

# ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Dutton Analyst: Anne Mazur Bill Number: SB 633

Related Bills: See Legislative History Telephone: 845-5404 Introduced Date: February 22, 2005

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** State Agencies That Collect & Administer Taxes Shall Have Burden Of Proof In Court Or Administrative Tax Proceedings

## SUMMARY

This bill would:

- Add a new provision to the Government Code to shift the burden of proof from a taxpayer to the agencies collecting taxes in certain situations.
- Add a new provision to the Evidence Code regarding the Board of Equalization (BOE)'s standard of evidence in sustaining fraud penalties. This change does not affect the department and is not discussed in this analysis.

## PURPOSE OF THE BILL

It appears the purpose of this bill is to alter the burden of proof for taxpayers that have fully cooperated with the state agency when pursuing their administrative and judicial remedies.

## EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2006, and would apply to court and administrative proceedings involving determinations issued on or after this date.

## POSITION

Pending.

## ANALYSIS

### FEDERAL/STATE LAW

**Under federal law**, the IRS is authorized to require taxpayers to keep certain records. Taxpayers may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on taxpayers' inability to substantiate such items or based on third-party information returns (e.g., W-2s or 1099s). If collection is determined by the IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Board Position:

\_\_\_\_\_ S      \_\_\_\_\_ NA      \_\_\_\_\_ NP  
\_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
\_\_\_\_\_ N      \_\_\_\_\_ OUA      \_\_\_\_\_ X PENDING

Department Director

Date

Will Bush

7/1/2005

Taxpayers may appeal preliminary deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the appeal, under the federal system, the taxpayer may either: (1) file a petition to redetermine the deficiency assessment with the Tax Court, or (2) pay the assessment and file a claim for refund with the IRS. If the taxpayer chooses the latter, once the claim is denied (or no action is taken by the IRS within six months), the taxpayer may file suit for refund in a U.S. district court or the U.S. Court of Federal Claims.

In Tax Court proceedings, taxpayers have the burden of proving that the deficiency assessment is incorrect. In suits for refund in federal court, taxpayers have the burden of proving that they are entitled to a refund of overpaid taxes. Taxpayers must establish the merits of these claims by a preponderance of the evidence. These actions are independent judicial proceedings in a trial court based upon information submitted by the parties under rules of evidence applicable in federal courts. Both the taxpayer and the IRS can appeal final adverse determinations to appellate courts, except small claims division determinations, which are binding.

The IRS Restructuring and Reform Act of 1998 enacted provisions that shift the burden of proof to the IRS in any court proceeding for factual issues if the taxpayer introduces credible evidence with respect to factual issues. This change applies to income, estate, gift, and generation-skipping taxes. For the burden of proof to shift, the taxpayer must:

- Comply with requirements to substantiate any item.
- Keep records required by law or regulation.
- Cooperate with reasonable IRS requests for witnesses, information, documents, meetings and interviews (according to the federal conference report, this includes exhausting the taxpayer's administrative remedies, including any appeal rights provided by the IRS).
- Have net worth of \$7 million or less if the taxpayer is a partnership, corporation, or trust.

The burden of proof also shifts to the IRS when the IRS adjusts income through the use of statistical information on unrelated taxpayers. The IRS has the burden of producing evidence when penalties or other additions to tax are imposed.

**Under current state law**, all taxpayers may be requested by the Franchise Tax Board (FTB) to furnish substantiation of the items reflected on their income tax returns, and FTB is authorized to require water's-edge taxpayers to keep certain records. The FTB may issue a proposed deficiency assessment based on the following: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns, or information FTB receives from the IRS. If collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes a proposed deficiency assessment or jeopardy assessment, the taxpayer may either (1) protest the assessment by filing a written "protest" with FTB, or (2) pay the assessment and file a claim for refund. If the protest of the proposed assessment is denied, the taxpayer may appeal to the BOE. If the appeal is denied by the BOE, the taxpayer must pay the assessment. Under California law, no legal action may be taken in court to challenge a deficiency prior to its full payment, unless it is an action to determine the residency of the taxpayer.

After payment of a disputed tax, a taxpayer may file a claim for refund with the FTB. If the claim is denied or no action is taken on the claim within six months, the taxpayer may appeal to the BOE or initiate legal action for a refund in superior court. Throughout these processes, the burden to establish that the FTB determination is incorrect is on the taxpayer.

In the event of a final adverse BOE decision on appeal of FTB's denial of the claim for refund, the taxpayer's only recourse is to bring an action for refund against the state in superior court. In administrative appeals, there is a rebuttable presumption that the FTB action is correct. A taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of establishing the merits of their claims by a preponderance of the evidence.

**Under current state law**, in appeals before the BOE, the FTB has the burden of producing additional information to prove the correctness of an assessment based upon third-party information (e.g., W-2 or 1099) if the taxpayer sets forth a reasonable argument regarding the disputed income, appeals FTB's action, and fully cooperates with FTB.

### THIS BILL

This bill would shift the burden of proof to a state agency that collects and administers taxes with respect to a factual issue related to ascertaining the tax liability of a cooperating taxpayer in any of the following situations:

- Court proceedings,
- Administrative tax proceedings, and
- Evaluation of tax compliance conducted by employers,<sup>1</sup> contractors, or agents of the state agency.

The bill would define "cooperating taxpayer" as a taxpayer that has both:

1. Complied with all relevant statutory, regulatory, or case law substantiation requirements to substantiate any item on any tax return filed with the FTB.
2. Maintained all records as required by the Revenue and Taxation Code or any rules or regulations issued by FTB and upon a reasonable request by FTB, has provided those records to the state agency.

The bill would also do the following:

- Define "state agency" as FTB, BOE, and Employment Development Department.
- Define "tax liability" as any tax assessed by FTB, including any interest charge or penalties levied in association with the tax.
- Define "administrative proceeding" as the hearing before members of the BOE for disputes concerning taxes collected by the FTB.
- Require a "preponderance of evidence" standard of burden of proof.
- Not apply to an adjustment proposed and made to a taxpayer's federal income tax return by the federal government.
- Not subject a taxpayer to unreasonable search or access to records in violation of the U.S. Constitution, the California Constitution, or any other law.

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<sup>1</sup> For purposes of this analysis, department staff assumes that the author intended to reference "employees" rather than "employers." See Technical Considerations for the recommended amendment.

## IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- The bill appears to be internally inconsistent. Subdivision (a) of Section 15706 states that burden of proof will shift, in addition to any court or administrative proceedings, in “any evaluation of tax compliance...”; however, subdivision (i) says the bill will only apply to court or administrative proceedings involving determinations issued on or after the operative date of the bill. Therefore, department staff suggests that operative date language be clarified to indicate when the bill would apply with respect to evaluations of tax compliance.
- The bill refers to “any court or administrative tax proceeding.” It is not clear whether the referenced court proceedings are limited to tax disputes. Furthermore, the definition of “administrative proceeding” for disputes concerning taxes collected by the FTB is limited to “the hearing before members of the [BOE].” Appeals of FTB actions to the BOE may be determined without an oral hearing before the five-member BOE. Clarification may be necessary if this bill is intended to apply to appeals to the BOE where taxpayers waive their right to oral hearing.
- The bill states it will only apply to court or administrative proceedings involving determinations issued on or after the operative date of the bill; however it does not define the term “determinations.” It is unclear whether the term means determinations by the taxing agency or determinations in the administrative or court proceedings. The federal provision applies to court proceedings arising in connection with examinations commenced after the date of enactment or, if there was no examination, court proceedings arising in connection with taxable periods or events beginning or occurring after the date of enactment. Department staff suggests similar language be considered for this bill.
- This bill would require FTB to engage in more extensive evidence gathering activities, which would likely result in more lengthy and intrusive audits. Accordingly, additional audit and legal staff may be needed. In this regard, it would be helpful to require a “cooperating taxpayer” to fully comply with written information document requests. Otherwise, taxpayers could assert they are “cooperating” without providing sufficient information to conduct a complete audit. This could also diminish FTB’s ability to impose a penalty for failure to furnish information. Shifting the burden of proof to FTB may require longer retention of records and increased costs for storage.
- Under current law, FTB is not authorized to require most taxpayers to keep any records (books, papers, writings, etc.), statements, returns, or other information appropriate to determine the correct amount of tax reported on the tax return. To conform to the federal burden of proof provisions, legislation would also be needed to conform to the federal record-keeping requirements.
- In refund cases or in protest cases where the taxpayer asserts a new issue to support their position, the department may not have had an opportunity to obtain supporting documents from the taxpayer. It is unclear whether the audit staff would be required to seek additional supporting data for all cases to protect the state’s interest in the event the case is protested or appealed.

- It is unclear what the author intends by “any evaluation of tax compliance conducted by employers, contractors, or agents of the state agency.” Such an evaluation could presumably occur during the audit or administrative protest process. Furthermore, it is unclear what is meant by “employers, contractors, or agents of the state agency.” Generally, only FTB employees conduct audits, protests, and represent the FTB in appeals before BOE members. However, the Attorney General represents FTB in court proceedings and certain taxpayer accounts may be contracted out to private collection agencies.
- The bill provides that the burden of proof shift would not apply to adjustments proposed and made to a taxpayer’s federal income tax return by the federal government. Presumably this language is intended to exempt from the burden shift disputes relating to FTB’s deficiency assessments based on federal determinations. However, the current bill language appears insufficient to accomplish this purpose because it does not expressly reference FTB adjustments proposed on a taxpayer’s California income tax return based on federal adjustments.
- FTB’s existing filing enforcement program uses third-party (e.g., W-2 or 1099) and statistical information to identify nonfilers and underreporters and to estimate their tax liabilities. As noted above, current state law provides that in appeals before the BOE, the FTB already has the burden of producing additional information to prove the correctness of an assessment based upon third-party information if the taxpayer sets forth a reasonable argument regarding the disputed income, appeals FTB’s action, and fully cooperates with FTB. Since these situations are already addressed by statute, the author may want to consider excepting them from the provisions of this bill. If the author intends to set a new standard, it may be redundant or conflict with the existing rule.

### TECHNICAL CONSIDERATIONS

This bill would shift the burden of proof in “any evaluation of tax compliance conducted by employers, contractors, or agents of the state agency...” Department staff believes that reference to “employers” of the state agency is erroneous, and that the author intended to reference “employees” of the state agency. Therefore, department staff recommends that, in line 21 of page 2 of the bill, the term “employers” should be replaced with “employees.”

Department staff also notes a presumed typographical error on line 5 of page 3 of the bill. The term “collect” should be replaced with “collected.”

### **LEGISLATIVE HISTORY**

SB 1222 (Knight, 1999/2000) would have shifted the burden of proof to FTB in court proceeding for factual issues, penalties, and adjustments to income based on statistical information, but not for issues resulting from federal changes. This bill failed to pass out of the first house by January 31 of the second year of the session.

AB 436 (McClintock, 1999/2000) would have added the Taxpayer’s Rights Act that included taxpayer rights provisions including shifting the burden of proof to taxing agencies in any legal action contesting the validity of any tax. This bill failed to pass out of the first house by January 31 of the second year of the session.

SB 1478 (Rainey, 1997/1998) would have declared legislative intent to conform to the IRS Restructuring and Reform Act of 1998 including shifting the burden of proof to state agencies collecting taxes in any court or administrative proceeding under certain conditions. This bill was held in the Senate Revenue and Taxation Committee.

AB 1631 (Sweeney, 1997/1998) would have declared legislative intent to conform to the federal law relating to shifting the burden of proof in connection with income taxes paid by California taxpayers. This bill was held in the Assembly Appropriations Committee.

SB 1166 (Hurt, 1997/1998) would have shifted the burden of proof from taxpayers to the "board" in court proceedings under certain conditions and declare legislative intent to conform to the then pending federal taxpayer bill of rights' legislation. This bill failed to pass out of the first house by January 31 of the second year of the session.

### **OTHER STATES' INFORMATION**

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws do not have laws providing for a shift of burden of proof to the tax agency comparable to what is proposed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

### **FISCAL IMPACT**

The departmental costs associated with this provision are unknown, but would most likely increase substantially due to the additional evidence that would be required on all cases to support the state's position on any potential litigation cases. Department staff will develop the costs as this bill moves through the legislative process.

### **ECONOMIC IMPACT**

This proposal would result in a negative revenue impact on the state's income tax revenue. It is not possible to determine the number or types of cases in which the burden of proof would shift to the department under this proposal; therefore, the amount of annual revenue losses is unknown.

### **ARGUMENTS/POLICY CONCERNS**

This bill does not conform to the federal burden of proof law, but is instead much broader. This bill does not limit the burden of proof shift to court proceedings or individual and small business taxpayers. Also, the bill does not require the taxpayer to meet the minimum threshold of providing credible evidence with respect to factual issues in dispute. Under general principles of tax law, it is well settled that deductions are a matter of legislative grace, and the burden is on the taxpayer to establish entitlement to the claimed deduction. Similarly, tax law holds that the taxpayer has the burden of proof to establish an overpayment. Without the requirement that the taxpayer meet the minimum threshold of credible evidence, it could be difficult in many cases for the taxing agency to meet its burden of proof because the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.

### **LEGISLATIVE STAFF CONTACT**

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