

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Tran Analyst: William Koch Bill Number: AB 1387
Related Bills: See Legislative History Telephone: 845-4372 Introduced Date: February 27, 2009
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 Franchise Tax Board (FTB) and is not discussed in this analysis.

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 on January 1, 2010, and would be specifically operative with respect to court and administrative tax proceedings involving assessments and notices of determination issued on or after this date.

POSITION

Pending.

ANALYSIS

FEDERAL 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-2 or 1099).

Table with Board Position (S, NA, NP, SA, O, NAR, N, OUA, X, PENDING) and Department Director/Date (Selvi Stanislaus, 04/16/09)

Taxpayers may appeal preliminary notices of proposed deficiencies 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 re-determine 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.<sup>1</sup> 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.

## STATE LAW

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.

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<sup>1</sup> IRC 6201(d)

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 the taxpayer disputes a proposed deficiency 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 Board of Equalization (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.

### 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 "cooperating taxpayer" in the following situations:

- Administrative tax proceedings, or
- Court proceedings

This bill would define "cooperating taxpayer" as a taxpayer that has done 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.

The provisions of this bill affecting FTB would apply to court and administrative tax proceedings involving assessments or notices of determination issued on or after the effective date of this bill.

#### 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 FTB’s written information document requests, including requests made during administrative tax proceedings.
- This bill is silent on who would determine whether the taxpayer is a “cooperating taxpayer.” It is recommended that the bill be amended to allow FTB to determine whether the taxpayer is 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, there are no statutes or regulations requiring a California taxpayer to maintain specific records. As a result, taxpayers are not required to maintain any particular document, and therefore could claim they met the definition of “cooperating taxpayer” without maintaining and providing any documents. It appears this bill is fashioned after a similar federal law; however, federal law does have statutory requirements for record keeping. If it is the author’s intent to make California law on shifting the burden of proof the same as federal law, it is recommended that the bill be amended to prescribe specific 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 bill fails to specify a timeframe for a taxpayer to submit credit evidence. A taxpayer could submit credible evidence to FTB the day of the BOE hearing and argue the burden of proof has shifted to FTB. It is recommended that the bill be amended to require a cooperating taxpayer to submit credible evidence within a specified period.
- 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.” This phrase could be interpreted to shift the burden of proof on all factual issues if the taxpayer introduces credible evidence for only one factual issue. It is recommended that the bill be amended to revise the language to shift the burden of proof to FTB with respect to a factual issue only 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. During protest, a taxpayer often asserts a new issue or argument to support its position. Consequently, an information request issued by FTB during audit-prior to protest-does not include a request for documents supporting a subsequently raised issue or argument. It is recommended that the bill be amended either to prevent a shift of the burden of proof in these circumstances or to 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 the right to an oral hearing would not be subject to the shift in the burden of proof. Currently, the substantial majority of taxpayers waive the 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 would still apply to taxpayers that waive the right to an oral hearing before BOE.
- The bill states that it would only apply to court or administrative tax proceedings involving assessments or notices of determination issued on or after the effective date of the bill. It is unclear if the author’s intent is to exclude matters related to a claim for refund. It is recommended that the bill be amended to clarify if the provisions of this bill apply to proceeding involving a claim for refund.

## LEGISLATIVE HISTORY

AB 2727 (La Malfa, 2007/2008) contained provisions identical to this bill. AB 2727 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

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<sup>st</sup> 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<sup>st</sup> 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<sup>st</sup> 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<sup>st</sup> of the second year of the session.

## **OTHER STATES' INFORMATION**

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* do not have laws shifting the 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**

FTB assumes no additional resources would be approved by the Legislature to compensate for the effects of this bill. 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

Audit staff anticipates that more time will be required to develop cases, including additional time to prepare information document requests and subpoenas as well as following up with third-parties. Audit staff estimates this bill would result in a 10% to 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 because taxpayers waive the right to a hearing. For 2008, 33 taxpayers requested a hearing for their tax appeal<sup>2</sup>. Because the provisions of this bill would only apply to a hearing rather than appeals submitted on briefs, staff estimates that the number of taxpayers requesting a hearing would double. Staff also estimates

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<sup>2</sup> For 2007, 65 taxpayers requested a hearing for their tax appeal.

that preparing a tax appeal for hearing consumes, on the average, approximately 40 hours of additional work per case, which would total an additional 1,320 hours of staff time (33 additional deficiency cases x 40 hours = 1,320 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 1387 Operative for assessments and notices of determination issued on or after January 1, 2010 (\$ in Millions)			
	2009-10	2010-11	2011-12
Unsustained Assessments		-\$85	-\$220
Reduced Audit Revenue	-\$60	-\$90	-\$120
Reduced Self-Compliance *	unknown loss	unknown loss	unknown loss
* A rule of thumb estimate is that for every 1% decrease in self-compliance under the PIT and CTL caused by a bill, roughly \$600 million in tax revenue would be lost. See discussion below regarding decrease in compliance.			

Revenue Discussion

The revenue impact of this bill would depend on 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.

1. Unsustained Assessments

Currently, cases in protest and appeal status for both personal income tax (PIT) and corporate tax law (CTL) programs total approximately \$2.5 billion in tax assessments. In any year, this balance generally holds steady, increasing/decreasing annually due to the completion of cases and the addition of new cases entering the protest and appeal stage. Since this balance represents assessments issued during various prior years, only one-third or \$835 million is estimated to relate to assessments issued during one year. In addition, since this proposal would impact assessments issued after January 1, 2010, \$835 million is the estimated value of assessments made during 2010. Absent this bill, these cases would have been gradually completed over four years, with the first phase (about one-fifth or \$170 million) resolved two years later, during 2012.

Under this proposal, these cases are anticipated to proceed to the appeal stage and be heard by the BOE. Having these cases resolved through a BOE hearing would delay resolution by one to two years, as well as reduce FTB's sustainment rate by an estimated one-third.

Of the \$170 million in assessments currently resolved at the protest stage, these assessments would, under the bill, be resolved one to two years later. This results in a total revenue loss of \$170 million for calendar year 2012.

For the second year, 2013, the revenue impact includes two components, 1) unresolved cases from 2012, these cases also have a reduced sustainment rate, and 2) loss of revenue due to 2013 assessments that would have been resolved during the protest stage but will now be heard before the BOE. The net impact of these two components for calendar year 2013 results in a loss of \$278 million.

The revenue loss in the table reflects fiscal year cash flows and accrual rules. Meaning, for the first year, the impact of \$170 million for calendar year 2012 is split between two fiscal years with \$85 million ( $\$170 \text{ million} \times 50\%$ ) attributed to fiscal year 2011-12; this revenue is then accrued back one fiscal year to 2010-11.

## 2. Reduction in audit assessments

This bill would require FTB to need to engage in more extensive evidence-gathering during audit, which 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 revenue from these assessments would have been realized over five years. Therefore, under this bill, the revenue loss from the reduction in assessments in any year would be realized over five years. The estimated reduction in revenue due to the lower volume of cases completed under the bill is estimated at \$60 million for fiscal year 2010-11 (\$20 million for 2010 and \$40 million for 2011). This figure is accrued back one year.

## 3. Decreased Self-Compliance

By shifting the burden of proof from the taxpayer to the department for hearings before the BOE, it is anticipated that taxpayers will take more aggressive tax positions, knowing that the option to proceed to the BOE is available. 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 or delayed.

## **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 would 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 or credit. 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 would be difficult in many cases for the taxing agency to meet its burden of proof because the taxpayer has control of the records necessary to prove 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 the taxing agency for these taxpayers 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 because these taxpayers have sole control of corroborating records.

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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