Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Zettle	Analyst:	Marion Mann DeJong	Bill Number:	AB 110
Related Bills:	See Legislative History	Telephone:	845-6979	Amended Date:	05/02/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Teacher Retention Credit/Disallowance of Credit by FTB

SUMMARY

This bill would expressly prevent the Franchise Tax Board (FTB) from penalizing a taxpayer for incorrectly claiming the teacher retention credit, except in cases of fraud.

SUMMARY OF AMENDMENTS

The May 2, 2001, amendments deleted the provisions of the bill relating to the Manufacturers' Investment Credit and replaced them with the provision discussed in this analysis.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to protect taxpayers that claim the teacher retention tax credit in good faith.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or engage in certain activities that they may not otherwise undertake.

Existing federal law does not have a credit comparable to the teacher retention tax credit.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
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_____ N	_____ OUA	___X___ PENDING		

Current state law allows a teacher retention tax credit for credentialed teachers based upon years of service as a credentialed teacher. The teacher must hold a preliminary or professional teaching credential and be a classroom teacher in any California public or private elementary, secondary, or vocational-technical school (including those on Indian reservations or military installations located in California) providing education for kindergarten through 12th grade.

Existing federal and state laws require that interest be charged on unpaid taxes beginning from the original due date of the return until the date of payment. The assessment of interest is not considered a penalty, but a charge for the taxpayer's use of the money.

Existing state law provides for the correction of mathematical errors during the processing of returns, resulting in account adjustments that can generate a bill for additional tax or a reduction or increase in the amount of refund claimed on a return.

Existing state law provides for the mailing of notices of proposed deficiency assessments, with the right of protest and appeal, where FTB determines that the amount of tax due after tax credits is greater than the amount shown on the return, after correction for mathematical errors during processing.

Existing federal and state laws authorize penalties for failure to meet the deadlines for filing returns, paying taxes, or furnishing information. The most common state penalties that could apply to taxpayers claiming the teacher retention credit are as follows:

- *Failure to File a Return by the Due Date Penalty*. The penalty is 5% of the tax due, after applying payments and credits made on or before the due date, for each month the return is late, up to 25%.

- *Failure to Pay Tax by Due Date Penalty.* The penalty for failure to pay the tax shown on the return by the due date is 5% of the unpaid tax plus 0.5% of the unpaid tax per month or part of any month the tax remains unpaid. The maximum penalty is 25% of the unpaid tax.

- *Failure to Furnish Information Penalty*. The failure to furnish information penalty may be imposed if a taxpayer fails or refuses to file a return after notice and demand or provide information, unless the failure was due to reasonable cause. The amount of the penalty is 25% of the tax deficiency based on estimated income information or attributable to the issue for which the information was required.

- *Accuracy-Related Penalty*. An accuracy-related penalty of 20% of the portion of the underpayment of tax may be imposed if the underpayment is due to one or more of the following:

    - Negligence;
    - Substantial understatement of tax;
    - Substantial valuation misstatement;
    - Substantial overstatement of pension liabilities; or
    - Substantial estate or gift tax valuation understatement.

The accuracy-related penalty is not assessed if reasonable cause and good faith has been shown by the taxpayer in regards to the underpayment. See "Background" discussion below for more information on this penalty.

- *Fraud Penalty*. A fraud penalty may be imposed if any part of any underpayment of tax is due to fraud. The penalty is 75% of the unpaid tax.

THIS BILL

In the event that FTB determines that a taxpayer is ineligible for the teacher retention credit, this bill would require the taxpayer's liability for the year the credit was claimed to be increased by the amount of the credit plus applicable interest. Except in the case of fraud, this bill would prevent FTB from assessing any fines or penalties if a taxpayer were ineligible for the teacher retention credit.

IMPLEMENTATION CONSIDERATIONS

As written, the bill could be interpreted to prevent imposition of penalties unrelated to claiming the teacher retention credit (e.g. failure to file a return by the due date). In addition, the bill does not specify which process FTB should use when increasing the individuals tax liability when disallowing a credit. It could be done when processing the return in which case there would be no protest rights. Or, it could be done through the deficiency assessment process which includes protest and appeal rights. Department staff is working with the author to resolve these concerns. According to the author's staff, the author intended to prevent the imposition of the accuracy-related penalty that would be imposed during the audit process.

If the bill were amended as indicated by the author's staff, implementing this bill would not affect the department's programs and operations since it would not change current law and department practice. Currently, if upon audit the taxpayer were found to be ineligible for the teacher retention credit, department staff would issue a proposed assessment for the additional tax due (credit amount) plus interest. Except in the case of fraud, it is unlikely that FTB would assess any penalties on a taxpayer for incorrectly claiming the credit.

LEGISLATIVE HISTORY

AB 2879 (Jackson, Stats. 2000, Ch. 75) enacted the teacher retention tax credit. AB 1080 (Villaraigosa, Stats. 2000, Ch. 603) simplified the method of determining tax imposed on a teacher's salary for purposes of the credit limitation contained in the teacher retention tax credit.

AB 149 (Zettel 2001/2002) would extend the teacher retention tax credit to credentialed individuals who provide support services to students (e.g., school psychologists, language specialists, counselors, and school nurses) and to preschool, prekindergarten, and adult education teachers that are credentialed. AB 149 is in the Assembly Revenue and Taxation Committee.

PROGRAM BACKGROUND

The accuracy-related penalty may be imposed on the portion of any underpayment of tax required to be shown on the return. The penalty is equal to 20% of the portion of the underpayment attributable to one or more of the following:

- Negligence;
- Substantial understatement of tax;
- Substantial valuation misstatement;
- Substantial overstatement of pension liabilities; or
- Substantial estate or gift tax valuation understatement.

The law provides relief provisions or exceptions for each of these situations. In general, there are three common defenses (relief provisions) which the taxpayer can raise to avoid the assessment of the penalty. These three defenses are:

1. *substantial authority* exists for the tax treatment of an item on the return,
2. *adequate disclosure* of the transaction has been made on the original return, and
3. *reasonable cause* and good faith has been shown by the taxpayer in regards to the underpayment.

Depending on the situation causing the understatement, meeting any one of these three defenses will preclude the assessment of the accuracy-related penalty.

The defense of reasonable cause and good faith addresses the taxpayer's reasons for the tax treatment of an item. If the taxpayer has reasonable cause and has acted in good faith in determining the treatment of an item, then the penalty will not apply, regardless of whether the taxpayer meets the defenses of adequate disclosure or substantial authority.

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer.

The following is FTB's policy regarding the assessment of penalties in general and specifically the accuracy-related penalty.

> "It is the Audit Division policy to consider the imposition of any penalty in each case where the penalty is applicable. In the event the accuracy-related penalty is proposed to be assessed, documentation regarding the assessment of the penalty, including a detailed analysis of the taxpayer's failure to meet each of the three defenses to the assessment of the penalty, is necessary in the audit work papers. Further, where the penalty is assessed, a discussion with the taxpayer and/or the tax representative regarding the assessment of the penalty, including a discussion of each defense, is necessary."

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws authorize penalties for failure to meet the deadlines for filing returns, paying taxes, or furnishing information. It could not be determined if any of these states prevent the assessment of penalties with regard to a specific credit. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This bill would not impact the department's costs.

ECONOMIC IMPACT

This bill would not impact state income tax revenues.

ARGUMENTS/POLICY CONCERNS

Under current law and department practice, if a taxpayer were found to be ineligible for the teacher retention credit, department staff would issue a proposed assessment for the additional tax due plus interest. FTB would not assess any penalties if the taxpayer claimed the credit in good faith on a timely-filed, fully-paid return and provided information requested during the audit. Therefore, this bill does not appear to be necessary.

Moreover, prohibiting the imposition of penalties for taxpayers that claim the benefits of a particular tax provision for which they are ineligible is unprecedented. This bill would be the first precedent for prohibiting a penalty even if a taxpayer has no reasonable basis, short of fraud, to claim a credit initially.

LEGISLATIVE STAFF CONTACT

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