Revenue and Taxation Code legalizes fraudulent activity under statutorily prescribed thresholds.

- **Proposed Solution:** Repeal the amendments made by AB 139, namely the $15,000 tax liability threshold, the recurrence requirement, and the narrow exception for individuals who are mentally incompetent, suffer from dementia or Alzheimer's disease, or similar conditions.

- **Major Concerns/Issues:** Revising the existing language would do each of the following:
  - Prevent refund fraud beneath the current monetary threshold from occurring without consequence, which would have a proven deterrent effect on frivolous activity non-filers (FANs).
  - Prevent and punish fraudulent refund cases as they most often occur--a single year occurrence.
  - Allow existing case law in the area of diminished capacity to continue to be applied to situations where an individual is mentally incompetent or suffers from dementia, Alzheimer's disease, or a similar condition.

- **Revenue:**

Estimated Revenue Impact of LP 07-01 Enactment Assumed after 6/30/07 Effective for Tax Years 2008 and forward ($ in Millions)			
Fiscal Impact	2007-08	2008-09	2009-10
Revenue Gain	a/	$1	$2

a/ Minor revenue gain of under $500K

It is estimated that the thresholds added by AB 139 reduce revenue attributable to enforcement by $2 million annually. This proposal would repeal the provisions added by AB 139 and would be expected to restore revenue estimates to previous levels.

- **Proposed By:** Accounts Receivable Management Division

Title

Revenue and Taxation Code Misdemeanor Provision/AB 139 Clean-Up

Introduction

This proposal would repeal the monetary threshold, repeated occurrence requirements, and exception provisions added by AB 139 (Stats. 2005, Ch. 74) to the Revenue & Taxation Code section that makes the acts of failing to file a return or filing false returns a misdemeanor.

Program History/Background

Historically, the department utilized the misdemeanor failure to file or filing false returns statutes to prosecute taxpayers who refused to file returns and focused on W-2 wage earners or self-employed taxpayers with two or more years of noncompliance. Accounts with failure to file assessments that could not be resolved could be referred to FTB Investigations Bureau for misdemeanor consideration. Based on taxpayer contact, grounds for assessment, and case history, the Investigations Bureau would refer the case to the local district attorney's office for prosecution. The use of the district attorney (DA) provided an independent review of the appropriateness of the misdemeanor charge. Once a case was filed with the DA, the taxpayer was arraigned. Upon conviction, restitution could be ordered for all of the tax, penalties, interest, and cost of investigation and prosecution.

Current Federal Law

Federal law provides that any person who fails to pay any tax, file a return, or supply return information is guilty of a misdemeanor, and upon conviction, can be fined up to $25,000 ($100,000 in the case of a corporation), or imprisoned up to a year, or both, and also has to pay the costs of prosecution. Federal law does not include any limitations on the amount of tax liability, repeat occurrences, or express exceptions for mental incapacity in its misdemeanor provision. Fraudulent returns filed under penalty of perjury can be punishable upon conviction as a felony, with fines up to $100,000 or imprisonment up to three years or both. .

Current State Law

State law provides that, regardless of intent, any person who fails to file a return or supply required return information, submits a false or fraudulent return, or assists any person to evade tax by not filing a return or submitting false or fraudulent return is guilty of a misdemeanor.

Beginning in 2005, the statute was amended to require that the criminal actions must result in an estimated delinquent tax liability of at least $15,000, and must occur repeatedly over a period of two years or more. Previously, criminal actions had no threshold criteria or recurrence requirement. Also in 2005, individuals who are mentally incompetent or suffer from dementia, Alzheimer's disease, or similar conditions are expressly exempted from these misdemeanor provisions. Following conviction for the offense, the person can be fined up to $5,000 or imprisoned up to a year or both at the discretion of the court, and can also be ordered to pay for the costs of investigation and prosecution.

Problem

Limitations amended into the failure to file or filing false return misdemeanor statute legalizes fraudulent activity under statutorily prescribed thresholds.

Proposed Solution

Repeal the amendments made by AB 139, namely the $15,000 tax liability threshold, the recurrence requirement, and the exceptions for individuals who are mentally incompetent, suffer from dementia or Alzheimer's disease, or similar conditions.

Effective/Operative Date of Solution

If adopted in the 2007 legislative session, the proposal would be effective and operative beginning January 1, 2008 for actions or failures occurring on or after that date.

Justification

Revising the existing language would do each of the following:

- Prevent refund fraud operating beneath the current monetary threshold from occurring without consequence. A tax liability of $15,000 corresponds to a taxable income of slightly less than $150,000, which provides a significant ceiling under which criminal activity may operate with impunity. Significantly, this proposal would have a proven deterrent effect on frivolous activity non-filers (FANs).
- Prevent and punish fraudulent refund cases as they most often occur--a single year occurrence.
- Allow existing case law in the area of diminished capacity continue to be applied to situations where an individual is mentally incompetent or suffers from dementia, Alzheimer's disease, or a similar condition.

Implementation

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

Fiscal Impact

This proposal will not impact the department's costs.

Economic Impact

Estimated Revenue Impact of LP 07-01 Enactment Assumed after 6/30/07 Effective for Tax Years 2008 and forward ($ in Millions)			
Fiscal Impact	2007-08	2008-09	2009-10
Revenue Gain	a/	$1	$2

a/ Minor revenue gain of under $500K

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

Tax Revenue Discussion

The current inventory of FTB's Investigations unit is approximately $15 million. Based on an analysis of Investigations' caseloads, current felony cases were evaluated for the likelihood that if a case were pled out as a misdemeanor, would the result be a dismissal because the alleged criminal acts would fall below the threshold requirements of the misdemeanor statute. It is estimated that the thresholds added by AB 139 reduce revenue attributable to enforcement by $2 million annually. This proposal would repeal the provisions added by AB 139 and would be expected to restore revenue estimates to previous levels.

This proposal would apply to criminal conduct occurring on or after January 1, 2008. Fraudulent returns filed after that date would likely not be investigated until some time in 2009 and may not be fully resolved until later. Therefore, it is estimated that the revenue effect of this proposal will fully phase in by 2010. Estimated revenues are accrued back one year.

The estimate presented above does not include an analysis of potential behavioral changes by taxpayers not under investigation. The revisions implemented in AB 139 could result in decreased levels of voluntary taxpayer compliance. Repealing the AB 139 revisions could eliminate any potential changes in voluntary taxpayer compliance.

<u>Policy Considerations</u>

Codifying a dollar threshold above which prosecution for failure to file or for filing a false return can be charged permits criminal activity under that threshold. A tax liability of $15,000 corresponds to a taxable income of slightly less than $150,000, which provides a significant ceiling under which criminal activity may operate without consequences.

The recently added requirement that wrongful actions must occur in at least two different taxable years allows multiple frauds to occur in a single year that are now statutorily immune from prosecution.

Misdemeanor charges are typically included in felony tax cases as a "lesser included offense." This means that a jury may consider both the felony, which requires a showing of intent to evade tax, and the misdemeanor, which does not require an intent to evade element. The lesser-included offenses permit prosecutors additional flexibility in plea bargain negotiations. Currently, prosecutors have lost the ability to negotiate some felonies down to misdemeanors because there will be cases where an offense qualifies for felony prosecution but fails to meet the new dollar or time threshold requirement for a misdemeanor. The inflexibility created by AB 139 may cause more harsh and less appropriate punishment applied to taxpayers – namely more felony convictions.

Limiting the circumstance where the department can pursue FANs also limits the proven deterrent effect that investigation and prosecution have on these persons. At the end of the 1970's, the department had on record approximately 12,000 self-identified FANs. Through a concerted effort of misdemeanor prosecution and media attention on enforcement measures, the frivolous activity population declined to less than 3,000 by the end of the 1980's. Repealing the AB 139 provisions would allow the FTB Investigations Bureau to maintain a visible presence for criminal consequences to discourage the behavior of FANs.

The department participates in criminal prosecutions handled by the DAs for elder abuse, grand theft, and embezzlement. Tax charges are often added to such cases by the DA because evidence supporting the tax crimes is relatively easy to establish. The ability of the DAs to prosecute these perpetrators successfully is negatively impacted by the provisions added by AB 139.

Established case law already allows for diminished capacity to be asserted as a defense where an individual is mentally incompetent or suffers from dementia, Alzheimer's disease, or a similar condition. Repealing the provision of AB 139 that expressly exempts prosecution for specific conditions would allow the broader protections of diminished capacity to apply and avoid the need to development new case law.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 07-01

AMENDMENT 1

Section 1. Section 19701 of the Revenue and Taxation Code is amended to read:

19701. Any person who does any of the following is liable for a penalty of not more than five thousand dollars ($5,000):

(a) With or without intent to evade any requirement of Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part or any lawful requirement of the Franchise Tax Board, ~~repeatedly over a period of two years or more,~~ fails to file any return or to supply any information required, or who, with or without that intent, makes, renders, signs, or verifies any false or fraudulent return or statement, or supplies any false or fraudulent information~~, resulting in an estimated delinquent tax liability of at least fifteen thousand dollars ($15,000)~~.

(b) Aids, abets, advises, encourages, or counsels any person to evade the tax imposed by Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) by not filing any return or supplying any information required under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part, or, by making, rendering, signing, or verifying any false or fraudulent return or statement, or by supplying false or fraudulent information.

(c) Under this part, is required to pay any estimated tax or tax, who willfully fails to pay that estimated tax or tax, at the time or times required by law or regulations.

The penalty shall be recovered in the name of the people in any court of competent jurisdiction. Counsel for the Franchise Tax Board may, upon request of the district attorney or other prosecuting attorney, assist the prosecuting attorney in presenting the law or facts to recover the penalty at the trial of a criminal proceeding for violation of this section.

That person is also guilty of a misdemeanor and shall upon conviction be fined not to exceed five thousand dollars ($5,000) or be imprisoned not to exceed one year, or both, at the discretion of the court, together with costs of investigation and prosecution. ~~The preceding sentence shall not apply to any person who is mentally incompetent, or suffers from dementia, Alzheimer's disease, or similar condition.~~

(d) For purposes of subdivision (a), the president of a corporation, or the chief operating officer, is the person presumed to be responsible for filing any return or supplying information required from that corporation.

SECTION 2. <u>The amendments made by Section 1 are applicable to actions or failures occurring on or after January 1, 2008.</u>

LEGISLATIVE PROPOSAL 07-10
EXECUTIVE SUMMARY

- **Title:** Disallowance Of Deduction Upon Failure To Report Payments For Personal Services/Technical Clean-Up

- **Problem:** A technical conformity bill enacted in 2000 inadvertently failed to update three specific Revenue & Taxation Code (R&TC) cross-references, thereby making the authority unclear for FTB to disallow a deduction for payment of personal services and impose a corresponding penalty where the taxpayer failed to provide a Form 1099.

- **Proposed Solution:** Amend R&TC sections 17299.8, 19175, and 24447 to refer to current section 18631 instead of repealed code sections.

- **Major Concerns/Issues:** None.

- **Revenue:** This proposal would not impact the state's income tax revenue because this proposal merely clarifies existing law by resolving an ambiguity.

- **Proposed By:** Accounts Receivable Management Division & Filing Division

Title

Disallowance Of Deduction Upon Failure To Report Payments For Personal Services/Technical Clean-Up

Introduction

AB 2892 (Assembly Committee on Revenue & Taxation, Stats. 2000, Ch. 863) conformed to federal information reporting requirements. That bill inadvertently failed to update cross-reference for two Revenue & Taxation Code (R&TC) sections the act repealed. This proposal would correct the omitted cross-references.

Current State Law

Existing state law provides that the Franchise Tax Board (FTB) may disallow a deduction for payments made to an individual or entity for payments made as remuneration for personal services if not reported, as required. In addition, current state law imposes a penalty if any person or entity fails to report amounts paid as remuneration for personal services.

AB 2892 (Assembly Committee on Revenue & Taxation, Stats. 2000, Ch. 863) added, amended, renumbered, and repealed various sections of the R&TC to conform more closely to the language and structure of the Internal Revenue Code.

Background

California law generally follows federal law by requiring businesses to file information returns reporting payments made by or to other persons (Forms W-2 and 1099). This information is matched against income tax returns and generally used for purposes of identifying taxpayers that have underreported or failed to report corresponding amounts received as income and to verify certain deductions.

The provision of disallowance of a deduction if the taxpayer failed to file information returns was enacted as part of the tax amnesty legislation in 1984, and was amended a few years later to make the provision discretionary rather than mandatory in its application.

Problem

A technical conformity bill enacted in 2000 inadvertently failed to update three specific R&TC cross-references, thereby making the authority unclear for FTB to disallow a deduction for payment of personal services and impose a corresponding penalty where the taxpayer failed to provide a Form 1099.

Proposed Solution

Amend R&TC sections 17299.8, 19175, and 24447 to refer to current section 18631 instead of repealed code sections.

Effective/Operative Date of Solution

This proposal would correct a clerical cross-reference error and would be operative for taxable years beginning on or after January 1 of the year the proposal is effective.

Justification

The proposed amendments would remove any ambiguity regarding the authority of FTB to disallow deductions for payments made for personal services if the taxpayer failed to provide a Form 1099. By removing ambiguity from the current law, possible disputes between taxpayers and the department will be eliminated.

Implementation

Implementation of this proposal would not significantly impact the department.

Fiscal Impact

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

Economic Impact

This proposal would not impact the state's income tax revenue because this proposal merely clarifies existing law by resolving an ambiguity.

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. The states of *Illinois, Massachusetts, and New York* have the same provisions as California. It's not clear if *Michigan* and *Minnesota* have this same provision.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 07-10

AMENDMENT 1

Section 17299.8 of the Revenue & Taxation Code is amended as follows:

17299.8. The Franchise Tax Board may disallow a deduction under this part to an individual or entity for amounts paid as remuneration for personal services if that individual or entity fails to report the payments required under Section 13050 of the Unemployment Insurance Code or Section ~~18637 or 18638~~ 18631 on the date prescribed therefore (determined with regard to any extension of time for filing).

AMENDMENT 2

Section 24447 of the Revenue & Taxation Code is amended as follows:

24447. The Franchise Tax Board may disallow a deduction under this part to an individual or entity for amounts paid as remuneration for personal services if that individual or entity fails to report the payments required under Section 13050 of the Unemployment Insurance Code or Section ~~18637 or 18638~~ 18631 on the date prescribed therefore (determined with regard to any extension of time for filing).

AMENDMENT 3

Section 19175 of the Revenue & Taxation Code is amended as follows:

19175. (a) In addition to the penalty imposed by Section 19183 (relating to failure to file information returns), if any person or entity fails to report amounts paid as remuneration for personal services as required under Section 13050 of the Unemployment Insurance Code or ~~Sections 18637 and 18638~~ Section 18631 on the date prescribed therefore (determined with regard to any extension of time for filing), that person or entity may be liable for a penalty determined under subdivision (b).

(b) For purposes of subdivision (a), the amount determined under this subdivision is the maximum rate under Section 17041 multiplied by the unreported amounts paid as remuneration for personal services.

(c) The penalty imposed by subdivision (a) shall be assessed against that person or entity required to file a return under Section 13050 of the Unemployment Insurance Code or Section ~~18637 or 18638~~ 18631.

(d) Article 3 (commencing with Section 19031) of this chapter (relating to deficiency assessments) shall not apply with respect to the assessment or collection of any penalty imposed by subdivision (a).

(e) The penalty imposed under subdivision (a) shall be in lieu of the penalty imposed under Section 13052.5 of the Unemployment Insurance Code (relating to unreported compensation). In the event that a penalty is imposed under this section and Section 13052.5 of the Unemployment Insurance Code, only the penalty imposed under Section 13052.5 of the Unemployment Insurance Code shall apply.

LEGISLATIVE PROPOSAL 07-11
EXECUTIVE SUMMARY

Title: Notice To FTB Of The Administration Of A Decedent's Estate Required By Estate Representative

- **Problem:** Lack of knowledge of a decedent's financial affairs by the estate representative frequently results in the failure to discover and resolve a California income tax obligation, thus contributing to the tax gap.

- **Proposed Solution:** Amend Probate Code Section 9202 to require notice of the administration of a decedent's estate to FTB by the estate representative.

- **Major Concerns/Issues:** This change will provide FTB with an opportunity to file an appropriate claim in the estate before assets could be distributed. This proposal would provide the following benefits:
    - Reduce the clerical functions performed by both FTB and probate courts that are necessitated by the failure of an estate representative to notify FTB of an estate,
    - Create an automatic notice mechanism to satisfy already existing statutory requirements for an estate representative to notify reasonably ascertainable creditors so that a decedent's state tax obligations are resolved within the estate administration,
    - Reduce the number of instances where beneficiaries of an estate are pursued by FTB through the transferee process.

- **Revenue:**

Estimated Revenue Impact Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2007 ($ in Millions)		
2006-07	2007-08	2008-09
$1.0	$5.0	$5.0

- **Proposed By:** ARM Division

Title

Notice To FTB Of The Administration Of A Decedent's Estate Required By Estate Representative

Introduction

This proposal would put in place a process to assure that Franchise Tax Board (FTB) has an opportunity to file a timely estate claim for a decedent's unpaid income tax obligations.

Current Federal Law

The administration of decedent estates is exclusively a matter of state law.

Current State Law

Probate estate proceedings are administered in the county where the decedent resided or owned real property. The personal representative of a decedent's estate is required to make a reasonably diligent effort to identify creditors of the decedent and is required to provide any reasonably ascertainable creditor with a Notice of Administration of a Decedent's Estate (notice). The notice is to be provided within four months after the date the representative receives letters of administration or within 30 days from when the representative first has knowledge of the creditor. Additionally, under certain circumstances, the representative is required to provide specific notice to the Director of Health Services and the Director of the California Victims Compensation and Government Claims Board.

Creditors of a decedent, including a state agency, are required to file a claim in the estate proceedings within specific timeframes to obtain payment of a debt. All claims filed in an estate must be resolved prior to closing the administration of the estate.

After a return is filed reporting both income earned by the decedent and income earned by the estate, a representative may request a prompt audit of that return by FTB. If FTB determines that the amount of tax reported is proposed to be adjusted, a notice proposing to assess the tax or commence a proceeding in court without assessment for the collection of tax within 18 months from the date the representative requested the audit. FTB is barred from making a claim in a probate proceeding after the 18-month period expires.

A claim by a public entity is not barred unless notice has been provided to that entity. If written notice is not provided, the claim is enforceable by an action against the beneficiaries of the estate for the unpaid claim. If property is distributed before expiration of the time allowed a public entity to file a claim, the public entity has a claim against the beneficiaries of the estate that received the property. FTB's recourse when estate assets have been distributed before a claim is filed is to pursue a transferee assessment against the beneficiaries that received the estate assets.

Background

FTB's method of collecting a decedent's liability depends on how assets of the decedent are disbursed. Generally, there are three methods available to wind-up a decedent's affairs.

Depending on the size of the estate and actions taken prior to the taxpayer's death, assets are transferred through a court probate estate proceeding, through a trust established prior to the taxpayer's death, or informally by family members.

FTB's Decedent Unit receives a Notice of Administration of a Decedent's Estate (notice) in two ways:

1. The representative provides actual notice to FTB as required for reasonably ascertainable creditors of an estate, or
2. FTB's Decedent Unit independently identifies an open probate by searching probate case files in the superior courts of all 58 California counties.

FTB initiates a search for a probate estate when the FTB Decedent Unit determines that a taxpayer with an income tax liability is deceased. FTB sends a Request for Probate Information (FTB Form 4777) to the superior court to locate probate information. The superior court probate clerk in any of the 58 counties that a FTB Form 4777 is sent must search their records for probate information and return the form indicating whether a probate estate was established in that county. If probate information is located, FTB files a Creditor's Claim in the proceeding.

The Decedent Unit estimates that of the 50,000 estates probated each year approximately 65% are fully compliant with their tax obligations or have no obligations to resolve. The Decedent Unit estimates that of the remaining 35% of cases probated annually, 25% of those estates, or 4,375 cases, provide notice to FTB or are independently located by FTB staff. Approximately 13,125 cases, or 75% of the remaining probate case universe, are never located and reviewed by FTB.

Estates often distribute assets before FTB can file a Creditor's Claim. During the last five years, FTB has pursued approximately 94 transferee assessment cases with an estimated value of $1.8 million. The department ultimately discharges many similar decedent accounts for cost benefit reasons.

Problem

Lack of knowledge of a decedent's financial affairs by the estate representative frequently results in the failure to discover and resolve a California income tax obligation, thus contributing to the tax gap.

Proposed Solutions

Amend Probate Code Section 9202 to require notice of the administration of a decedent's estate to FTB by the representative of the estate.

Effective/Operative Date of Solution

If enacted in the 2007 legislative session, this proposal would be effective January 1, 2008, and would be effective for any estate proceeding open on or initiated after that date.

Justification

This proposal would provide the following benefits:

- Reduce the clerical functions performed by both FTB and probate courts that are necessitated by the failure of an estate representative to notify FTB of an estate,

- Create an automatic notice mechanism to satisfy already existing statutory requirements for an estate representative to notify reasonably ascertainable creditors so that a decedent's state tax obligations are resolved within the estate administration,
- Reduce the number of instances where beneficiaries of an estate are pursued by FTB through the transferee process, and
- Provide finality to the decedent's affairs.

Implementation

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

Fiscal Impact

This proposal would reduce the effort by FTB and superior court clerks searching for open probate cases and would be expected to result in less resources spent pursuing after-the-fact-remedies such as transferee assessments. The transferee assessment process is a manual collection procedure that is costly, time consuming, and often not pursued for cost benefit reasons. FTB discharges approximately 165 accounts each year with an estimated value of $2.0 million for cost benefit reasons that could be resolved through timely probate claims. These options would afford greater compliance through the probate court procedures and would assist the department to file more claims in a timely manner to result in increased revenues to the state.

Because FTB currently has processes in place to issue probate claims in response to notices, no additional information technology resources would be needed. Staff augmentation of 2 PYs would allow the Decedent Unit to absorb the increase in the volume of notices. This option would reduce the effort spent searching for open probate cases.

Economic Impact

Revenue Estimate

Based on data and assumptions discussed below, the PIT Tax revenue impact from this bill would be as follows:

Estimated Revenue Impact Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2007 ($ in Millions)		
2006-07	2007-08	2008-09
$1.0	$5.0	$5.0

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

Revenue Discussion

In FY 2005-06, FTB's Decedent Unit collected $4.5 million from claims filed with Probate Courts. The Decedent Unit estimates that it is notified timely in about 25% of the probate cases and would anticipate an increase in notices of 3 times. The cases that would result from the increased notices are expected to have smaller liabilities than the current cases for which FTB receives notice. The Decedent Unit estimates that the tax per case that would be collected from the new cases under this proposal would be 40% of current collections per case. Additional revenue collections from probate claims would be $5.4 million ($4.5 million currently collected x 3 (increase in notices) x 40% = $5.4 million). Anticipating that the phase-in of compliance to these new requirements would still result in the pursuit of transferee assessments to resolve an account, the new revenue from this proposal of $5.4 million would be reduced by approximately $0.3 million that would be collected from decedent's heirs after disbursements from probate, leaving a net new revenue gain of $5.1 million in FY 2007-08.

This proposal would apply to probate cases open on or initiated after January 1, 2008. Estimates are rounded and accrued back one year because they relate to tax liabilities from prior years. It is assumed that it would take a year until probate attorneys would be fully aware of this proposal as new law.

Policy Considerations

Probate seeks to bring finality to the affairs of the decedent by providing a process for resolution of all claims against the estate and the distribution of the remaining assets to the beneficiaries. The failure of the estate representative to notify a state tax department of the administration of the estate makes finality of the affairs of the decedent illusive.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 07-11

AMENDMENT 1

Amend Section 9202 of the Probate Code to read:

9202. (a) Not later than 90 days after the date letters are first issued to a general personal representative, the general personal representative or estate attorney shall give the Director of Health Services notice of the decedent's death in the manner provided in Section 215 if the general personal representative knows or has reason to believe that the decedent received health care under Chapter 7 (commencing with Section 14000) or Chapter 8 (commencing with Section 14200) of Part 3 of Division 9 of the Welfare and Institutions Code, or was the surviving spouse of a person who received that health care. The director has four months after notice is given in which to file a claim.

(b) Not later than 90 days after the date letters are first issued to a general personal representative, the general personal representative or estate attorney shall give the Director of the California Victim Compensation and Government Claims Board notice of the decedent's death in the manner provided in Section 216 if the general personal representative or estate attorney knows or has reason to believe that an heir is confined in a prison or facility under the jurisdiction of the Department of Corrections or the Department of the Youth Authority or confined in any county or city jail, road camp, industrial farm, or other local correctional facility. The director of the board shall have four months after that notice is received in which to pursue collection of any outstanding restitution fines or orders.

<u>(c)(1) Not later than 90 days after the date letters are first issued to a general personal representative, the general personal representative or estate attorney shall give notice of the administration of the estate to the Franchise Tax Board. The notice shall be given as provided in Section 1215.</u>

<u>(2) The provisions of this subsection shall apply to estates for which letters are issued on or after January 1, 2008, and estates where, as of January 1, 2008, an order for final distribution has not been made.</u>

LEGISLATIVE PROPOSAL 07-13
EXECUTIVE SUMMARY

- **Title:** Water's-Edge Audits

- **Problem:** Franchise Tax Board (FTB) has had sufficient experience auditing water's-edge returns, which was originally required in the water's-edge legislation to assure compliance, such that the mandatory audit requirement is now unnecessary.

- **Proposed Solution:** Amend Revenue and Taxation Code section 25114(a) relating to the examination of water's-edge taxpayers to eliminate the requirement for FTB to conduct a detailed examination—primarily of transfer pricing issues—when an initial examination reveals potential noncompliance, regardless of the potential net revenue benefit to the state. In addition, FTB would be allowed to apply discretion for deciding when to examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of <u>all</u> factors, including the relative levels of noncompliance and materiality.

- **Major Concerns/Issues:** None.

- **Revenue:** Based on data and assumptions discussed below, the revenue impact from this bill would be as follows:

Estimated Revenue Impact of LP 07-13 Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2007		
2007/08	2008/09	2009/10
None	None	None

- **Proposed By:** Audit Division

Title

Water's-Edge Audits

Introduction

This proposal would permit the Franchise Tax Board (FTB) to conduct audits of water's-edge taxpayers on a discretionary, rather than mandatory, basis.

Background

A significant issue for water's-edge taxpayers is the assignment of income among related taxpayers within and without the water's-edge group; thus, when the water's-edge statutes were enacted, language was included that requires FTB to examine the annual filings for taxpayers making the water's-edge election. FTB evaluates each water's-edge case that it audits for potential noncompliance of this issue—known as transfer pricing—and generally follows the results of federal examinations of this issue.

IRC section 482 requires that all transactions between related entities be transacted 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. 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 and industry experts.

Current Federal Law

The 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 taxpayers.

Under advance pricing agreements (APAs) with the IRS, taxpayers prospectively determine and apply transfer pricing methodologies to international transactions by related foreign or domestic taxpayers. 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

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 business income. The effect of a water's-edge election is that some foreign unitary entities are no longer part of the combined reporting group, which raises the same transfer pricing audit issues that arise under federal law.

Revenue and Taxation Code (RTC) section 25114 requires FTB to examine water's-edge returns for potential noncompliance. If potential noncompliance is found, current law requires FTB to conduct a detailed examination of the issue, regardless of the net revenue benefit to the state, unless the IRS is addressing the issue. These examination requirements have been in place since the water's-edge statutes[1] were originally enacted in 1986.

Problem

FTB has had sufficient experience auditing water's-edge returns, which was originally required in the water's-edge legislation to assure compliance, such that the mandatory audit requirement is now unnecessary.

Proposed Solution

Amend RTC section 25114(a) relating to the examination of water's-edge taxpayers to eliminate the requirement for FTB to conduct a detailed examination—primarily of transfer pricing issues—when an initial examination reveals potential noncompliance, regardless of the potential net revenue benefit to the state. In addition, FTB would be allowed to apply discretion for deciding when to examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of <u>all</u> factors, including the relative levels of noncompliance and materiality.

Effective/Operative Date of Solution

If enacted in 2007, this proposal would be effective on January 1, 2008, and would specifically apply to audits commenced on or after that date.

Justification

Allowing FTB discretion to review and examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of <u>all</u> factors, including the relative levels of noncompliance and materiality, would result in more efficient tax administration for both taxpayers and the department. Mandatory transfer pricing examinations are time consuming and burdensome to both the department and the taxpayer.

Implementation

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

Fiscal Impact

Any savings that might result from this proposal would be re-directed to other revenue producing activities.

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[1] RTC sections 25110 - 25115 were added by SB 85 (Stats. 1986, Ch. 660), applicable to taxable years beginning on or after January 1, 1988. The language of section 25114 was originally part of section 25110. SB 85 (Stats. 1988, Ch. 989) amended this language out of section 25110 and into section 25114, replacing the original language of section 25114. SB 1229 (Stats. 1999, Ch. 987) subsequently amended section 25114.

Economic Impact

Tax Revenue Estimate

Based on data and assumptions discussed below, the revenue impact from this bill would be as follows:

Estimated Revenue Impact of LP 07-13 Effective On Or After January 1, 2008 Enactment Assumed After June 30, 2007		
2007/08	2008/09	2009/10
None	None	None

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

Revenue Discussion

Under this proposal, FTB would no longer be required to conduct detailed water's-edge audits for noncompliance issues, including transfer pricing, that are unlikely to produce revenue. Therefore, this proposal would have no impact on state income tax revenues.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS FOR LP 07-13

AMENDMENT 1

SECTION 1. Section 25114 of the Revenue and Taxation Code is amended to read:

25114. (a) The Franchise Tax Board, for purposes of administering the provisions of this article, shall examine the returns filed by taxpayers subject to these provisions.~~ Where this examination reveals potential noncompliance, a detailed examination shall be made, notwithstanding the potential net revenue benefit to the state, unless the taxpayer is being examined by the Internal Revenue Service for the same year or years on the same issues.~~

(b) (1) In any case of two or more organizations, trades, or businesses (whether or not organized in the United States and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among these organizations, trades, or businesses, if the board determines that the distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of these organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B) of the Internal Revenue Code), the income with respect to that transfer or license shall be commensurate with the income attributable to the intangible property.

(2) In making distributions, apportionments, and allocations under this section, the Franchise Tax Board shall generally follow the rules, regulations, and procedures of the Internal Revenue Service in making audits under Section 482 of the Internal Revenue Code. Any of these rules, regulations, and procedures adopted by the Franchise Tax Board shall not be subject to review by the Office of Administrative Law.

(3) If the Internal Revenue Service has conducted a detailed audit pursuant to Section 482 of the Internal Revenue Code or Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code and has made adjustments pursuant to those provisions, it shall be presumed, to the extent that the provisions relate to the determination of the amount of income and factors required to be taken into account pursuant to Section 25110, that no further adjustments are necessary for this state's purposes. If the Internal Revenue Service has conducted a detailed audit pursuant to Section 482 of the Internal

Revenue Code or Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code and has made or proposed no adjustments to the transactions examined, it shall be presumed, to the extent that the provisions relate to the determination of the amount of income and factors required to be taken into account pursuant to Section 25110, that no adjustment is necessary for this state's purposes. These presumptions apply to all Internal Revenue Service audit determinations, including determinations made by the Appeals and Competent Authority. These presumptions shall be overcome if the Franchise Tax Board or the taxpayer demonstrates that an adjustment or a failure to make an adjustment was erroneous, if it demonstrates that the results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons, or if substantially the same federal tax result was obtained under other sections of the Internal Revenue Code. No inference shall be drawn from an Internal Revenue Service failure to audit international transactions pursuant to Section 482 of the Internal Revenue Code or Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code and it shall not be presumed that any of those transactions were correctly reported.

(c) The amendments made by the act adding this subdivision shall apply to examinations commenced by the Franchise Tax Board on or after the effective date of that act. An examination will be considered commenced when a taxpayer is first contacted by the Franchise Tax Board concerning any examination with respect to the return.

LEGISLATIVE PROPOSAL 07-21
EXECUTIVE SUMMARY

- **Title:** Eliminate Potential Double Inclusion Of Income When Dividend Distributions Are Made To Newly Formed Corporations Within The Unitary Group**.**

- **Problem:**

  1. Current law lacks a rule to prevent inclusion of the same income twice when dividends are paid from a member of a combined unitary group to a newly formed member.
  2. Current dividend elimination rules are susceptible to misinterpretation by taxpayers that can result in including the same income twice in the unitary group return.

- **Proposed Solution:**

  1. Add an exception to the dividend elimination rules for dividends paid from a member of a combined unitary group to a newly formed member.
  2. Conform to the department's practice of allowing dividend elimination when dividends are paid from the payor's earnings when the payer and payee filed on a comparable combined unitary basis in another state.
  3. Conform to the department's practice that dividends paid out of the earnings of a non-taxpayer member of the California combined unitary group to another non-taxpayer member of the group are eliminated from business income.

- **Major Concerns/Issues:** None

- **Revenue:**

Estimated Revenue Impact of LP 07-21 Effective for tax years BOA 1/1/2007 Enacted after 7/01/2006		
2006/07	2007/08	2008/09
Minor*	Minor*	Minor*

*Revenue loss of less than $500,000.

Proposed By: Legal Division

Title

Eliminate Potential Double Inclusion Of Income When Dividend Distributions Are Made To Newly Formed Corporations Within The Unitary Group.

Introduction

The proposal would amend current law to resolve problems relating to the elimination of dividend income.

Current Federal Law

Under federal law, a group of affiliated corporations that meet certain ownership requirements may elect to file a single tax return called a consolidated tax return. In general, if a corporation owns at least 80 percent[1] of another corporation or of multiple corporations, those corporations are considered an affiliated group and can file a consolidated tax return.

A 100-percent dividend elimination is allowed to the dividend recipient (payee) if at the close of the day on which the dividend is received the payor and payee are members of the same affiliated group[2] and had been affiliated members for each day of the year preceding the date the dividends are paid.[3]

A federal regulation provides relief for dividends paid between a member of an affiliated group and a newly organized holding company of the group. The regulation provides an exception to the general rule for a newly formed corporation that fails the statute's requirement of being a member of the affiliated group for each day of the year preceding the date the dividend was paid.[4]

Current State Law

Under state law, a group of affiliated corporations (which is determined under state law using a more than 50 percent, rather than 80 percent, ownership test) is referred to as a "commonly controlled group." Corporations in a "commonly controlled group" that meet certain requirements must file on a combined basis if they are part of a unitary business.

State law provides that dividends paid by one member of combined unitary group out of "income "previously described of the unitary business" to another member of the group are eliminated from the payee's taxable income. It has been the department's practice that "income" refers to apportionable (business) income. A combined unitary group doing business wholly within California or doing business within and outside of California could have apportionable (business) income. "Previously described of the unitary business" was clarified in *Willamette Industries, Inc.* v. *Franchise Tax Board* (1995) 34 Cal.App.4th 1396A to mean dividends paid out of earnings and profits when the payor and payee were members of the same combined unitary group.

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[1] At least 80% of the stock possessing the voting power and at least 80% of the total value of all the classes of stock. [Internal Revenue Code (IRC) section 1504(a)(2)].
[2] IRC section 243(b)(1)(A).
[3] Treasury Regulation section 1.243-4(a)(2)(ii).
[4] Treasury Regulation section 1.243-4(a)(5).

A “dividend” is defined as a means by which a corporation distributes earnings or profits to its shareholders. “Earnings and profits” is an accounting concept meant to reflect what a corporation will have available for distribution to shareholders as a dividend at any specific time. A corporation’s net profits or surplus is often referred to as earnings and profits. Under specific statutory rules, dividends are assumed to be paid first from a corporation’s current earnings and profits, and thereafter from prior years' accumulated earnings and profits[5]. For California purposes, earnings and profits may be calculated as follows:

State net income after state tax adjustments
Plus: nontaxable income (i.e., intercompany dividends)
Plus: artificially created deductions (i.e., depreciation)
Less: nondeductible expenses (i.e., federal income tax)
Equals: earnings and profits

Generally, a dividend received by a corporation is included in income. Dividends paid out of the earnings and profits of a member of a unitary business are eliminated from the income of the recipient corporation if the dividend was paid from the payor's earnings and profits accumulated in a year when the payor and payee of the dividends were affiliated corporations in a unitary business. The intent of creating this law was to eliminate inclusion of income twice in the tax base of the unitary group tax return.

Program History/Background

The literal reading of the dividend elimination statute could be interpreted to mean the payor and/or payee must be California taxpayers before the payee may eliminate dividends received from the payor. The department has felt the statute is not clear on its face and it has been the department’s practice to allow the dividend elimination provided by the current statute regardless of whether the payor and payee are taxpayer or “non-taxpayer” members of the California combined unitary group return. “Non-taxpayer” members of the combined unitary group are members that have their business income included in the calculation of the combined group’s taxable income, but are separately considered by California as doing business solely outside of the state and not subject to California tax.

In addition, the department has felt the dividend elimination statute is unclear relating to whether earnings and profits, accumulated when the payor and payee were members of a combined group taxable outside of California, would be used in the calculation of dividend elimination. It has been the department’s practice to allow the dividend elimination provided by the current statute regardless of whether the payor or payee had previously filed California returns, as long as the payor and payee filed as members of a comparable unitary business outside of California when the earnings arose.

This proposal would amend law to conform to the department’s practices discussed above.

Problem

[5] IRC section 316(a)(2) and R&TC section 24451.

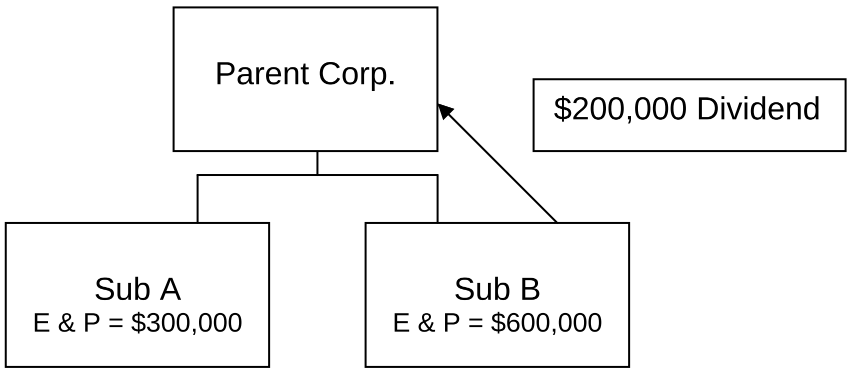
1. Current law lacks a rule to prevent inclusion of the same income twice when dividends are paid from one member of the unitary group to a newly formed member.

2. Current dividend elimination rules are susceptible to misinterpretation by taxpayers that can result in including the same income twice in the unitary group return.

<u>Examples</u>

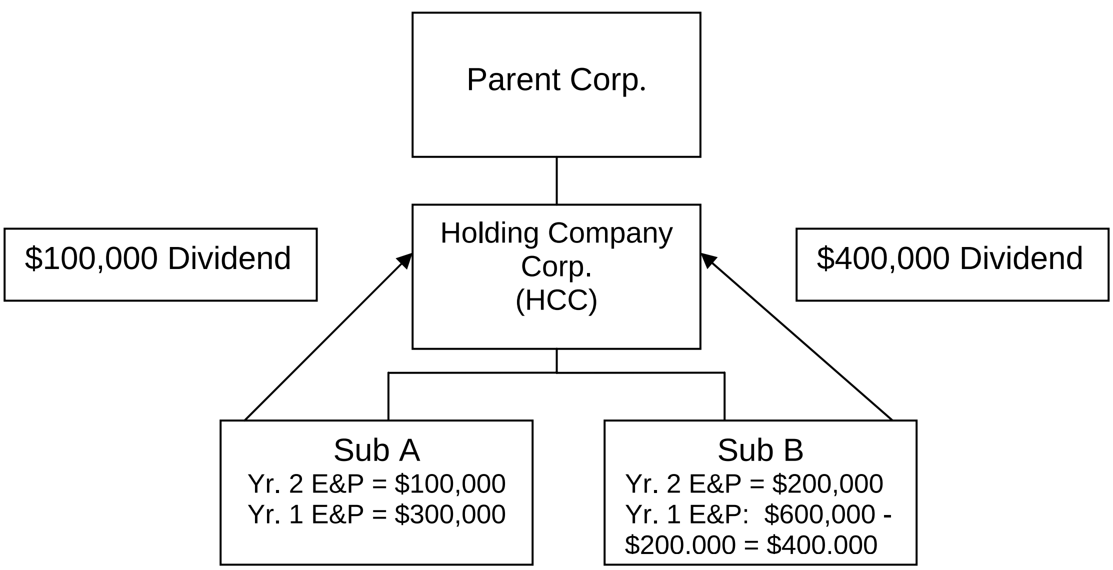
The Year 1 example below illustrates current law and the Year 2 example shows how the unintended inclusion of the same income twice may occur between members of a unitary business when a corporation is newly formed.

Example: Year 1



In Year 1, Parent Corp. and Subs A and B were members of a combined unitary business. Sub A had current year earnings and profits (E & P) of $300,000 and Sub B had E & P of $600,000. Sub B paid Parent Corp. a dividend equal to $200,000, and Parent Corp. eliminated the $200,000 dividend from taxable income because the dividends were paid out of earnings and profits when Parent Corp. and Sub B were members of a unitary business.

Example: Year 2



In Year 2, Parent Corp. forms a new subsidiary, HCC. Sub A pays HCC a $100,000 dividend and Sub B pays HCC a $400,000 dividend. The combined business income of Parent Corp, Sub A, and Sub B is included in a California combined unitary business. HCC may eliminate from income the $100,000 dividend received from Sub A because the dividend was paid from earnings and profits (year 2) when HCC and Sub A were members of a combined unitary business. HCC may eliminate from income only $200,000 of the $400,000 dividend received from Sub B because only $200,000 of the dividend was paid from earnings and profits accumulated when HCC and Sub B were members of a combined unitary business (year 2). The other $200,000 of dividend was paid from Sub B's earnings and profits from a year before HCC became a member of the combined unitary business (year 1).

The Year 2 example illustrates when the inclusion of the same income twice may occur if a dividend is paid to a newly formed corporation in the combined unitary business. The dividends distributed in year 2 from earnings and profits were already included in income for year 1, but would again be included in income in year 2 because the newly formed corporation HCC and Sub B were not affiliated members of the unitary business in year 1. If instead HCC was never created and the dividends had been paid directly to Parent Corp., Parent Corp. could have eliminated from income the dividends received from Sub B because Parent Corp. was a member of the unitary business in Year 1.

Proposed Solution

Amend current law to provide the following provisions:

- Conform to the department's practice that if dividends are paid from income earned in years prior to the payor and payee filing a combined California combined unitary return, dividend elimination would be allowed if the earnings are from a return filed on a comparable combined unitary basis in another state that included the payor and payee.
- Conform to the department's practice that dividends paid out of the earnings of a non-taxpayer member of the California combined unitary group to another non-taxpayer member of the group are eliminated from business income.
- Add an exception to the dividend elimination rules for dividends paid from a member of a combined unitary group to a newly formed member of the combined unitary group if the payee has been a member of the combined unitary group since the payee corporation's formation.
- Add anti-abuse provisions relating to newly formed members of a combined unitary group.
- Grant the Franchise Tax Board authority to create regulations relating to the inclusion of the same income twice and anti-abuse provisions.

This proposal would apply to a member of a unitary combined group whether doing business wholly within California or doing business within and outside of the state.

Effective/Operative Date of Solution

The provisions added by this proposal would specifically apply to taxable years beginning on or after January 1, 2007. The proposal includes a provision that no inference be drawn from the provisions added by the proposal relating to newly formed corporations for taxable years beginning on or before January 1, 2007. The provisions added to resolve problems one and two are declaratory of existing law.

Justification

1. Conforming to the department's practice of allowing dividend elimination for dividends paid out of unitary earnings and profits from one non-taxpayer member of the combined unitary group to another non-taxpayer member would prevent the same income from being taxed twice.
2. Providing an exception to the dividend elimination rules for certain dividends paid to newly formed corporations because it would prevent the same income from being included twice in income of the unitary group: first as unitary earnings and second as dividend income.

Implementation

Implementing this proposal would require some changes to existing tax form instructions and publications, which could be accomplished during the normal annual update.

Fiscal Impact

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

Economic Impact

Tax Revenue Estimate:

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

Estimated Revenue Impact of LP 07-21 Effective for tax years BOA 1/1/2007 Enacted after 7/01/2006		
2006/07	2007/08	2008/09
Minor*	Minor*	Minor*

*Revenue loss of less than $500,000.

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

Revenue Estimate Discussion

The revenue impact of this legislative proposal was estimated to be minor for the following reasons:

- The department's audit staff confirms that the inclusion of the same income twice when dividends are paid from a member of the unitary business group to a newly created member is uncommon. Most taxpayers are aware of the potential double inclusion of income in the unitary group's business income and can apply tax planning techniques to avoid the inclusion of income twice.
- The clarification of existing law relating to the earnings and profits from nontaxpayer members of a combined unitary business results in no revenue impact because the amendments conform to the department's current practice.

Even though the revenue impact of this legislative proposal was estimated to be minor, it is possible, but unlikely, that the revenue loss for a particular year may be more than minor because a taxpayer may be unaware of the inclusion of the same income twice "trap" from forming a new corporation in the unitary group.

Other States

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

Florida and *Illinois* generally follow current federal law relating to dividends paid between members of an affiliated group. Massachusetts allows a deduction from net income equal to 95 percent of the value of all dividends received by the taxpayer if the taxpayer owns at least 15 percent of the voting stock of the corporation paying such dividends. *Michigan* and *New York* lack provisions allowing dividend received deductions, and *Minnesota* allows a dividend received deduction between members of a unitary group calculated using a formula based on the ownership and apportionment percentage.

Additional Comments

Problem number three of this proposal is a product of the Eagles Lodge West 2006 retreat.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 07-21

SECTION 1. Section 25106 of the Revenue and Taxation Code is amended to read:

25106. (a) In any case in which the ~~tax~~ apportionable income of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of ~~another~~ ~~corporation~~ one or more other corporations with which it is doing or has done a unitary business, all dividends paid by one to another of any of those corporations shall, to the extent those dividends are paid out of the apportionable income previously described of the unitary business, be eliminated from the income of the recipient and, except for purposes of applying Section 24345, shall not be taken into account under Section 24344 or in any other manner in determining the tax of any member of the unitary group.

(b)For purposes of subdivision (a):

(1) Dividends paid to a corporation that is a member of the unitary group shall be treated as paid out of the income previously described of the unitary business if the following conditions are satisfied:

(A) The recipient corporation was formed subsequent to the accrual of the apportionable income from which the dividends were paid.

(B) During the period from formation to the receipt of those dividends, the recipient corporation was a part of the unitary group.

(2) "Apportionable income previously described of the unitary business" shall include apportionable income earned by members of the unitary group during taxable years when the apportionable income of the unitary group would have been determined under this chapter if any member of that corporation's unitary group was subject to tax in this state at the time that apportionable income was earned.

(c) If a transaction is determined to have been engaged in or structured with a principal purpose of avoiding the tax imposed by this part, the Franchise Tax Board may deny any dividend elimination under this section.

(d) The Franchise Tax Board may prescribe any regulations that may be necessary or appropriate to carry out the purpose of this section, which purpose is to prevent taxation of dividends received by a member of a unitary group where those dividends were paid out of the apportionable income of the unitary business.

(e)(1) Except as provided in paragraph (2), the amendments made by the act adding this subdivision shall apply to taxable years beginning on or after January 1, 2007. No inference shall be drawn for taxable years beginning before January 1, 2007, as to whether dividends received by a corporation are eliminated under this section when the corporation was formed subsequent to the accrual of apportionable income from which the dividends are paid.

(2) The provisions of paragraph (2) of subdivision (b) are declaratory of existing law.

LEGISLATIVE PROPOSAL 07-22
EXECUTIVE SUMMARY

- **Title:** Change Due Date Of Taxpayers' Bill Of Rights Annual Report To Legislature

- **Problem:** The existing statutory due date of October 1st for the Taxpayers' Bill of Rights Annual Report, which must include information about newly enacted laws, provides insufficient time for Franchise Tax Board staff to prepare the report because the statutory due date is either too close or overlaps the period for the Governor to act on legislation.

- **Proposed Solution:** Amend existing law by changing the Taxpayers' Bill of Rights Annual Report statutory due date to December 1st.

- **Major Concerns/Issues:** None

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

- **Proposed By:** Taxpayer Advocate Bureau

Title

Change Due Date Of Taxpayers' Bill Of Rights Annual Report To Legislature

Introduction

This proposal would change the due date of the statutorily-required Taxpayers' Bill of Rights Report.

Current State Law

The Franchise Tax Board (FTB) is required to provide an annual Taxpayers' Bill of Rights Report (report) to the Legislature no later than October 1^{st}. The report is required to include information on proposals requiring legislative changes resulting from the annual Taxpayers' Bill of Rights hearing as well as other changes in statute or regulations.

The Legislature maintains a legislative calendar governing the introduction and processing of legislative measures during each two-year regular session. The first year of the two-year session allows the Legislature until the second week of September to pass bills, and the second year of the two-year session allows the Legislature until August 31^{st} to pass bills. The Governor has 30 days from either of those dates to sign or veto bills passed by the Legislature (see chart below under background).

Background

The following are the 2000 to 2006 legislative calendars commencing with the end of session:

2000 - Session ended August 31, last day for Governor to act September 30
2001 - Session ended September 14, last day for Governor to act October 14
2002 - Session ended August 31, last day for Governor to act September 30
2003 - Session ended September 12, last day for Governor to act October 12
2004 - Session ended August 31, last day for Governor to act September 30
2005 - Session ended September 9, last day for Governor to act October 9
2006 - Session ended August 31, last day for Governor to act September 30

Problem

The existing statutory due date of October 1^{st} for the report, which must include information about newly enacted laws, provides insufficient time for FTB staff to prepare the report because the statutory due date is either too close or overlaps the period for the Governor to act on legislation.

Proposed Solution

Amend existing law by changing the Taxpayers' Bill of Rights Annual Report statutory due date to December 1^{st}.

Effective/Operative Date of Solution

If enacted in the 2007 legislative session, the provision would be effective and operative beginning January 1, 2008.

Justification

The department needs until December 1st to provide a complete and accurate report because the report is currently due before or at the time the Governor has to sign legislation.

Fiscal Impact

No departmental costs are associated with this proposal.

Economic Impact

Revenue Discussion

This proposal would not affect income tax revenue.

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FRANCHISE TAX BOARD'S
LEGISLATIVE PROPOSAL 07-22
As Introduced

AMENDMENT 1

Revenue and Taxation Code Section 21006 is amended to read as follows:

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

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

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

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

(B) The amount of tax involved.

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

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

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

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

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

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

(1) Changes in statute or board regulations.

(2) Improvement of training of board personnel.

(3) Improvement of taxpayer communication and education.

(4) Increased enforcement capabilities.

LEGISLATIVE PROPOSAL 07-23
EXECUTIVE SUMMARY

- **Title:** Separate Actions For Separate Issues

- **Problem:**

  - If a court action on a claim for refund for a particular taxable year is final, taxpayers are barred from bringing subsequent court actions for claims for refund for the same taxable year, unless based on a federal Revenue Agent's Report.

  - The current law codification of *Pope Estate*, which applies the doctrine of res judicata to tax lawsuits, is susceptible to more than one interpretation on the issue of whether it limits the issues that "shall" be asserted as a defense by Franchise Tax Board (FTB).

- **Proposed Solution:** Amend current law to:

  - Statutorily overrule the *Pope Estate* decision by allowing a taxpayer to file a lawsuit for refund of taxes in a subsequent court action with respect to discrete issues not raised in a prior lawsuit for the same year.

  - Clarify FTB's authority to issue multiple assessments or determine overpayments as the circumstances warrant, raise set-off on amounts that are not evidenced by a final assessment, and allow FTB's set-offs or subsequent assessments to be considered in a subsequent court action for the same year, in all circumstances.

- **Major Concerns/Issues:**

  - Allowing a single issue to be resolved in a court action without risking closure of the entire taxable year could resolve cases faster.

  - Allowing more than one court action for a single taxable year is contrary to the concept of judicial economy and bringing finality to the question of the correct amount of tax owing for a given tax year.

- **Revenue:** This proposal would not alter the amount of tax liability due. This proposal could accelerate the resolution of some cases with multi-issue disputes; however, the resulting reduced interest on assessments and refunds is unknown.

- **Proposed By:** Legal Division

Title

Separate Actions For Separate Issues

Introduction

This proposal would change the legal doctrine of res judicata as applied by a long established court decision to lawsuits against FTB for refund of taxes.

Program History/Background

Res judicata in a tax setting means that the entire tax liability for a taxable year is a single cause of action and would prevent another lawsuit once final action on the merits for that lawsuit has occurred in court. Thus, under existing law, the concept of res judicata applies to the entire tax liability for a taxable year and once a court makes a final determination regarding the amount of tax liability for a particular taxable year that tax liability cannot be changed by a subsequent judicial proceeding.

The rule of *res judicata* often conflicts with other judicial doctrines. The doctrine of *exhaustion of administrative remedies* requires that issues be presented at the lowest administrative level possible, and the *variance doctrine*, or "grounds of the claim" rule, prevents a court from considering issues or grounds not explicitly stated in the **original** administrative claim. Taxpayers who discover an additional issue or argument during the administrative process can be prevented from raising that issue in the existing proceeding by the variance or exhaustion doctrines, but then barred from asserting it as an additional claim if the statute of limitations (SOL) is closed or if a court has made a final determination of tax liability for that year by the *res judicata* principle. Taxpayers can file more than one administrative refund claim for a single taxable year on different issues, as long as both claims are filed within the applicable statute of limitations (See *Appeal of Baptista* 82-SBE-281).

This issue was previously discussed by members of the California State Bar Taxation Section State and Local Committee, Franchise Tax Board (FTB) staff, and other governmental staff at the invitation of the State Bar Committee. As a result of these discussions, FTB staff proposed Legislative Proposal 01-30, which would have created an exception to the judicial doctrine of *res judicata* (claim preclusion) that requires all issues for a single tax year to be considered together where a different or separate tax issue was discovered or asserted during the administrative process. That proposal was not approved by the three-member FTB.

At the 2006 State Bar meeting, the State Bar members asked FTB staff to resubmit the proposal to acknowledge recent court decisions[1], more clearly explaining the problem that arises when a completely different or new issue is discovered or developed during the administrative process.

[1] *Preston v. State Bd. of Equalization*, 25 Cal. 4th 197 (Cal. 2001) affirming the "grounds of the claim" rule.and J. H. McKnight Ranch, Inc. v. Franchise Tax Bd., 110 Cal.App.4th 978 (2003) relating to the "grounds of the claim" rule and the “variance doctrine”.

Current Federal Law

The United States Supreme Court held in *Commissioner* v. *Sunnen* (1948) 333 U.S. 591 that the tax liability for a taxable year was a single cause of action, and *res judicata* prevents another lawsuit once final action on the merits has occurred in court. Internal Revenue Code (IRC) section 6212(c) generally provides that the Internal Revenue Service (IRS) shall issue a single deficiency letter per tax year, with various exceptions. There is no restriction on the number of refund claims or amended returns that a taxpayer may file with the IRS for a tax year, if the claims are filed within the statute of limitations. Federal law follows the variance and grounds of the claim doctrines (*Angelus Milling Co. v. Comm'r* 325 U.S. 293 (1945).)

A suit for refund for a particular taxable year does not bar the IRS from proposing subsequent deficiency assessments for the same taxable year on a different issue or bar a Tax Court challenge to that deficiency. (See *Hemmings v. Comm'r.* (1995) 104 TC 221, for an extensive discussion of the history of federal law in this area.)

Current State Law

A California Court of Appeal decision, *Pope Estate Co. v. Johnson* (1941) 43 Cal. App. 2d 170, applies the doctrine of *res judicata* to California tax litigation. The decision stands for the proposition that a lawsuit against FTB for refund of taxes decides the correct amount of tax for the years at issue rather than just the discrete issues of tax law raised in the lawsuit. Therefore, a lawsuit gives a final determination of the amount of tax liability for a particular taxable year that cannot be changed by a subsequent lawsuit.

Suits for refund

Revenue and Taxation Code (R&TC) section 19802(b), the codification of the Pope Estate rule of res judicata, by its terms limits the issues that "shall" be asserted as a defense **by FTB** to reduce or eliminate the amount sought by a taxpayer in a claim for refund action in court. While there has been some question over the meaning of "shall" in this context, from the legislative history of the provision, the better view is that it means that only those grounds "must" be raised or be barred, and other issues need not be raised and so may be litigated in a subsequent proceeding. Section 19802(b) limits FTB's defenses to only those issues evidenced by a final assessment (i.e., final proposed deficiency assessments, notices of tax due or final notices of action). As a result, according to this interpretation of "shall," all other issues, including those resulting from a Revenue Agent's Report (RAR), may be raised by FTB in subsequent actions. (See FTB's summary of AB 2487, as amended June 15, 1984.)

Taxpayers have no such protection. Unless the new issue is based on a federal RAR under R&TC section 19802(b), the following apply:

- The doctrine of exhaustion of administrative remedies prevents a taxpayer from raising an issue that has not been considered in the administrative process.
- The variance doctrine prevents additional issues that were not in the original claim from being considered in the court action.
- The *Pope Estate* rule of res judicata prevents those issues from ever being litigated once there is a final court action on that taxable year.

Preston v. State Bd. of Equalization 25 Cal.4th 197 (2001) affirmed the "grounds of the claim" rule – that any suit for refund is limited to the grounds stated in the original claim and may not include grounds not stated in the claim, but held that an "inartfully stated" claim that put the government on notice of the contested item was sufficient. It also discussed the exhaustion of administrative remedies requirement that issues requiring factual determination must be raised at the lowest administrative level possible and normally may not be added during the judicial process. This means that if a taxpayer is limited to the issues raised in the original refund claim up to and including litigation for the taxable year, no additional issues can be presented for the tax year.

FTB staff has taken a more conservative view of the statutory provision, and, prior to the California Supreme Court's *Preston* decision, has traditionally not objected to additional issues raised after the claim was filed being included in court actions. Thus, there has been no case challenging the ability of FTB to issue additional assessments after a final judicial determination for the taxable year.

<u>Proposed Deficiency Assessments</u>

R&TC section 19034 requires FTB to set forth the reasons for a proposed assessment and the computation thereof on the notice. This means that FTB is limited to the issues raised in the Notice of Proposed Assessment (NPA) and must issue a separate, timely NPA to adjust different issues. However, there is no limit on the number of separate NPAs that can be issued for a single tax year, as long as the statute of limitations is open. (See *Wertin v. Franchise Tax Bd.* 68 Cal.App.4th 961 (1998); *Montgomery Ward & Co. v. Franchise Tax Bd.* 6 Cal.App.3d 149 (1970).)

<u>Administrative Refund Claims</u>

Each claim for refund must be in writing and specifically state the grounds upon which it is based. (R&TC section 19322.) Failure to raise an issue in the original refund claim precludes the taxpayer from raising it later (variance doctrine) (See J. H. McKnight Ranch, Inc. v. Franchise Tax Bd., 110 Cal.App.4th 978 (2003); *Appeal of Beneficial California, Inc*., 96-SBE-001.) Taxpayers can file more than one administrative refund claim for a single tax year on different issues, as long as both claims are filed within the applicable statute of limitations (*Appeal of Baptista* 82-SBE-281).

<u>Problem</u>

- If a court action on a claim for refund for a particular taxable year is final, taxpayers are barred from bringing subsequent court actions for claims for refund for the same taxable year, unless based on a federal RAR.

- The current law codification of *Pope Estate*, which applies the doctrine of res judicata to tax lawsuits, is susceptible to more than one interpretation on the issue of whether it limits the issues that "shall" be asserted as a defense by FTB.

Proposed Solution

Amend current law to:

- Statutorily overrule the *Pope Estate* decision by allowing a taxpayer to file a lawsuit for refund of taxes in a subsequent court action with respect to discrete issues not raised in a prior lawsuit for the same year.
- Clarify FTB's authority to issue multiple assessments or determine overpayments as the circumstances warrant, raise set-off on amounts that are not evidenced by a final assessment, and allow FTB's set-offs or subsequent assessments to be considered in a subsequent court action for the same year, in all circumstances.

Effective/Operative Date of Solution

This proposed solution would explicitly apply to actions filed pursuant to Section 19382 or Section 19385, relating to taxpayer suits for refund, filed on or after January 1, 2008**,** with respect to any taxable year where no previous action under either one of those sections has become final as of or prior to January 1, 2008. An action will be considered final if the period for reconsideration or appeal of a judicial decision has expired.

Justification

In the view of the state bar members, current law prevents taxpayers from exercising their right to a speedy and efficient judicial determination of a tax issue without giving up the right to claim additional refund amounts due to different tax issues that are discovered or identified later in the process.

Implementation

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

Fiscal Impact

This proposal should not significantly affect departmental costs.

Economic Impact

This proposal would not alter the amount of tax liability due. This proposal could accelerate the resolution of some cases with multi-issue disputes. This would result in reduced interest payments for both assessments and refunds. Because the effect of reduced interest on payments and reduced interest on refunds offset each other, the net effect in any year is unknown in advance.

Policy Considerations

This proposal would depart from the present rule of law that a claim for refund adjudicates the amount of tax due for a particular taxable year, not just the discrete issues of tax law raised in the lawsuit.

Other Agency/Industry Impacted

This proposal could be viewed as burdening the judicial system and violating policies favoring judicial economy and allowing "piecemeal litigation."

This proposal could be viewed as contrary to FTB's current practice of not making multiple assessments for a single taxable year, and where different FTB staff may be contacting a taxpayer multiple times on different issues, this might be considered burdensome to the taxpayer.

Agency/Industry Arguments

- Allowing a single issue to be resolved in a court action without risking closure of the entire taxable year could resolve cases faster.
- Allowing more than one court action for a single taxable year is contrary to the concept of judicial economy and bringing finality to the question of the correct amount of tax owing for a given tax year.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS LP 07-23

AMENDMENT 1

SECTION 1. Section 19802 of the Revenue and Taxation Code is amended to read:

19802. (a) In the determination of any case arising under this part, the rule of res judicata is applicable only if the liability involved is for the same year as was involved in another case previously determined.

(b) Notwithstanding subdivision (a) and the holding in Pope Estate Company v. Johnson, 43 Cal. App. 2d 170, the Franchise Tax Board may, within the applicable statute of limitations, propose deficiencies, make assessments, and determine overpayments with respect to issues (including adjustments based upon federal determinations) not included or considered in another action previously determined for the same year. In addition, any claim for refund or credit by a taxpayer resulting from issues not included or considered in another action previously determined for the same year (including claims based upon federal determinations made subsequent to the filing of the action) may be asserted by the taxpayer in a subsequent action. ~~in any action filed pursuant to Section 19382 (relating to taxpayer suits for refund), in addition to the defenses or relief sought in the action, the Franchise Tax Board shall assert in defense only those unpaid liabilities of the taxpayer for the same year which are evidenced by any of the following:~~

~~(1) A final proposed assessment.~~

~~(2) A notice of tax due.~~

~~(3) A final notice of action.~~

~~In addition, any refund claim of a taxpayer for the same year resulting from a federal audit adjustment made subsequent to the filing of the action need not be asserted by the taxpayer in that action.~~

(c) The amendments made by the act adding this subdivision shall apply to actions filed pursuant to Section 19382 or Section 19385, relating to taxpayer suits for refund, filed on or after January 1, 2008, with respect to any taxable year where no previous action under either one of those sections has become final as of or prior to January 1, 2008. An action will be considered final if the period for reconsideration or appeal of a judicial decision has expired.

LEGISLATIVE PROPOSAL 07-25
EXECUTIVE SUMMARY

- **Title:** Confidentiality Of Settlement Negotiations

- **Problem:** Allowing either party to an income or franchise tax appeal pending before the Board of Equalization to use settlement offers or statements made in pursuit of settlement as evidence would have a chilling effect on the full participation by the parties to negotiate and settle a tax dispute.

- **Proposed Solution:** Amend Section 19442 of the Revenue and Taxation Code to exclude evidence of settlement offers and statements made in pursuit of settlement between the taxpayer or their representatives and FTB staff in all administrative civil tax dispute forums in California.

- **Major Concerns/Issues:** None.

- **Revenue:** This bill would not impact the state's income tax revenue.

- **Proposed By:** Legal Division

Title

Confidentiality Of Settlement Negotiations

Introduction

This proposal would add a specific provision to the Revenue and Taxation Code prohibiting the admissibility of either any settlement offers or any statements made in pursuit of settlement from being used as evidence in any subsequent adjudicative proceeding.

Program History/Background

Legislation was adopted in 1992 specifically authorizing Franchise Tax Board (FTB) to settle administrative civil tax disputes. The program is voluntary. Successful settlement negotiations eliminate the hazards and risks of further litigation, which is a benefit to both the taxpayer and the state. The settlement program has collected in excess of $8.69 billion dollars since its inception. To ensure the success of the program, it is necessary to follow the longstanding public policy in California favoring laws excluding any aspect of settlement negotiations as evidence in subsequent adjudicative proceedings.

Current Federal Law

Under Rule 408 of the federal Rules of Evidence, an offer of compromise or an attempt to compromise a disputed claim is not admissible to prove liability for or invalidity of the claim or its amount. In addition, federal law prohibits a party in an alternative dispute resolution proceeding from disclosing any dispute resolution communication (5 USC §574).

Current State Law

Under Evidence Code section 1152, settlement offers and offers of compromise made by a party in a civil lawsuit are inadmissible in court proceedings to prove such party's liability for loss or damage. Similarly, under Government Code section 11415.60, settlements, settlement offers, and statements made in settlement negotiations between an "agency" and a party are inadmissible in any adjudicative proceeding or civil action to prove liability, except to the extent provided in Evidence Code section 1152; however, appeals heard by Board of Equalization (BOE) are exempt from the Administrative Procedure Act.

Problem

Allowing either party to an income or franchise tax appeal pending before the BOE to use settlement offers or statements made in pursuit of settlement as evidence would have a chilling effect on the full participation by the parties to negotiate and settle a tax dispute.

Proposed Solution

Amend Section 19442 of the Revenue and Taxation Code (R&TC) to exclude evidence of settlement offers and statements made in pursuit of settlement between the taxpayer or their representatives and FTB staff in all administrative civil tax dispute forums in California.

Effective/Operative Date of Solution

If enacted in the 2007 legislative session, this proposal would be effective January 1, 2008, and be operative as of that date.

Justification

For the settlement program to be successful, taxpayers or their representatives and FTB staff must be free to make settlement offers and engage in frank and open discussions of the strengths and weaknesses of each party's respective position without fear that statements made related to the settlement negotiations could subsequently be used by one party against the other in a subsequent proceeding before the BOE.

Implementation

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

Fiscal Impact

No departmental costs are associated with this proposal.

Economic Impact

This bill would not impact the state's income tax revenue.

Other States

Because laws excluding settlement negotiations as evidence in subsequent adjudicative proceedings are a matter of longstanding public policy in California, a comparison of tax adjudication laws of other states would have little bearing on the subject at issue.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP07-25

AMENDMENT 1

Section 19442 of the Revenue and Taxation Code is amended as follows:

19442. (a) It is the intent of the Legislature that the Franchise Tax Board, its staff, and the Attorney General pursue settlements as authorized under this section with respect to civil tax matters in dispute that are the subject of protests, appeals, or refund claims, consistent with a reasonable evaluation of the costs and risks associated with litigation of these matters.

(b) (1) Except as provided in paragraph (3) and subject to paragraph (2), the executive officer or chief counsel, if authorized by the executive officer, of the Franchise Tax Board may recommend to the Franchise Tax Board, itself, a settlement of any civil tax matter in dispute.

(2) No recommendation of settlement shall be submitted to the Franchise Tax Board, itself, unless and until that recommendation has been submitted by the executive officer or chief counsel to the Attorney General. Within 30 days of receiving that recommendation, the Attorney General shall review the recommendation and advise in writing the executive officer or chief counsel of the Franchise Tax Board of his or her conclusions as to whether the recommendation is reasonable from an overall perspective. The executive officer or chief counsel shall, with each recommendation of settlement submitted to the Franchise Tax Board, itself, also submit the Attorney General's written conclusions obtained pursuant to this paragraph.

(3) (A) A settlement of any civil tax matter in dispute involving a reduction of tax or penalties in settlement, the total of which reduction of tax and penalties in settlement does not exceed seven thousand five hundred dollars ($7,500), may be approved by the executive officer and chief counsel, jointly. The executive officer shall notify the Franchise Tax Board, itself, of any settlement approved pursuant to this paragraph.

(B) On January 1 of each calendar year beginning on or after January 1, 2004, the Franchise Tax Board shall increase the amount specified in subparagraph (A) to the amount computed under this subparagraph. That adjustment shall be made as follows:

(i) The Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index, as modified for rental equivalent homeownership for all items, from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(ii) The Franchise Tax Board shall then:

(I) Compute the percentage change in the California Consumer Price Index from the later of June 2003 or June of the calendar year prior to the last increase in the amount specified in subparagraph (A).

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

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

(c) Whenever a reduction of tax or penalties or total tax and penalties in settlement in excess of five hundred dollars ($500) is approved pursuant to this section, there shall be placed on file in the office of the executive officer of the Franchise Tax Board a public record with respect to that settlement. The public record shall include all of the following information:

(1) The name or names of the taxpayers who are parties to the settlement.

(2) The total amount in dispute.

(3) The amount agreed to pursuant to the settlement.

(4) A summary of the reasons why the settlement is in the best interests of the State of California.

(5) For any settlement approved by the Franchise Tax Board, itself, the Attorney General's conclusion as to whether the recommendation of settlement was reasonable from an overall perspective.

The public record shall not include any information that relates to any trade secret, patent, process, style of work, apparatus, business secret, or organizational structure, that if disclosed, would adversely affect the taxpayer or the national defense.

(d) The members of the Franchise Tax Board shall not participate in the settlement of tax matters pursuant to this section, except as provided in subdivision (e).

(e) (1) Any recommendation for settlement shall be approved or disapproved by the Franchise Tax Board, itself, within 45 days of the submission of that recommendation. Any recommendation for settlement that is not either approved or disapproved by the Franchise Tax Board, itself, within 45 days of the submission of that recommendation shall be deemed approved. Upon approval of a recommendation for settlement, the matter shall be referred back to the executive officer or chief counsel in accordance with the decision of the Franchise Tax Board.

(2) Disapproval of a recommendation for settlement shall be made only by a majority vote of the Franchise Tax Board. Where the Franchise Tax Board disapproves a recommendation for settlement, the matter shall be remanded to Franchise Tax Board staff for further negotiation, and may be resubmitted to the Franchise Tax Board, in the same manner and subject to the same requirements as the initial submission, at the discretion of the executive officer or chief counsel.

(f) (1) All settlements entered into pursuant to this section shall be final and nonappealable, except upon a showing of fraud or misrepresentation with respect to a material fact.

(2) A settlement may include matters that may otherwise be included in an agreement under Section 19441.

(3) Settlements pursuant to this section do not preclude assessments or refunds under Section 19059, 19060, or 19311 (relating to application of federal adjustments).

(g) (1) Any proceedings undertaken by the Franchise Tax Board itself pursuant to a settlement as described in this section shall be conducted in a closed session or sessions. ~~Except as provided in subdivision (c), any settlement entered into pursuant to this section shall constitute confidential tax information for purposes of Article 2 (commencing with Section 19542) of Chapter 7.~~

(2) Except as provided in subdivision (c), any settlement entered into pursuant to this section shall constitute confidential tax information for purposes of Article 2 (commencing with Section 19542) of Chapter 7.

(3) Notwithstanding any other provision of law, no evidence of an offer of settlement made during settlement negotiations is admissible in any adjudicative proceeding or civil action, including, without limitation, any appeal to the board pursuant to Sections 19045, 19085 or 19324, whether as affirmative evidence, by way of impeachment, or for any other purpose, and no evidence of conduct or statements related to the settlement negotiations is admissible to prove liability for any tax, penalty, fee or interest, except to the extent provided in Section 1152 of the Evidence Code.

(4)~~(2)~~ A settlement approved by the Franchise Tax Board, itself, shall be final and conclusive, to the same extent as an agreement under Section 19441 approved by the Franchise Tax Board, itself.

(h) This section shall apply only to civil tax matters in dispute existing on or after the effective date of the act adding this subdivision.

(i) The Legislature finds that it is essential for fiscal purposes that the settlement program authorized by this section be expeditiously implemented. Accordingly, 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 determination, rule, notice, or guideline established or issued by the Franchise Tax Board in implementing and administering the settlement program authorized by this section.

(j) The amendments made to this section by Chapter 258, Sec. 1. of the statutes of 2002 ~~the act adding this subdivision~~ shall apply to any settlements approved on or after January 1, 2003.

(k) The amendments made to this section by the act adding this subdivision shall apply to any settlements approved on or after the date of enactment, without regard to taxable year.

(Amended by Stats. 2002, Ch. 258, Sec. 1. Effective January 1, 2003.)