

ANALYSIS OF AMENDED BILL

Author: Rainey, et. Al. Analyst: Marion Mann DeJong Bill Number: SB 1478

Related Bills: AB 1631, AB 1633, Telephone: (916) 845-6979 Amended Date: 03/19/98

SB 1425 Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Shift Burden Of Proof/Tax Collecting State Agencies

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 introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 3, 1998, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

This bill would add a new provision to the Government Code to shift the burden of proof from taxpayers to any state agencies collecting taxes in any court or administrative proceeding under certain conditions.

This bill also would make legislative findings and declarations regarding the burden of proof, state tax collection agencies and public perception of the tax system.

SUMMARY OF AMENDMENT

The March 19, 1998, amendments significantly changed the burden of proof provisions and added legislative findings and declarations.

The Legislative History, Background, Departmental Costs and Board Position in the department's analysis of the bill as introduced February 3, 1998, still apply. The remainder of that analysis is replaced with the following.

EFFECTIVE DATE

This bill would become operative on January 1, 1999, and would apply to administrative or court proceedings that begin on or after that date.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position: <input type="checkbox"/> S <input type="checkbox"/> O <input type="checkbox"/> SA <input type="checkbox"/> OUA <input type="checkbox"/> N <input type="checkbox"/> NP <input type="checkbox"/> NA <input type="checkbox"/> NAR <input checked="" type="checkbox"/> PENDING	Agency Secretary Position: <input type="checkbox"/> S <input type="checkbox"/> O <input type="checkbox"/> SA <input type="checkbox"/> OUA <input type="checkbox"/> N <input type="checkbox"/> NP <input type="checkbox"/> NA <input type="checkbox"/> NAR DEFER TO _____	GOVERNOR'S OFFICE USE Position Approved ___ Position Disapproved ___ Position Noted ___ By: _____ Date: _____
Department/Legislative Director Date Gerald H. Goldberg 4/7/98	Agency Secretary Date _____ _____	

SPECIFIC FINDINGS

Under current federal law, taxpayers may be required to keep certain books and records and 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 items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal appeals system, the taxpayer may either: (1) appeal the assessment to the Tax Court (which has a small claims division for amounts of \$10,000 or less), or (2) pay the assessment and file a claim for refund with the IRS. Once the IRS denies the claim, the taxpayer may file suit for refund in an U.S. District Court or the U.S. Court of Claims.

In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

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 certain taxpayers (i.e., water's-edge taxpayers) may be required to keep certain records. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that 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 an assessment, the taxpayer may (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund (in which case the taxpayer may proceed to the Board of Equalization [BOE] or Superior Court if the claim is denied or no action is taken on the claim within six months).

The taxpayer's administrative forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of their position by a preponderance of the evidence.

In the event of a final adverse BOE decision the taxpayer's recourse is to pay the amount due and bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. The FTB is rarely a plaintiff in court. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

This bill, in its legislative findings and declarations, asserts that in all cases in American jurisprudence, other than tax cases, "the burden of proof is upon the government or the plaintiff."

Under current federal and state law, in cases where the IRS or FTB is asserting civil fraud on the part of the taxpayer, the government has the burden of proof, and the standard applied is clear and convincing evidence. In criminal tax matters (intent to evade or fraud), as with other criminal cases, the government has the burden of proving the case beyond a reasonable doubt.

Under current state law regarding jeopardy assessments, the FTB has the burden of proving that a jeopardy exists (Section 19084(a)(4)). However, the taxpayer has the burden of proof in regards to the tax liability.

This bill would shift the burden of proof from taxpayers to any state agency collecting taxes in any court or administrative proceeding with respect to any factual or legal issue relevant to determining the tax liability of a cooperating taxpayer.

This bill would provide the following definitions.

- "State agency" would mean the Franchise Tax Board (FTB), the Board of Equalization (BOE) and the Employment Development Department (EDD).
- "Tax liability" would mean any tax assessed by and owed to a state agency, including any interest charge or penalties levied in association with the tax.
- "Cooperating taxpayer" would mean a taxpayer who provides the state agency relevant records maintained by the taxpayer upon a reasonable request by the state agency. Relevant records would be those records that are directly related to the matter or issue in dispute and are maintained by the taxpayer pursuant to existing law.
- "Administrative proceeding" would mean (1) a hearing before the members of the BOE for disputes concerning taxes collected by the BOE and FTB, and (2) a hearing before the Unemployment Insurance Appeals Board for disputes concerning taxes collected by EDD.
- "Court proceeding" would mean a proceeding in the superior court or any appellate proceeding thereafter.

This bill would provide that the standard for the burden of proof upon state agencies would be a preponderance of the evidence, and that "pursuant to existing

law" the standard for fraud or intent to evade shall remain as clear and convincing evidence.

This bill would not be construed to supersede or limit the application of any legal requirement to substantiate any item.

Policy Considerations

This bill would raise the following policy considerations.

- Shifting the burden of proof in any administrative or court proceeding potentially could 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 instances involving these types of 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. 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.

- 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 (with the exception of civil fraud). The taxpayer is the plaintiff in all California Superior Court actions involving income taxes. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.
- The shift in the burden of proof in this bill concerns any "factual or legal issue" and includes both superior courts and appellate proceedings there after. Appellate courts review questions of law, not fact, in the lower court decision which has been appealed. All factual issues are resolved (or the case is sent back for resolution) prior to the appeal. The standards for appellate review are based upon long-standing statutory and case law determinations concerning the parties and the assertions for review. If the taxpayer is the appellant, it is unclear how a "burden of proof" would shift to the FTB (is the appellate court supposed to become a trier of fact?). It seems that the burden shift would be limited to superior court so that standard appellate review would continue based upon the factual records in the underlying action.

- 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 the same, 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 Revenue and Taxation Code (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 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) Relevant and Reasonable. Taxpayers and FTB may disagree about what is relevant or reasonable. (2) 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?
- 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 and generally are not protested at the state level. 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 for any cases that are contested.
- This bill provides that "pursuant to existing law, the burden of proof in cases involving fraud or intent to evade shall remain as clear and convincing." For civil fraud cases, the standard for the burden of proof is clear and convincing evidence. However, for criminal cases (fraud and

intent to evade) the standard for the burden of proof is beyond a reasonable doubt. This provision would appear to reduce the burden of proof regarding criminal cases and may conflict with constitutional principles of due process.

- The bill does not address whether the burden would remain with the taxpayer if the taxpayer raises "new issues" for the first time at appeal. Under current law, the burden of proof is with the party raising the new issue.
- 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 evidence gathering activities. This may require personnel additions to the audit and legal staff.
- This bill would shift the burden of proof for all administrative or court proceedings beginning on or after January 1, 1999. Due to the rebuttable presumption of correctness that exists under current law the department may not have prepared current cases to meet the shift in the burden of proof. The bill should be effective for assessment which are proposed after January 1, 1999, in order to give the department sufficient time to prepare the factual issues in the case.

Technical Consideration

Amendment 1, requested by the author's staff, would delete unnecessary language from the definition of tax liability. The phrase "by and owed to a state agency" is unnecessary and makes the bill ineffective since taxes are not "owed" until after the administrative proceeding, and court proceedings involve "refunds" not amounts "owed."

FISCAL IMPACT

Tax Revenue Estimate

This bill would result in unknown, but potentially significant, revenue losses.

Tax Revenue Discussion

The revenue losses for this bill would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenue lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "cooperating taxpayer." Currently, the Department has approximately \$120 million of tax assessments in appeals.

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of \$795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact may result from reduced self-assessed reporting, which could have an effect on departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1478
As Amended March 19, 1998

AMENDMENT 1

On page 3, modify lines 25 through 27 as follows:

(2) "Tax liability" means any tax assessed ~~by and owed to a state agency,~~
including any interest charge or penalties levied in association with the tax.