# 2014 Legislative Proposals

| LP | Title |
|---|---|
| LP - A | Conform to the Federal Research Credit Methods |
| LP - B | Dependant Taxpayer Identification Numbers |
| LP - C | Business Entities e-Filing Requirement |
| LP - D | First-Time Abatement of Timeliness Penalties |

# LEGISLATIVE PROPOSAL - A
# EXECUTIVE SUMMARY

- **Title:** Conform to the Federal Research Credit Methods

- **Problem:** The California research credit uses outdated methods and rules that complicate its calculation.

- **Proposed Solution:** This proposal would simplify the calculation of the California research credit by generally conforming to the federal methods of calculating the research credit and to the recent federal changes to the credit's calculation rules for acquisitions, dispositions, and aggregations.

- **Fiscal Impact:** This proposal would not significantly impact the department's costs.

- **Revenue:**

| Estimated Revenue Impact of LP - A<br>For Taxable Years Beginning On or After January 1, 2014<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | |
|---|---|---|
| 2014-15 | 2015-16 | 2016-17 |
| - $75 | - $80 | - $80 |

## Title

Conform to the Federal Research Credit Methods

## Introduction

This proposal would simplify the calculation of the California research credit.

## Program History/Background

### The Research Credit

Technological development is an important component of economic growth. However, although an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. The reason for this behavior is because costly scientific and technological advances made by one firm may be cheaply copied by its competitors. Research is one area where economists generally agree that government intervention in the marketplace may improve overall economic efficiency.[1]

Congress enacted the federal research credit in 1981 "to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy."[2] The general purpose of the federal research credit is to increase research activities beyond what they otherwise would be. California enacted a similar research credit in 1987 by conforming, with modifications, to the federal credit, for research conducted in this state.

Based on the most recent data available, the following table shows the amounts of California research credits that were allowed in tax years 2007 through 2010:

| California Research Credits Allowed | | | | | |
|---|---|---|---|---|---|
| *Personal Income Tax* | | | *Corporation Tax* | | |
| Tax Year | Returns | Credit Allowed | Tax Year | Returns | Credit Allowed |
| 2007 | 3,769 | $74,879,522 | 2007 | 2,020 | $1,099,287,499 |
| 2008 | 3,618 | $58,315,512 | 2008 | 2,483 | $1,234,539,271 |
| 2009 | 3,817 | $57,589,786 | 2009 | 2,441 | $992,887,123 |
| 2010 | 4,738 | $81,689,930 | 2010 | 3,069 | $1,800,187,225 |

[1] JCX-45-11, Tax Incentives for Research, Experimentation, and Innovation, issued on September 16, 2011, by the Staff of the Joint Committee on Taxation.

[2] See House Report 99-426, at 177 (1985), and Senate Report 99-313, at 694 (1986).

### The California Research Credit Becomes Outdated

The federal and state research credits have been significantly modified since their inceptions, generally with changes occurring first at the federal level followed by California conforming to those changes, with applicable modifications. However, in recent years, California has not modified its credit to follow significant federal changes, resulting in complicated differences between federal and state law.

## Current Federal/State Law

California conforms to the federal research credit, with modifications. Explanations of the general federal research credit rules are provided below, followed by applicable state modifications.

### The Research Credit's Separate Components

Federal Law

The federal research credit is the sum of three separate credit components, the general research credit, the university "basic research" credit, and the energy research credit, as described below:

1. **The General Research Credit** – There are two methods of calculating the general research credit, the "standard method" and the "alternative simplified method" (herein referred to as the "simplified method"). More detail on calculating these methods is provided below under "Calculating the General Research Credit," but generally they function as follows:
    - *The Standard Method* - For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed a complicated-to-calculate base amount.
    - *The Simplified Method* - In lieu of claiming the general research credit under the "standard method," taxpayers may elect to claim a research credit under the "simplified method" generally equal to 14 percent of the amount by which the taxpayer's qualified research expenses for the taxable year exceed a simplified base amount.
2. **The University "Basic Research" Credit** – This separate component of the research credit is only available to corporations,[3] and provides a research credit for corporate cash expenses paid for basic research conducted by universities and scientific research organizations.
3. **The Energy Research Credit** – This separate component of the research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.

This proposal would generally impact the California calculation of the general research credit, therefore detailed descriptions of the university "basic research" credit and the energy research credit are not provided.

---

[3] IRC section 41(e).

State Law

California law conforms, with modifications, to two of the three separate federal research credit components, the general research credit and the university "basic research" credit, but does not conform to the energy research credit.[4]

For purposes of the California research credit, the terms "qualified research" and "basic research" include only research conducted in California.

**Calculating the General Research Credit**

Federal Law

Federal law currently allows two methods to calculate the general research credit, the "standard method" and the "simplified method." A third calculation method, the "alternative incremental method" (herein referred to as the "incremental method"), expired for federal purposes in 2008; however, this method is also described below because California continues to allow it.

*The Standard Method*

For general research expenditures, a taxpayer may claim a federal research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed a base amount.

- Base Amount - The base amount for the current year is generally computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[5]

  In calculating the general research credit under the "standard method," a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

[4] R&TC sections 17052.12 and 23609.

[5] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under IRC section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).

- Gross Receipts - For purposes of measuring gross receipts for the research credit, gross receipts generally means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction of cost of goods sold), reduced by returns and allowances. However, gross receipts do not include receipts from the sale or exchange of a capital asset, repayments of loans or similar instruments, or receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business.[6]

*The Simplified Method*

For amounts paid or incurred after 2006, taxpayers are allowed to elect to calculate their general research credit using the "simplified method" in lieu of the "standard method."[7]

The research credit calculated under the "simplified method" is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the "simplified method" in lieu of the "standard method" applies to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury.

*The Incremental Method*

For taxable years beginning after June 30, 1996, and before January 1, 2009, taxpayers were allowed to elect to calculate their general research credit using the "incremental method" in lieu of the "standard method."[8] A taxpayer electing the "incremental method" was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced.

- Credit Rates & Base Amounts - Generally, for amounts paid or incurred after 2006 and before 2009,[9] under the "incremental method:"
    - A credit rate of 3 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent;
    - A credit rate of 4 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of 2 percent; and

---

[6] Treasury Reg. Section 1.41-3(c).

[7] IRC section 41(c)(5).

[8] IRC section 41(c)(4).

[9] Lower credit rates applied to years that preceded 2007, and a special transition rule applied for fiscal-year 2006-2007 taxpayers.

- o A credit rate of 5 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 2 percent.

- Gross Receipts - For purposes of calculating the general research credit using the "incremental method," gross receipts had the same definition that's provided above for the "standard method."

State Law

California currently conforms, with modifications, to two of the federal methods used to calculate the general research credit—the "standard method" and the "incremental method." California does not conform to the "simplified method."

*The Standard Method*

California conforms to the federal "standard method" of calculating the general research credit, with modifications. For general research expenditures, a taxpayer may claim a state research credit equal to 15 percent of the amount by which the taxpayer's California qualified research expenses for a taxable year exceed a base amount.

- Base Amount - California generally conforms to the federal rules for determining the base amount, with the gross-receipts modification described below. And, similar to federal law, a taxpayer's California base amount cannot be less than 50 percent of its current-year California qualified research expenses.
- Gross Receipts - California law generally conforms to the federal definition of gross receipts to calculate the research credit under the "standard method," modified to take into account only those gross receipts from the sale of property held for sale in the ordinary course of business that is delivered or shipped to a purchaser within California, regardless of f.o.b. point or any other condition of the sale.[10]

*The Simplified Method*

California law specifically does not conform to the "simplified method,"[11] meaning taxpayers may elect the "simplified method" for federal purposes but not for state purposes.

*The Incremental Method*

Taxpayers are allowed to elect to calculate their general research credit using the "incremental method" in lieu of the "standard method." California conforms to the federal "incremental method" with modifications, including the modification that specifically provides that the federal

---

[10] R&TC sections 17052.12(g)(3) and 23609(h)(3).
[11] R&TC sections 17052.12(g)(4) and 23609(g)(4).

December 31, 2008, termination date does not apply.[12] As a result, taxpayers may continue to elect the "incremental method" under California law even though such an election may no longer be made for federal purposes.

An election to use the "incremental method" in lieu of the "standard method" applies to all succeeding taxable years unless revoked with the consent of the Franchise Tax Board. Other modifications are described below:

- Credit Rates & Base Amounts - Under the California "incremental method:"[13]
    - A credit rate of 1.49 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but does not exceed a base amount computed by using a fixed-base percentage of 1.5 percent;
    - A credit rate of 1.98 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but does not exceed a base amount computed by using a fixed-base percentage of two percent; and
    - A credit rate of 2.48 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.
- Gross Receipts - For purposes of calculating the general research credit under the "incremental method," gross receipts have the same meaning that they have for purposes of calculating the general research credit under the "standard method," as described above.

**Eligible Expenses**

Federal Law

Qualified research expenses eligible for the research credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[14]

---

[12] R&TC sections 17052.12(h) and 23609(i).

[13] R&TC sections 17052.12(g)(1) and 23609(h)(1).

[14] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under IRC section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in IRC section 501(c)(3) (other than a private foundation) or IRC section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. IRC section 41(b)(3)(C).

Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law Internal Revenue Code (IRC) section 174,[15] but also must be undertaken for the purpose of discovering information that is technological in nature,[16] the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[17]

In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer; (6) related to social sciences, arts, or humanities; or (7) funded by any grant, contract, or otherwise by another person (or governmental entity).[18] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

<u>State Law</u>

California law generally conforms to the federal rules for expenses eligible for the research credit, but does not conform to the special rules that allow contract research expenses to include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research. And, research does not qualify for the state research credit if it is conducted outside of California.

---

[15] Notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized, IRC section 174 provides that taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business that represent research and development costs in the experimental or laboratory sense, and the term "research or experimental expenditures" generally includes all such costs attributable to the development or improvement of a product. Under California law, R&TC sections 17201 and 24365 generally conform to IRC section 174, with applicable state modifications.

[16] For purposes of the research credit, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. Treasury Reg. section 1-41-4(a)(4).

[17] IRC section 41(d)(3).

[18] IRC section 41(d)(4).

## 2013 Federal Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures

Federal Law

Special rules apply for computing the research credit when a major portion of a trade or business (or unit thereof) changes hands, and for the aggregation of expenditures among commonly-controlled or otherwise-related entities, and these rules were modified in 2013.[19]

For taxable years beginning before January 1, 2012:

- Qualified research expenses and gross receipts arising in taxable years prior to the change of ownership of a trade or business are treated as transferred to the acquiring taxpayer with the trade or business that gave rise to those expenses and receipts for purposes of re-computing the acquiring taxpayer's fixed-base percentage.[20] Qualified research expenses incurred during the taxable year including or ending with a change of ownership are treated as transferred to the acquiring taxpayer with the trade or business for purposes of determining the credit for the acquiring taxpayer's first taxable year including the acquisition. And, to prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise-related entities, a special aggregation rule provides that all members of the same controlled group of corporations or all members of a group of businesses under common control are treated as a single taxpayer.[21]
- The credit allowable to each member of a controlled group has a two-prong calculation: (1) to the extent the group credit does not exceed the sum of the stand-alone entity credits of all of the group members, such group credit is allocated among the members in proportion to the stand-alone credits of the controlled group; and (2) to the extent the group credit exceeds the sum of the stand-alone entity credits of all of the group members, that excess is allocated among the members in proportion to the qualified research expenses of the members.

For taxable years beginning after December 31, 2011, the special rules for taxpayers under common control, and the special rules for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, are modified as follows:

- Qualified research expenses paid or incurred by the disposing taxpayer in a taxable year that includes or ends with a change in ownership are treated as current year qualified research expenses of the disposing taxpayer and such expenses are not treated as current year qualified research expenses of the acquiring taxpayer. Further, the disposing taxpayer's and acquiring taxpayer's base period amounts are adjusted by a pro-rated amount.

---

[19] On January 2, 2013, Congress modified the rules relating to acquisitions, dispositions, and aggregation of expenditures under Section 301 of the American Taxpayer Relief Act of 2012 (Public Law 112-240).

[20] IRC section 41(f)(3).

[21] IRC section 41(f)(1).

- The credit allowable to each member of a controlled group of corporations or each member of a group of businesses under common control is determined on a proportionate basis to its share of the current year aggregate qualified research expenses (i.e., the gross qualified research expense allocation method).[22]

State Law

California law conforms to the federal rules[23] that relate to the research credit aggregation of expenditures, allocations, and adjustments for certain acquisitions, etc., as of the "specified date" of January 1, 2009, and as a result does not conform to the modifications that were made in 2013. Thus, the federal rules that apply to taxable years beginning before January 1, 2012, continue to apply under California law.

**Problem**

The California research credit uses outdated methods and rules that complicate its calculation.

**Proposed Solution**

This proposal would simplify the calculation of the California research credit by conforming to federal methods of calculating the general research credit and to the recent federal changes to the credit's calculation rules for acquisitions, dispositions, and aggregations, as described below.

**Conforming to the Federal Methods of Calculating the General Research Credit**

This proposal would bring California into conformity with the federal calculation methods by eliminating the election to use the "incremental method" for taxable years beginning after 2013, and instead would allow taxpayers to elect to use the "simplified method," with the following California modifications:

- Qualified research would mean research conducted in California; and
- The California research credit under the "simplified method" would allow a research credit equal to 10.5 percent of California qualified research expenses that exceed 50 percent of the average California qualified research expenses for the three preceding taxable years.[24]

An election to use the "simplified method" in lieu of the "standard method" would apply to all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

---

[22] The provision overturns the stand-alone entity credit approach contained in Treas. Reg. section 1.41–6(c).

[23] The federal rules under IRC section 41(f).

[24] The credit rate under the California "simplified method" would be reduced to 4.5 percent if a taxpayer has no California qualified research expenses in any one of the three preceding taxable years.

**2013 Federal Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures**

This proposal would conform to the recent federal modifications to the special rules that apply for computing the research credit when a major portion of a trade or business (or unit thereof) changes hands, and for the aggregation of expenditures among commonly-controlled or otherwise-related entities.

## Effective/Operative Date of Solution

If enacted during the 2014 legislative session, this proposal would be effective immediately and operative for taxable years beginning on or after January 1, 2014.

## Justification

Conforming to the federal methods used to calculate the general credit, and to the recent federal changes to acquisitions, dispositions, and aggregations, would provide businesses conducting research in California with a simplified calculation option, eliminate confusing differences between federal and state law, and reduce recordkeeping requirements.

## Implementation

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

## Fiscal Impact

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

## Economic Impact

Revenue Estimate

| Estimated Revenue Impact of LP - A<br>For Taxable Years Beginning On or After January 1, 2014<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | |
|---|---|---|
| 2014-15 | 2015-16 | 2016-17 |
| - $75 | - $80 | - $80 |

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

<u>Revenue Discussion</u>

**In General**

Approximately $1.8 billion of California research credits are currently allowed annually. The revenue impact of this proposal would depend on the number of taxpayers claiming the research credit and the calculation method used.

**Conforming to Federal Methods and Changes to Acquisitions, Dispositions, and Aggregations**

*Conforming to Federal Methods*

The amount of the California general research credit that's calculated using the "incremental method" is approximately 3 percent, or $55 million, of the total research credit allowed ($1,800,000,000 x 3% ≈ $55,000,000). Using actual tax return data, a micro-simulation model was used to estimate the revenue impact of eliminating the election to calculate the general research credit under the "incremental method" and instead allowing an election of the "simplified method" at a general credit rate of 10.5 percent.[25] The simulation assumed that taxpayers that have been calculating their general credit using the "incremental method" would instead use the "simplified method," and that taxpayers that are currently calculating their general research credit using the "standard method" would elect the "simplified method" if it increases the amount of their credit. This change is estimated to result in a revenue loss of approximately $75 million.

*Conforming to Changes to Acquisitions, Dispositions, and Aggregations*

Conforming to the recent federal changes to acquisitions, dispositions, and aggregations is estimated to have a negligible revenue impact.

**<u>Pro & Con Arguments</u>**

Pro: This proposal would simplify the calculation of the California research credit, which could encourage more small businesses to conduct research in California.

Con: This proposal would not conform to all of the components of the federal research credit.

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

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to *California's* economy, business entity types, and tax laws. A review of these states' laws found that each state provides its own research credit for research conducted within the state, as described below.

[25] The credit rate under the California "simplified method" would be reduced to 4.5 percent if a taxpayer has no California qualified research expenses in any one of the three preceding taxable years.

*Florida* allows a corporate research tax credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within *Florida*. The combined total amount of tax credits which may be granted to all business enterprises during any calendar year is $9 million; taxpayers must apply for the credit, which is allocated in the order in which applications are received. *Florida* calculates its base amount using the average amount of *Florida* research expenses for the prior four years.

*Illinois* allows an individual and corporate tax research credit of 6.5 percent of qualified research expenses in excess of a base amount for research conducted within *Illinois*. *Illinois* calculates its base amount using the average amount of *Illinois* research expenses for the prior three years.

*Massachusetts* allows corporate taxpayers to claim an excise-tax research credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within *Massachusetts. Massachusetts* uses the federal definition of gross receipts to compute its base amount, and that base amount is calculated the same way as the federal base amount under the "standard method," using only state amounts.

*Michigan* replaced the Michigan Business Tax with a corporate income tax for taxable years beginning on or after January 1, 2012. There is no research credit under the state's new corporate or personal income tax.

*Minnesota* allows a two-tiered individual and corporate tax research credit for research conducted within *Minnesota*: (1) for qualified research expenses up to $2 million, the credit is 10 percent of expenses in excess of a base amount; and (2) for qualified research expenses in excess of $2 million, the credit is 2.5 percent of expenses in excess of a base amount. *Minnesota* uses the federal definition of gross receipts to compute its base amount, and that base amount is calculated the same way as the federal base amount under the "standard method," using only state amounts.

*New York* allows a research credit equal to 50 percent of the taxpayer's federal research credit, subject to a limit of 3 percent of qualified research expenses attributable to research conducted in *New York*. The research credit is only available to firms in targeted industries such as biotechnology, pharmaceutical, cutting-edge technology, clean technology, green technology, financial services, agriculture, and manufacturing.

## LEGISLATIVE STAFF CONTACT

Scott McFarlane
Legislative Analyst, FTB
(916) 845-6075
scott.mcfarlane@ftb.ca.gov

Mandy Hayes
Revenue Manager, FTB
(916) 845-5125
mandy.hayes@ftb.ca.gov

Gail Hall
Legislative Director, FTB
(916) 845-6333
gail.hall@ftb.ca.gov

| | |
|---|---|
| Analyst | Scott McFarlane |
| Telephone # | 845-6075 |
| Attorney | Pat Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP - A

SECTION 1. Section 17052.12 of the Revenue and Taxation Code is amended to read:

17052.12. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "net tax" (as defined by Section 17039) for the taxable year an amount determined in accordance with Section 41 of the Internal Revenue Code, relating to credit for increasing research activities, except as follows:

(a) For each taxable year beginning before January 1, 1997, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(b)(1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(3) For each taxable year beginning on or after January 1, 2000, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(c) Section 41(a)(2) of the Internal Revenue Code shall not apply.

(d) "Qualified research" shall include only research conducted in California.

(e) In the case where the credit allowed under this section exceeds the "net tax," the excess may be carried over to reduce the "net tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(f)(1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code, relating to qualified research expenses, is modified to exclude from the definition of "qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax provided by Section 6378.

(2) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 11 (commencing with Section 23001)."

(g)(1)(A) For each taxable year beginning on or after January 1, 2000, and before January 1, 2014:

~~(A)~~(i) The reference to "3 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

~~(B)~~(ii) The reference to "4 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

~~(C)~~(iii) The reference to "5 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

~~(2)~~(B) Section 41(c)(4)(B) of the Internal Revenue Code shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 1998, and before January 1, 2014. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

(C) Section 41(h)(2) of the Internal Revenue Code, relating to termination of alternative incremental credit, is modified by substituting “beginning on or after January 1, 2014” for “beginning after December 31, 2008”.

(2)(A) For taxable years beginning on or after January 1, 2014, Section 41(c)(5) of the Internal Revenue Code, relating to election of alternative simplified credit, shall apply, except as otherwise provided.

(i) The reference to “14 percent” in Section 41(c)(5)(A) of the Internal Revenue Code is modified to read “10.5 percent.”

(ii) The reference to “6 percent” in Section 41(c)(5)(B)(ii) of the Internal Revenue Code is modified to read “4.5 percent.”

(B) Section 41(c)(5)(C), relating to election, shall not apply and in lieu thereof an election under Sections 41(c)(5)(A) and 41(c)(5)(B) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 2014. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

(3) Section 41(c)(7) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

~~(4) Section 41(c)(5) of the Internal Revenue Code, relating to election of alternative simplified credit, shall not apply.~~

(h) Except as otherwise provided in this section, Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(i) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (e); except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

(j) Section 41(a)(3) of the Internal Revenue Code shall not apply.

(k) Section 41(b)(3)(D) of the Internal Revenue Code, relating to amounts paid to eligible small businesses, universities, and federal laboratories, shall not apply.

(l) Section 41(f)(6) of the Internal Revenue Code, relating to energy research consortium, shall not apply.

(m) The amendments made by subdivisions (b) and (c) of Section 301 of the American Taxpayer Relief Act of 2012 (Public Law 112-240), relating to inclusion of qualified research expenses and gross receipts of an acquired person and aggregation of expenditures, shall apply, except as otherwise provided.

(n) The amendments made to this section by the act adding this subdivision shall apply to taxable years beginning on or after January 1, 2014.

SEC. 2. Section 23609 of the Revenue and Taxation Code is amended to read:

23609. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "tax" (as defined by Section 23036) an amount determined in accordance with Section 41 of the Internal Revenue Code, relating to credit for increasing research activities, except as follows:

(a) For each taxable year beginning before January 1, 1997, both of the following modifications shall apply:

(1) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(2) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "12 percent."

(b)(1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, both of the following modifications shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(3) For each taxable year beginning on or after January 1, 2000, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(c)(1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code, relating to qualified research expenses, is modified to exclude from the definition of "qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax provided by Section 6378.

(2) "Qualified research" and "basic research" shall include only research conducted in California.

(d) The provisions of Section 41(e)(7)(A) of the Internal Revenue Code, relating to basic research, shall be modified so that "basic research," for purposes of this section, includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that the term does not include any of the following:

(1) Basic research conducted outside California.

(2) Basic research in the social sciences, arts, or humanities.

(3) Basic research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors.

(4) Any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e)(1) In the case of a taxpayer engaged in any biopharmaceutical research activities that are described in codes 2833 to 2836, inclusive, or any research activities that are described in codes 3826, 3829, or 3841 to 3845, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, or any other biotechnology research and development activities, the provisions of Section 41(e)(6) of the Internal Revenue Code, relating to qualified organizations, shall be modified to include both of the following:

(A) A qualified organization as described in Section 170(b)(1)(A)(iii) of the Internal Revenue Code and owned by an institution of higher education as described in Section 3304(f) of the Internal Revenue Code, relating to definition of institution of higher education.

(B) A charitable research hospital owned by an organization that is described in Section 501(c)(3) of the Internal Revenue Code, relating to list of exempt organizations, is exempt from taxation under Section 501(a) of the Internal Revenue Code, relating to exemption from taxation, is not a private foundation, is designated a "specialized laboratory cancer center," and has received Clinical Cancer Research Center status from the National Cancer Institute.

(2) For purposes of this subdivision:

(A) "Biopharmaceutical research activities" means those activities that use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms to make commercial products, as opposed to pharmaceutical activities that make use of chemical compounds to produce commercial products.

(B) "Other biotechnology research and development activities" means research and development activities consisting of the application of recombinant DNA technology to produce commercial products, as well as research and development activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery.

(f) In the case where the credit allowed by this section exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(g) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 10 (commencing with Section 17001)."

(h)(1)(A) For each taxable year beginning on or after January 1, 2000, and before January 1, 2014:

~~(A)~~(i) The reference to "3 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

~~(B)~~(ii) The reference to "4 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

~~(C)~~(iii) The reference to "5 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

~~(2)~~(B) Section 41(c)(4)(B) of the Internal Revenue Code shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 1998, and before January 1, 2014. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

(C) Section 41(h)(2) of the Internal Revenue Code, relating to termination of alternative incremental credit, is modified by substituting "beginning on or after January 1, 2014" for "beginning after December 31, 2008".

(2)(A) Section 41(c)(5) of the Internal Revenue Code, relating to election of alternative simplified credit, shall apply, except as otherwise provided.

(i) The reference to "14 percent" in Section 41(c)(5)(A) of the Internal Revenue Code is modified to read "10.5 percent."

(ii) The reference to "6 percent" in Section 41(c)(5)(B)(ii) of the Internal Revenue Code is modified to read "4.5 percent."

(B) Section 41(c)(5)(C), relating to election, shall not apply and in lieu thereof an election under Sections 41(c)(5)(A) and 41(c)(5)(B) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 2014. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

(3) Section 41(c)(7) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

~~(4) Section 41(c)(5) of the Internal Revenue Code, relating to election of the alternative simplified credit, shall not apply.~~

(i) Except as otherwise provided in this section, Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(j) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (f), except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

(k) Section 41(a)(3) of the Internal Revenue Code shall not apply.

*(l)* Section 41(b)(3)(D) of the Internal Revenue Code, relating to amounts paid to eligible small businesses, universities, and federal laboratories, shall not apply.

(m) Section 41(f)(6) of the Internal Revenue Code, relating to energy research consortium, shall not apply.

(n) The amendments made by subdivisions (b) and (c) of Section 301 of the American Taxpayer Relief Act of 2012 (Public Law 112-240), relating to inclusion of qualified research expenses and gross receipts of an acquired person and aggregation of expenditures, shall apply, except as otherwise provided.

(o) The amendments made to this section by the act adding this subdivision shall apply to taxable years beginning on or after January 1, 2014.

# LEGISLATIVE PROPOSAL - B
# EXECUTIVE SUMMARY

- **Title:** Dependent Taxpayer Identification Numbers

- **Problem:** Lack of a requirement that a Taxpayer Identification Number (TIN) for each dependent be included on the state tax return precludes the department from validating Dependent Exemption Credits (Dependent Credits) during return processing, which delays the correction of erroneous or duplicated Dependent Credits and increases the cost of correcting these errors for taxpayers and the department.

- **Proposed Solution:** Amend current state law to provide that no Dependent Credit would be allowed unless the dependent's TIN is included on the respective return.

- **Fiscal Impact:** This proposal would require the department to respond to and resolve taxpayer contacts when their Dependent Credit has been disallowed resulting in additional costs of approximately $512,000 for the first year, fiscal year 2014-15, and $504,000 annually thereafter. Any costs attributable to system changes are expected to be absorbable.

- **Revenue:**

| Estimated Revenue Impact of LP - B<br>Dependent Taxpayer Identification Numbers on Tax Returns<br>For Taxable Years Beginning On or After January 1, 2015<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | |
|---|---|---|
| 2014-15 | 2015-16 | 2016-17 |
| + $10 | + $10 | + $11 |

## Title

Dependent Taxpayer Identification Numbers

## Introduction

This proposal would require a taxpayer identification number (TIN) for each dependent claimed on the state tax return.

## Current Federal Law

Under federal law, no dependent exemption is allowed unless the TIN of the dependent is included on the federal return.[1]

A TIN is an identification number used by the Internal Revenue Service (IRS) in the administration of tax laws. A social security number is issued by the Social Security Administration whereas all other TINs are issued by the IRS. Examples of TINs are as follows:

- Social Security Number "SSN"
- Individual Taxpayer Identification Number "ITIN"
- Taxpayer Identification Number for Pending U.S. Adoptions "ATIN"

## Current State Law

Existing state law prohibits the disallowance of the Dependent Credit if the return lacks a TIN.[2] This provision was added in 1997[3] following the Internal Revenue Code (IRC) change that required the TIN of dependents on the personal income tax return in response to concerns about obtaining a TIN for newborns in time to include the TIN on the return.

Additionally, state law provides that a return information notice (RIN) that includes any amount of tax that is more than the amount reported on the tax return due to a mathematical error, e.g., an inaccuracy in computation, is not a deficiency assessment and the taxpayer lacks protest or appeal rights on that RIN. However, the department may choose to collect the amount inaccurately omitted via a Notice of Proposed Assessment (NPA).[4]

## Program History/Background

In order to claim the Dependent Credit, a taxpayer is required to provide the name and relationship of the related individual. Conversely, for each dependent exemption reported, the IRS requires the name, relationship, and, since 1987, the TIN.

---

[1] Internal Revenue Code section 151 (e)
[2] Revenue and Taxation Code section 17054 (d) (2)
[3] SB 1233 (Lockyear, Chapter 612, Statutes of 1997) and SB 455 (Alpert, Chapter 611, Statutes of 1997)
[4] Revenue and Taxation Code section 19051

Requiring the TIN has allowed the federal government to verify the dependent TIN against the social security data base during return processing, and deny the dependent exemption when an inaccurate TIN is provided, or the same TIN has been reported on another return. The IRC was amended to require dependent TINs on individual tax returns because Congress viewed the TIN requirement as an enforcement mechanism for ensuring the same dependent was not claimed on multiple returns. As a result of this new requirement, seven million fewer dependent exemptions were claimed on the 1987 federal tax returns than on the 1986 federal tax returns.

Recently, the department conducted a study that confirms that failing to require the dependent TIN on the California personal income tax return (return) results in substantial noncompliance. Specific examples are situations where the same dependent is claimed three or more times on different returns, and usually this turns out to be a wholly fictitious dependent. Another common situation is where a Dependent Credit is claimed by the primary or secondary filer. The most prevalent error is the same dependent claimed exactly twice, which may indicate two parents have improperly claimed the same child, such as separated parents, or a parent has claimed their child as a dependent and that child has filed a return and claimed himself or herself.

Because state law lacks a requirement to include a dependent TIN on the return, the majority of disallowed Dependent Credits are identified when the department receives shared information from the IRS. On average, this information is received 18 months after the return's due date and includes information on the federal disallowance of dependent exemptions for failure to provide or validate the accuracy of the dependent's TIN. The remaining disallowed Dependent Credits are identified during the department's audits of the Head of Household filing status or the Child and Dependent Care Credit. Taxpayers are notified via an NPA when the Dependent Credit is proposed to be disallowed.

The department is currently implementing the Enterprise Data to Revenue (EDR) project that uses new technologies with the department's current systems with a projected goal to facilitate the validation and correction of data reported on returns through the return analysis process. This process will be performed upfront when returns are filed. If this proposal's requirement to include a dependent's TIN is enacted into law, inaccuracies identified on a taxpayer's return, such as a dependent's TIN that has been claimed on multiple returns or that do not exist, could be adjusted immediately. Requiring dependent TINs on the return would increase the department's accuracy and customer service as the adjustments could be completed at the time of return processing instead of many months later.

## Problem

Lack of a requirement that a TIN for each dependent be included on the return precludes the department from validating Dependent Credits during return processing, which delays the correction of erroneous or duplicated Dependent Credits and increases the cost of correcting these errors for taxpayers and the department.

## Proposed Solution

For taxable years beginning on or after January 1, 2015, amend current state law to provide that no Dependent Credit would be allowed unless the identification number of that individual is included on the return claiming the Dependent Credit.

Any disallowance of the Dependent Credit due to the omission of a TIN would be treated as a math error by the department.

## Effective/Operative Date of Solution

If enacted in the 2014 legislative session, the provisions of this proposal would be effective and operative beginning January 1, 2015, and specifically operative for taxable years beginning on or after January 1, 2015.

## Justification

This proposal would allow the department to confirm that a dependent's TIN is used only once, which would increase the integrity of the returns, reduce inaccurate returns, and erroneous Dependent Credits. This proposal would also increase the timeliness of the department's compliance efforts, and decrease the amount of incorrect refunds issued to taxpayers.

Additionally, this proposal would allow the department to create an automated versus manual method for examining Dependent Credits that could reduce departmental cost by implementing a less expensive method of verifying Dependent Credits and notifying taxpayers of deficiencies, whereas a result of timely notifying a taxpayer that improperly claimed Dependent Credits could have less interest and penalties applied.

## Implementation

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

## Fiscal Impact

This proposal would require the department to respond to and resolve taxpayer contacts when their Dependent Credit has been disallowed resulting in additional costs of approximately $512,000 for the first year, fiscal year 2014-15, and $504,000 for each subsequent year. Any costs attributable to system changes are expected to be absorbable.

## Economic Impact

Revenue Estimate

| Estimated Revenue Impact of LP - B<br>Dependent Taxpayer Identification Numbers on Tax Returns<br>For Taxable Years Beginning On or After January 1, 2015<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | |
|---|---|---|
| 2014-15 | 2015-16 | 2016-17 |
| + $10 | + $10 | + $11 |

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

Revenue Discussion

The estimated revenue impact of this proposal depends on the number of taxpayers that improperly claim Dependent Credits. The resulting revenue from this proposal is due to an administrative change rather than a change to the calculation of tax liability.

Each year approximately 12 million Dependent Credits are claimed on 7.6 million returns. It was assumed that less than 1 percent, or approximately 65,000 of these returns will be initially disallowed or rejected during processing as a result of the requirements of this proposal. It is estimated that 15 percent of these rejections would be reversed because the taxpayer had correctly claimed the Dependent Credit. The remaining 85 percent or 55,000 represent the number of returns with one or more disallowed Dependent Credits. The average tax impact per return is estimated to be $209, for an initial revenue impact of $11,000,000. However, a portion of this amount, approximately $850,000, would result in assessments that would need to be collected from taxpayers because they owed tax before the credit was disallowed. However, it is estimated that only 60 percent of this portion would actually be collected over the next five years. The result is an estimated revenue impact of approximately $10,000,000 in the first year. This number is grown, fiscalized, and standard rounding was applied to arrive at the numbers above.

## Pro & Con Arguments

Pro: Requiring taxpayers to provide TINs for dependents would reduce inaccurate Dependent Credit claims and increase compliance.

Con: Increasing the information on the return could add to the complexity of the return and increase the perception of the return as a more cumbersome document.

## 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* only has a corporation income tax; therefore a comparison *Florida* law is irrelevant.

Generally*, Illinois* does not require a TIN to be reported on the return in order to claim a dependent exemption. However, a Nonresident Alien is required to attach the federal 1040 NR or the 1040 NR-EZ when filing the state return.

*Massachusetts* has a Dependent Information Schedule that requires the dependent's name, relationship, TIN, and date of birth.

*Michigan* does not require a TIN to be reported on the return or an attached federal return in order to claim a dependent exemption.

*Minnesota* has a Child and Dependent Care Credit Schedule, Minnesota Working Family Credit Schedule, and a K-12 Education Credit Schedule that requires, among other information, the dependent's name, TIN, and date of birth.

*New York* requires a dependent's name, relationship, TIN, and date of birth to be reported on the return in order to claim the dependent exemption.

## Additional Comments

The proposed procedure to notify a taxpayer that the Dependent Credit was disallowed through a RIN would permit the department to adjust the return during processing. If the taxpayer disputes the adjustment, he or she would have an opportunity to provide documentation supporting eligibility for the credit, or file a formal claim for refund.

**LEGISLATIVE STAFF CONTACT**

Janet Jennings
Legislative Analyst, FTB
(916) 845-3495
janet.jennings@ftb.ca.gov

Mandy Hayes
Revenue Manager, FTB
(916) 845-5125
mandy.hayes@ftb.ca.gov

Gail Hall
Legislative Director, FTB
(916) 845-6333
gail.hall@ftb.ca.gov

| | |
|---|---|
| Analyst | Janet Jennings |
| Telephone # | (916) 845-3495 |
| Attorney | Pat Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP - B

SECTION 1. Section 17054 of the Revenue and Taxation Code is amended to read:

17054. In the case of individuals, the following credits for personal exemption may be deducted from the tax imposed under Section 17041 or 17048, less any increases imposed under paragraph (1) of subdivision (d) or paragraph (1) of subdivision (e), or both, of Section 17560.
(a) In the case of a single individual, a head of household, or a married individual making a separate return, a credit of fifty-two dollars ($52).
(b) In the case of a surviving spouse (as defined in Section 17046), or a husband and wife making a joint return, a credit of one hundred four dollars ($104). If one spouse was a resident for the entire taxable year and the other spouse was a nonresident for all or any portion of the taxable year, the personal exemption shall be divided equally.
(c) In addition to any other credit provided in this section, in the case of an individual who is 65 years of age or over by the end of the taxable year, a credit of fifty-two dollars ($52).
(d) (1) A credit of two hundred twenty-seven dollars ($227) for each dependent (as defined in Section 17056) for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents. The credit allowed under this subdivision for taxable years beginning on or after January 1, 1999, shall not be adjusted pursuant to subdivision (i) for any taxable year beginning before January 1, 2000.
(2) <u>(A) For taxable years beginning on or after January 1, 2015, no credit may be allowed under paragraph (1) with respect to any individual unless the identification number, as defined in Section 6109 of the Internal Revenue Code, of that individual is included on the return claiming the credit.</u>
~~The credit allowed under paragraph (1) may not be denied on the basis that the identification number of the dependent, as defined in Section 17056, for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents, is not included on the return claiming the credit.~~
<u>(B) Any disallowance of a credit due to the omission of a correct identification number required under this subdivision, may be assessed by the Franchise Tax Board in the same manner as is provided by Section 19051 in the case of a mathematical error appearing on the return.</u>
(3)(A) For taxable years beginning on or after January 1, 2009, the credit allowed under paragraph (1) for each dependent shall be equal to the credit allowed under subdivision (a). This subparagraph shall cease to be operative for taxable years beginning on or after January 1, 2011, unless the Director of Finance makes the notification pursuant to Section 99040 of the Government Code, in which case this subparagraph shall cease to be operative for taxable years beginning on or after January 1, 2013.
(B) For taxable years that subparagraph (A) ceases to be operative, the credit allowed under paragraph (1) for each dependent shall be equal to the amount that would be allowed if subparagraph (A) had never been operative.

(e) A credit for personal exemption of fifty-two dollars ($52) for the taxpayer if he or she is blind at the end of his or her taxable year.
(f) A credit for personal exemption of fifty-two dollars ($52) for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.
(g) For the purposes of this section, an individual is blind only if either (1) his or her central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or (2) his or her visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.
(h) In the case of an individual with respect to whom a credit under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual’s taxable year begins, the credit amount applicable to that individual for that individual’s taxable year is zero.
(i) For each taxable year beginning on or after January 1, 1989, the Franchise Tax Board shall compute the credits prescribed in this section. That computation shall be made as follows:
(1) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.
(2) The Franchise Tax Board shall add 100 percent to the percentage change figure which is furnished to them pursuant to paragraph (1), and divide the result by 100.
(3) The Franchise Tax Board shall multiply the immediately preceding taxable year credits by the inflation adjustment factor determined in paragraph (2), and round off the resulting products to the nearest one dollar ($1).
(4) In computing the credits pursuant to this subdivision, the credit provided in subdivision (b) shall be twice the credit provided in subdivision (a).

# LEGISLATIVE PROPOSAL - C
# EXECUTIVE SUMMARY

- **Title:** Business Entities e-Filing Requirement

- **Problem:** If the return of a business entity is prepared using tax preparation software, but a paper return for that business entity is filed, the department must process that return using costly manual data capture methods that lack the accuracy and efficiency associated with e-filing.

- **Proposed Solution:** Require a business entity that files a return that was prepared using tax preparation software, to file the return by electronic technology, unless the business entity, upon request, is granted a waiver. The FTB may grant a waiver if it determines the business entity is unable to comply with the requirements due to, but not limited to, technology constraints, where compliance would result in undue financial burden, or due to circumstances that constitute reasonable cause, and not willful neglect.

  In addition, a provision would be added that would impose a $500 penalty on a business entity that files a return but fails to e-file that return when required to do so under the requirements discussed above, unless the failure is due to reasonable cause and not willful neglect.

- **Fiscal Impact:** To the extent that this proposal would increase the number of taxpayers filing electronic returns verses paper, it would generate cost savings in the earlier years of implementation. The department estimates a cost savings of approximately $935,000, for fiscal year 2014-15 attributable to a reduction in personnel and equipment needed to key the business entity returns that convert from paper to e-filing and assumes that in the first year of requiring a business to e-file, a 76 percent e-file compliance rate will be achieved. The fiscal year 2014-15 savings would be offset by a onetime implementation cost of approximately $95,000, for a net savings of approximately $840,000. In addition, approximately $510,000 in aggregate cost savings is estimated for fiscal years two through four (2015-16 through 2017-18); and cost savings in fiscal year five (2018-19) of approximately $1.2 million, that assumes a 90 percent e-file compliance rate, by reducing work performed by vendors as the work transitions back to the department and through the elimination of maintenance support contracts. The cost savings that would result from this proposal would allow staff to work higher priority workloads.

- **Revenue:** This proposal would not accelerate revenue because of the following reasons:

  - The timing or amount of estimated tax payments made by a business entity would remain unchanged.
  - The department does not prioritize e-filed returns over paper returns.
  - The fact that refunds would be expected to reach taxpayers faster if they choose to e-file is estimated as having an insignificant impact to revenue.
  - The penalty would be imposed so infrequently that the revenue would be negligible because the department anticipates business entities would either comply with the e-file requirements or obtain a waiver.

## Title

Business Entities e-Filing Requirement

## Introduction

This proposal would require certain business entities to use electronic filing (e-filing).

## Program History/Background

The Franchise Tax Board (FTB) offers voluntary e-filing[1] of personal income tax returns and returns for corporations, partnerships, exempt organizations,[2] and limited liability companies.

The Business e-Filing Program process allows the return of a business entity to be transmitted electronically. There are several tax preparation software brands available to business entities to utilize for e-filing.[3] The tax preparation software formats the electronic return from the business entity to an acceptable standardized readable tax record for batching and transmission through the Internet to the FTB. The FTB validates the data and sends an acknowledgement back to the filer on every e-filed return received. The Business e-Filing Program accepts the current year and two prior tax years for e-filing. An estimated 46 percent of business entities voluntarily e-filed with the FTB for filing season 2012. See Exhibit A, "FTB e-File Process."

The Internal Revenue Service (IRS) has an e-file system referred to as Modernized e-File (MeF). MeF is a federal web-based system that allows e-filing of corporate, individual, partnership, exempt organization, and excise returns. The IRS MeF format utilizes the same standardized technology as California's Business e-File Program. Several states that lack an e-file program participate in the Federal and State (Fed/State) program. Both the federal and state returns are transmitted to the IRS, and the IRS forwards the state return to the appropriate state tax authority.[4]

## Current Federal Law

Under federal regulations, certain large corporations and other business entities are required to file federal income and information returns electronically. E-filing is optional, but encouraged, for smaller entities.

The IRS mandates e-filing for the following:

- Large corporations with $10 million or more in total assets.
- A partnership with more than 100 partners.[5] A partnership that fails to file Schedules K-1 is assessed a penalty of $50.00 for each Schedule K-1.
- Certain large tax-exempt organizations with total assets of $10 million.
- Private foundations and charitable trusts regardless of their asset size.

---

[1] FTB Publication 1346B, "2012 Business e-file Guide for Software Developers and Transmitters," <https://www.ftb.ca.gov/professionals/efile/forms/1346b/1346b.pdf >.
[2] Excluding California Exempt Organization Business Income, Form 109.
[3] "Approved e-File Software for California," <https://www.ftb.ca.gov/professionals/efile/prosoftware.shtml>, dated October 11, 2013.
[4] California is an independent state and receives state returns directly from the tax software provider, via Secure Web Internet File Transfer system, known as SWIFT.
[5] Schedules K-1.

In addition, tax preparers that file at least 250 returns, including income tax returns, exempt organization returns, information returns, excise tax returns, and employment tax returns, are mandated to e-file.

The IRS allows for exceptions and hardship waivers from the e-filing requirement. A taxpayer may request a waiver if the taxpayer is unable to meet e-filing requirements due to technology constraints or where compliance with the requirements would result in undue financial burden on the taxpayer.[6]

The IRS may issue a failure to file penalty if a business entity chooses to file a paper return rather than e-file. A failure to file penalty is generally five percent of the tax owed for each month, up to a maximum of 25 percent. If the return is over 60 days late, the minimum penalty for late filing is the lesser of $135 or 100 percent of the tax owed.

## Current State Law

Current state law lacks a requirement for a business entity to e-file. The department's Business e-File Program allows business entities to voluntarily e-file returns.

State law requires income tax preparers who prepare more than 100 California individual income tax returns annually or prepare one or more using tax preparation software to e-file all personal income tax returns.

The failure to e-file penalty is $50 per return filed on paper that should have been e-filed, unless it is shown that the failure to e-file is due to reasonable cause and not due to willful neglect.

## Problem

If the return of a business entity is prepared using tax preparation software, but a paper return for that business entity is filed, the department must process that return using costly manual data capture methods that lack the accuracy and efficiency associated with e-filing.

## Proposed Solution

Add a provision to the Revenue and Taxation Code that would require a business entity that files an acceptable return that was prepared using tax preparation software, to file the return by electronic technology in a form and manner prescribed by the FTB, unless the business entity, upon request, is granted a waiver.

Any business entity required to file a return electronically may annually request a waiver of the e-file requirements from the FTB. The FTB may grant a waiver if it determines the business entity is unable to comply with the requirements due to, but not limited to, technology constraints, where compliance would result in undue financial burden, or due to circumstances that constitute reasonable cause, and not willful neglect.

---

[6] IRS Notice 2010-13.

This provision would provide the following definitions:

- "Acceptable return" means any original return or amended return that is required to be filed, other than the exempt organization return for unrelated business taxable income (Form 109).
- "Business entity" means a corporation, including an S corporation, an organization exempt from tax, partnership, or limited liability company classified as a corporation or a partnership.
- "Tax preparation software" means any computer software program used to prepare an acceptable return or for use in tax compliance, that uses electronic technology.
- "Electronic technology" includes, but is not limited to, internet, cloud computing, or an electronic information delivery system.
- "Technology constraints" means an inability of the tax preparation software used by a taxpayer to electronically file the acceptable return as required by this section as a result of the complex nature of the return or inadequacy of the software.

In addition, a provision would be added that would impose a $500 penalty on a business entity that files a return but fails to e-file that return when required to do so under the requirements discussed above, unless the failure is due to reasonable cause and not willful neglect.

**Effective/Operative Date of Solution**

This proposal would be effective January 1, 2015. The e-filing requirements would specifically apply to taxable years beginning on or after January 1, 2014, and to acceptable returns filed on or after January 1, 2015. The penalty provision would be delayed by one year and would apply to returns filed for taxable years beginning on or after January 1, 2015.

**Justification**

Requiring a business entity to e-file a return when a taxpayer uses tax preparation software would result in the FTB processing returns more quickly, which would expedite approved refunds and utilize cost-effective technology to meet operational goals.

Department staff reports that 86 percent of the paper returns filed by business entities are produced using approved tax preparation software ready for e-filing. However, only 46 percent of these returns are e-filed. The department anticipates that approximately 80 percent would e-file in the first year of the requirement with the remainder of the population obtaining a waiver of the requirement based on, but not limited to, technology constraints, undue financial burden, or reasonable cause. As a result, the additional burden to taxpayers subject to the proposed e-filing requirement is expected to be minor.

E-filing a return lowers the initial cost of processing returns. The FTB estimates that the average cost to the department to process a business entity paper filed return is $6.00 (includes complex and smaller taxpayer returns), as opposed to 36 cents (primarily based on smaller taxpayer returns) for an e-filed return.

Requiring a business entity to e-file rather than file a paper return that was prepared using tax preparation software would simplify the department's tax-filing process because of the following:

- E-filing a return shortens the processing time for returns because FTB's e-file processes verify and validate certain aspects of the return before it is accepted for processing, ensuring a more accurate return, with fewer errors.
- E-filing a return reduces data entry errors because rekeying data into FTB's systems is not needed.
- E-filing a return automates a substantial amount of tax data collected by taxpayers and processed by the FTB. For example, CA Form 100 has up to 40 pages of forms and schedules manually keyed by data operators into FTB systems.

Business e-file benefits include the following:

- Fast Processing - The FTB can process an e-filed return quicker than a paper return. Time saved in processing translates to quicker refunds.
- Accurate Returns - The e-file program checks returns for common error conditions before the returns are processed. This provides the business entity with the opportunity to correct the return and avoid a notice. The error rate for paper returns is approximately 10 percent, while e-file returns have an error rate of less than 1 percent.
- Proof of Filing - Generally within 24 to 48 hours the FTB provides an acknowledgment that the business entity's return has been received and accepted.

## Implementation

Implementing this proposal would require the development of procedures and forms, taxpayer education and outreach efforts, and staff training to respond to questions and requests regarding the e-filing requirement and waiver process.

## Fiscal Impact

To the extent that this proposal would increase the number of taxpayers filing electronic returns verses paper, it would generate cost savings in the earlier years of implementation. The department estimates a cost savings of approximately $935,000, for fiscal year 2014-15 attributable to a reduction in personnel and equipment needed to key the business entity returns that convert from paper to e-filing and assumes that in the first year of requiring a business to e-file, a 76 percent e-file compliance rate will be achieved. The fiscal year 2014-15 savings would be offset by a onetime implementation cost of approximately $95,000, for a net savings of approximately $840,000.

In addition, approximately $510,000 in aggregate cost savings is estimated for fiscal years two through four (2015-16 through 2017-18); and cost savings in fiscal year five (2018-19) of approximately $1.2 million, that assumes a 90 percent e-file compliance rate, by reducing work performed by vendors as the work transitions back to the department and through the elimination of maintenance support contracts. The cost savings that would result from this proposal would allow staff to work higher priority workloads.

## Economic Impact

This proposal would not accelerate revenue because:

- The timing or amount of estimated tax payments made by a business entity would remain unchanged.
- The department does not prioritize e-filed returns over paper returns.
- The fact that refunds would be expected to reach taxpayers faster if they choose to e-file is estimated as having an insignificant impact to revenue.

Although this proposal would impose a $500 penalty on a business entity that fails to e-file when required to do so, the estimated revenue associated with this penalty would be negligible because the department anticipates business entities that would be required to e-file would comply with the requirement or obtain a waiver under the provisions of the proposal. This has been the department's experience with current law's mandated e-file for certain tax preparers preparing individual tax returns. Although certain tax preparers have been subject to the penalty, the department has been able to work with the tax preparers to either comply with the law or obtain a waiver of the e-file requirement.

## Pro & Con Arguments

Pro: Some may say that requiring e-filing for certain business entities would improve taxpayer service and governmental efficiency.

Con: Some may say that it will be costly for certain software providers to implement e-filing because they may absorb the cost of developing e-filing for California purposes.

## Other States

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* because of similarities to California's economy, business entity types, and tax laws.

Under *Florida* law, a taxpayer required to e-file a federal corporate income tax return is required to file their *Florida* corporate income tax returns electronically via the IRS's MeF Fed/State Program using approved software.

*Illinois* and the IRS have developed the Illinois Business Income Tax MeF Program. *Illinois* requires any corporation, S corporation, and partnership that e-files its federal income tax to file its equivalent *Illinois* income tax return for the same taxable year electronically. *Illinois* does not require e-filing of amended returns.

A *Massachusetts* S corporation that has income from customers or clients of $100,000 or more is required to e-file a corporation tax return. A *Massachusetts* partnership with 25 or more partners must e-file, and a partnership with less than 25 partners that has income or loss of $50,000 or more is required to e-file.

*Michigan* has an enforced e-file requirement for Michigan Business Tax (MBT) and Corporation Income Tax (CIT). All eligible MBT and CIT returns prepared using tax preparation software or a computer-generated form are required to be e-filed. *Michigan* participates in the IRS MeF program: accepting both MBT and CIT Fed/State e-file returns.

*Minnesota* accepts e-filed corporate franchise, fiduciary, S corporation, and partnership returns through participating tax software providers. *Minnesota* will begin its transition to the Fed/State MeF program. An internet based e-filing platform allows a tax preparer to transmit both federal and *Minnesota* state returns through the IRS system.

*New York* requires a corporation and a partnership to e-file if they self-prepare tax documents without the assistance of a tax professional, utilize approved e-file tax software to prepare the return, or utilize a computer to prepare, document, or calculate an extension or estimated tax payment; and the corporation and partnership has broadband internet access.

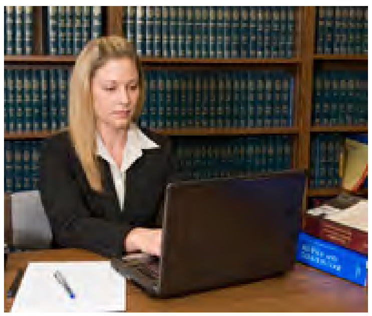
**LEGISLATIVE STAFF CONTACT**

| | | |
|---|---|---|
| Jane Raboy | Mandy Hayes | Gail Hall |
| Legislative Analyst, FTB | Revenue Manager, FTB | Legislative Director, FTB |
| (916) 845-5718<br>jane.raboy@ftb.ca.gov | (916) 845-5125<br>mandy.hayes@ftb.c.agov | (916) 845-6333<br>gail.hall@ftb.ca.gov |

Exhibit A - FTB e-File Process

# Business Entity Return e-file Process

Business Entity → Transmits to FTB Using the Internet → FTB



**Uses**
**Tax Preparation Software**

**Transmission by**
**Tax Preparation Software or**
**Tax Software Provider**

**FTB Validates Data**
**and Returns Acknowledgement**

- Tax software providers approved in the IRS e-file Program are automatically enrolled in the California e-file program.
- The e-file Program allows the state return to be transmitted independent of the federal return and does not require the federal return to be accepted prior to the state return being transmitted.
- Acknowledgement received from FTB

- Business e-file performs Business Rule Validation
- Creates Acknowledgment File (Rejected or Accepted)
- Accepted returns are sent for additional processing
- FTB returns acknowledgement back to the filer on every e-file return received

| | |
|---|---|
| Analyst | Jane Raboy |
| Telephone # | (916) 845-5718 |
| Attorney | Pat Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP - C

*SECTION 1. Section 18621.10* is *added to the Revenue and Taxation Code to read:*

18621.10. (a) For taxable years beginning on or after January 1, 2014, if an acceptable return of a business entity was prepared using a tax preparation software, that return must be filed using electronic technology in a form and manner prescribed by the Franchise Tax Board.
(b) For purposes of this section:
(1) "Acceptable return" means any original or amended return that is required to be filed pursuant to Article 2 (commencing with Section 18601), Section 18633, Section 18633.5, or Article 3 (commencing with section 23771) of chapter 2 of Part 11, other than the return for unrelated business taxable income required by Section 23771.
(2) "Business entity" means a corporation, including an S corporation, an organization exempt from tax pursuant to Chapter 4 (commencing with section 23701) of Part 11, or a partnership, or a limited liability company.
(3) "Tax preparation software" means any computer software program used to prepare an acceptable return or for use in tax compliance.
(4) "Electronic technology" includes, but is not limited to internet, cloud computing, or an electronic information delivery system.
(5) "Technology constraints" means an inability of the tax preparation software used by a taxpayer to electronically file the acceptable return as required by this section as a result of the complex nature of the return or inadequacy of the software.
(c) Any business entity required to file a return electronically under this section may annually request a waiver of the requirements of this section from the Franchise Tax Board with respect to an acceptable return filed for a taxable year. The Franchise Tax Board may grant a waiver if it determines the business entity is unable to comply with the requirements of this section due to, but not limited to, technology constraints, where compliance would result in undue financial burden, or due to circumstances that constitute reasonable cause, and not willful neglect as applicable with respect to the penalty imposed under Section 19171.
(d) This section applies to an acceptable return required filed on or after January 1, 2015.

*SEC. 2. Section 19171 is added to the Revenue and Taxation Code to read:*

19171. (a) A business entity required to electronically file a return pursuant to Section 18621.10 that files a return in a manner that fails to comply with Section 18621.10, may be subject to a penalty in the amount of five hundred dollars ($500) for each failure, unless the failure is due to reasonable cause, and not willful neglect.
(b) This section shall apply to returns filed for taxable years beginning on or after January 1, 2015.

# LEGISLATIVE PROPOSAL - D
# EXECUTIVE SUMMARY

- **Title:** First-Time Abatement of Timeliness Penalties

- **Problem:** The absence of state authority for timeliness penalty abatement creates taxpayer confusion and results in costly taxpayer-filed protests and appeals to the Board of Equalization.

- **Proposed Solution:** Amend state law to establish penalty abatement for these timeliness penalties similar to the federal first-time abatement procedure.

  This proposal would require the Franchise Tax Board, upon taxpayer request, to abate a failure-to-file or failure-to-pay penalty when:

  - Reasonable cause is either absent or the taxpayer chooses to forgo a reasonable cause review, and for the calendar year of the request for abatement and four tax years immediately prior to the request for abatement:
    - The taxpayer is otherwise compliant with their income or franchise tax filing requirement; and
    - The taxpayer has paid, or is current on an arrangement to pay, all tax currently due.

- **Fiscal Impact:** The changes that this proposal seeks to make are estimated to cost approximately $449,000 to implement with on-going annual additional costs of approximately $380,000.

- **Revenue:**

| Estimated Revenue Impact of LP - D<br>For Timeliness Penalty Relief Granted On or After January 1, 2015<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | | | |
|---|---|---|---|---|
| 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 |
| - $5.4 | - $24 | - $23 | - $21 | - $18 |

## Title

First-Time Abatement of Timeliness Penalties

## Introduction

This proposal would provide a penalty relief program for timeliness penalties (failure to file or failure to pay).

## Program History/Background

On September 19, 2012, the Treasury Inspector General for Tax Administration (Inspector) released its final audit report on the Internal Revenue Service's (IRS's) penalty abatement procedures.[1] The Inspector found that most taxpayers eligible for the IRS's first-time abatement penalty waiver were not offered, and did not receive, penalty relief. The Inspector estimated that for tax year 2010, approximately 250,000 taxpayers with failure-to-file penalties and 1.2 million taxpayers with failure-to-pay penalties did not receive first-time abatement penalty relief even though they were qualified under the IRS's first-time abatement waiver criteria. The Inspector estimated that the total of unabated penalties eligible for this penalty relief was in excess of $181 million.

The Inspector further found that the first-time abatement waiver is not used to its full potential as a compliance tool because it is granted to taxpayers before they demonstrate full compliance by paying their current tax liability.

Finally, the Inspector found that taxpayers qualified to receive penalty relief based on reasonable cause would receive first-time abatement relief instead. This was a disadvantage to taxpayers because the utilization of the first-time abatement relief rendered a taxpayer ineligible for a specified period for a subsequent first-time abatement relief. Performing the reasonable cause penalty relief could preserve the first-time abatement relief for subsequent periods.

This proposal would address the issues raised in the Inspector's report by:

- Prohibiting first-time abatement penalty relief based on compliance history when reasonable cause exists, unless specifically elected by the taxpayer.
- Requiring payment compliance before allowing penalty abatement, either by being paid in full or being up to date on a payment arrangement.

## Current Federal Law

Current federal law imposes penalties for failing to timely file a tax return or to timely pay tax. The penalties apply to individuals, corporations, partnerships, and S corporations.

---

[1] Penalty Abatement Procedures Should Be Applied Consistently to All Taxpayers and Should Encourage Voluntary Compliance, Final Report Issued on September 19, 2012, Reference Number 2012-40-113, Treasury Inspector General for Tax Administration.

*Failure-to-File Penalty*

The penalty for failure to file an income tax return by the due date is 5 percent of the amount of tax required to be shown on the return, less any earlier payments or credits, for the first month the return is late. The penalty increases by 5 percent, to a maximum of 25 percent, for each additional month the return remains unfiled. The penalty is calculated as the lesser of $100 or the amount of tax required to be shown on the return for failing to file within 60 days of the due date, including extensions.

*Failure-to-Pay Penalty*

The penalty for failing to pay the tax shown on an income tax return or an assessed deficiency by the due date is generally one-half percent of the tax due for the first month the payment is late, increasing by one-half percent per month that the balance remains outstanding to a maximum of 25 percent.

*First-Time Abatement Penalty Relief*

Beginning in 2001, taxpayers requesting abatement of the failure-to-file and the failure-to-pay penalties may be granted relief under the IRS administrative practice of abating these penalties for taxpayers with a history of compliance.[2] First-time abatement penalty relief is available under the IRS's general authority, rather than being allowed by statute or regulation.

In the IRS's modified first-time abatement policy,[3] dated April 5, 2013, a reasonable cause explanation provided by the taxpayer will be considered after considering the first-time abatement analysis. If the analysis shows that the taxpayer is not eligible for penalty relief under first-time abatement, then the taxpayer's explanation will be used to determine if reasonable cause penalty relief criteria is met. For a taxpayer that is given relief under the first-time abatement, correspondence sent to the taxpayer states:

> *"We are pleased to inform you that your request to remove the (use applicable penalty, i.e. failure to file, failure to pay, or failure to deposit) penalty(s) has been granted. However, this action has been taken based solely on your compliance history rather than on the information provided…IRS will base decisions on removing any future (failure to file, failure to pay, failure to deposit) penalties on any information you provide that meets reasonable cause criteria."*

This relief is generally available for any tax period if the taxpayer:

- Has not previously been required to file a return or has no prior penalties, except the estimated tax penalty, for the preceding three years, and
- Has filed, or filed a valid extension for, all currently required returns and paid, or arranged to pay, any tax due. For example, a taxpayer would be considered current if they have an open installment agreement. If the taxpayer is not currently in compliance with this requirement and all other criteria are met, the taxpayer is provided the opportunity to fully comply before reasonable cause is considered.

---

[2] Internal Revenue Manual - 20.1.1 Introduction and Penalty Relief

[3] First Time Abate Policy Modified, Taxpayers Must Be Current with Filing & Payment Requirements, Internal Revenue Manual Procedural Update, Number SBSE-20-0413-0690, April 5, 2013.

A penalty assessed and subsequently reversed in full will generally be considered to show compliance for that period.

Penalty relief can only apply to a single tax period. For example, if a request for penalty relief is being considered for two or more tax periods, the earliest tax period that meets the criteria will receive penalty relief, not all the tax periods being considered.

*Reasonable Cause Exception*

Taxpayers have the right to ask that certain penalties be abated if they can show that there was reasonable cause for failure to comply. In order for a penalty to be canceled, reasonable cause must exist. Reasonable cause means the act occurred despite the exercise of ordinary business care and prudence and the failure was due to events beyond the filer's control. Some examples of reasons provided by a taxpayer that may be accepted as reasonable cause, if substantiated, are 1) the business records were destroyed by fire, 2) the taxpayer was mentally incompetent, and 3) the dishonored payment was due to a bank error.

## Current State Law

Current state law imposes penalties when a taxpayer fails to file a tax return on or before its due date or fails to pay the tax due as shown on their tax return by the due date of the return. The penalties apply to individuals, corporations, partnerships, limited liability companies (LLCs), and S corporations.

*Penalty Relief*

The Revenue and Taxation Code (R&TC) explicitly requires the Franchise Tax Board (FTB) to impose penalties for a taxpayer's failure to timely file a return or a taxpayer's failure to timely pay tax, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

The R&TC has no provision similar to the federal first-time abatement policy, nor does the FTB have any formal administrative policy that is similar to the federal policy for abatement of the timeliness penalties based on a taxpayer's history of compliance. Unlike the IRS, the FTB does not have specific legal authority to specify the circumstances of reasonable cause on this basis, without a statutory change, such that a first-time abatement could be applied.

*Failure-to-File Penalty*

The penalty for failure to file an income tax return by the due date is 5 percent of the amount of tax required to be shown on the return, less any earlier payments or credits, for the first month the return is late. The penalty increases by 5 percent, to a maximum of 25 percent, for each additional month the return remains unfiled. The penalty is calculated as the lesser of $100 (or $135 for taxable years beginning on or after January 1, 2010, for individuals or fiduciaries) or the amount of tax required to be shown on the return for failing to file within 60 days of the due date, including extensions.

In case of fraudulent failure to file, the penalty is increased to 15 percent per month, up to a 75 percent maximum.

If a partnership, an LLC that is classified as a partnership, or an S corporation fails to file on time, or files a return that does not give information with respect to gross income, deductions, and persons entitled to distributive shares, a monthly penalty is assessed, not to exceed 12 months at $18 multiplied by the number of persons who were partners, LLC members, or shareholders during the taxable year.

*Failure-to-Pay Penalty*

The penalty for failure to pay the tax shown on an income tax return or an assessed deficiency by the due date is generally 5 percent of the tax not paid by the original due date of the return. In addition to the 5 percent underpayment penalty, a monthly penalty will also be charged on the tax unpaid as of the original due date of the return. The monthly penalty is imposed at one-half percent (.005) per month, or fraction of a month that the tax remains unpaid, up to a maximum of 40 months (20 percent). The aggregate amount of penalty shall not exceed 25 percent of the total unpaid tax.

Similar penalties apply for nonpayment of the $800 annual tax imposed on LLCs and the $800 tax imposed on limited liability partnerships.

The penalty is not assessed if, for the same year, the sum of any penalties imposed for failing to file a return is equal to or greater than the late-payment penalty. If the penalty for late payment exceeds the failure-to-file penalty, only the excess is due in addition to those penalties.

*Reasonable Cause Exception*

In general, current state law generally conforms to the federal rules for determining reasonable cause.

## Problem

The absence of state authority for timeliness penalty abatement creates taxpayer confusion and results in costly taxpayer-filed protests and appeals to the Board of Equalization (BOE).

## Proposed Solution

The proposed solution would amend state law to establish penalty abatement for these timeliness penalties similar to the federal first-time abatement procedure.

This proposal would require the FTB, upon taxpayer request, to abate a failure-to-file or failure-to-pay penalty when:

- Reasonable cause is either absent or the taxpayer chooses to forgo a reasonable cause review, and for the calendar year of the request for abatement and four tax years immediately prior to the request for abatement:
    - o The taxpayer is otherwise compliant with their income or franchise tax filing requirement; and
    - o The taxpayer has paid, or is current on an arrangement to pay, all tax currently due.

**Effective/Operative Date of Solution**

If the proposal were enacted during the 2014 legislative session in non-urgency legislation, it would be effective January 1, 2015, and specifically operative for requests for abatement made on or after that date and requests made prior to January 1, 2015, at a time when the statute of limitations for action was still open.

**Justification**

Historically compliant taxpayers that file or pay late are penalized with the same severity as noncompliant taxpayers because the FTB lacks the authority to consider compliance history in the determination of whether to abate these penalties.

A statutory change is necessary because the FTB lacks the broad, general authority granted to the IRS that allows for an administrative relief program.

Authorizing the FTB to grant penalty relief that is similar to the IRS practice of granting administrative relief to compliant taxpayers could reduce taxpayer dissatisfaction and result in increased filing compliance.

Over the last two years, the FTB's legal division has received approximately 150 appeal cases where the primary issue is a timeliness penalty. There are approximately 90 open appeal cases in the current inventory where a timeliness penalty is the primary issue.
It is expected that this proposal would significantly reduce the volume of cases that are appealed to the BOE based on a denial of state penalty relief where a taxpayer had received federal first-time abatement penalty relief.

This proposal would also reduce the amount of time that is expended on appeal cases that contain multiple issues, one of which is a timeliness penalty. Over the last two years, the FTB's legal division has received approximately 300 appeal cases where one of the issues is a timeliness penalty. There are approximately 180 open appeal cases in the current inventory where one of the issues is a timeliness penalty.

## Implementation

This proposal would require changes to the department's accounting systems to allow tracking of taxpayers that have received penalty relief based on their compliance history. Additionally, the department would require the development of procedures, training materials, notices, forms, instructions, and other documents necessary to implement the penalty relief this proposal would allow.

Further, call center and accounts receivable staff estimates an increase in taxpayer requests for penalty relief and a resulting increase in the volume of "reasonable cause" determinations that would require additional staff to maintain acceptable response times.

## Fiscal Impact

Staff estimates a cost of approximately $449,000 for the systems changes, additional staffing, and development of procedures, notices, forms, instructions, and other documents necessary to implement this proposal with on-going annual additional staffing costs of approximately $380,000 to address the estimated increase in taxpayer contacts resulting from this proposal.

## Economic Impact

### Revenue Estimate

| Estimated Revenue Impact of LP - D<br>For Timeliness Penalty Relief Granted On or After January 1, 2015<br>Enactment Assumed After June 30, 2014<br>($ in Millions) | | | | |
|---|---|---|---|---|
| 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 |
| - $5.4 | - $24 | - $23 | - $21 | - $18 |

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

### Revenue Discussion

Every year approximately $450 million in timeliness penalties are assessed by the department. Approximately 12 percent, or $50 million, of penalties assessed would be eligible for abatement under the provisions of this proposal. The economic impact to the state is measured as the loss of penalties that would have otherwise been collected.

Of the total annual amount eligible for abatement, it is assumed that approximately 40 percent, or $20 million, would be abated under the terms of this proposal. Additionally, it is assumed that approximately 65 percent of the penalties abated under the terms of this proposal would have been collected over a five-year period. The resulting estimated abatement (loss) is grown and fiscalized resulting in the revenue impact reflected in the table above.

**Other Agency/Industry Impacted**

It is expected that the number of appeals to the BOE of an FTB denial of penalty relief when federal first-time abatement relief was granted would be significantly decreased. A reduction in appeals could reduce costs incurred by taxpayers and the BOE.

**Pro & Con Arguments**

Pro: Authorizing the FTB to implement first-time abatement penalty relief would reduce taxpayer dissatisfaction, result in increased filing compliance, and decrease the costs incurred by taxpayers and the BOE.

Con: Abating a penalty that is assessed based on a taxpayer's voluntary action, or inaction, would reward the noncompliant behavior that the penalty was enacted to prevent.

**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* has no personal income tax. The corporate failure-to-file and failure-to-pay penalties may be abated if the failure is due to a reasonable cause and not willful neglect.

Under *Illinois* law, the failure-to-file and failure-to-pay penalties may be abated for reasonable cause. Additionally, the failure-to-file penalty may be abated in situations where a tax return is due more often than once annually, the late filing is nonfraudulent, and a late filing has not occurred during the two years immediately preceding the normal due date of the late-filed return.

*Massachusetts* and *New York* laws allow for the abatement of the failure-to-file and failure-to-pay penalties if the failure is due to reasonable cause and not willful neglect. A taxpayer's history of compliance may be included in a reasonable cause determination, but is not by itself reasonable cause.

*Michigan* and *Minnesota* laws allow for the abatement of the failure to file and failure to pay penalties if the failure is due to reasonable cause and not willful neglect. Additionally, under *Minnesota* law, a taxpayer that paid 90 percent of the amount due by the normal due date, filed the return by the extended due date, and paid the balance of the tax due when the return was filed is presumed to have reasonable cause to abate the failure-to-pay penalty.

## LEGISLATIVE STAFF CONTACT

Diane Deatherage
Legislative Analyst, FTB
(916) 845-4783
diane.deatherage@ftb.ca.gov

Mandy Hayes
Revenue Manager, FTB
(916) 845-5125
mandy.hayes@ftb.ca.gov

Gail Hall
Legislative Director, FTB
(916) 845-6333
gail.hall@ftb.ca.gov

| | |
|---|---|
| Analyst | Diane Deatherage |
| Telephone # | (916) 845-4783 |
| Attorney | Pat Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS FOR LP - D

SECTION 1. Section 19132.5 of the Revenue and Taxation Code is repealed.

~~19132.5. (a) In the case of a qualified taxpayer, no penalty shall be assessed under Section 19132 if the return is filed timely (not later than the extended due date granted under Section 18567 or 18604) and the tax required to be paid on or before the due date of the return, without regard to extension, is paid within the following time:~~

~~(1) In the case of an individual, partnership, or fiduciary, within six months of the original due date of the return.~~

~~(2) In the case of a corporation, within seven months of the original due date of the return.~~

~~(b) Any penalty imposed under Section 19132 shall be assessed from the original due date of the return if the taxpayer fails to pay the tax within the time specified in this section.~~

~~(c) This section shall apply to payment of the amount shown as tax on the original returns required to be filed during calendar year 1994.~~

~~(d) For purposes of this section, "qualified taxpayer" means any corporation, fiduciary, partnership, or individual taxpayer to whom one of the following applies as a result of the Northridge earthquake of January 1994, any related aftershock, or any related casualty:~~

~~(1) The qualified taxpayer sustained any significant property loss.~~

~~(2) The qualified taxpayer suffered a loss of employment due to property damage suffered by his or her employer.~~

~~(3) The qualified taxpayer realized significant loss of business income from a business located within the Northridge earthquake area.~~

SEC. 2. Section 19132.5 of the Revenue and Taxation Code is added to read as follows:

Section 19132.5. A timeliness penalty shall be abated under the provisions of this section.

(a) For purposes of this section, the term "timeliness penalty" means a penalty imposed under Section 19131, 19132, 19172, or 19172.5.

(b) If requested by a taxpayer, either orally or in writing, a timeliness penalty, that has been considered and rejected for abatement, waiver, or rescission pursuant to the provisions of the section under which the penalty was imposed shall be abated, if:

(1)(A) The taxpayer has not previously been required to file a California return under Part 10 (commencing with Section 17001), this part, or Part 11 (commencing with Section 23001); or

(B) No other timeliness penalty has been imposed by the Franchise Tax Board in the calendar year of the request for abatement or in the prior four tax years; and

(2) The taxpayer has filed all returns required under Part 10 (commencing with Section 17001), this part, or Part 11 (commencing with Section 23001), as of the date of the taxpayer's request for abatement; and

(3) Excluding the timeliness penalty that is the subject of the abatement request, the taxpayer has paid in full, or arranged to pay pursuant to an installment agreement, any tax, penalties, fees,

and interest due for all currently required returns and the taxpayer is current with all installment payments.

(c) For purposes of applying subdivision (b):

(1) A timeliness penalty imposed and subsequently abated due to a determination of reasonable cause, or reasonable cause and not willful neglect with respect to the taxpayer, or the taxpayer's spouse, shall be considered to have not been imposed.

(2) A timeliness penalty is considered imposed on the original due date of the return for the taxable year for which the penalty is imposed.

(3) If a taxpayer requests abatement for more than one taxable year and two or more taxable years would be eligible for abatement under this section, then only the penalty for the earliest taxable year shall be abated.

(4) This section shall apply to requests for abatement made before, on, or after the effective date of the act adding this section.

(5) The taxpayer may elect to forgo consideration of abatement, waiver or rescission pursuant to the provisions of the section under which the penalty was imposed and instead elect relief under this section.

(d) The Franchise Tax Board may issue any regulations necessary or appropriate to implement the purposes of this section.

SEC. 3. The Legislature finds and declares that the abatement of timeliness penalties by this act serves a public purpose and does not constitute a gift of public funds within the meaning of Section 6 of Article XVI of the California Constitution.