INITIAL STATEMENT OF REASONS FOR
THE ADDITION OF CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 17052.6

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

Revenue & Taxation Code (RTC) section 17052.6 provides that a Child and Dependent Care Expenses (CDC) tax credit shall be allowed for taxable years beginning on or after January 1, 2000 in an amount equal to a percentage (based on federal adjusted gross income) of the federal CDC credit determined in accordance with Section 21 of the Internal Revenue Code. The federal CDC credit is a tax credit based on qualifying expenses incurred for the care of a qualifying person which made it possible for a taxpayer to work or to seek employment.

Treasury Regulation section 1.21-1(k) provides that a taxpayer claiming the CDC Credit must maintain adequate records or other sufficient evidence to substantiate the expenses" in accordance with section 6001 and the regulations thereunder." However, the federal regulations under Internal Revenue Code section 6001 lack the specificity of appropriate verifying documentation which the Franchise Tax Board has determined would benefit both claimant taxpayers and the Franchise Tax Board in determining eligibility for the CDC Credit under RTC section 17052.6.

The Franchise Tax Board may request information regarding the taxpayer's California CDC Credit within the California statute of limitations period, which is usually the later of four years from the due date of the return or the date the return is filed. Thus a taxpayer is required to produce substantiating documentation after the care is provided and after a return is filed. This creates a challenge for taxpayers who did not collect appropriate documentation from their care provider at the time the care was provided, as they are now required to retroactively collect documentation from a provider that they may not be in contact with anymore.

SPECIFIC PURPOSE FOR THE ADOPTION OF THE REGULATION

The purpose of the proposed regulatory section is to provide the taxpayers with clarity as to the records/documents that they can retain and provide upon request to establish entitlement to the CDC Credit. Through such clarity, the taxpayer will have the advantage of knowing what documents to obtain and retain, at the time that they are procuring their child or dependent care services, rather than at the time that they are contacted by the Franchise Tax Board to provide such documentation, thus eliminating the challenge of retroactively collecting documentation.

NECESSITY/PROBLEM THE REGULATION INTENDS TO ADDRESS

The proposed regulatory action is necessary to alleviate the difficulties that taxpayers face when asked to collect supporting documentation to establish entitlement to the CDC Credit after the opportunity to easily collect that documentation has passed. The proposed regulation offers taxpayers the opportunity to know what they will be asked to provide to prove entitlement to the CDC Credit at the outset; therefore, they can collect the necessary documentation at the time that they procure their care services when the communication channels with their care provider are open and convenient.

Subsection (a) of the regulation provides a general rule that a taxpayer must maintain adequate records to substantiate entitlement to the CDC Credit, as provided in the remainder of the regulation.

Subsection (b), made up of five subparts detailed individually below, provides a description of each legal requirement that the Franchise Tax Board looks to when verifying entitlement to the CDC Credit and specific documents that the taxpayer can provide to establish that each legal requirement is met.

- Subsection (b)(1) references the legal requirement that the care be provided to an individual, identified by a taxpayer identification number, that is the taxpayer's "qualifying person." As such, the qualifying person's identity, taxpayer identification number, and age must be established by the taxpayer. The subsection indicates that the qualifying person's birth certificate and Social Security Account Number card can establish that this legal requirement is met.

- Subsection (b)(2) references the legal requirement that the qualifying person be mentally or physically disabled if the qualifying person is thirteen or older. This subsection indicates that medical records that demonstrate the physical or mental incapacity of the qualifying person can establish that this legal requirement is met.

- Subsection (b)(3) references the legal requirement that the taxpayer establish their care provider's identity and taxpayer identification number. This subsection references documents that can be provided to establish identity and documents that can be provided to establish the taxpayer identification number.

- Subsection (b)(4) references the legal requirement that the care be provided within California. This subsection indicates that the provider's California driver's license or identification card reflecting the provider's California address or a utility bill in the provider's name for the address at which the care was provided can establish that this legal requirement is met. The subsection exempts taxpayers from providing this information if the care is provided within their home.

- Subsection (b)(5) speaks to the legal requirement that the taxpayer substantiate their care expenses. This subsection indicates that proof of payment such as canceled checks/money orders, receipts, invoices, or year-end statements can establish that this legal requirement is met .

Subsection (c) provides an alternative method of producing "other sufficient evidence" to establish compliance with the legal requirements set forth in subsection (b) when the taxpayer is unable to produce the specific documents identified in subsection (b).

Subsection (d) provides a standard for maintaining the specific records required by this regulation section through reference to Internal Revenue Code section 6001 and the regulations thereunder. Subsection (d) is consistent with the substantiation standard for claiming the federal CDC credit, set forth in Treasury Regulation section 1.21-1(k).

Subsection (e) provides that the taxpayer shall produce the records required by this regulation section upon the Franchise Tax Board's request. Subsection (e) further provides that the CDC credit will be denied in the event that the taxpayer fails to produce such records.

Subsection (f) provides five examples illustrating scenarios in which evidence which is not identified in subsection (b) is provided by a taxpayer to attempt to satisfy the legal requirements referenced in subsection (b).

- The example in subsection (f)(1) illustrates a scenario in which the taxpayer paid her care provider, an individual, in cash and did not have receipts for her payments. The taxpayer submits a notarized statement, signed under penalty of perjury, from her provider which confirms the amounts paid by the taxpayer for childcare services. The example in subsection (f)(1) provides that such a statement may be sufficient evidence under subsection (c) to establish the proof of payment required by subsection (b)(5) .

- The example in subsection (f)(2) illustrates a scenario in which the taxpayer paid her care provider, an individual, in cash and did not have receipts for her payments. The taxpayer submits a federal form W-10, Dependent Care Provider's Identification and Certification, that is notarized and signed by the care provider, with a handwritten statement above the signature confirming the amounts paid by the taxpayer for childcare services. The example in subsection (f)(2) provides that while the W-10 may be sufficient evidence under subsection (c) to establish the provider's identity and taxpayer identification number, it is not sufficient to establish proof of payment required by subsection (b)(5) .

- The example in subsection (f)(3) illustrates a scenario in which the qualifying person's care was provided in the child care provider's home by an individual care provider. The taxpayer submitted a notarized statement, signed under penalty of perjury, from the provider confirming the California address at which the care was provided. The example in subsection (f)(3) provides that such a statement may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4) .

- The example in subsection (f)(4) illustrates a scenario in which the qualifying person's care was provided at a location that the care provider, an individual residing outside of California, rents in California. The taxpayer submitted a notarized statement, signed under penalty of perjury, from the provider confirming the California address at which the care was provided. The example in subsection (f)(4) provides that such a statement may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4) .

- The example in subsection (f)(5) illustrates a scenario in which the qualifying person's care is provided by an organization. The taxpayer submitted a copy of the year-end statement from the care provider which is printed on the organization's letterhead. The example in subsection (f)(5) provides that the organization's letterhead may be sufficient evidence under subsection (c) to establish the physical location at which the care was provided, as required by subsection (b)(4).

Subsection (g)(1) provides that this regulation shall apply to records required to be maintained for tax years beginning on or after January 1, 2013. Subsection (g)(2) provides that this regulation shall also apply when a taxpayer elects to submit the documentation required by this regulation for tax years beginning prior to January 1, 2013.

BENEFITS OF THE REGULATION

Taxpayers will benefit from having direction on the documentation that will establish entitlement to the CDC Credit at the earliest possible point; therefore, they can gather this documentation at the time that the services are being provided. This makes substantiation a much less difficult task for the taxpayer, and eliminates the retroactive documentation collection obstacle that taxpayers face when attempting to establish entitlement to the CDC Credit. In addition, the Franchise Tax Board will save resources by receiving adequate documentation as specified in this regulation rather than having to do an ad hoc analysis based on other possible evidence. There are no benefits of the proposed regulation to the health and welfare of California residents, worker safety, and the state's environment.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting proposed Regulation section 17052.6, the Franchise Tax Board relied on two interested parties meetings held in May, 2011 and February, 2012. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

Government Code section 11346.2, subdivision (b)(5), requires the Franchise Tax Board to consider alternatives to the proposed regulatory action that would lessen any adverse impact on affected private persons or small business. The Franchise Tax Board has evaluated the impacts and estimates that compliance with the proposed regulation will require no more than 15 minutes of clerical time from care providers to provide identity documentation and proof of payment. Therefore, the Franchise Tax Board has determined that there will be no adverse economic impact on affected private persons or small business; and as such, there are no reasonable alternatives to the proposed regulatory action that would lessen adverse impact.

ECONOMIC IMPACT ANALYSIS

Revenue & Taxation Code (RTC) section 17052.6 provides that a Child and Dependent Care Expenses (CDC) tax credit shall be allowed for taxable years beginning on or after January 1, 2000 in an amount equal to a percentage (based on federal adjusted gross income) of the federal CDC credit determined in accordance with Section 21 of the Internal Revenue Code (IRC). Treasury Regulation section 1.21-1(k) provides that a taxpayer claiming the CDC credit must maintain adequate records or other sufficient evidence to substantiate the expenses "in accordance with IRC section 6001 and the regulations thereunder." However, the federal regulations under IRC section 6001 lack the specificity of appropriate verifying documentation which the Franchise Tax Board has determined would benefit both claimant taxpayers and the Franchise Tax Board in determining eligibility for the CDC credit under RTC section 17052.6.

The purpose of the proposed regulatory section is to provide taxpayers with clarity as to the records/documents that they can retain and provide upon request to establish entitlement to the CDC credit. Taxpayers will benefit from having direction on the documentation that will establish entitlement to the CDC Credit at the earliest possible point; therefore, they can gather this documentation at the time that the services are being provided. This makes substantiation a much less difficult task for the taxpayer, and eliminates the retroactive documentation collection obstacle that taxpayers face when attempting to establish entitlement to the CDC Credit. In addition, the Franchise Tax Board will save resources by receiving adequate documentation as specified in this regulation rather than having to do an ad hoc analysis based on other possible evidence.

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has made the following assessments regarding the proposed regulation:

<u>Creation or Elimination of Jobs Within the State</u>

Since the proposed regulation only affects the documentation required to be supplied from existing care providers and taxpayers, the adoption of the proposed Regulation section 17052.6 would not have any impact on the number of jobs within the state. It is anticipated that the additional clerical time on the part of the care provider to supply identity documentation and proof of payment documentation as required under this proposed regulation will not exceed 15 minutes per child or dependent.

<u>Creation of New or Elimination of Existing Businesses Within the State</u>

Since the proposed regulation only affects the documentation required to be supplied from existing care providers and taxpayers, the adoption of the proposed Regulation section 17052.6 would not have any impact on the number of businesses created or eliminated.

Expansion of Businesses or Elimination of Existing Businesses Within the State

Since the proposed regulation only affects the documentation required to be supplied from existing care providers and taxpayers, the adoption of the proposed Regulation section 17052.6 would not have any impact on the expansion or elimination of businesses currently operating in the state.

ADVERSE ECONOMIC IMPACT ON BUSINESS

Since the proposed regulation will clarify the substantiation requirements for taxpayers, and compliance with the proposed regulation will require no more than 15 minutes of clerical time (per child/dependent) on the part of the care provider, the Franchise Tax Board has determined that there will be no adverse economic impact on business.