United Californians
for Tax Reform

# Tax Bulletin CA-2006-01B
## Reducing the number of complex tax returns

Today over five million California taxpayers choose to claim itemized deductions rather than accept the available standard deduction. This decision causes them to:

1 maintain detailed records of expenses
2 slog through the 79 pages of nearly incomprehensible instructions required by the 540 Tax Form
3 pay professional tax preparers hundreds of dollars to prepare their tax returns.

This need not be so. If the standard deduction were doubled to $6500 for single taxpayers and to $13000 for married taxpayers filing jointly, nearly half of these taxpayers would choose the standard deduction. They then could file their taxes on the 540-2EZ Tax Form in minutes without professional help. This would save both them and The Franchise Tax Board considerable expense.

Fortunately this increase in the standard deduction can be accomplished with no loss in state tax revenue by eliminating the $87 personal tax credit. This change would maintain the progressive tax burden which collects 0.11% of revenue in the 1st quintile rising to collect 81.8% in the 5th quintile.

The distribution of the CA tax burden for each Quintile of taxpayers is shown in table 1. Today, the average tax paid by taxpayers in the first Quintile is $12 increasing to $9445 for taxpayers in the 5th Quintile. Our proposed changes would maintain the current tax distribution. The same results could also be obtained by eliminating the 1% tax rate, the Senior tax credit , and the renters credit.

TABLE 1 DISTRIBUTION OF TAX BURDEN AT EACH QUINTILE OF CASH INCOME (3)

| Quintile of Taxpayers | * | 1st | 2nd | 3rd | 4th | 5th |
|---|---|---|---|---|---|---|
| New Average Tax | | $ 24 | $132 | $ 492 | $ 1430 | $ 9426 |
| Average Tax 2002 | | $12 | $ 124 | $ 517 | $ 1448 | $ 9445 |
| Tax Revenue - 2002 | 1 | 0.11 | 1.1 | 4.5 | 12.5 | 81.8 |
| Cash Income - 2002 | 2 | 2.4 | 6.6 | 11.8 | 19.9 | 59.3 |

* Note: 1 The values shown are the percentage of total CA Income Tax revenue
2 The values shown are the percentage of total CA Adjusted Gross Income
3 Data for CA 2002 tax year: Cash Income $735 Billion; Income Tax Revenue $31 Billion

Roland Boucher, Chairman

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APPENDIX

TABLE 2 PRESENT DISTRIBUTION OF TAX BURDEN AND CASH INCOME (3)

| Quintile of Taxpayers | * | 1st | 2nd | 3rd | 4th | 5th |
|---|---|---|---|---|---|---|
| Average Tax Paid | | $ 12 | $124 | $ 517 | $ 1448 | $ 9445 |

Tel 949 552-9174 11 Deerspring Irvine CA 92504 Fax 949 552-5749

| | | | | | | |
|---|---|---|---|---|---|---|
| Average Tax Rate | | 0.19% | 0.69% | 1.60% | 2.66% | 5.81% |
| Tax Revenue - CA | 1 | 0.11 | 1.1 | 4.5 | 12.5 | 81.8 |
| Cash Income - CA | 2 | 2.4 | 6.6 | 11.8 | 19.9 | 59.3 |

* Note: 1 The values shown are the percentage of total CA Income Tax revenue
2 The values shown are the percentage of total CA adjusted gross income
3 Data for CA 2002 tax year: Cash Income $735 Billion; Income Tax Revenue $31 Billion

TABLE 2A DISTRIBUTION OF TAX BURDEN WITH $6500 STANDARD DEDUCTION
AND AFTER ELIMINATING THE $87 PERSONAL TAX CREDIT

| Quintile of Taxpayers | * | 1st | 2nd | 3rd | 4th | 5th |
|---|---|---|---|---|---|---|
| Average Tax Paid | | $ 24 | $132 | $ 492 | $ 1431 | $ 9430 |
| Average Tax Rate | | 0.37% | 0.74% | 1.53% | 2.63% | 5.80% |
| Tax Revenue - CA | 1 | 0.21 | 1.2 | 4.3 | 12.4 | 81.7 |
| Cash Income - CA | 2 | 2.4 | 6.6 | 11.8 | 19.9 | 59.3 |

* Note: 1 The values shown are the percentage of total CA Income Tax revenue
2 The values shown are the percentage of total CA Adjusted Gross Income
3 Data for CA 2002 tax year: Cash Income $735 Billion; Tax Revenue $31 Billion

TABLE 2B DISTRIBUTION OF TAX BURDEN WITH $6500 STANDARD DEDUCTION
AND WITH NO 1% TAX RATE; NO SENIOR CREDIT; NO RENTERS CREDIT

| Quintile of Taxpayers | * | 1st | 2nd | 3rd | 4th | 5th |
|---|---|---|---|---|---|---|
| Average Tax Paid | | $ 12 | $116 | $ 467 | $ 1390 | $ 9443 |
| Average Tax Rate | | 0.19% | 0.64% | 1.45% | 2.56% | 5.81% |
| Tax Revenue - CA | 1 | 0.11 | 1.00 | 4.09 | 12.16 | 82.63 |
| Cash Income - CA | 2 | 2.4 | 6.6 | 11.8 | 19.9 | 59.3 |

* Note: 1 The values shown are the percentage of total state Income tax revenue
2 The values shown are the percentage of total adjusted gross income
3 Data for CA 2002 tax year: Cash Income $735 Billion; Tax Revenue $31 Billion

Tel 949 552-9174 11 Deerspring Irvine CA 92504 Fax 949 552-5749

**SpidellPublishing*Inc.***
***Your California Solution Since 1975***

December 1, 2006

Attn: Debbie Newcomb
FTB Taxpayer Advocate
P. O. Box 157
Rancho Cordova, CA 95741-0157

**RE: 2006 Taxpayers' Bill of Rights Hearing**

The editors at Spidell Publishing would like to publicly thank these FTB employees for their outstanding civil service during 2006:

- Rose Anderson, FTB's Tax Practitioner Liaison
- Bruce Langston and Patrick Kusiak of the Legal Branch
- Cathy Cleek, Marlene White and Anne Miller, FTB management
- Brian Putler (Legislative Services Bureau)

Throughout the year these individuals helped ensure that taxpayers' rights were protected. They helped Spidell editors communicate to 22,000 tax professionals, who prepare more than six million tax returns, on many tax issues.

The editors at Spidell have three recommendations for consideration at the 2006 taxpayers' bill of rights hearing, which are attached. You may contact me at (530) 676-0662 or gina@spidell.com with any questions and for follow-up. Thank you for your consideration.

Sincerely,

Gina Rodriquez, Sacramento Editor
Spidell Publishing, Inc.

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**2006 Taxpayers' Bill of Rights Hearing**

**Issue #1 - 50% Interest Penalty (leftover from 2005): Need for Reasonable Cause Exception**
**Issue #2 - Dependency Exemption Rules for Noncustodial Parents: Need for Conformity**
**Issue #3 – Registered Domestic Partners: Need for Legislative Fix to Combined Federal AGI**

## Issue #1
## 50% Interest Penalty: Need for Reasonable Cause Exception

The 50% interest penalty under R&TC §19777.5 clearly does not meet the government's objectives of penalty imposition. Penalties exist to encourage voluntary compliance by supporting the standards of behavior expected under the IRC and the R&TC. To achieve this desired effect penalties must be proportionate to the offense they intend to correct, severe enough to deter noncompliance, and applied by the IRS and the FTB in a consistent, accurate, and impartial manner. In addition, the taxpayers against whom a penalty is imposed must be given an opportunity to have their interest heard and considered (IRS Penalty Policy Statement P-1-18; IRM 120.1.1.2).

Beginning April 1, 2005, the FTB began imposing the new 50% interest penalty on all amnesty-eligible liabilities. The penalty equals 50% of interest due up to March 31, 2005, on all amounts that are "due and payable" as of March 31, 2005, or that "become due and payable" after March 31, 2005 — the end of the amnesty application period. Unlike the 50% interest penalty that the BOE imposes, there is no reasonable cause exception to the FTB penalty.

Because there is no reasonable cause exception for the FTB's interest penalty, there are many disheartening stories and situations where the FTB's assessment of the penalty is blatantly unfair or inequitable. For example, a court case that overturned a filing position after the return was filed, delayed audits, and other situations like the one below that a practitioner recently shared with us, all have led to the assessment of the onerous penalty.

An individual with no apparent heirs or assets died in 1980. In Sept. 2005, however, an investment company realized that it still had (yes, after 25 years) the deceased's account worth more than $200,000. It is unclear why the investment company failed to escheat the account to the State Controller. After discovering the decades-old account, the investment company hired investigators and found the heirs. The assets were then turned over to the probate court, which appointed a special administrator to file back tax returns and settle all liabilities before distributing the remaining assets to the heirs. A practitioner was hired by the special administrator to file all returns and pay all outstanding tax liabilities. After filing the 1982 – 2005 Forms 541 with the FTB and paying $3,900 in back taxes, the FTB returned the favor and assessed a $4,372 interest penalty (the FTB also assessed about $11,000 in late penalties and interest, which they should eventually abate for reasonable cause).

It is these types of stories that cause us to question the California tax system and the way it is being administered. No one in this type of situation should be subject to a penalty.

***Recommendation***: Sponsor clean-up legislation to eliminate the unintended effects of the 50% interest penalty by providing a reasonable cause exception or simply provide the FTB Advocate with the authority to administer some type of equity relief to taxpayers in these and other types of situations.

## Issue #2
## Dependency Exemption Rules for Noncustodial Parents: Need for Conformity

California has not yet conformed to the federal Gulf Opportunity (GO) Zone Act '05 (P.L. 109-135) change to the definition of a child (R&TC §17024.5). The GO Zone Act retroactively repeals the 2004 law change that provided that a divorce decree was binding when claiming a child as a dependent. WFTRA '04 (P.L. 108-311) changed IRC §152 to follow the divorce decree when determining which parent claimed the child as a dependent. California conforms to this 2004 statute and the custodial parent is always granted the dependency exemption. The result is that, for 2005 and subsequent tax returns, federal and state laws conflict when determining who may claim the dependency exemption for a child. This means that if divorced parents cannot agree on who will claim a child, and the divorce decree grants the exemption to the noncustodial parent, here's what may happen:

- Custodial parent claims the child for federal purposes because federal law gives first choice to the custodial parent.
- Noncustodial parent claims the child for California purposes because California law looks to the divorce decree.

If the parents agree as to who claims the child's dependency exemption one of them must complete IRS Form 8332, **Release of Claim to Exemption for Child of Divorced or Separated Parents**.

If the custodial parent claims the dependent exemption, then the noncustodial parent signs Form 8332, which the custodial parent attaches to California return.

If the noncustodial parent claims the exemption, then the custodial parent signs Form 8332, which the noncustodial parent attaches to his or her federal return. AB 115 (Ch. 05-691) conformed California to the IRC §152 changes made by WFTRA '04. However, California has not yet conformed to the repeal contained in the GO Zone '05 Act.

In early 2006, the FTB told us that they would try to get conforming legislation enacted prior to April 15, 2006, so that it could be retroactive to the 2005 taxable year, thereby eliminating this difference. That didn't happen, and divorced California taxpayers are once again faced with this filing complication.

To make matters worse, most tax software does not address this state and federal difference. Taxpayers that follow federal law on their state return will be in an audit trap.

**Example of Differing Dependency Exemptions**

Willie and Sallie are divorced. Willie has full physical custody of their child, Freddie, but the divorce decree grants Sallie the dependency exemption. They cannot agree on who will claim Freddie as a dependent. For federal purposes, Willie claims Freddie. Sallie may not claim Freddie because Willie will not release the dependency exemption and provide Sallie with IRS Form 8332, **Release of Claim to Exemption for Child of Divorced or Separated Parents**. For California purposes, Sallie claims Freddie because California law conforms to the changes to IRC §152 changes contained in WFTRA '04 (before the GO Zone Act change) and the divorce decree determines who may claim the exemption. Freddie is still Willie's qualifying child for purposes of establishing Willie as head of household for both federal and California.

## Issue #3
## Registered Domestic Partners: Need for Legislative Fix to Combined Federal AGI Rule

Registered domestic partners (RDPs) in California will be required to file as married for taxable years beginning on or after January 1, 2007 (SB 1827, Ch. 06-802). SB 1827 requires domestic partnerships that are registered with the Office of the California Secretary of State (SOS), as of the close of the taxable year, to file using the same rules that apply to married couples, even though they are prohibited from doing so under federal law (R&TC §§17024.5, 18521; Family Code §297.5).

SB 1827 §1 states, "It is the intent of the Legislature in enacting this bill that the inconsistency between registered domestic partners and spouses with respect to state income taxation be removed, registered domestic partners be permitted to file their income tax returns jointly or separately on terms similar to those governing spouses, and the earned income of registered domestic partners be recognized appropriately as community property."

Under California law, federal AGI is used to compute certain limitations, phaseouts and thresholds. A few examples include the phase out of itemized deductions and personal exemption credits, rental real estate passive activity phaseouts, and the income eligibility limits on Roth IRA contributions.

The FTB sought an amendment to SB 1827 to provide that, for purposes of computing limitations based on AGI, AGI is the total amount of AGI for each RDP shown on the federal tax return (R&TC §17024.5(g)(2)(B)). This amendment became law in SB 1827.

***Using a combined federal AGI for two RDPs in a joint return will not always provide the same result as married couples filing joint. This appears to be an unintended consequence of SB 1827.***

Because of the FTB's amendment to SB 1827, the RDP tax rules do not achieve their stated purpose of removing the "inconsistency between registered domestic partners and spouses with respect to state income taxation," and it presents a huge tax preparation challenge.

**Example of Combining Federal AGIs – RDP with Smaller Phaseouts**
**(Tax Decrease)**

Robin and Sean are RDPs and have:

| | Robin | Sean | Combining two federal AGIs | AGI if they were married |
|---|---|---|---|---|
| Wages | $100,000 | $225,000 | | |
| Rental loss | ( 25,000) | 0 | | |
| Total | $75,000 | $225,000 | $300,000 | $325,000 |

As an RDP, they have no phaseout of itemized deductions or personal exemptions because their combined federal AGI is $300,000. If they were allowed to file as a married couple on their federal return, they would not have been able to use any of their rental loss. This is because their AGI for federal purposes would have been $325,000 had they been allowed to file as married. So, they would have had these phaseouts:

(1) Personal exemption phaseout:

(a) $\frac{\$325,000 - 301,491}{2,500}$ = $9.40 (rounded up to 10)

(b) $10 × 12 = $120

(c) $182 - 120 = $62

(2) Itemized deduction phaseout = ($325,000 - 301,391) × 6% = $1,411

Note that example uses 2005 phaseout numbers for illustration purposes only.

**Example of Combining Federal AGIs – RDP with Larger Phaseouts**
**(Tax Increase)**

Jean and Gerri are RDPs and have:

| | Jean | Gerri | Combining two federal AGIs | AGI if they were married |
|---|---|---|---|---|
| Wages | $200,000 | $ 50,000 | | |
| Capital loss | ( 70,000)* | 70,000 | | |
| Total | $197,000 | $120,000 | $317,000 | $250,000 |

*Capital loss is limited to $3,000

As an RDP, the couple that files a joint federal return will not be subject to phase outs of itemized deductions or personal exemptions because their two combined federal AGIs would have been $250,000. However, the RDP, combining their federal AGIs is subject to a phase out of personal exemptions equal to $84 and a phase out of itemized deductions equal to $931 ($317,000 - $301,491) x 6%).

Note that example uses 2005 phaseout numbers for illustration purposes only.

***Recommendation***: Correct SB 1827's version of R&TC §17024.5(g)(2)(B). Instead of saying that limitations are to be based on combined federal AGI, it should be based on what AGI would have been had the couple filed a joint federal return. This would better accomplish the state goals of SB 1827 and ease the compliance burden.