

# ANALYSIS OF AMENDED BILL

Author: Sweeney Analyst: Marion Mann DeJong Bill Number: AB 1631

Related Bills: AB 1633, SB 1425, Telephone: (916) 845-6979 Amended Date: 03/02/98  
SB 1478 Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Shift Burden of Proof/"Taxpayer's Rights Protection Act of 1998"

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended February 6, 1998.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED February 6, 1998, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

Under the Revenue and Taxation Code (R&TC), this bill would do the following:

- Shift the burden of proof from taxpayers to the Board of Equalization (BOE) with respect to sales taxes under certain circumstances. This provision does not impact the programs administered by the department.
- Shift the burden of proof from taxpayers to the Franchise Tax Board (FTB) in any court or administrative tax proceeding or in any evaluation of tax compliance with respect to factual or legal issues relevant to ascertaining the liability of a "cooperating taxpayer."
- Require FTB to provide taxpayers, upon their request, with itemized receipts proportionately allocating, in dollars, the taxpayer's total tax payments among specified major expenditure categories.
- Allow a taxpayer to make payment of taxes by making a deposit in the nature of a cash bond to stop the running of interest and still preserve the taxpayer's right to file a claim for refund.

DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

Board Position:

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

Agency Secretary Position:

\_\_\_ S      \_\_\_ O  
 \_\_\_ SA    \_\_\_ OUA  
 \_\_\_ N     \_\_\_ NP  
 \_\_\_ NA    \_\_\_ NAR  
 DEFER TO \_\_\_\_\_

**GOVERNOR'S OFFICE USE**

Position Approved    \_\_\_  
 Position Disapproved \_\_\_  
 Position Noted        \_\_\_

Department/Legislative Director      Date  
 Gerald H. Goldberg                      3/12/98

Agency Secretary                      Date

By:    Date:

Under the Unemployment Insurance Code (UIC), this bill would do the following:

- Provide that interest shall not be charged on penalties and would make related clarifying changes. This provision does not impact the programs administered by the department.
- Amend the due process provisions to allow taxpayers to make partial payments and remain in the appeals process. This provision does not impact the programs administered by the department.

#### SUMMARY OF AMENDMENT

The March 2, 1998, amendments made numerous technical changes and made the following changes to the burden of proof provisions:

- Provided that the burden of proof would shift from taxpayers to the BOE or FTB in any evaluation of tax compliance with respect to "legal issues" as well as "factual issues."
- Modified the definition of "cooperating taxpayer" to specify that the taxpayer must provide access to all available relevant books and records "maintained by the taxpayer."

These amendments result in an additional implementation concern regarding the terms "legal issues" and "maintained by the taxpayer" used in the burden of proof provisions since these items are not defined. Undefined terms can lead to disputes between taxpayers and the department.

Except for Amendments 1 and 7, which were included in the March 2 amendment, the department's analysis of the bill as amended February 6, 1998, still applies. Because the March 2, 1998, amendments made substantive changes only to the burden of proof provisions, the policy and implementation considerations discussed in the department's prior analysis only for burden of proof are reiterated below.

### **1. Burden of Proof**

#### Policy Considerations

This provision would raise the following policy considerations.

- Shifting the burden of proof in any court or administrative tax proceeding or in any evaluation of tax compliance would impact every assessment made by the department and could result in reduced compliance and more intrusive audits.

The Tax Executives Institute, representing approximately 5,000 corporate tax professionals, indicated in a letter to the Congressional Ways and Means Committee Chair that its organization fears that shifting the burden of proof would result in a much more intrusive IRS.

Because wage earners' and retired individuals' records 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. Such taxpayers

may be more likely to take aggressive positions on returns and contest audit results. Audits would have to be more thorough to obtain the proof necessary to sustain audit findings.

Further, filing enforcement efforts may be impaired since deficiency assessments issued to taxpayers that do not file returns are sometimes based on limited income information.

- On the other hand, for many taxpayers the income tax system is their only contact with government and the large bureaucracy frightens them. Thus, they may not protest or appeal audit findings even if they believe them incorrect. Proponents believe that this provision would create a better balance between government and taxpayers.
- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California Superior Court actions. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.
- Federal legislation regarding the burden of proof has not been enacted. Generally, state legislation is enacted after federal legislation to allow the state to conform (where applicable) to new federal law. If this bill is enacted and the federal legislation is not enacted or is revised to be different, taxpayers may be confused by the differences in federal and state law. Thus, state legislation in this area may be premature. Further, this provision is much broader than the proposed federal legislation.
- Currently, the taxpayer is asked to substantiate the amounts reported on the return, and deductions are considered to be a matter of legislative grace. The Internal Revenue Code (IRC) and R&TC have few statutes that specifically require substantiation; the requirement to substantiate an item rests mainly in case law regarding burden of proof.
- Unlike Tax Court or other federal courts, the administrative review of tax cases by the BOE is currently performed in an informal environment without extensive evidentiary rules. This is designed to provide a "user friendly" forum to taxpayers contesting their assessment. A shift in the burden of proof would necessitate some formalization of the evidentiary elements of these proceedings. Accordingly, this bill may lead to a "greater balance" between the parties, but may lead to a more formalized hearing process with a greater need for professional representation for taxpayers.

#### Implementation Considerations

This provision would raise the following implementation considerations. Department staff is available to help the author resolve these concerns.

- The terms "administrative tax proceeding," "any evaluation of tax compliance" and "legal issue" are not defined. Undefined terms can lead to disputes between taxpayers and the department. Unless administrative tax proceeding is defined, it is unclear if the burden of proof would shift to FTB at some internal department administrative proceeding or at the BOE (which is the external administrative proceeding).

- The term "cooperating taxpayer" is defined by using several terms that can be interpreted in more than one way. Determining if a taxpayer was cooperating would be difficult. The following examples illustrate some potential issues. (1) Available. If the taxpayer is deducting expenses passed through from a partnership, would the partnership records be considered available to the taxpayer? What about a taxpayer that does not maintain records or destroys the records? (2) Relevant and Reasonable. Taxpayers and FTB may disagree about what is relevant or reasonable. (3) Maintained by the taxpayer. Are books and records maintained by the taxpayer if they are in the possession of an agent (bookkeeper, accountant), general partner or corporate parent?
- The term "relevant books and records" again uses terms that can be interpreted in more than one way (i.e., pertinent, directly related, issue at hand, normally maintained, average prudent businessperson).
- Excluding federal or state tax returns filed with another agency from relevant books and records could result in audit delays. In some cases those records may no longer be available. For example, since the statute of limitations under federal law is shorter than under state law (generally three years instead of four years), the return may no longer be available from the IRS.
- One significant department workload is assessments based upon federal Revenue Agent Reports (changes made by the IRS to gross income or deductions reported on the federal return). Currently, such adjustments are presumed to be correct. It is unclear whether this provision would remove that presumption and require the department to prove that the changes made by the IRS to the federal return are correct.
- In refund cases or in protest cases where the taxpayer asserts a new issue supporting 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.
- Currently, FTB generally retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- The potential of a shift in the burden of proof would require FTB to engage in more extensive evidentiary gathering activities. This may require personnel additions to the audit and legal staff.
- The circumstances under which the burden of proof would shift for tax matters already in progress are unclear. For example, if the taxpayer filed a protest before the bill's effective date, but action was taken after the effective date, would the burden of proof shift to FTB?