Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Cook	Analyst:	William Koch	Bill Number:	AB 1006
Related Bills:	See Legislative History	Telephone:	845-4372	Introduced Date:	February 18, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: FTB Burden Of Proof In Any Court Or Administrative Tax Proceeding/Revise Statute Of Limitation On Specified Actions & Audits To 3 Years/FTB Must Have Just Cause Before Commencing Audit

SUMMARY

This bill would do the following:

Provision No. 1: Add a new provision to the Government Code for tax controversy cases that would place the burden of proof for factual determinations from the taxpayer to the Franchise Tax Board (FTB).

Provision No. 2: Require the FTB to have "just cause" to begin any audit.

Provision No. 3: Reduce the Statute of Limitations (SOL) for the FTB to issue a proposed deficiency assessment from four years (six in certain instances) to three years.

Provision No. 4: Reduce the SOL for a taxpayer to amend his or her separate return to a joint return from four years to three years from the original due date of the return.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to level the playing field and ensure that all audits conducted by the FTB are with merit and fall within the law, and also give taxpayers the opportunity to properly defend themselves.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2012, and operative as of that date. Provisions No. 1 specifically would only apply to court and administrative proceedings involving assessments and notices of determination issued on or after the operative date of this bill. Because the other provisions of this bill lack language specifying otherwise, those provisions would apply as of January 1, 2012. Provision No. 2 would apply to audits commenced on or after January 1, 2012. Provision No. 3 would apply to Notices of Proposed Assessment mailed on or after January 1, 2012. Provision No. 4, would apply to amended returns filed on or after January 1, 2012.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL LAW

Under federal law, the IRS is authorized to establish substantiation requirements the taxpayer must satisfy to prove entitlement to deductions and credits and require taxpayers to keep certain records. The taxpayer may be requested by the IRS to substantiate items reflected on his or her federal income tax returns. The IRS may issue a deficiency assessment based on taxpayer's inability to substantiate such items or based on third-party information returns (e.g., Forms W-2 or 1099).

In general, the IRS must issue a deficiency assessment within three years after the later of the original due date of the return, or the date the return was filed. Returns filed prior to the original due data are deemed to be filed on the original due date. For omissions of gross income greater than 25 percent of the gross income stated on the return, the period to issue a deficiency assessment is increased from three years to six years. Refunds must generally be claimed within the later of three years from the date the return was filed or two years from the date of payment.

The taxpayer 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, the taxpayer has the burden of proving that the deficiency assessment is incorrect. In suits for refund in federal court, the taxpayer has the burden of proving that he or she is entitled to a refund of overpaid taxes. The evidentiary burden the taxpayer 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.[1] 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.

[1] IRC 7491 as added by Section 3001(a) of P.L. 105-206, and amended by Section 4002(b) of P.L. 105-277.

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 certain 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.[2] 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.

Current federal law allows a taxpayer to amend his or her separate return to a joint return within three years from the original due date of the return.

STATE LAW

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

The 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 the FTB receives from the IRS.

In general, the FTB must issue a deficiency assessment within four years after the later of the original due date of the return, or the date the return was filed. Returns filed prior to the original due date are deemed to be filed on the original due date. For omissions of gross income greater than 25 percent of the gross income stated on the return, the period to issue a deficiency assessment is increased from four years to six years. Refunds must generally be claimed within the later of four years from the original due date of the return, four years from the date the return was filed if filed by the extended due date, or one year from the date of payment

If the taxpayer disputes a proposed deficiency assessment, the taxpayer may either: (1) protest the assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund. If the protest of a proposed assessment is denied in whole or in part, the taxpayer may appeal to the Board of Equalization (BOE). Throughout the protest and appeal process, the taxpayer has the burden to establish that the FTB's determination is incorrect. If the appeal is denied by the BOE, the taxpayer must pay the assessment but may subsequently file a claim for refund as discussed below.

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 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 the refund process, the burden to establish that the taxpayer is entitled to a refund of overpaid taxes is on the taxpayer.

[2] IRC 6201(d).

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 the BOE, the 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 the FTB's action, and fully cooperates with the FTB.

Current state law allows a taxpayer to amend his or her separate return to a joint return within four years from the original due date of the return.

THIS BILL

Provision No. 1: Place Burden of Proof to the FTB

This provision would change the burden of proof from the taxpayer to the FTB with respect to a factual issue related to ascertaining the tax liability of a taxpayer in the following situations:

- Administrative tax proceedings, or
- Court proceedings

This provision would also do the following:

- Define "tax liability" as any tax or fee assessed or determined by the 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 that the FTB meet the "preponderance of evidence" standard of burden of proof for oral hearings before the BOE.
- 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.
- Apply to court and administrative tax proceedings involving assessments or notices of determination issued on or after the operative date of this bill.

Provision No. 2: Require the FTB to Have "Just Cause" to Begin any Audit

This provision would require the FTB to have "just cause" to begin any audit and prohibit the FTB from beginning any audit more than three years from the date a return is filed.

Provision No. 3: Audit Statute of Limitations-Deficiency Assessments

This provision would:

- Reduce the general SOL for the FTB to issue a deficiency assessment from four years to three years.

- In the case of an omission of gross income in excess of 25 percent, reduce the SOL for the FTB to issue a deficiency assessment from six years to three years.

- In the case of a corporation with an omission of gross income in excess of 25 percent, reduce the SOL for FTB to commence, without assessment, a proceeding in court for the collection of tax from six years to three years.

- Reduce the SOL for the FTB to issue a deficiency assessment based on change to a taxpayer's federal return from four years to three years from the date the taxpayer or the IRS notifies the FTB of the change.

- Reduce the SOL for the FTB to issue a deficiency assessment relating to an involuntary conversion from four years after the taxpayer notifies the FTB of the purchase of replacement property, the failure to acquire replacement property within the replacement period, or the intent not to replace the property, to three years after the date the return was filed.

- Reduce the SOL for the FTB to issue a deficiency assessment relating to information reporting requirements for certain foreign and foreign-owned corporations from four years to three years after the date the information is furnished to the FTB.

- Reduce the SOL for the FTB to issue a deficiency assessment relating to the realization of noncash patronage allocations from four years to three years from the date the taxpayer notifies the FTB of the realization.

Provision No. 4: SOL to Amend Return from Separate to Joint

This provision would reduce the SOL for a taxpayer to amend his or her separate return to a joint return from four years to three years from the original due date of the return.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- Historically the burden of proof has been on the taxpayer in tax controversy cases because the taxpayer has possession and control of the records pertaining to his or her own tax return. Under the bill, a taxpayer could refuse to provide the FTB information requested during an audit in an attempt to prevail on appeal by depriving the FTB the evidence necessary to meet the burden of proof.

- This bill would place the burden of proof on the FTB for a deficiency assessment issued by the FTB based on changes to a taxpayer's federal income tax return by the IRS. Changing the burden of proof for cases based on federal audits could require the FTB to reexamine issues already determined by the IRS.

- For franchise and income tax appeals made to the BOE, this bill would be limited to oral hearings. Thus, appeals where the taxpayer waives the right to an oral hearing would not be subject to the change in the burden of proof. Currently most taxpayers waive the right to an oral hearing. If it is the author's intent that this bill apply to all appeals before the BOE, the author may wish to clarify the language to state that the burden of proof would apply to any taxpayer that waives the right to an oral hearing before the 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 operative date of the bill. Consequently, it would not extend to claims for refund. It is recommended that the bill be amended to clarify the provisions of the bill in this regard.

- This bill would require the FTB to have "just cause" to begin any audit, but fails to define just cause. Undefined terms or phrases could lead to disputes with taxpayers and complicate the administration of this bill. It is recommended that this bill be amended to define "just cause."

LEGISLATIVE HISTORY

AB 2195 (Silva, 2009/2010) would have placed the burden of proof on the agency collecting taxes in certain situations, in addition to other provisions not impacting the FTB. The provision that would have changed the burden of proof from a taxpayer to the agency collecting taxes was amended out of AB 2195.

AB 1387 (Tran, 2009/2010) would have would have placed the burden of proof on the agency collecting taxes in certain situations. AB 1387 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 2727 (La Malfa, 2007/2008) would have placed the burden of proof on the agency collecting taxes in certain situations. 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 placed the burden of proof on the agency collecting taxes in certain situations. AB 1600 and SB 633 failed to pass out of the first house by January 31st of the second year of the session.

SB 1222 (Knight, 1999/2000) would have placed the burden of proof on the FTB in court proceedings 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 31st 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 placing the burden of proof on the taxing agencies in any legal action contesting the validity of any tax. This bill failed to pass out of the first house by January 31st 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 placing the burden of proof on the 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 placing the burden of proof on the taxing authority in connection with income taxes paid by California taxpayers. This bill was held in the Assembly Appropriations Committee.

SB 1166 (Hurtt, 1997/1998) would have placed the burden of proof on 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 31st of the second year of the session.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* do not have laws placing the burden of proof on the tax agency comparable to what is proposed by this bill.

The SOL for *Florida, Illinois, Massachusetts*, and *New York* to issue a deficiency assessment is generally 3 years after the date the tax return is filed.

The SOL for *Michigan* and *Minnesota* to issue a deficiency assessment is generally 4 years and 3.5 years respectively, after the date the tax return is filed.

FISCAL IMPACT

The FTB assumes no additional resources would be approved by the Legislature to compensate for the effects of this bill. This bill would not significantly impact the department's costs; rather, this bill would result in Audit and Legal staff spending more time developing cases. Spending more time developing cases combined with the reduction of the SOL for the FTB to issue a deficiency assessment would result in fewer audits conducted and resolved each year.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1006 as Introduced February 18, 2011, Enactment Assumed After June 30, 2011 ($ in Millions)		
2011-12	2012-13	2013-14
-$220	-$500	-$850

This estimate does not include any revenue loss from a decrease in self compliance that may occur due to placing the burden of proof on the FTB. A rule of thumb estimate is that for every 1 percent decrease in compliance under the Personal Income Tax Law and Corporation Tax Law caused by this change, roughly $600 million in tax revenue would be lost.

LEGAL CONCERNS

Although identified as a simple majority vote by the Legislative Counsel, it appears this bill should require a 2/3rds vote of the Legislature due to the passage of Proposition 26 in the November 2010 general election. Proposition 26, among other things, requires that a bill that would result in any taxpayer paying a higher tax to be passed by not less than a 2/3rds vote of the Legislature. The provision of this bill that reduces the SOL for a taxpayer to amend his or her separate return to a joint return could result in some taxpayers paying a higher tax, and as a result, it appears Proposition 26 would apply.

POLICY CONCERNS

This bill might be characterized as conforming California law to federal law; however, it would not limit application of the change in the burden of proof to court proceedings or an individual and small business taxpayer 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.

Without conforming to the federal requirement that the taxpayer meet a 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, placing the burden of proof on the taxing agency for this type of taxpayer would be somewhat insignificant. However, businesses dealing primarily with cash transactions, those in the “underground economy,” could benefit from a change in the burden of proof due to the voluntary compliance nature of providing such information to taxing agencies because this type of taxpayer has sole control of corroborating records.

The current burden of proof requirements reflect the fact that the taxpayer is in control of the records and documents related to their tax return. If the burden of proof is placed on the FTB, the taxpayer may have little or no incentive to maintain accurate documentation. 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.

While this bill would reduce the general SOL for the FTB to issue a deficiency assessment from four years to three years, it would leave unchanged the general four-year SOL for the taxpayer to file a claim for refund. This imbalance could provide a taxpayer the opportunity to wait until after the three-year assessment SOL to file a claim for refund for a tax year, which would prevent the FTB from identifying any offsetting deficiency items for the tax year for which the claim for refund is filed.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: Proponents may argue the provisions of this bill would ease taxpayer burden.

Con: Opposition may argue this bill would be another tool available for a taxpayer to avoid paying the correct amount of tax either by exploiting the burden of proof or by anticipating the decreased likelihood of being audited due to the reduced SOL for the FTB to issue a deficiency assessment.

LEGISLATIVE STAFF CONTACT

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