Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Gorell	Analyst:	Diane Deatherage	Bill Number:	AB 1203
Related Bills:	None	Telephone:	845-4783	Introduced Date:	February 22, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Waive Penalties & Interest Retroactively on Additional Tax Due When Tax Laws are Found Unconstitutional

SUMMARY

This bill would waive interest and penalties assessed on additional tax that is owed due to a court holding a statute unconstitutional.

This analysis will not address the bill's changes to the Sales and Use Tax Law, as they do not impact the department or state income tax revenue.

RECOMMENDATION

No position.

Summary of Suggested Amendments

Amendment 1 would clarify the bill's language to:

- Specify the language on when a statutory provision has been declared unconstitutional by a final decision of an appellate court;
- Address the unnecessary requirement that the taxpayer relied upon the statute;
- Amend the language related to the timeframe under which the taxpayer would be required to pay the additional tax that is owed; and
- Correct the description of the recomputation of the tax for relief from interest and penalties.

REASON FOR THE BILL

The reason for the bill is to prevent undue hardship to taxpayers that would otherwise be subject to interest and penalties as a result of a court holding that a statute is retroactively unconstitutional.

EFFECTIVE/OPERATIVE DATE

This bill would become effective and operative January 1, 2014.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL LAW

Under federal law, interest is imposed on the additional tax assessed from the date that the tax is originally due, until the date the tax is paid. Interest may be abated if there are unreasonable errors or delays by the IRS. The abatement of interest will be considered only if the taxpayer did not contribute to the delay or error.

Under federal law, a request for interest abatement may not be made with the appeal or during Tax Court proceedings on the deficiency. Only after the federal deficiency becomes final can the taxpayer request abatement of interest in a separate procedure.

There are several penalties that may be assessed at the federal level, including the following:

- Failure to File – The penalty is usually 5 percent for each month, or part of a month, that a return is late, but not more than 25 percent. The penalty is based on the tax not paid by the due date (without regard to extensions).
- Failure to Pay – This penalty is ½ of 1 percent (.50 percent) of unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty cannot be more than 25 percent of the unpaid tax and is subject to the penalty relief provisions under reasonable cause.
- Accuracy Related - The penalty is generally equal to 20 percent of the underpayment. The penalty is 40 percent of any portion of the underpayment that is attributable to a gross misstatement, an undisclosed noneconomic substance transaction, or an undisclosed foreign financial asset transaction.
- Underpayment of Estimated Tax – The penalty is an amount equal to the underpayment rate[1] multiplied by the amount of the underpayment. The penalty does not apply if the taxpayer's required estimated tax for the year is less than $1,000 or the taxpayer makes timely estimated tax payments that are at least equal to 90 percent of the current year's tax or 100 percent of the preceding year's tax. Effective for taxable years 2002 and after, a special rule applies to high-income taxpayers with adjusted gross income over $150,000 (or $75,000 if married filing separately) where 110 percent is substituted for 100 percent of the preceding year's tax.

STATE LAW

The California Constitution prohibits an administrative agency, such as the Franchise Tax Board (FTB), from declaring a statute invalid or unenforceable in the absence of an appellate court determination that the statute is unenforceable or unconstitutional.

Like federal law, state law imposes interest on the additional amount of tax assessed from the date that the tax is originally due until the date the tax is paid. Because California conforms to the current federal interest abatement rules, interest may be abated in limited circumstances if there are unreasonable errors or delays by the FTB.

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[1] The underpayment rate is the sum of the Federal short-term rate, as determined by the Secretary of the Treasury, and three percentage points (two percentage points in the case of a corporation).

The FTB may assess penalties, some of which are similar to federal penalty provisions. The following list is not exhaustive:

- Failure to File – The penalty is 5 percent for each month, or part of a month, that a return is late, but not more than 25 percent. The penalty is based on the tax not paid by the due date (without regard to extensions).
- Failure to Pay Tax/Late Payment – This penalty is 5 percent of the total tax unpaid plus ½ of 1 percent for every month the payment of tax is late up to 40 months. This penalty cannot not exceed 25 percent of the total unpaid tax.
- Accuracy Related – The penalty is generally 20 percent of the underpayment of tax. The penalty is 40 percent of any portion of the underpayment that is attributable to a gross misstatement, an undisclosed noneconomic substance transaction, or an undisclosed foreign financial asset transaction.
- Underpayment of Estimated Tax – The penalty conforms to the federal underpayment of estimated tax law, with the modification that the underpayment does not apply if the taxpayer's required estimated tax for the year is less than $500 (or $250 if a married person or registered domestic partner filing separately) instead of the federal amount of $1,000. High-income taxpayers have different estimated tax requirements based on adjusted gross income. In addition, existing law provides for a waiver of the penalty for an underpayment of estimated tax if the underpayment was created or increased by any provision of law that is chaptered during and operative for the taxable year of the underpayment.

THIS BILL

This bill would prohibit the assessment of interest, penalties, or both, with respect to additional tax due for a taxable year if all of the following apply:

- The additional tax is an increase in tax for a taxable year beginning on or after January 1, 2014, to the extent the additional tax is attributable to a court holding that a statute is unconstitutional, and that additional tax is required to be collected from the taxpayer due to that holding, as announced by the FTB;
- The taxpayer relied on that statute when calculating the tax liability; and
- The additional tax is paid within 60 days of the notice of proposed assessment receipt or within the timeframe allowed by an installment payment agreement.

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.

As currently written, the bill would relieve a taxpayer of penalties and interest accrued on additional tax due (difference between tax as recomputed and the amount of tax as originally computed) as a result of a statute that is later held to be unconstitutional by a final court decision if the taxpayer relied on the statute. However, the application of a court decision may result in the taxpayer being subject to the underpayment of estimated tax penalty in the current year of the

final court decision where the taxpayer has made estimated tax payments relying on the unconstitutional provision, but correctly files an original return without computing tax under the unconstitutional provision. If the author intends to include the relief of the underpayment of estimated tax penalty, the author should amend the bill.

This bill would require that the additional tax be paid within 60 days of the receipt of a notice of proposed assessment (NPA) by the board in order for the interest and penalty exclusion to apply. The term "board" may be confusing and should be substituted with "Franchise Tax Board." Amendment 1 would address this implementation consideration.

Because the date a taxpayer received an NPA could be difficult to determine with certainty, the author may wish to amend this bill to refer to a date more easily documented, such as 60 days after the mailing date. For example, an existing statute relating to protesting NPAs provides that a taxpayer may file a protest "within 60 days after the mailing" of each NPA. Amendment 1 contains suggested revision language.

The bill is unclear how partial payments or how multiple issues contained within an NPA with which the taxpayer disagrees would be handled. As a result, if an NPA contained both the unconstitutional statute adjustment and other adjustments, the taxpayer may be forced to pay the additional tax due in order to contest the other adjustments and thus lose their prepayment remedy of protesting and appealing the NPA as to the other adjustments. The author may wish to amend the language to clarify the author's intent.

If the author intends to extend the penalty and interest exclusion to taxpayers that receive correspondence other than an NPA or file an amended return as a result of a court holding, this bill should be amended.

TECHNICAL CONSIDERATIONS

The definition of "court holding" is undefined and not a commonly-used term. Amendment 1 is provided to clarify when a court decision is final, which may be less confusing. In addition, the bill would require taxpayers to rely on the unconstitutional statute, but only taxpayers that relied on the unconstitutional statute would receive an assessment of additional tax. Amendment 1 would delete this superfluous requirement.

This bill requires that the FTB "announce" that the statute is unconstitutional due to a court holding. Under the provisions of Article III, section 3.5, of the California Constitution, the final decision of the appellate court declaring a statute unconstitutional is the event triggering a state agency's (such as the FTB's) authority to no longer enforce the statute (or portion thereof, depending upon the court's decision). Amendment 1 is provided to clarify when a statute is held to be unconstitutional.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* statutes do not specifically address remedies for taxpayers affected by court holdings in which a provision is found unconstitutional. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

Implementing this bill would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Cases in which provisions of the Revenue and Taxation Code have been found unconstitutional are relatively infrequent. In order to determine the potential impact to the General Fund, both the frequency with which a law is found unconstitutional and the amount of tax related to the unconstitutionality would be required. Because the department is unable to predict the frequency and the dollar value of these court determinations, the revenue impact to the General Fund under this bill is unknown.

However, department staff have developed an order-of-magnitude estimate based on current interest rates. For every $10 million in open years' total tax liability, the forgone interest and penalties would be approximately $1 million.

This analysis does not include forgone interest and penalties relating to sales and use tax.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that this bill would prevent undue hardship to taxpayers that would otherwise be subject to interest, and penalties as a result of a court holding that occurred, possibly years after the taxpayer's returns were filed.

Opponents: Some could say that with the state's current fragile economy, modifying the assessment of interest and penalties should be avoided.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1203
As Introduced on February 22, 2013

AMENDMENT 1

On page 2, delete lines 16 through 29, and on page 3, delete lines 1 through 4, and insert:

19396. (a) If, on or after January 1, 2014, any deduction, credit or exclusion provided for in Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001) is finally adjudged unconstitutional or is for any reason finally adjudged invalid, or discriminatory under the California Constitution, or the laws or the Constitution of the United States by an appellate court (within the meaning of Article III, section 3.5 of the California Constitution) and the tax of a taxpayer that filed a return for a taxable year is required to be recomputed for that taxable year by disallowing the deduction, credit, or exclusion, both of the following shall apply:

(1) No penalty shall be imposed with respect to any difference between the amount of the tax as recomputed and the amount of the tax as originally computed.

(2) No interest shall be imposed with respect to that difference in tax for periods prior to the date the taxpayer is notified of the recomputation and the additional tax due.

(b) This section shall only apply if that difference in tax is paid by the taxpayer within 60 days of the date the Franchise Tax Board mails to the taxapayer a notice of proposed assessment with respect to that difference in tax.