

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: La Malfa Analyst: Nicole Kwon Bill Number: AB 2727

Related Bills: See Legislative History Telephone: 845-7800 Introduced & Amended Dates: February 22, & March 25, 2008

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Shift Burden Of Proof/BOE And FTB

SUMMARY

This bill would do the following:

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

SUMMARY OF AMENDMENTS

As introduced, this bill would add a new provision to shift the burden of proof from a taxpayer to the agency collecting taxes.

The March 25, 2008, amendments made various changes including replacing a state agency with the Board Of Equalization (BOE) and the Franchise Tax Board (FTB).

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, 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, 2009, and would apply to court and administrative proceedings involving assessments and notices of determinations issued on or after this date.

POSITION

Pending.

Board Position:

_____ S _____ NA _____ NP
_____ SA _____ O _____ NAR
_____ N _____ OUA X PENDING

Department Director

Date

Selvi Stanislaus

4/11/08

ANALYSIS

FEDERAL/STATE LAW

Under federal law, the Internal Revenue Service (IRS) is authorized to establish substantiation requirements and 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., Forms 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.

Taxpayers may appeal preliminary notices of proposed deficiencies or jeopardy assessments to the IRS. In the event the IRS denies the appeal and issues a notice of deficiency, under the federal system, the taxpayer may either: (1) file a petition to redetermine the deficiency with the Tax Court, or (2) pay the deficiency 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. The evidentiary burden taxpayers must meet is 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 adverse determinations to an appellate court, except U.S. Tax Court 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 a factual issue if the taxpayer introduces credible evidence with respect to that factual issue. This change applies to income, estate, gift, and generation-skipping taxes. For the burden of proof to shift, the taxpayer must first introduce credible evidence regarding a factual issue and all of the following:

- Comply with current requirements under law or regulation to substantiate any item reflected on the federal income tax returns.
- 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 of an individual 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.

In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the Secretary by a third party, the Secretary has the burden of producing reasonable and probative information concerning the information return.¹ The taxpayer has to cooperate fully with the Secretary, which includes providing access to and inspection of all witnesses, information, and documents within the control of the taxpayer within a reasonable time.

Under current state law, all taxpayers may be requested by FTB to furnish substantiation of the items reflected on their income tax returns and FTB is authorized to require only water's-edge taxpayers to keep certain records.

FTB may issue a proposed deficiency assessment based on the following: a taxpayer's 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 a proposed assessment is denied, the taxpayer may appeal to the BOE. Throughout the protest and appeal process, taxpayers have the burden to establish that FTB's determination is incorrect. If the appeal is denied by the BOE, the taxpayer must pay the assessment.

Under California law, a court challenge can be made only upon full payment of the deficiency. The sole exception is a declaratory action to determine the residency of the taxpayer.

After payment of a disputed tax, a taxpayer may file a claim for refund with 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 the refund process, the burden to establish that the taxpayer is entitled to a refund of overpaid taxes is on the taxpayer.

A taxpayer in a lawsuit for refund of taxes paid is the plaintiff. The taxpayer has the burden of proof to establish the merits of their claim, like plaintiffs in other civil actions, by a preponderance of the evidence.

Under state law, in modified conformity to federal law in connection with appeals before BOE, FTB has the burden of producing reasonable and probative additional information to prove the correctness of an assessment that is based upon third-party information returns (e.g., Form 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.

¹ IRC 6201(d)

THIS BILL

This bill would shift the burden of proof from the taxpayer to either BOE or FTB with respect to a factual issue related to ascertaining the tax liability of a taxpayer that has established that it is a cooperating taxpayer in any of the following situations:

- Administrative tax proceedings, or
- Court proceedings

This bill would define “cooperating taxpayer” as a taxpayer that meets all of the following: (1) complied with all relevant statutory, regulatory, or case law to substantiate any item on a return or claim filed with BOE or FTB, (2) maintained all records as required by the Revenue and Taxation Code or any regulations issued by BOE or FTB and upon a reasonable request by the state agency, has provided those records to the state agency, and (3) provided credible evidence with respect to any factual issue relevant to determining the tax liability of the taxpayer.

This bill would also do the following:

- Define “tax liability” as any tax or fee assessed or determined by BOE or FTB, including any interest accrued or penalties levied in association with the tax or fee.
- Define “administrative tax proceeding” as the oral 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 apply to an appeal filed with BOE subject to the provisions of existing law regarding the burden of producing additional information when a taxpayer is challenging an information return.
- 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.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations. Department staff is available to work with the author’s office to resolve the implementation considerations.

- This bill defines the term “cooperating taxpayer” to mean a taxpayer that meets all the three criteria specified in the bill. Taxpayers, however, could assert they are “cooperating” without providing sufficient information to conduct a complete audit. It is recommended that the bill be amended to require a “cooperating taxpayer” to comply fully with written information document requests, including requests made during the administrative tax proceedings. In addition, the bill is silent on who will make determinations associated with whether the taxpayer was a “cooperating taxpayer.”

- This bill would define a “cooperating taxpayer” as a taxpayer that maintains all records as required by the Revenue and Taxation Code or any regulations issued by BOE or FTB. Under current law, other than for water’s-edge entities, FTB has no authority to issue regulations requiring any taxpayer to maintain any records. As a result, taxpayers are not required to maintain any particular records to substantiate information reported on the tax return other than information appropriate to determine the correct amount of tax. If it is the author’s intent to conform to the federal burden of proof provisions, it is recommended that the bill be amended to conform to the federal authority to prescribe record-keeping requirements.
- This bill states that the burden of proof will shift to FTB when the cooperating taxpayer “has provided credible evidence to FTB with respect to any factual issue.” The timing of when the burden of proof will actually shift from the taxpayer to FTB is unclear with regard to the phrase “has provided credible evidence to FTB with respect to any factual issue.” In addition, this phrase could be interpreted to shift the burden of proof on all factual issues if the taxpayer introduces credible evidence of only one factual issue. It is recommended that the bill be amended to clarify when the timing of this submission of credible evidence would occur and revise the language to shift the burden of proof to FTB with respect to a factual issue if the taxpayer introduces credible evidence of that factual issue.
- This bill states that a “cooperating taxpayer,” upon a reasonable request by the state agency, should provide the requested records. In protest cases or refund cases where the taxpayer asserts a new issue to support their position, the department would normally not include requests regarding that issue in information requests to obtain supporting documents from the taxpayer. It is recommended that the bill be amended to prevent a shift in the burden of proof in these circumstances or clarify that FTB would be permitted to seek additional supporting records for such new issues.
- This bill is limited to “oral hearings” before BOE. Presumably, appeals where the taxpayer waives their right to an oral hearing would not be subject to the shift in the burden of proof. Currently, the substantial majority of taxpayers waive their right to an oral hearing before BOE. If this is not the author’s intent, the author may wish to clarify the language to state that the shift in the burden of proof will still apply to taxpayers that waive their right to an oral hearing before BOE.
- This bill would limit the application of the shift of burden to oral hearings. The FTB staff learns whether there will be an oral hearing after opening briefs are prepared and filed by the taxpayer and the department.
- The bill states that it will only apply to court or administrative tax proceedings involving assessments or notices of determination issued on or after the operative date of the bill. With respect to FTB, assessments are only issued after all pre-payment administration proceedings have been exhausted. In addition, this language appears to exclude matters related to a claim for refund.

TECHNICAL CONSIDERATION

On page 4, line 13, replace “operative” with “effective” to clarify the effective date of this bill.

LEGISLATIVE HISTORY

AB 1600 (La Malfa, 2007/2008) and SB 633 (Dutton, 2005/2006) would have shifted the burden of proof from a taxpayer to the agency collecting taxes in certain situations. AB 1600 and SB 633 failed to pass out of the first house by January 31 of the second year of the session.

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

It is assumed no additional resources to hire new personnel would be available to FTB. Accordingly, this bill would not significantly impact the department's costs. Rather this bill would result in current staff spending more time developing the cases for the following divisions of the department:

Audit

This bill would result in a 10-20% increase in the number of hours required to complete an audit case resulting in fewer audits closed each year.

Legal

The majority of BOE appeals are decided on briefs with the taxpayer waiving oral hearing. For 2007, 65 taxpayers requested an oral hearing for their tax appeal. Staff estimates that the number of taxpayers requesting an oral hearing as a result of this bill would double. Staff also estimates that preparing a tax appeal for oral hearing consumes, on the average, approximately 40 hours of additional work per case, which would total an additional 2,600 hours of staff time (65 deficiency cases x 40 hours = 2,600 hours). To accommodate this additional work, legal staff would need to be redirected from other work.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 2727 As Amended 3/25/08 (\$ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Unsustained assessments	-\$280	-\$305	-\$330	-\$345
Decreased audit revenue	-\$20	-\$60	-\$90	-\$115
Decreased self-compliance *	---	unknown loss	unknown loss	unknown loss
* A rule of thumb estimate is that for every 1% of current tax revenues generated under the PIT and CT Laws that is lost under the bill, equates to roughly \$600 million.				

Revenue Discussion

The revenue impact of this bill would be dependent upon the following:

1. Unsustained assessments due to the burden of proof shifting to the FTB,
2. Fewer audit assessments in future years due to the additional time required to complete each audit, and
3. Decreased self-compliance in future years.

Currently, the department has approximately \$2.7 billion of tax assessments in protest status for both personal income tax (PIT) and corporate tax law (CTL) programs. Additionally, the department has approximately \$300 million in the appeals process and another \$165 million in litigation. While the actual impact of this bill on extant cases in protest, appeals, and litigation is unknown, a reasonable estimate by litigation experts in FTB's Legal Division is that at least one-third of current extant cases in protest, appeals, and litigation will not be sustained because of the burden of proof shift contained in this bill.

Therefore, it is assumed that roughly one-third of assessments currently in protest, appeals, and in litigation would be the amount that would not be sustained due to the burden of proof shifting to FTB. The total amount of unsustainable assessments attributable to the provisions of this bill would be approximately \$1.1 billion (\$3.2 billion divide by 3). It is assumed that, absent the bill, the \$1.1 billion in revenue would be realized ratably, or about \$265 million annually each fiscal year.

Additionally, because the burden of proof would shift to the FTB under the bill, based on discussions with FTB audit and legal staff, it is expected that the sustainment rate of ongoing FTB assessments would drop by about 10% of total annual assessments. It is estimated that this would result in a cash loss of about \$20 million in 2008-09. When the impact of the reduced sustainment rate is fully phased-in after five-years (2013-14), the revenue loss would be about \$110 million.

The annual total loss due to unsustainable assessments is the sum of these two components. That is, for 2008-09, the \$265 million (attributed to existing assessments) plus the \$15 million (attributed to ongoing assessments) equals the \$280 million in the table.

This bill would require FTB to engage in more extensive evidence gathering activities that would result in more lengthy audits. Assuming static staffing levels in Audit Division of the department, audits would require more hours to complete, and there would be fewer audits completed. Consequently, audit activities would generate less in assessments under this bill than under current law. Under this bill, it is projected that audit activities would generate about \$220 million less in assessments under the PIT and CTL programs. Absent the bill, the cash from these assessments would have flowed in over five-years. Therefore, under this bill, the revenue loss from the reduction in assessments in any one year would be realized over five-years. The estimated reduction in cash due to the lower volume of cases completed under the bill is estimated at \$20 million in 2008-09. When the impact of the reduced assessments is fully phased-in after five-years, the revenue loss would be about \$150 million per year.

To measure the potential decrease in self-compliance revenue in future years, a rule of thumb estimate would be that for every 1% decrease in self-compliance under the PIT and CTL caused by this bill, roughly \$600 million in tax revenue would be lost.

Estimates are accrued back one year as tax liabilities are attributed to prior tax years.

ARGUMENTS/POLICY CONCERNS

Although the bill appears to conform California law to federal law, it would not limit application of the shift of the burden of proof to court proceedings or individual and small business taxpayers as required under the federal law. This bill does not require the taxpayer to meet the minimum threshold of providing evidence with respect to a factual issue in dispute. Under long standing case law, deductions and credits are characterized as a matter of legislative grace, and the burden is on the taxpayer to establish entitlement to the claimed deduction. Similarly, tax law cases hold 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.

Because the records of wage earners and retired individuals are supplied to the IRS and FTB by employers and others, shifting the burden of proof to taxing agencies in these instances would be somewhat insignificant. However, businesses dealing primarily with cash transactions, those in the “underground economy,” could benefit from a shift in the burden of proof due to the voluntary compliance nature of providing such information to taxing agencies.

The current burden of proof requirement reflects the fact that the taxpayer is in control of the records and documents related to his or her tax return. If the burden of proof shifted to FTB, the taxpayer may have little or no incentive to maintain accurate documentation because the taxpayer could assert they are “cooperating” without providing sufficient information to conduct a complete audit. This would make the deficiency determination process extremely difficult and could result in more time-consuming and intrusive audits involving third-party interviews, credit report requests, review of other agencies’ returns, and/or searches for any available relevant documents maintained by the taxpayer and/or others.

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