Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Chang	Analyst:	Diane Deatherage	Bill Number:	AB 1450
Related Bills:	None	Telephone:	845-4783	Introduced Date:	February 27, 2015
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Penalty for Failure-to-File after Notice and Demand or Failure-to-Furnish Information after Notice and Demand / Change from 25% to up to 10%

SUMMARY

This bill would modify the penalty for failure-to-file after notice and demand or failure-to-furnish information after notice and demand, hereinafter collectively referred to as the “demand penalty,” under the Administration Franchise and Income Tax Law.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to make the assessment of the demand penalty more equitable by giving the Franchise Tax Board (FTB) authority to adjust the percentage rate of the penalty that would be assessed, taking into account each taxpayer’s good faith effort to comply with the FTB’s demand to file a return or a demand to furnish information, as well as lowering the maximum amount of the penalty to 10 percent.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2016, and operative as of that date.

PROGRAM BACKGROUND

Individuals

A regulation[1] was created to provide specific direction because the demand penalty provision contains discretionary language (states that the FTB "may add a penalty", as opposed to requiring the FTB to impose a penalty). Prior to the regulation, the FTB's historical administrative practice was to issue a Demand for Tax Return immediately in all circumstances, thereby automatically triggering imposition of the penalty where there was a failure to respond by a nonfiler.

[1] Cal. Reg. section 19133.

Board Position:						Executive Officer	Date
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Under the regulation, the FTB will issue a Request for Tax Return to a first time individual nonfiler instead of a Demand for Tax Return. The Request for Tax Return will not trigger a demand penalty unless the taxpayer fails to respond. A taxpayer will only be assessed the demand penalty where the taxpayer fails to timely respond to a current Demand for Tax Return and the taxpayer had also failed to timely respond to a Request for Tax Return or a Demand for Tax Return at any time during the four-taxable-year period preceding the taxable year at issue.

Business Entities

Under existing law, a business entity that fails to file a tax return after receiving a notice of demand to file or fails to furnish information after receiving a notice of demand for information may be subject to a demand penalty.

FEDERAL/STATE LAW

The demand penalty has no federal counterpart.

Under existing state law, the FTB may impose a demand penalty when a taxpayer fails or refuses to furnish information requested by the FTB in writing, or fails or refuses to file a return subsequent to receiving a Demand for Tax Return. The demand penalty is designed to penalize a taxpayer for failing to respond to a notice and demand.

The demand penalty is 25 percent of the tax (for failure to file a return) or 25 percent of the portion of the deficiency relating to the information requested, without taking into account any payments or withholding. The penalty “stacks” on top of the 25 percent failure to file penalty, and can be abated only by a showing of reasonable cause.

To establish reasonable cause, a taxpayer must show that the failure to file the return, reply to the notice and demand, or request for information occurred despite the exercise of ordinary business care and prudence. Examples of reasonable cause include death and illness of the taxpayer, the taxpayer’s records were destroyed by fire or flood, or the taxpayer had a temporary absence from the home.

THIS BILL

This bill would authorize the FTB to impose a variable rate demand penalty of up to 10 percent. When determining the amount of the penalty to impose, the FTB would be required to consider whether the taxpayer has made a good faith effort to comply with the information request or notice and demand.

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.

This bill would apply to failures and refusals to respond that occur on or after January 1, 2016. If the author intends for the bill to apply to notices issued on or after January 1, 2016, regardless of the timing of the failure to respond, this bill should be amended.

The discretion to impose a penalty rate that ranges from zero to 10 percent may result in inconsistent application of the penalty and could lead to increased appeal and litigation costs. The author may wish to amend the language to apply a fixed percentage based on defined circumstances for consistency and equity.

This bill would require the implementation of a resource intensive, manual determination of the penalty percentage rate for every failure or refusal to respond penalty that is assessed. Additionally, the department's accounting and collection systems would require significant modification to allow for such manipulation.

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.

Although *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* laws provide for timeliness penalties (failure-to-pay and failure-to-file), no penalty comparable to the variable rate penalty that this bill would establish. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipates the costs to be significant. As the bill moves through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 1450 As Introduced February 27, 2015 Assumed Enactment After June 30, 2015 ($ in Millions)		
2015-16	2016-17	2017-18
- $7.5	- $20	- $28

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

Revenue Discussion

This estimate is based on current demand penalties assessed and collected by the FTB. In 2012, approximately $270 million in demand penalties were assessed. This value is grown[2] by projected growth in tax returns of 1.5 percent to a total of $286 million in 2016. It is estimated $36 million of the total demand penalty assessments in 2016 would be paid upon notification and $250 million would proceed to collection. After abatement and withdrawals of approximately $62 million, it is assumed 50 percent of the demand penalties would be collected within the first three years of assessment.

The result of reducing the penalty rate from 25 percent to “up to 10 percent” for demand penalties, expected to be collected in 2016, would result in a net revenue loss of approximately $13 million. This revenue loss is the result of both the reduction in penalty rate and taxpayer compliance as a result of the demand penalty reduction. The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the estimates shown in the table above.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say the existing demand penalty is excessive and does not take into account whether or not a taxpayer made a good faith effort to comply with the FTB's notice and demand.

Opponents: Some may argue that by lowering the penalty percentage, the incentive for a taxpayer to respond to a notice and demand may decrease.

LEGISLATIVE STAFF CONTACT

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[2] Indexed using Department of Finance forecasts.