AMNESTY MATTERS

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5	CalTax Submission
6	Chief Counsel Relief of Amnesty Penalty (MR 05-27)
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11	Revenue Estimate - Eliminate Amnesty Penalty for Taxpayers That Made Protective Claims
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SUMMARY OF INTERESTED PARTY ACTION

At the June 15, 2005, meeting of the three-member Franchise Tax Board, staff was directed to work with the taxpayer community and return with specific language to address unintended consequences of amnesty and to protect innocent taxpayers who may be unfairly caught in the system. Specific scenarios discussed by the board where there may be unintended consequences included retroactive law changes and pending federal action. Staff was asked to report back to the board with proposals, including those not selected for recommendation. Finally, staff was asked to consider administrative resolutions as appropriate.

Since the last board meeting, staff has taken the following actions:

6-17-05 Staff scheduled an interested parties meeting for June 23, 2005, at FTB's Sacramento headquarters. This meeting was ultimately rescheduled at the request of the invitees.

7-13-05 The interested parties' meeting is attended by approximately 25 individuals, either in person or via phone. Attendees were asked to describe all of their concerns and proposed solutions. Assignments for development of proposed solutions were also made.

7-15-05 Staff distributed to the interested parties lists of unintended consequences and proposed solutions along with assignments. The lists were circulated for comment and an opportunity to add additional items to the lists.

7-22-05 Staff incorporated comments received from interested parties and distributed updated lists of unintended consequences, proposed solutions, and assignments for development. These lists are included separately in staffs' written materials for this agenda item. Both staff and the interested parties committed to provide written proposals by August 19, 2005, to allow for inclusion in materials for this meeting of the three-member FTB. At the suggestion of one of the members of the taxpayer community, the parties were asked whether they wanted a follow-up meeting. Due to lack of response, a follow-up meeting was not scheduled.

8-19-05 Cal-Tax, representing the taxpayer community, provided its finished written solutions. FTB staff distributed its written solutions and revenue estimates. These written items are included separately in materials for this agenda item.

8-22-05 Interested parties were asked to provide comments to the FTB staff solutions and revenue by August 22, 2005. No additional comments were received.

FTB Amnesty Clean-Up Proposal Project
Revised July 21, 2005

List of Unintended Consequences of Amnesty as Offered by Interested Parties

a. The penalty will be imposed on post-amnesty balances due, including deficiencies and self-assessed amounts, that are the result of post-amnesty changes in law, regulations, or interpretation or application thereof by audit staff that retroactively impact amnesty eligible years.

b. The term "due and payable" as used in Section 19777.5 is not expressly defined for purposes of computing the amnesty penalty and the meaning, therefore, is subject to interpretation.

c. The amnesty penalty, although measured by interest, is not deductible.

d. Protective claim moneys were deposited with FTB in lieu of applying for amnesty. Taxpayers that request a refund of these deposits before the examination process is complete will risk exposure to the amnesty penalty on any post-amnesty deficiencies. For the period that the funds remain on deposit with FTB, it is not otherwise available for business operations or investment.

e. A taxpayer that paid and filed a protective claim will receive under-market interest on amounts refunded.

f. A taxpayer is denied use of any overpayment amounts while underlying audits and protests are completed, which can take several years to resolve under the regular tax controversy process.

g. Certain limited partnerships, including LLCs treated as limited partnerships for tax purposes, and corporations failed to complete the dissolution process with the Secretary of State and therefore, although inactive, remain in existence and continue to be subject to the annual tax (limited partnerships) and to the minimum franchise tax (corporations). These taxpayers will now be subject to the amnesty penalty in addition to the annual tax and the minimum franchise tax. (Revised.)

h. The amnesty penalty will be imposed on post-amnesty deficiencies resulting from disputes that were in the pipeline—i.e., under audit or in pursuit of remedies—at the beginning of amnesty.

i. The amnesty penalty will be imposed on post-amnesty deficiencies resulting from understatements that were due to acts of god, such as natural disasters, acts of terrorism, or other catastrophic events over which the taxpayer had no control.

j. The amnesty penalty will be imposed on federal tax adjustments – i.e. federal RAR adjustments unknown at the beginning of the amnesty. (Added.)

k. The amnesty penalty applies broadly to all taxpayers, but additional protection should be afforded to those taxpayers who either made a good faith effort to estimate and pay potential tax underpayments within the amnesty period or taxpayers who regularly file and pay taxes timely. (Added.)

FTB Amnesty Clean-Up Proposal Project
Revised July 21, 2005

<u>List of Proposed Solutions With Assignments for Development</u>

1. Eliminate the amnesty penalty for all taxpayers that paid in and filed a protective claim for amnesty-eligible years. **FTB – revenue only.**

2. Eliminate or reduce amnesty penalty for taxpayers that didn't file a protective claim or apply for amnesty, but that regularly file and pay taxes on time. **Cal-Tax.**

3. Accelerate the protest process. **Cal-Tax.**

4. Clarify definition of "due and payable." See **March 29, 2005, FTB meeting materials.**

5. Chief Counsel relief of amnesty penalty. **FTB.**

6. Convert amnesty penalty to interest. **FTB.**

7. Eliminate amnesty penalty in situations where there is a post-amnesty change in law, change in interpretation of law, or clarification of law that retroactively impacts amnesty-eligible tax years. **FTB**. (Revised.)

8. Provide limited amnesty penalty relief for inactive limited partnerships and corporations that failed to apply for amnesty. **FTB**.

9. Adjust interest rate paid on overpayments to the protective claim class of corporations to be the same as the rate of interest paid on underpayments. **FTB.**

10. Establish a "good faith determination" exception to the amnesty penalty modeled after Regulation 19164. **Cal-Tax.**

11. Establish reasonable cause exception [for failing to apply for amnesty or understatement of tax]. **Cal-Tax**.

12. Provide for application of reasonable cause exception on an issue-splitting basis. **Cal-Tax.**

13. Create an exception to the amnesty penalty for those taxpayers under audit, protest, appeal, settlement negotiation, or litigation, at the start of amnesty, comparable to the exception to the 40% accuracy-related penalty. **FTB – revenue only.** (Added.)

14. Eliminate the post-amnesty penalty for individual taxpayers with adjusted gross income less than $100,000 (married filing joint) or $50,000 (single, married filing separate). **FTB – revenue only.** (Added.)

Franchise Tax Board

DRAFT ANALYSIS OF AMENDED BILL

Author:	Klehs	Analyst:	Anne Mazur	Bill Number:	AB 1614
Related Bills:	See Legislative History	Telephone:	845-5404	Amended Date:	August 15, 2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Amnesty Clean-Up

SUMMARY

This bill would provide relief to certain taxpayers with respect to the tax amnesty program administered by the department as follows:

1. Increase the interest rate paid on any resulting overpayments the same as the rate of interest paid on underpayments for corporations that made amnesty protective claim payments.
2. Require the department to return amnesty protective claim payments upon taxpayer's written request within 45 days of the request.
3. Provide an exception to the amnesty penalty for underpayments attributable to a post-amnesty change in regulation, legal ruling, or published court decision.
4. Provide an exception to the amnesty penalty for taxpayers that paid at least 90% of the total tax for a taxable year by the last day of amnesty, March 31, 2005.
5. Permit taxpayers to request relief from the amnesty penalty on a pre-payment basis from the Chief Counsel of FTB with post-payment appeal of that determination on an abuse of discretion standard.

Each of these provisions is discussed separately in this analysis. The bill also contains double jointing language to prevent chaptering issues with AB 911 (Chu), as amended June 20, 2005.

SUMMARY OF AMENDMENTS

The August 15, 2005, amendments deleted provision that would have changed the Revenue and Taxation Code relating to Sales and Use Tax Law and inserted clean-up provisions related to the recently concluded income and franchise tax amnesty program.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to prevent an unfair burden on taxpayers that may occur as a result of the tax amnesty program.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR		
_____ N	_____ OUA	_____ PENDING		

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this provision would be effective and generally operative for penalties issued on or after the effective date. According to the author, the intent was to make the provisions of this bill retroactive to the end of amnesty, March 31, 2005. The bill would need to be amended to achieve that result.

POSITION

Pending

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact of AB 1614 (in millions)				
	2004/2005	2005/2006	2006/2007	**Total**
Increase Corporation Overpayment Interest Rate	– $12	– $28	– $44	**– $84**
Return Of Protective Claim Payments Upon Request	none	none	none	**none**
Amnesty Penalty Exclusion For Post-Amnesty Law Changes Affecting Amnesty Years	none	none	none	**none**
90% Safe Harbor For Amnesty Penalty				
Reduction in penalties	– 19	– 7	– 4	**– 30**
Acceleration of protective claims	– 120	60	60	**0**
Chief Counsel Relief Of Amnesty Penalty	– 9	– 3	– 2	**– 14**

Note: Overlap between the 90% safe harbor and chief counsel relief provisions will result in a cumulative total for all proposals that is less than a revenue loss of $128 million.

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

Individual revenue discussions are included separately below for each provision.

1. INCREASE CORPORATION OVERPAYMENT INTEREST RATE

EFFECTIVE /OPERATIVE DATA OF SOLUTION

If this proposal were enacted as an urgency statute, it would be effective upon enactment and apply to determine interest on overpayments attributable to protective claim payments made in lieu of participating in the amnesty program and that were made on or after January 1, 2005, and before April 1, 2005, as of the date the overpayment becomes effective.

ANALYSIS

CURRENT FEDERAL LAW

The interest rate the IRS pays to corporations on overpayments is the short-term federal rate plus two percentage points. The underpayment rate for corporations is the short-term federal rate plus three percentage points. For larger corporate overpayments, i.e., any portion that exceeds $10,000, the rate is reduced to the sum of the short-term federal rate plus one-half of one percentage point. These rates are adjusted quarterly, with each successive rate becoming effective two months after the date of each quarterly adjustment. As of April 1, 2005, the federal interest rate for corporate overpayments was 5% while the rate for underpayments was 6%.

CURRENT STATE LAW

Current state law provides that in the case of any corporation, the overpayment rate specified is to be the lesser of 5% or the bond equivalent rate of 13-week U.S. Treasury bills, beginning on or after July 1, 2002. California modifies federal law by requiring that the overpayment rate for individual taxpayers be the same as the underpayment rate. The adjusted annual rate of interest applies to both overpayments and underpayments. The rate of interest on overpayments and underpayments is determined semi-annually. For the period July 1, 2005, through December 31, 2005, the adjusted annual rate of interest is 5%, except the rate on overpayments of corporate franchise and income tax is 2%.

THIS PROVISION

This provision would increase the overpayment interest rate paid to corporations to 5%, which is equal to the underpayment interest rate, for corporate taxpayers that paid and filed protective claims during amnesty.

IMPLEMENTATION CONSIDERATIONS

The department's Business Entities Tax System (BETS) currently calculates the 2% interest rate on the total amount of an overpayment issued to a corporation. Since this automated system cannot accommodate the change made to the interest rate on an overpayment limited to amnesty protective claims, the interest rate adjustment would need to be done manually by staff.

LEGISLATIVE HISTORY

SB 1100 (Senate Budget Committee, Stats. 2004, Ch. 226), among other things, established a tax amnesty program.

AB 1768 (Oropeza, Stats. 2002, Ch. 1127), among other things, established a lower interest rate to apply to refunds and credits of corporation overpayments.

PROGRAM BACKGROUND

To encourage taxpayers to participate in the Amnesty Program, the amnesty legislation established an additional penalty on amounts owed or new amounts assessed for taxable year 2002 and prior taxable years that were not paid by March 31, 2005, the end of the amnesty period. The penalty is generally equal to 50% of the interest on the amount owed or to be owed.

Protective claims are payments taxpayers estimated might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. A protective claim differs from the traditional claim for refund in that the taxpayer did not have to set forth the specific grounds on which the claim is based at the time the payment was made. As of July 31, 2005, 642 corporate taxpayers made payments and filed protective claims in the amount of approximately $3.5 billion.

FISCAL IMPACT

The department's costs to administer this proposal would require the interest rate adjustment to be done manually by staff as described under Implementation, which would be done at a minor cost to the department.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses annually beginning in 2005-06.

Estimated Impact of Adjusting the Interest Rate On Overpayments to that of Underpayments (in millions)		
2004-05	2005-06	2006-07
-$12	-$28	-$44

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

Revenue Discussion

Prior to the close of the amnesty period, corporations made payments totaling $3.5 billion accompanied by protective claims for refunds. It is estimated that roughly 45% of these payments, or $1.58 billion, will be refunded. The estimate assumes that 1/3 of this amount, $525 million, will be refunded in each of the next three fiscal years. Since most of the overpayments were deposited in March 2005, refunds issued during fiscal year (FY) 2005/06 will, on average, earn interest for 9 months. Refunds issued in FY 2006/07 will, on average, earn interest for 21 months, and refunds issued in 2007/08 will, on average, earn interest for 33 months. The current interest rate differential between overpayments and underpayments of 3% was applied, with compounding where appropriate, to the amounts anticipated to be refunded in each fiscal year (e.g., for refunds issued in 2005/06: $525 million x 3% x .75 years = $12 million in interest).

It should be noted that the assumption above that all issues will be resolved within three years may be too short in some cases. If cases are not all resolved within three years, the total revenue loss from this proposal would increase, but the revenue losses in the first year or two would decrease. Under the state's accruing methods, revenues from these refunds are recognized in the fiscal year prior to the year in which the refund is actually issued.

ARGUMENTS/POLICY CONCERNS

By adjusting the interest rate on overpayments for only the class of corporate taxpayers that paid and filed protective claims to avoid the amnesty penalty and not corporate taxpayers with overpayments outside of amnesty, this proposal could raise a constitutional challenge based on the argument that preferential treatment is given to an identified class of taxpayers.

2. RETURN OF PROTECTIVE CLAIM PAYMENTS UPON REQUEST

ANALYSIS

FEDERAL/STATE LAW

The federal American Jobs Creation Act of 2004 added IRC § 6603, which among other things streamlined and simplified the federal system of applying advance tax deposits to suspend the running of interest. Accordingly, the IRS recently issued procedures applicable to tax deposits made after 10/22/2004. These procedures include instructions for designating remittances as deposits, treatment of undesignated remittances, treatment of deposits made during an examination, treatment of deposits made after an examination, conversion of amounts previously deposited as cash bonds to tax deposits, requests for return of deposits and determination of underpayment interest where a tax deposit has been made.

These new procedures apply only to payments made for a tax year after a return is filed and before a final liability is assessed that are specifically designated as deposits. Payments made before a return is filed are estimated tax payments, on which the statute of limitations runs if no return is filed. Payments made after a final liability is determined are applied to the final liability according to normal payment allocation rules, normally to the year designated, then to the oldest year.

Under current California law—section 19041.5 and FTB Notice 99-9—unless the taxpayer specifically designates an advance payment as a cash bond, it will be treated as a prepayment of tax liability expected to be due for the year and stop the running of deficiency interest as well as earn interest if it is ultimately refunded. FTB will refund any deposit the taxpayer did not designate as a cash-bond on request where there is no final liability.

THIS PROVISION

This provision would require the department to return within 45 days of a written request any payment made by a taxpayer on or after January 1, 2005, and before April 1, 2005, that is not applied to satisfy a liability, including final deficiencies and self-assessed amounts. By its express terms, the provision would not prevent the imposition of the post-amnesty penalty.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 115 (Klehs, 2005/2006), as amended June 20, 2005, would amend section 19041.5 to repeal the cash bond provisions and incorporate the provisions of new IRC section 6603 by reference. These amendments would provide that payments made during protest or appeal would be treated as deposits until the protested or appealed deficiency became final.

FISCAL IMPACT

This provision would not significantly impact the department's costs. Current department procedures can accommodate this proposal and process refund requests within the required time

ECONOMIC IMPACT

This proposal does not impact income tax revenues.

POLICY CONCERNS

The department believes that this provision is declaratory of existing law and that procedures are currently in place to return such advance payments upon request by a taxpayer as contemplated by this provision. As such, the department already has the authority and procedures to accommodate quick returns of deposits as contemplated by this provision. Under current law, unless the taxpayer specifically designates an advance payment as a cash bond under section 19041.5, the payment will be treated as a prepayment of tax liability expected to be due for the year and stop the running of deficiency interest as well as earn interest if it is ultimately refunded. FTB will refund any deposit the taxpayer did not designate as a cash-bond on request where there is no final liability. AB 115 (Klehs), as amended June 20, 2005, would amend section 19041.5 to incorporate the provisions of the new IRC section 6603. As such, payments made during protest or appeal would be treated as deposits until the protested or appealed deficiency became final.

3. AMNESTY PENALTY EXCEPTION FOR POST-AMNESTY LAW CHANGES AFFECTING AMNESTY YEARS

ANALYSIS

STATE LAW

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that did not participate, but had an outstanding balance at the end of amnesty, would be subject to a penalty in an amount equal to 50% of the current interest owing on their account. In addition, taxpayers that have final amounts become due for amnesty-eligible years after

the conclusion of amnesty, whether from additional assessments or self-assessed amounts, are also liable for the amnesty penalty.

THIS PROVISION

This provision would make an exception to the amnesty penalty for underpayments attributable to a regulation, legal ruling of counsel, or a published federal or California court decision that becomes final after the end of the tax amnesty program period (March 31, 2005).

IMPLEMENTATION CONSIDERATIONS

Implementing this proposal would not significantly impact the department's programs or operations.

This situation contemplated by this provision is common. Generally, any published court decision will impact a year that is open for assessment. This provision would be implemented manually, generally by audit staff in the course of completing an examination. In the case of automated assessments, taxpayers would have to inform the department that an applicable law change exists.

It is the intent of the author that this provision not apply with respect to a taxpayer that is the petitioner in a court case resulting in a published decision. The author may want to amend the provision to clarify this point.

OTHER STATES' INFORMATION

Eleven states[1] and New York City had an amnesty program during 2003. Research showed that of those states, *Illinois, New York*, and *Virginia* imposed strict penalties or interest rate increases and did not expressly provide any relief from those penalties or interest increases for existing assessments or for any future liabilities that occur after the amnesty period.

FISCAL IMPACT

This proposal would not significantly impact the department's costs.

ECONOMIC IMPACT

It cannot be predicted which, if any, laws or regulations will be altered in the future. Consequently, no revenue effect can be assigned to this proposal.

4. 90% SAFE HARBOR FOR AMNESTY PENALTY

ANALYSIS

THIS PROVISION

This provision would provide an exception to the post-amnesty penalty if a taxpayer paid at least 90% of the total tax for a taxable year before the end of the tax amnesty program period (March 31, 2005).

[1] Arizona, Colorado, Florida, Illinois, Kansas, Maine, Massachusetts, Missouri, New York, North Dakota, and Virginia.

IMPLEMENTATION CONSIDERATIONS

The department's taxpayer accounting systems would be reprogrammed to determine whether a taxpayer meets the 90% threshold. These program changes would not significantly impact existing programs and would not require any additional resources. To the extent that this provision has retroactive affect, penalties imposed prior to the effective date of this bill would be manually reviewed and processed.

Department staff assumes that the 90% threshold would be redetermined with each post-amnesty final deficiency or self-assessed amount. A taxpayer that is within the safe harbor with respect to a post-amnesty assessment may no longer meet the threshold if there are additional assessments or self-assessments. If the taxpayer is no longer in the safe harbor, the amount of the penalty would be computed taking into account only those payments made through March 31, 2005. Payments made after that date would be disregarded for purposes of computing the amount of the amnesty penalty.

The bill does not define the term "total tax."

FISCAL IMPACT

The department would incur minor and absorbable costs for systems reprogramming.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue gain or loss from this bill would be as follows:

Estimated Revenue Impact Amnesty Penalty - 90% Safe Harbor Fiscal Year (in millions)			
	2004-05	**2005-06**	**2006-07**
Penalty Reduction	-$19	-$7	-$4
Acceleration	-120	60	60

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

This revenue estimate has two components. The first is a reduction in amnesty penalties. The second is an acceleration effect where taxpayers would withdraw some or all of their protective claim payments upon the adoption of this proposal. Revenue losses from the second component would be offset in future years by either increased payments or reduced refunds at the time the relevant cases are finally resolved.

The department has previously estimated total amnesty penalty revenue to be $168 million. Based on an analysis of those taxpayers who have filed protective claims, it is estimated that approximately 20% of these penalties will be paid by taxpayers with protective claims. Based on the same analysis, this safe harbor provision is estimated to eliminate 90% of these penalties ($168 million x 20% x 90% = $30 million). These losses are distributed across fiscal years based on earlier estimates of the timing of the amnesty penalty payments, and accrued back one year.

This estimate assumes that 5 percent ($170 million) of the $3.5 billion in protective claim payments will be withdrawn in response to this proposal and that the offsets will be spread over a three-year period. The outflow for fiscal year 2005/06 (on a cash-flow basis) will be $170 million less $50 million in offsets that flow back in later during the fiscal year equals $120 million. The remaining offsets will produce revenue gains of $60 million in each of the following two years. All estimates were then accrued back one year.

POLICY CONCERNS

Because 90% of total tax is the bright line for this safe harbor, taxpayers that fail to meet the 90% by even one dollar would still be subject to the penalty.

5. CHIEF COUNSEL RELIEF OF AMNESTY PENALTY

ANALYSIS

STATE LAW

The amnesty penalty imposed under Revenue and Taxation Code section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under section 19101 for the period beginning generally on the original due date of the return for the taxable year to the last date of the amnesty period of March 31, 2005. This penalty applies to balances outstanding on March 31, 2005.

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied for amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

The penalty under section 19777.5(a) is a strict liability penalty, meaning that the penalty is applied without exception if the conditions described above exist. In addition, current law prohibits a taxpayer from filing a claim for refund for any amounts paid in connection with the amnesty penalty.

Taxpayers subject to certain tax shelter-related penalties may request the Chief Counsel of the Franchise Tax Board to grant relief. The standards of such relief depend on the specific penalty. For example, the chief counsel relief of the penalty under section 19773 for a reportable transaction understatement requires all of the following to apply:

- The taxpayer has a history of complying with relevant income tax laws.
- The violation is due to an unintentional mistake of fact.
- Imposing the penalty would be against equity and good conscience.
- Rescinding the penalty would promote compliance with relevant income tax requirements and effective tax administration.

THIS PROVISION

This provision would permit taxpayers to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty after it has been imposed if any of the following criteria exist:

- The taxpayer demonstrates that there was substantial authority, as defined, for the treatment of an item resulting in the underpayment on which the penalty was imposed.
- The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding examination, which results in a final deficiency or self-assessed amount upon which the penalty was imposed.
- Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

Also permit taxpayers to file a claim for refund of an amount paid in connection with the penalty on the grounds that the Chief Counsel's failure to grant relief was an abuse of discretion.

IMPLEMENTATION CONSIDERATIONS

Over 600,000 bills imposing the amnesty penalty will be mailed to taxpayers that did not successfully apply for amnesty and had balances due as of the end of amnesty. A substantial number of taxpayers receiving these bills may request relief. This would result in a high-volume workload for the department to process and analyze each request.

FISCAL IMPACT

This proposal would require additional resources to process a potentially large volume of requests for relief in the first year. FTB staff will continue to develop costs as the bill progresses.

ECONOMIC IMPACT

Revenue Estimate

Based on the assumptions and data discussed below, the revenue loss from this proposal is as follows:

Estimated Revenue Impact Chief Counsel Relief of Amnesty Penalty (in millions)		
2004-05	2005-06	2006-07
-$9	-$3	-$2

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

Based on the department's experience with penalty relief requests relative to other tax programs, it is assumed that the Chief Counsel would abate approximately 10% of amnesty penalties imposed in the initial years, dropping to 7% beginning with 2006/07. One specified standard for penalty relief relates to IRS contact after the end of amnesty for amnesty years. Since the normal federal statute of limitations for the 2002 taxable year will begin to expire in early 2006, the revenue impact resulting from granting relief based on this standard would become negligible in 2006/07.

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FTB Amnesty Clean-Up Proposal Project
Revised August 19~~July 21~~, 2005

List of Unintended Consequences of Amnesty as Offered by Interested Parties

a. The penalty will be imposed on post-amnesty balances due, including deficiencies and self-assessed amounts, that are the result of post-amnesty changes in law, regulations, or interpretation or application thereof by audit staff that retroactively impact amnesty eligible years.

b. The term "due and payable" as used in Section 19777.5 is not expressly defined for purposes of computing the amnesty penalty and the meaning, therefore, is subject to interpretation.

c. The amnesty penalty, although measured by interest, is nonetheless virtually rendered non-deductible for federal purposes.~~not deductible.~~

d. Protective claim moneys were deposited with FTB in lieu of applying for amnesty. Taxpayers that request a refund of these deposits before the examination process is complete will risk exposure to the amnesty penalty on any post-amnesty deficiencies. For the period that the funds remain on deposit with FTB, it is not otherwise available for business operations or investment.

e. A taxpayer that paid and filed a protective claim will receive under-market interest on amounts refunded.

f. A taxpayer is denied use of any overpayment amounts while underlying audits and protests are completed, which can take several years to resolve under the regular tax controversy process.

g. Certain limited partnerships, including LLCs treated as limited partnerships for tax purposes, and corporations failed to complete the dissolution process with the Secretary of State and therefore, although inactive, remain in existence and continue to be subject to the annual tax (limited partnerships) and to the minimum franchise tax (corporations). These taxpayers will now be subject to the amnesty penalty in addition to the annual tax and the minimum franchise tax. (Revised.)

h. The amnesty penalty will be imposed on post-amnesty deficiencies resulting from disputes that were in the pipeline—i.e., under audit or in pursuit of remedies—at the beginning of amnesty.

i. The amnesty penalty will be imposed on post-amnesty deficiencies resulting from understatements that were due to acts of god, such as natural disasters, acts of terrorism, or other catastrophic events over which the taxpayer had no control.

j. The amnesty penalty will be imposed on federal tax adjustments – i.e. federal RAR adjustments unknown at the beginning of the amnesty. (Added.)

k. The amnesty penalty applies broadly to all taxpayers, but additional protection should be afforded to those taxpayers who either made a good faith effort to estimate and pay potential tax underpayments within the amnesty period or taxpayers who regularly file and pay taxes timely. (Added.)

List of Proposed Solutions With Assignments for Development

1. Eliminate the amnesty penalty for all taxpayers that paid in and filed a protective claim for amnesty-eligible years. **FTB – revenue only.**

2. Eliminate or reduce amnesty penalty for taxpayers that didn't file a protective claim or apply for amnesty, but that regularly file and pay taxes on time. **Cal-Tax.**

   The penalty imposed under Section 19777.5(a)(1) and (2) will be waived if a taxpayer has a good history of tax compliance and the taxpayer had a reasonable basis for the return position that resulted in additional tax being due.

   This exception shall not be a blanket tax return exception, but will be decided on an issue-by-issue basis.

3. Accelerate the protest process. **Cal-Tax.**
   The protest process needs to be accelerated. The timeframe from the Notice of Proposed Assessment (NPA) and the end of the protest process should be 24 months. If this deadline is not met, the protest should automatically be deemed denied.

4. Clarify definition of "due and payable." See **March 29, 2005, FTB meeting materials.**

5. Chief Counsel relief of amnesty penalty. **FTB.**
   (a) The Chief Counsel of the Franchise Tax Board may rescind all or any portion of the penalty imposed by this section if the Chief Counsel determines that the taxpayer acted in good faith. Any determination made by the Chief Counsel under this subdivision may be reviewed de novo in an administrative or judicial proceeding.

   (b) Article 3 of Chapter 4 (relating to deficiency assessments), Article 1 of Chapter 6 (relating to claims for refund), and Article 3 of Chapter 6 (relating to suits for refund) shall apply with respect to the assessment, collection, or refund of any penalty imposed under this section.

Support for the de novo review

"…proceedings before this [SBE] board are de novo and that this board and the Franchise Tax Board are two separate entities."

Appeal of Sierra Production Service, Inc., 90-SBE-010 (Sept. 12, 1990), fn. 4.

"[A] refund action obviates the need for this sort of 'correction' of an SBE determination because the taxpayer's contention is heard de novo in superior court."

Nast v. State Board of Equalization, 46 Cal.App.4th 343, 348 (1996)

6. Convert amnesty penalty to interest. **FTB.**

7. Eliminate amnesty penalty in situations where there is a post-amnesty change in law, change in interpretation of law, or clarification of law that retroactively impacts amnesty-eligible tax years. **FTB**. (Revised.)

8. Provide limited amnesty penalty relief for inactive limited partnerships and corporations that failed to apply for amnesty. **FTB**.

9. Adjust interest rate paid on overpayments to the protective claim class of corporations to be the same as the rate of interest paid on underpayments. **FTB.**

10. Establish a "good faith determination" exception to the amnesty penalty modeled after Regulation 19164. **Cal-Tax. (See #11.)**

11. Establish reasonable cause exception [for failing to apply for amnesty or understatement of tax]. **Cal-Tax**.
    Reasonable Cause Exception: (Responses for #s 10 and 11.)
    The penalty imposed under Section 19777.5(a)(1) and (2) will be waived if a taxpayer was assessed additional tax as a result of:

    1. A disagreement between the taxpayer and the California Franchise Board regarding issues of law or fact that resulted in an underpayment of tax if the increased tax due is attributable to the taxpayer's good faith determination, whether based on the facts or unresolved legal issues, of either:

        a. The components which are a part of one or more unitary businesses for purposes of determining the income derived from or attributable to this state pursuant to Section 25101, or
        b. Amounts which are attributable to the classification of an item as business or nonbusiness income for purposes of Article 2 of Chapter 17 of this part.

12. Provide for application of reasonable cause exception on an issue-splitting basis. **Cal-Tax. (Please refer to #2.)**

13. Create an exception to the amnesty penalty for those taxpayers under audit, protest, appeal, settlement negotiation, or litigation, at the start of amnesty, comparable to the exception to the 40% accuracy-related penalty. **FTB – revenue only.** (Added.)

14. Eliminate the post-amnesty penalty for individual taxpayers with adjusted gross income less than $100,000 (married filing joint) or $50,000 (single, married filing separate). **FTB – revenue only.** (Added.)

MISCELLANEOUS REQUEST 05-27
EXECUTIVE SUMMARY

- **Title:** Chief Counsel Relief of Amnesty Penalty

- **Problem Statement:** The amnesty penalty is imposed automatically for any underpayment related to an amnesty-eligible year and may not be waived or abated for any reason.

- **Proposed Solution:** Permit a taxpayer to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty if one of the following criteria exists:

  - The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding examination, which results in a final deficiency or self-assessed amount upon which the penalty is imposed.
  - Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

  In instances where the chief counsel denies relief, permit the taxpayer to file a claim for refund the penalty on the grounds that the chief counsel's action of denying relief was an abuse of discretion.

  This proposal also offers alternatives and identifies variables that could be utilized to provide more targeted relief.

- **Major Concerns/Issues:** Over 600,000 bills imposing the amnesty penalty will be mailed to taxpayers that did not participate in tax amnesty and had balances due at the end of the amnesty period. A substantial number of taxpayers receiving these bills may request relief.

- **Revenue:**

  The revenue loss from this proposal is as follows:

Estimated Revenue Impact For Chief Counsel Relief of Amnesty Penalty (in millions)		
2004-05	2005-06	2006-07
- $ 5	- $ 1	Minor Loss*

*A minor loss is less than $500,000.

2005 Miscellaneous Request
MR 05-27

Title

Chief Counsel Relief of Amnesty Penalty

Introduction

This proposal would allow taxpayers to request chief counsel review for relief of the amnesty penalty if certain criteria are met. This proposal also offers alternatives and identifies variables that could be utilized to provide more targeted relief.

Current State Law

Tax Amnesty

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that chose not to participate in the program are subject to new and enhanced penalties with respect to any new and existing liabilities for amnesty-eligible years.

The amnesty penalty imposed under Revenue and Taxation Code section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under section 19101 for the period beginning generally on the original due date of the return for the taxable year to the last date of the amnesty period of March 31, 2005. This penalty applies to balances outstanding on March 31, 2005.

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied for amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

The penalty under section 19777.5(a) is applied without exception if the conditions described above exist. In addition, current law prohibits a taxpayer from filing a claim for refund for any amounts paid in connection with the amnesty penalty.

Voluntary Compliance Initiative

Taxpayers subject to certain tax shelter-related penalties may request the Chief Counsel of the Franchise Tax Board to grant relief. The standards of such relief depend on the specific penalty. For example, the chief counsel relief of the penalty under section 19773 for a reportable transaction understatement requires <u>all</u> of the following to apply:

- The taxpayer has a history of complying with relevant income tax laws.
- The violation is due to an unintentional mistake of fact.
- Imposing the penalty would be against equity and good conscience.

- Rescinding the penalty would promote compliance with relevant income tax requirements and effective tax administration.

Problem

The amnesty penalty is imposed automatically for any underpayment related to an amnesty-eligible year and may not be waived or abated for any reason.

Proposed Solution

Permit a taxpayer to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty if one of the following criteria exists:

- The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding examination, which results in a final deficiency or self-assessed amount upon which the penalty is imposed.
- Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

In instances where the chief counsel denies relief, permit the taxpayer to file a claim for refund of the penalty on the grounds that the chief counsel's action of denying relief was an abuse of discretion.

Effective/Operative Date of Solution

If this proposal were an urgency statute, it would be effective upon enactment and apply to amnesty penalties imposed under section 19777.5(a) after the end of the amnesty period, i.e., March 31, 2005.

Justification

Permitting a taxpayer to request chief counsel review of the imposition of the amnesty penalty in particular circumstances would allow relief of the penalty where imposition of the penalty would be particularly harsh because the taxpayer either was not aware that the IRS would audit their tax return and propose an adjustment or based on the facts and circumstances of the specific case, it would be against equity and good conscience to impose the penalty.

Implementation

Over 600,000 bills imposing the amnesty penalty will be mailed to taxpayers that did not participate in tax amnesty and had balances due at the end of the amnesty period. A substantial number of taxpayers receiving these bills may request relief.

Fiscal Impact

This proposal would require additional resources to process a potentially large volume of requests for relief in the first year. The resource need would depend on the alternative chosen.

Economic Impact

Based on the assumptions and data discussed below, the revenue loss from this proposal is as follows:

Estimated Revenue Impact For Chief Counsel Relief of Amnesty Penalty (in millions)		
2004-05	2005-06	2006-07
-$ 5	-$ 1	Minor Loss*

*A minor loss is less than $500,000.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Based on the department's experience with penalty relief requests relative to other tax programs, it is assumed that the chief counsel would abate approximately 5% of amnesty penalties imposed in the initial years, dropping to 2% beginning with 2006/07. The drop from 5% to 2% would be attributable to the standard for penalty relief relating to initial IRS contact for audit after the end of amnesty for amnesty years. Since the federal statute of limitations for the 2002 taxable year will begin to expire in early 2006, the revenue impact from granting relief based on this standard would become negligible in 2006/07. The remaining 2% of penalty relief would be attributable to the "equity and good conscience" standard.

Alternatives/Variables

1. Target chief counsel relief with a pre-condition based on taxpayer size, type, or ability to pay.

a. Provide relief only to taxpayers that paid at least 90% of their final tax liability for the relevant tax year by March 31, 2005. This alternative would target relief for those taxpayers that paid a substantial portion of their liability during the amnesty period.

Estimated Revenue Impact Alternative 1a (in millions)		
2004-05	2005-06	2006-07
-$ 3	Minor Loss	Minor Loss

b. Provide relief only to small businesses and lower income individuals. Limiting relief in this manner attempts to target relief to taxpayers that may not have had resources to retain professional representation and to taxpayers that were unable to pay their liability. Small business could be defined for this purpose as a business with total income of less than $5 million and individuals with adjusted gross income less than $100,000 for taxpayers filing a joint return.

Estimated Revenue Impact Alternative 1b (in millions)		
2004-05	2005-06	2006-07
-$ 1	Negligible Loss*	Negligible Loss*

*A negligible loss is less than $150,000.

c. Limit requests for relief to individuals. Limiting relief in this manner attempts to target individuals as a group that may be more likely than business entities to prepare their own returns and represent themselves in handling tax matters.

Estimated Revenue Impact Alternative 1c (in millions)		
2004-05	2005-06	2006-07
-$ 3	Minor Loss	Minor Loss

d. Limit requests for relief to corporations that filed protective claims. This alternative would target those taxpayers that made an effort to estimate their additional tax liabilities.

Estimated Revenue Impact Alternative 1d (in millions)		
2004-05	2005-06	2006-07
Minor Loss	Negligible Loss	Negligible Loss

2. Adopt chief counsel relief proposal included in AB 1614 (Klehs 2005/06) as amended August 15, 2005. The bill is being held in the Senate Revenue and Taxation Committee suspense file. The bill proposed the following:

Permit taxpayers to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty after it has been imposed if one of the following criteria exists:

- The taxpayer demonstrates that there was substantial authority, as defined, for the treatment of an item resulting in the underpayment on which the penalty was imposed.
- The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding examination, which results in a final deficiency or self-assessed amount upon which the penalty would be imposed.
- Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

In addition, permit taxpayers to file a claim for refund of an amount paid in connection with the penalty on the grounds that the chief counsel's failure to grant relief was an abuse of discretion.

Estimated Revenue Impact Alternative 2 AB 1614, as amended June 15, 2005 Chief Counsel Relief (in millions)		
2004-05	2005-06	2006-07
- $9	- $3	- $2

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO MR 05-27

AMENDMENT 1

SEC. 3. Section 19777.5 of the Revenue and Taxation Code is amended to read:

19777.5. (a) There shall be added to the tax for each taxable year for which amnesty could have been requested:

(1) For amounts that are due and payable on the last day of the amnesty period, an amount equal to 50 percent of the accrued interest payable under Section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.

(2) For amounts that become due and payable after the last date of the amnesty period, an amount equal to 50 percent of the interest computed under Section 19101 on any final amount, including final deficiencies and self-assessed amounts, for the period beginning on the last date prescribed by law for the payment of the tax for the year of the deficiency (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.

(b) The penalty imposed by this section is in addition to any other penalty imposed under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part.

(c) This section does not apply to any amounts that are treated as paid during the amnesty program period under paragraph (4) of subdivision (a) of Section 19733 or paragraph (1) of subdivision (b) of Section 19733.

(d) Article 3 (commencing with Section 19031), (relating to deficiency assessments) shall not apply with respect to the assessment or collection of any penalty imposed by subdivision (a).

(e)(1) Notwithstanding Chapter 6 (commencing with Section 19301), a taxpayer may not file a claim for refund or credit for any amounts paid in connection with the penalty imposed in subdivision (a), except as provided in paragraph (2).

(2) A taxpayer may file a claim for refund for amounts paid to satisfy the penalty imposed under subdivision (a) on the grounds that the failure of the Chief Counsel of the Franchise Tax Board (or his or her designee) to abate the penalty, in whole or in part, under the authority of subdivision (f) was an abuse of discretion.

(f)(1) Only the Chief Counsel of the Franchise Tax Board (or his or her designee) may abate all or any portion of a penalty imposed under subdivision (a) in either of the following circumstances:

(A) The penalty imposed under this section, or a portion thereof, is based on an underpayment resulting from a change or

correction by the Commissioner of Internal Revenue or other officer of the United States and the taxpayer was first contacted by the Internal Revenue Service concerning an examination of the return after the last day of the amnesty period specified in Section 19731.

(B) If taking into account all the facts and circumstances, it is against equity and good conscience to hold the taxpayer liable for the penalty imposed under this section (or any portion thereof).

(2) The board's determination on an appeal from the action of the Franchise Tax Board on a claim for refund filed pursuant to paragraph (2) of subdivision (g) shall be limited to whether the failure of the Chief Counsel (or his or her designee) to abate all or any portion of the penalty imposed under this section was an abuse of discretion.

(g) Notwithstanding Section 18415, the amendments made to this section by the act adding this subdivision shall apply to penalties imposed under this section after March 31, 2005.

MISCELLANEOUS REQUEST 05-28
EXECUTIVE SUMMARY

- **Title:** Convert Post-Amnesty Penalty to Additional Interest

- **Problem Statement:** Imposing a penalty on taxpayer accounts with a post-amnesty liability implies wrongdoing by the taxpayer.

- **Proposed Solution:** For assessments issued after a specified date, impose interest at the rate of 150% of the normal underpayment rate instead of imposing the existing post-amnesty penalty.

- **Major Concerns/Issues:** Because of the changes to the INC (nonfiler enforcement) system that would be required, implementing this proposal would result in a delay to the next fiscal year in mailing over 28,000 filing enforcement letters for amnesty years (i.e., 2002 and prior). This would delay collections of approximately $1 million in each of the fiscal years 2004/05 and 2005/06 to 2006/07 and 2007/08.

  Although the increased interest rate contemplated by this proposal is labeled as such, state law is not binding on the federal government. The IRS may determine that this increased interest rate is in fact a nondeductible penalty under the standards articulated in Rev. Rul. 78-196, 1978-1 C.B. 45, attached as an exhibit to the analysis.

- **Revenue:**

  The revenue loss from this proposal is as follows:

Estimated Revenue Impact Convert Post-Amnesty to Additional Interest (in millions)		
2004-05	2005-06	2006-07
- $6	- $4	- $2

2005 Miscellaneous Legislative Request
MR 05-28

Title

Convert Post-Amnesty Penalty to Additional Interest

Introduction

This proposal would convert the existing post-amnesty penalty to increased interest for liabilities that become final after the end of amnesty.

Current Federal/State Law

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that did not participate, but had an outstanding balance at the end of amnesty, would be subject to an amnesty penalty.

The amnesty penalty imposed under Revenue and Taxation Code section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under section 19101 for the period beginning generally on the original due date of the return for the taxable year to the last date of the amnesty period of March 31, 2005. This penalty applies to balances outstanding on March 31, 2005.

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied for amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

This penalty was modeled on the tax shelter penalty imposed by section 19777, which is measured by 100% of the interest payable under section 19101 for the period beginning with the last date prescribed by law for the payment of tax and ending on the date a notice of proposed assessment is mailed. Another tax shelter-related provision increases the underpayment interest rate to 150% of the normal underpayment interest rate for taxpayers that self-assess additional tax from a tax shelter before they are contacted by FTB

Interest, including interest on a tax deficiency, is generally deductible by corporate or individual taxpayers if it is incurred in connection with a trade or business. (*Redlark v. Commissioner* (9th Cir. 1998) 141 F.3d 936.)

For individuals, interest on underpayments is generally suspended if the taxpayer is not notified of an additional liability within 18 months of the date the applicable tax return is filed. The suspension period begins after the close of the 18-month period and ends 15 days after the date the department issues a notice stating the taxpayer's additional liability. Special rules apply with respect to changes resulting from federal action and tax shelter adjustments. Under a different provision, the department may also abate interest, generally, if it is attributable to any unreasonable error or delay by department staff in performing a ministerial or managerial act, or if the IRS abated interest due to an error or delay prior to a final federal determination. Finally, another provision permits the department

to waive interest for certain disaster victims or where a taxpayer demonstrates inability to pay solely because of extreme financial hardship caused by significant disability or other catastrophic circumstance.

Federal and California court decisions provide authority for retroactive application of changes in law:

- The United States Supreme Court in *United States v. Carlton* (1994) 512 U.S. 26, overturned a 9th Circuit Court of Appeals decision that had held a retroactive legislative "correction" to an estate tax provision to be an unconstitutional violation of due process.

- The California Supreme Court in *Preston v. State Bd. of Equalization* (2001) 25 Cal. 4th 197, 224, found that retroactive application of a sales tax statute was permissible where there was unequivocal legislative intent to apply the statutory change retroactively and where the retroactive application did not impair any vested property right of the claimant.

- The California Supreme Court in *Allen v. Franchise Tax Board* (1952) 39 Cal. 2d 109, considered whether an income averaging statute could be applied retroactively to lump sum amounts received in 1940. The statute was an urgency statute that took effect February 4, 1941. FTB argued that the taxpayer's tax liability vested at the close of the taxable year, December 31, 1940, so the February enactment could not change the 1940 liability. The Supreme Court disagreed, holding that liability for tax vested on the original due date for payment (i.e., April 15, 1941).

- The court in *Mudd v. McColgan* (1947) 30 Cal. 2d 463, held that the statute of limitations on assessments could be lengthened for all assessments not already barred by the statute of limitations on the date of enactment. This was followed in *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal. 2d 472.

- The court in *Demartino v. Commissioner* (2d Cir. 1988) 862 F.2d 400, held that former IRC section 6621, which established a 120% increased interest rate on certain tax motivated transaction assessments, was constitutional because it applied only to cases where the statute of limitations had not expired or where no final judicial action had occurred.

Problem

Imposing a penalty on taxpayer accounts with a post-amnesty liability implies wrongdoing by the taxpayer.

Proposed Solution

For assessments issued after a specified date, impose interest at the rate of 150% of the normal underpayment rate instead of imposing the existing post-amnesty penalty.

Effective/Operative Date of Solution

If this proposal is enacted as an urgency statute, it would become effective upon enactment. The provision would apply with respect to liabilities that become final after the end of the amnesty period, i.e., March 31, 2005.

Justification

Imposing an increased interest rate more accurately connotes a fiscal remedy for a post-amnesty liability.

Implementation

The department has identified the following implementation concerns:

This proposal would require the department to mail correction letters to any taxpayer that receives a bill for the post-amnesty penalty before enactment of this proposal to notify them of the change to increased interest.

Since this proposal would require reprogramming to the INC (nonfiler enforcement) system, implementing this proposal would result in a delay to the next fiscal year for mailing over 28,000 filing enforcement letters for amnesty years (i.e., 2002 and prior). See Revenue Discussion, below.

Fiscal Impact

The estimated cost to implement this proposal would be approximately $550,000 for modification of the individual and corporate tax systems to make the conversion from penalty to additional interest. Due to any potential delay in reprogramming, staff would have to manually process the increased interest rate until system changes become operational. Corrective notices would also have to be issued for any bills mailed before enactment of this proposal that should have reflected an increased interest rate rather than a penalty. Staff does not anticipate a large volume for this manual workload.

Conversion of the penalty to interest may result in a higher volume of requests for interest waiver to mitigate the additional amount of interest due. Department staff would be able to manage this workload with a minimal disruption to other workloads.

Economic Impact

Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this proposal would be as follows:

Estimated Revenue Impact Convert Post-Amnesty to Additional Interest (in millions)		
2004-05	2005-06	2006-07
- $6	- $4	- $2

Revenue Discussion

This proposal would impact revenue as follows:

- exposing affected revenues to interest abatement and suspension provisions,
- increasing taxpayer deductions in the year the interest payments are made, and
- decelerating revenues from the delay in mailing certain filing enforcement letters in order to implement this proposal.

Abatements and Suspensions: The amount of penalty revenue for the entire amnesty program that would be converted to interest by this provision was previously estimated to be $168 million. It is estimated that exposure to abatement and suspension provisions will reduce this amount by approximately 5%, resulting in reduced revenue of $8 million. The timing of these losses is assumed to follow the same pattern as the timing of the original penalty estimate: - $5 million, - $2 million, and - $1 million, in 2004/05, 2005/06, and 2006/07, respectively.

Interest Deductions: The portion of the additional interest that is paid in connection with a trade or business is deductible. The estimate assumes that 55% of the $160 million ($168 million - $8 million in suspensions and abatements) in interest payments will be deductible as business expenses. Assuming a 6% average tax rate on these deductions, the total revenue impact will approximate $5 million ($160 million x 55% x 6%). Only $1 million of this revenue loss will occur in fiscal year 2005/06, $2 million in 2006/07, and the balance of $2 million in later years.

It is further estimated that taxpayers would deduct interest for federal purposes in the amount of $13 million, $28 million, and $25 million, for tax years 2005, 2006, and 2007, respectively.

Deceleration: In addition to the revenue losses described above, there will be a delay in receiving some revenues because Filing Enforcement letters that are ready to be mailed would have to be held until FTB's computer system is updated to reflect the change of assessment from a penalty to additional interest. It is estimated that this delay would result in a loss of $1 million in fiscal years 2004/05 and 2005/06, and a compensating gain of $1 million in fiscal years 2006/07 and 2007/08.

Policy Considerations

Although the increased interest rate contemplated by this proposal is labeled as such, state law is not binding on the federal government. The IRS may determine that this increased interest rate is in fact a nondeductible penalty under the standards articulated in Rev. Rul. 78-196, 1978-1 C.B. 45.

Individual taxpayers would potentially receive a benefit in the form of a reduced interest amount as a result of being able to take into account interest suspension, abatement, or waiver provisions that reduce the amount of interest payable.

The conversion of the penalty to additional interest would be incompatible with other proposals that are currently being submitted, since many of those revise the "penalty." Also, existing provisions relating to the "penalty" such as the prohibition of claiming a refund of the amnesty penalty in section 19777.5(e) would no longer apply.

Legal Consideration

Despite legal authority upholding various retroactive changes in law, some taxpayers may challenge a retroactive imposition of interest as unconstitutional.

Other States

Illinois provides for an amnesty interest rate double that of the normal rate.

Alternative

As an alternative to the solution proposed above, the penalty could be replaced with additional interest equal to the amount of 50% of the interest computed without taking into account interest suspension, abatement, and waiver provisions that would otherwise reduce interest payable. This alternative would be computed in the same manner as the post-amnesty penalty under current law. However, this alternative increases the risk that the IRS will not respect the "interest" characterization of the change and might conclude that it was still a penalty for federal tax purposes.

Estimated Revenue Impact Convert Post-Amnesty to Additional Interest (in millions)		
2004-05	2005-06	2006-07
- $1	- $2	- $1

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS FOR MR 05-28

AMENDMENT 1

Revenue and Taxation Code Section 19777.5 is amended to read:

19777.5. (a) There shall be added to the tax for each taxable year for which amnesty could have been requested:

(1) For amounts that are due and payable on the last day of the amnesty period, an amount equal to 50 percent of the accrued interest payable under Section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.

(2) For amounts that become due and payable after the last date of the amnesty period, ~~an amount equal to 50 percent of the interest computed under Section 19101 on any final amount, including final deficiencies and self-assessed amounts, for the period beginning on the last date prescribed by law for the payment of the tax for the year of the deficiency (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.~~ for the period beginning on the last day prescribed by law for the payment of the tax for the taxable year (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731, interest on that amount shall be paid as provided under Section 19101 but at a rate of 150 percent of the adjusted annual rate established under Section 19521.

(b) The penalty imposed by this section is in addition to any other penalty imposed under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part.

(c) This section does not apply to any amounts that are paid before the end of the amnesty period or are treated as paid during the amnesty program period under paragraph (4) of subdivision (a) of Section 19733 or paragraph (1) of subdivision (b)of Section 19733.

(d) Article 3 (commencing with Section 19031), (relating to deficiency assessments) shall not apply with respect to the assessment or collection of any penalty imposed by subdivision (a).

(e) Notwithstanding Chapter 6 (commencing with Section 19301), a taxpayer may not file a claim for refund or credit for any amounts paid in connection with the penalty imposed in subdivision (a).

Revenue Rulings
Rev. Rul. 78-196, 1978-1 CB 45, IRC Sec(s). 162

Headnote:

Rev. Rul. 78-196, 1978-1 CB 45 -- IRC Sec. 162 (Also Section 163; 1.163-1.)

Reference(s): Code Sec. 162; Reg § 1.162-21

Penalties; savings and loan association liquidity deficiency.

A liquidity deficiency penalty, imposed by the Federal Home Loan Bank Board upon a Federal savings and loan association, that is computed in a manner similar to a computation of interest is a nondeductible fine or penalty within the meaning of section 162(f) of the Code.

Full Text:

Advice has been requested whether, under the circumstances described below, a liquidity deficiency penalty is a "fine or penalty" within the meaning of section 162(f) of the Internal Revenue Code of 1954.

The taxpayer, a Federal savings and loan association, was assessed and paid a liquidity deficiency penalty imposed by the Board of the Federal Home Loan Bank. The penalty was imposed because the taxpayer failed to maintain the level of liquid assets required under the Federal Home Loan Bank Act (the Act), 12 U.S.C. section 1421 (1932), amended by Pub. L. 90-505, 90th Cong., 2d Sess. (September 21, 1968).

The specific issue is whether the liquidity deficiency penalty is in the nature of an interest charge rather than a penalty.

Section 5A of the amendment to the Act provides, in part, that the liquidity requirements are a means for creating meaningful and flexible liquidity in savings and loan associations that can be increased when mortgage money is plentiful, maintained in easily liquidated instruments, and reduced to add to the flow of funds to the mortgage market in periods of credit stringency. More flexible liquidity helps support the two main purposes of the Act, that is, providing sound mortgage credit and a more stable supply of such credit.

In order to further the objectives of the Act, the Federal Home Loan Bank Board is authorized to impose a liquidity deficiency penalty when institutions fail to maintain the required level of liquid assets. The penalty is computed using the amount of the deficiency in required liquid assets for the period the deficiency existed, at a rate not to exceed the highest interest rate charged by the Board on advances of one year or less, plus 2 percent per annum.

Section 162(a) of the Code allows as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(f) of the Code provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law.

Section 1.162-21(a) of the Income Tax Regulations provides, in part, that no deduction shall be allowed under section 162(a) of the Code for any fine or penalty paid to a political subdivision of, or corporation or other entity serving as an agency or instrumentality of, the government of the United States.

Section 1.162-21(b)(1)(ii) of the regulations defines a fine or similar penalty to include an amount paid as a civil penalty imposed by Federal, state, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code.

S. Rep. No. 92-437, 92 Cong., 1st Sess. 73 (1971), 1972-1 C.B. 559, 600, in discussing the applicability of section 162(f) of the Code to civil penalties provides, in part, as follows:

In approving the provisions [section 162(f)] dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) *** .

On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose “penalties” to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing or interest charges than they are fines. It was not intended that this type sanction be disallowed *** .

The Federal Home Loan Bank has been held to be a Federal instrumentality organized to carry out public policy, whose functions are wholly governmental. *See Fahey v. O'Melveny & Meyers,* 200 F.2d 420, 446 (7th Cir. 1952), *cert. denied,* 345 U.S. 952 (1953).

In the instant situation, upon its failure to meet the liquidity requirement, the taxpayer was assessed and has paid a liquidity deficiency penalty to an instrumentality of the United States government for violation of a Federal law. The penalty is punitive in nature for allowing the liquidity deficiency to occur and constitutes a civil penalty within the meaning of section 1.162-21(b)(1)(ii) of the regulations. The penalty is not in the nature of a late filing fee because no ministerial filing deadline is involved. Neither is the penalty in the nature of an interest charge because no funds were borrowed, but rather

there was a liquid funds deficiency. Also, unlike interest, a liquidity deficiency penalty may be, for good cause shown, compromised, remitted, or mitigated, in whole or in part, by the Federal Home Loan Bank Board.

In addition, the fact that the amount of the liquidity penalty is computed by taking the amount of the liquidity deficiency and multiplying it by the annual rate of interest (plus 2 percent) that would be charged to borrow such amount, does not convert the penalty from a civil penalty into an interest charge for the use or forbearance of money. Other examples of nondeductible civil penalties **<Page 46>** computed on the basis of an annual interest rate are the additions to the tax under chapter 68 of the Code. An interest-like (0.5 percent per month) calculation is used to determine the amount of the addition to the tax imposed by section 6651(a)(2) for failure to pay timely the amount shown as a tax on any return, and the amount of such addition has been held not to represent interest but to be a nondeductible penalty under section 162(f). *May v. Commissioner*, 65 T.C. 1114 (1976); *see also Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977), reaching the same conclusion with respect to the section 6651(a)(1) failure to file penalty. Similarly, the 6 percent per annum addition to the tax, provided for in sections 6654 and 6655 of chapter 68 for failure by individuals and corporations to pay estimated income tax, such addition being calculated pursuant to express reference to the annual interest rate provisions in section 6621, is a nondeductible penalty. *S. Rep. No. 1622*, 83rd Cong., 2d Sess. 593, 594 (1954); section 1.162-21(b)(1)(ii) of the regulations.

Accordingly, the liquidity deficiency penalty paid by the taxpayer herein is a “fine or penalty” within the meaning of section 162(f) of the Code and, thus, is not allowable as a deduction on the taxpayer's Federal income tax return.

Document Title: Rev. Rul. 78-196, 1978-1 CB 45 -- IRC Sec(s). 162
Checkpoint Source: Revenue Rulings (1954 - Present)

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MISCELLANEOUS REQUEST 05-29
EXECUTIVE SUMMARY

- **Title:** Amnesty Penalty Relief For Post-Amnesty Changes In Law

- **Problem Statement:** Taxpayers, including those that participated in amnesty, may be subject to the amnesty penalty on any additional tax that becomes due as a result of a retroactive change in the interpretation of law resulting from a court decision, regulation, or ruling that occurs post-amnesty.

- **Proposed Solution:** Amend Revenue and Taxation Code Section 19777.5 to provide exceptions to the amnesty penalty in specified instances.

- **Major Concerns/Issues:** None.

- **Revenue:** It cannot be predicted which, if any, laws or regulations will be altered in the future. Consequently, no revenue effect can be assigned to this proposal.

2005 Miscellaneous Legislative Request
MR 05-29

Title

Amnesty Penalty Relief For Post-Amnesty Changes In Law

Introduction

This proposal would eliminate the amnesty penalty on balance due amounts that are generated as a result of a post-amnesty change in interpretation or application of law.

Current State Law

SB 1100 (Stats. 2004, Ch. 226) authorized the Franchise Tax Board to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that did not participate, but had an outstanding balance at the end of amnesty, would be subject to a penalty in an amount equal to 50% of the current interest owing on their account. In addition, taxpayers that have final amounts become due for amnesty-eligible years after the conclusion of amnesty, whether from additional assessments or self-assessed amounts, are also liable for the amnesty penalty.

Problem

Taxpayers, including those that participated in amnesty, may be subject to the amnesty penalty on any additional tax that becomes due as a result of a retroactive change in the interpretation of law resulting from a court decision, regulation, or ruling that occurs post-amnesty.

Proposed Solution

Amend Revenue and Taxation Code (R&TC) Section 19777.5 to provide exceptions to the amnesty penalty in specified instances.

Effective/Operative Date of Solution

As an urgency statute, this proposal would be effective immediately upon enactment and operative for penalties assessed under R&TC Section 19777.5(a)(2) on after March 31, 2005.

Justification

Penalty relief for underpayments caused by post-amnesty changes in the interpretation or application of law would protect taxpayers from incurring the amnesty penalty in situations where the change in law could not have been reasonably anticipated by taxpayers.

Implementation

Implementing this proposal would not significantly impact the department's programs or operations.

The situation contemplated by this proposal is common. Generally, any published court decision will impact a year that is open for assessment. This proposal would be implemented manually, generally by audit staff in the course of completing an examination. In the case of automated assessments, taxpayers would have to inform the department that an applicable law change exists.

Fiscal Impact

This proposal would not significantly impact the department's costs.

Economic Impact

It cannot be predicted which, if any, laws or regulations will be altered in the future. Consequently, no revenue effect can be assigned to this proposal.

Other States

Eleven states[1] and New York City had an amnesty program during 2003. Research showed that of those states, Illinois, New York, and Virginia imposed strict penalties or interest rate increases and did not provide any relief from those penalties or interest increases for existing assessments or for any future liabilities that occur after the amnesty period.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO MR 05-29

AMENDMENT 1

SECTION. 1. 19777.5. (a) There shall be added to the tax for each taxable year for which amnesty could have been requested:

(1) For amounts that are due and payable on the last day of the amnesty period, an amount equal to 50 percent of the accrued interest payable under Section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.

(2) For amounts that become due and payable after the last date of the amnesty period, an amount equal to 50 percent of the interest computed under Section 19101 on any final amount, including final deficiencies and self-assessed amounts, for the period beginning on the last date prescribed by law for the payment of the tax for the year of the deficiency (determined without regard to extensions) and ending on the last day of the amnesty period specified in Section 19731.

(b) The penalty imposed by this section is in addition to any other penalty imposed under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part.

(c) This section does not apply to any amounts that are treated as paid during the amnesty program period under paragraph (4) of subdivision (a) of Section 19733 or paragraph (1) of subdivision (b) of Section 19733.

(d)(1) For purposes of the computation of the penalty imposed under paragraph (2) of subdivision (a), the amount of interest computed under Section 19101 that would otherwise be used to compute the penalty shall be reduced by the amount of interest attributable to any amounts that become due and payable after the last day of the amnesty period specified in Section 19731, where those additional amounts are the result of a regulation, legal ruling of counsel (within the meaning of subdivision (b) of Section 11340.9 of the Government Code), or a published federal or California court decision that becomes final after the last day of the amnesty period specified in Section 19731 that is applicable for a taxable year beginning before January 1, 2003.

(2) The Franchise Tax Board shall implement this section in a reasonable manner.

(~~d~~e) Article 3 (commencing with Section 19031), (relating to deficiency assessments) shall not apply with respect to the assessment or collection of any penalty imposed by subdivision (a).

(~~e~~f) Notwithstanding Chapter 6 (commencing with Section 19301), a taxpayer may not file a claim for refund or credit for any

amounts paid in connection with the penalty imposed in subdivision (a).

SEC. 2. (a) This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting the necessity are:

To prevent taxpayers from being unfairly penalized under the amnesty program, it is necessary that this act take effect immediately.

(b) The amendments made to Section 19777.5 by this act shall apply to penalties imposed under paragraph (2) of subdivision (a) of that section after March 31, 2005.

MISCELLANEOUS REQUEST 05-30
EXECUTIVE SUMMARY

- **Title:** Relief From The Minimum Franchise Tax, Annual Tax, and Amnesty Penalty

- **Problem Statement:** Inactive business entities that failed to dissolve formally continue to accrue the annual or minimum franchise tax and all related penalties and interest, including the amnesty penalty.

- **Proposed Solutions:**

  Option A: Amend the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL) to provide that the annual tax or the minimum franchise tax would be abated for taxable years prior to January 1, 2003, if the taxpayer:
  - Filed a final return,
  - Ceased doing business in California by the end of that taxable year, and
  - Files a certificate of dissolution or cancellation with the Secretary of State within one year of the date of enactment.

  Abating the tax would also have the effect of eliminating the imposition of the amnesty penalty on those currently outstanding amounts.

  Option B: Amend the PITL and the CTL to provide that the annual tax or the minimum franchise tax would not be assessed for a taxable year after the year for which the final return is filed if two conditions are met: 1) the entity did not thereafter do business in California, and 2) dissolution, surrender, or cancellation of the entity is complete before the end of the 12-month period following the due date for the return for the final year.

- **Major Concerns/Issues:** None.

- **Revenue:**

Option A Estimated Revenue Impact of MR 05-30 Annual/Min Tax & Penalty Elimination					**Option B** Estimated Revenue Impact of MR 05-30 Prospective Elimination of Annual/Min Tax			
Assumed Effective Date 1/1/2005					Assume Effective for TYB 1/1/2005			
(In Millions)					(In Millions)			
Fiscal Years	2004/05	2005/06	2006/07		Fiscal Years	2005/06	2006/07	2007/08
	a/	-$1	a/			b/	-$1	-$1

a/ loss of less than $500,000

b/ loss of less than $250,000

2005 Miscellaneous Legislative Request
MR 05-30

Title

Relief From The Minimum Franchise Tax, Annual Tax, and Amnesty Penalty

Introduction

This proposal would relieve certain inactive business entities from the requirement to pay an annual or minimum franchise tax and the amnesty penalty.

Current State Law

Every corporation (including a limited liability company (LLC) classified as a corporation) incorporated or organized in, qualified to do business in, or doing business in California must annually pay to the state a minimum franchise tax of $800. The minimum franchise tax applies from the earlier of the date of incorporation or organization, qualification, or commencing to do business within California until the date of dissolution, surrender, or if later, the date the corporation ceases to do business in California. This liability exists regardless of whether the corporation is doing business or receiving income.

Every limited partnership, LLC not classified as a corporation, and limited liability partnership (LLP) registered, organized, or doing business in California must annually pay to the state a tax, in an amount equal to the minimum franchise tax, until a Certificate of Cancellation or a Notice of Change of Status, as applicable, is filed with the Office of the Secretary of State (SOS). In addition, an LLC not classified as a corporation must also annually pay a fee determined by the total income of the LLC.

Generally, a corporation, an LLC regardless of how classified, and an LLP organized within the state or registered with SOS must receive a tax clearance certificate from the Franchise Tax Board (FTB) before SOS will file the appropriate termination documents to extinguish the existence of the entity or its qualification to conduct business operations in California.

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that did not participate, but had an outstanding balance due at the end of amnesty, would be subject to a penalty in an amount equal to 50% of the current interest owing on their account. In addition, a penalty is also imposed on amounts that become due after the end of amnesty. This penalty is equal to 50% of the interest computed on the amount due.

Problem

Inactive business entities that failed to dissolve formally continue to accrue the annual or minimum franchise tax and all related penalties and interest, including the amnesty penalty.

Proposed Solutions

Option A: Amend the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL) to provide that the annual tax or the minimum franchise tax would be abated for taxable years prior to January 1, 2003, if the taxpayer:

- Filed a final return,
- Ceased doing business in California by the end of that taxable year, and
- Files a certificate of dissolution or cancellation with SOS within one year of the date of enactment.

Abating the tax would also have the effect of eliminating the imposition of the amnesty penalty on those currently outstanding amounts.

Option B: Amend the PITL and the CTL to provide that the annual tax or the minimum franchise tax would not be assessed for a taxable year after the year for which the final return is filed if two conditions are met: 1) the entity did not thereafter do business in California, and 2) dissolution, surrender, or cancellation of the entity is complete before the end of the 12-month period following the due date for the return for the final year.

Effective/Operative Date of Solution

If enacted as a tax levy or with urgency, this proposal would be effective immediately. Option A would be operative for taxable years beginning before January 1, 2003. Option B would be operative for taxable years beginning on or after January 1 of the year in which the provision becomes effective.

Justification

Eliminating the minimum franchise tax, annual tax, and amnesty penalty on inactive business entities that have failed to dissolve or cancel their existence formally provides relief for taxpayers that erroneously believed their liability was extinguished when they filed a final return.

Implementation

Implementing this proposal would not significantly impact the department programs or operations.

Fiscal Impact

This proposal would not significantly impact the department's costs.

Economic Impact

Based on data and assumptions discussed below, this proposal would result in the following revenue losses.

Option A

The revenue loss for Option A is approximately $1.8 million assigned to fiscal years as follows:

Option A Estimated Revenue Impact of MR 05-30 Annual/Min Tax & Penalty Elimination			
Effective Date 1/1/2006			
(In Millions)			
Fiscal Year	2004/05	2005/06	2006/07
	a/	-1	a/

a/ loss of less than $500,000

Tax Revenue Discussion:

This proposal would reduce revenues from entities that 1) filed a final return during the amnesty years, 2) have not yet formally dissolved with the SOS, 3) would have formally dissolved in the future absent this proposal, and 4) would have paid their outstanding tax liabilities upon dissolution.

Each year approximately 450 corporations that filed their final return three or more years ago revive in order to dissolve. This proposal includes entities other than reviving corporations, it is estimated that approximately 600 taxpayers would be affected by this proposal. Because most of these taxpayers will be relieved of multiple years of minimum tax payments, the amnesty penalty, and interest, it is assumed that the average revenue loss per taxpayer from this proposal is $3000. The total revenue loss would be $1.8 million (600 x $3000).

Option B

The revenue loss for Option B is approximately $1 million annually as follows:

Option B Estimated Revenue Impact of MR 05-30 Prospective Elimination of Annual/Min Tax			
Effective Date 1/1/2006			
(In Millions)			
Fiscal Year	2005/06	2006/07	2007/08
	b/	-$1	-$1

b/ loss of less than $250,000

Tax Revenue Discussion:

For entities that file a final return on or after January 1, 2005, this proposal would abate the annual or minimum franchise tax following the filing of the final return, if the dissolution process is completed with the SOS within a 12-month period.

Based on departmental data, it is estimated that approximately 27,000 business entities file a final return annually. Approximately 50%, or 13,500 of these entities formally dissolve within the first year after filing their final return. Assuming that 50% of the remaining entities, or 6,750 generate a new tax liability between the time they file their final return and the time they dissolve, and that 20% or 1,350 of these liabilities are collected, the annual revenue loss is approximately $1 million (1,350 X 800).

Policy Considerations

Because Option A lacks prospective relief the problem would continue to reoccur.

Other States

The states of Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York were reviewed because the tax laws in those states have similarities to California's tax laws.

Each of these states has a different process for allowing business entities to dissolve, cancel, or withdraw. Generally, each of these states requires that the business entity resolve any tax obligations prior to the state recognizing the business entity dissolution, cancellation, or withdrawal.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS FOR MR 05-30

OPTION A

AMENDMENT 1

Section 17937 is added to the Revenue and Taxation Code to read:

17937. (a) A limited partnership shall not be subject to the tax imposed by this chapter for a taxable year beginning before January 1, 2003, if the limited partnership did not conduct business in this state during the taxable year and does all of the following:

(1) Filed with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Did not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a certificate of cancellation with the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code before the end of the twelve-month period following the effective date of the Act adding this section.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633 that is filed on or before the due date of the return (as extended) that the taxpayer designated in the manner prescribed by the Franchise Tax Board as the taxpayer’s final tax return.

(c) No refund or credit shall be allowed pursuant to this section for amounts paid prior to the effective date of the act adding this section.

AMENDMENT 2

Section 17947 is added to the Revenue and Taxation Code to read:

17947. (a) A limited liability company shall not be subject to the tax and fee imposed by this chapter for a taxable year beginning before January 1, 2003, if the limited liability company did not conduct business in this state during the taxable year and does all of the following:

(1) Filed with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Did not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a certificate of cancellation with the Secretary of State pursuant to Section 17356 or 17455 of the Corporations Code before the end of the twelve-month period following the effective date of the Act adding this section.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633.5 that was filed on or before the due date of the return (as extended) that the taxpayer designated in the manner prescribed by the Franchise Tax Board as the taxpayer’s final tax return.

(c) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the tax imposed under this chapter for a taxable year after the taxable year for which the final tax return described in paragraph (1) of subdivision (a) was filed.

(d) No refund or credit shall be allowed pursuant to this section for amounts paid prior to the effective date of the act adding this section.

AMENDMENT 3

Section 17948.3 is added to the Revenue and Taxation Code to read:

17948.3. (a) A registered limited liability partnership shall not be subject to the tax imposed by this chapter for a taxable year beginning before January 1, 2003, if the registered limited liability partnership did not conduct business in this state during the taxable year and does all of the following:

(1) Filed with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Did not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a notice with the Secretary of State pursuant to Section 16954 or 16960 of the Corporations Code before the end of the twelve-month period following the effective date of the Act adding this section.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633 that was filed on or before the due date of the return (as extended) that the taxpayer designated in the manner prescribed by the Franchise Tax Board as the taxpayer’s final return.

(c) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the tax imposed under this chapter for a taxable year after the taxable year for which the final tax return described in paragraph (1) of subdivision (a) was filed.

(d) No refund or credit shall be allowed pursuant to this section for amounts paid prior to the effective date of the act adding this section.

AMENDMENT 4

Section 23332 of the Revenue and Taxation Code is amended to read:

23332. (a) Except in the case of a taxpayer subject to the provisions of Section 23222a, any taxpayer which is dissolved or withdraws from the state during any taxable year shall pay a tax only for the months of the taxable year which precede the effective date of the dissolution or withdrawal, according to or measured by (1) the net income of the preceding income year or (2) a percentage of net income determined by ascertaining the ratio which the months of the taxable year, preceding the effective date of dissolution or withdrawal, bears to the months of the income year, whichever is the lesser amount. The taxes levied under this chapter shall not be subject to abatement or refund because of the cessation of business or corporate existence of any taxpayer pursuant to a reorganization, consolidation, or merger (as defined by Section 23251). In any event, each corporation shall pay a tax not subject to offset for the period in an amount equal to the minimum tax prescribed by Section 23153.

(b) The provisions of subdivision (a) shall be applied only with respect to taxpayers which dissolve or withdraw before January 1, 1973. On and after that date, the tax for the taxable year in which the taxpayer ceases doing business, dissolves or withdraws shall be determined under the appropriate provisions of Section 23151.1, 23153, 23181, or 23183, whichever is applicable. However, if all of the following conditions are satisfied, a minimum franchise tax shall not be imposed with respect to the taxable year in which a tax clearance certificate is issued by the Franchise Tax Board:

(1) The taxpayer does not do business in this state at any time during that taxable year.

(2) The taxpayer files a certificate of dissolution or surrender with the Secretary of State prior to the beginning of that taxable year, in accordance with Section 1905 or 2112 of the Corporations Code.

(c)(1) A corporation shall not be subject to the minimum franchise tax imposed by this chapter for a taxable year beginning before January 1, 2003, if the corporation did not conduct business in this state during the taxable year and does all of the following:

(A) Filed with the Franchise Tax Board a timely final franchise tax return for a taxable year.

(B) Did not do business in this state after the end of the taxable year for which the final tax return was filed.

(C) Files a certificate of dissolution or surrender with the Secretary of State in accordance with Section 1905 or 2112 of the Corporations Code before the end of the twelve-month period following the effective date of the Act adding this section.

(2) For purposes of this subdivision, a “final franchise tax return” is a return filed pursuant to Section 18601 on or before the due date of the return (as extended) that the taxpayer designated in the manner prescribed by the Franchise Tax Board as the taxpayer’s final return for purposes of the tax imposed under Chapter 2. A final return for purposes of the tax imposed under Chapter 2 is a return filed

pursuant to Section 18601 where the taxpayer is not required to file a subsequent return to reflect the imposition of tax under Chapter 2.

(c) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the minimum franchise tax imposed under this chapter for a taxable year after the taxable year for which the final franchise tax return described in subparagraph (A) of paragraph (1) of this subdivision was filed.

(d) No refund or credit shall be allowed pursuant to this section for amounts paid prior to the effective date of the act adding this section.

OPTION B

AMENDMENT 1

Section 17937 is added to the Revenue and Taxation Code to read:

17937. (a) A limited partnership shall not be subject to the tax imposed by this chapter for a taxable year if the limited partnership does all of the following:

(1) Files with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Does not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a certificate of cancellation with the Secretary of State pursuant to Section 15623 or 15696 of the Corporations Code before the end of the twelve-month period beginning with the due date of the (determined without regard to extension) for the taxable year for which the final tax return described in paragraph (1) is filed.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633 that is filed on or before the due date of the return (as extended) that the taxpayer designates in the manner prescribed by the Franchise Tax Board as the taxpayer’s final tax return.

AMENDMENT 2

Section 17947 is added to the Revenue and Taxation Code to read:

17947. (a) A limited liability company shall not be subject to the tax and fee imposed by this chapter for a taxable year if the limited liability company does all of the following:

(1) Files with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Does not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a certificate of cancellation with the Secretary of State pursuant to Section 17356 or 17455 of the Corporations Code before the end of the twelve-month period beginning with the due date of the return (determined without regard to extension) for the taxable year for which the final tax return described in paragraph (1) is filed.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633.5 that is filed on or before the due date of the return (as extended) that the taxpayer designates in the manner prescribed by the Franchise Tax Board as the taxpayer’s final tax return.

(c) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the tax imposed under this chapter for a taxable year after the taxable year for which the final tax return described in paragraph (1) of subdivision (a) was filed.

AMENDMENT 3

Section 17948.3 is added to the Revenue and Taxation Code to read:

17948.3. (a) A registered limited liability partnership shall not be subject to the tax imposed by this chapter for a taxable year if the registered limited liability partnership does all of the following:

(1) Files with the Franchise Tax Board a timely final tax return for a taxable year.

(2) Does not do business in this state after the end of the taxable year for which the final tax return was filed.

(3) Files a notice with the Secretary of State pursuant to Section 16954 or 16960 of the Corporations Code before the end of the twelve-month period beginning with the due date of the return (determined without regard to extension) for the taxable year for which the final tax return described in paragraph (1) is filed.

(b) For purposes of this section, a “final tax return” is a return described in Section 18633 that is filed on or before the due date of the return (as extended) that the taxpayer designates in the manner prescribed by the Franchise Tax Board as the taxpayer’s final return.

(c) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the tax imposed under this chapter for a taxable year after the taxable year for which the final tax return described in paragraph (1) of subdivision (a) was filed.

AMENDMENT 4

Section 23332 of the Revenue and Taxation Code is amended to read:

23332. (a) Except in the case of a taxpayer subject to the provisions of Section 23222a, any taxpayer which is dissolved or withdraws from the state during any taxable year shall pay a tax only for the months of the taxable year which precede the effective date of the dissolution or withdrawal, according to or measured by (1) the net income of the preceding income year or (2) a percentage of net income determined by ascertaining the ratio which the months of the taxable year, preceding the effective date of dissolution or withdrawal, bears to the months of the income year, whichever is the lesser amount. The taxes levied under this chapter shall not be subject to abatement or refund because of the cessation of business or corporate existence of any taxpayer pursuant to a reorganization, consolidation, or merger (as defined by Section 23251). In any event, each corporation shall pay a tax not subject to offset for the period in an amount equal to the minimum tax prescribed by Section 23153.

(b) The provisions of subdivision (a) shall be applied only with respect to taxpayers which dissolve or withdraw before January 1, 1973. On and after that date, the tax for the taxable year in which the taxpayer ceases doing business, dissolves or surrenders shall be determined under the appropriate provisions of Section 23151.1, 23153, 23181, or 23183, whichever is applicable. However, if all of the following conditions are satisfied, a minimum franchise tax shall not be

imposed with respect to the taxable year in which a tax clearance certificate is issued by the Franchise Tax Board:

(1) The taxpayer does not do business in this state at any time during that taxable year.

(2) The taxpayer files a certificate of dissolution or surrender with the Secretary of State prior to the beginning of that taxable year, in accordance with Section 1905 or 2112 of the Corporations Code.

(c)(1) A corporation shall not be subject to the minimum franchise tax imposed by this chapter for a taxable year if the corporation does all of the following:

(A) Files with the Franchise Tax Board a timely final franchise tax return for a taxable year.

(B) Does not do business in this state after the end of the taxable for which the final franchise tax return was filed.

(C) Files a certificate of dissolution or surrender with the Secretary of State in accordance with Section 1905 or 2112 of the Corporations Code before the end of the twelve-month period beginning with the due date of the return (determined without regard to extension) for the taxable year for which the final franchise tax return described in subparagraph (A) is filed.

(2) For purposes of this subdivision, a “final franchise tax return” is a return filed pursuant to Section 18601 on or before the due date of the return (as extended) that the taxpayer designates in the manner prescribed by the Franchise Tax Board as the taxpayer’s final return for purposes of the tax imposed under Chapter 2. A final return for purposes of the tax imposed under Chapter 2 is a return filed pursuant to Section 18601 where the taxpayer is not required to file a subsequent return to reflect the imposition of tax under Chapter 2.

(3) The Franchise Tax Board may not refuse to issue a tax clearance certificate on the basis of an unpaid liability for the minimum franchise tax imposed under this chapter for a taxable year after the taxable year for which the final franchise tax return described in subparagraph (A) of paragraph (1) of this subdivision was filed.

MISCELLANEOUS REQUEST 05-31
EXECUTIVE SUMMARY

- **Title:** Adjust Interest Rate Paid To Corporations On Overpayments Made In Lieu Of Amnesty To The Rate Of Interest Paid On Underpayments

- **Problem Statement:** Some taxpayers feel that it is unfair to have paid and filed protective claims to avoid the amnesty penalty and receive an under-market interest rate on any amounts that are refunded.

- **Proposed Solution:** For corporate taxpayers that paid and filed protective claims during amnesty, increase the overpayment interest rate to 5%, which is equal to the underpayment interest rate.

- **Justification:** Protective claim moneys were deposited with FTB in lieu of participating in amnesty because the amounts owed by some taxpayers for 2002 and prior taxable years were not certain on March 31, 2005. By equalizing the interest rate for overpayment and underpayment for corporate taxpayers, amounts refunded will bear the same rate of interest as is imposed on an underpayment.

- **Major Concerns/Issues:** By adjusting the interest rate on overpayments for only the class of corporate taxpayers that paid and filed protective claims to avoid the amnesty penalty and not corporate taxpayers with overpayments outside of amnesty, this proposal could raise a constitutional challenge based on the argument that preferential treatment is given to an identified class of taxpayers.

- **Revenue:**

This proposal would result in the following revenue losses annually.

Estimated Impact of Adjusting the Interest Rate On Overpayments to that of Underpayments [$ In Millions]		
2004-05	2005-06	2006-07
-$12	-$28	-$44

MR 05-31

Title

Adjust Interest Rate Paid To Corporations On Overpayments Made In Lieu Of Amnesty To The Rate Of Interest Paid On Underpayments

Introduction

This proposal would create interest equalization for corporate taxpayers that filed protective claims in lieu of participating in amnesty so that any overpayment would bear the same interest rate imposed on underpayments.

Program History/Background

To encourage taxpayers to participate in the Amnesty Program, the legislation established an additional penalty on amounts owed or new amounts assessed for taxable year 2002 and prior taxable years that were not paid by March 31, 2005, the end of the amnesty period. The penalty is equal to 50% of the interest on the amount owed or to be owed.

Protective claims are payments taxpayers estimated might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. A protective claim differs from the traditional claim for refund in that the taxpayer does not have to set forth the specific grounds on which the claim is based. As of July 31, 2005, 642 corporate taxpayers filed protective claims in the amount of approximately $3.5 billion.

Current Federal Law

The interest rate the Internal Revenue Service charges and pays to corporations for overpayments is the short-term federal rate plus two percentage points. The underpayment rate for corporations is the short-term federal rate plus three percentage points. For larger corporate overpayments i.e., any portion that exceeds $10,000, the rate is reduced to the sum of the short-term federal rate plus one-half of one percentage point. These rates are adjusted quarterly, with each successive rate becoming effective two months after the date of each quarterly adjustment. As of July 1, 2002, the federal interest rate for corporate overpayment was 5% while the rate for underpayment was 6%.

Current State Law

Current state law provides that in the case of any corporation, the overpayment rate specified is to be the lesser of 5% or the bond equivalent rate of 13-week U.S. Treasury bills, beginning on or after July 1, 2002. California modifies federal law by requiring that the overpayment rate for individual taxpayers be the same as the underpayment rate. The adjusted annual rate of interest applies to both overpayments and underpayments. The rate of interest on overpayments and underpayments is determined semi-annually. For the period July 1, 2005, through December 31, 2005, the adjusted annual rate of interest is 5%, except the rate on overpayments of corporation franchise (income) tax is 2%.

Problem

Some taxpayers feel that it is unfair to have paid and filed protective claims to avoid the amnesty penalty and receive an under-market interest rate on any amounts that are refunded.

Proposed Solution

For corporate taxpayers that paid and filed protective claims during amnesty, increase the overpayment interest rate to 5%, which is equal to the underpayment interest rate.

Effective/Operative Date of Solution

If this proposal were enacted as an urgency statute, it would be effective upon enactment and apply to any refunded amounts for payments made under a protective claim in lieu of amnesty.

Justification

Protective claim moneys were deposited with FTB in lieu of participating in amnesty because the amounts owed by some taxpayers for 2002 and prior taxable years were not certain on March 31, 2005. By equalizing the interest rate for overpayment and underpayment for corporate taxpayers, amounts refunded will bear the same rate of interest as is imposed on an underpayment.

Implementation

The department's automated Business Entities Tax System (BETS) currently calculates the 2% interest rate on the total amount of an overpayment issued to a corporation. Since this automated system cannot accommodate the change made to the interest rate on an overpayment issued to a corporation, the interest rate adjustment would need to be done manually by staff.

Fiscal Impact

The department's costs to administer this proposal would require the interest rate adjustment to be done manually by staff as described under Implementation, which would be done at a minor cost to the department.

Economic Impact

Tax Revenue Estimate:

Based on data and assumptions discussed below, this provision would result in the following revenue losses annually beginning in 2005-06.

Estimated Impact of Adjusting the Interest Rate On Overpayments to that of Underpayments [$ In Millions]		
2004-05	2005-06	2006-07
-$12	-$28	-$44

Tax Revenue Discussion:

Just prior to the close of the amnesty period, corporations made payments totaling $3.5 billion accompanied by protective claims for refunds. It is estimated that roughly 45% of these payments, or $1.75 billion, will be refunded. The estimate assumes that 1/3 of this amount, $525 million, will be refunded in each of the next three fiscal years. Since most of the overpayments were deposited in March 2005, refunds issued during fiscal year (FY) 2005/6 will, on average, earn interest for 9 months. Refunds issued in FY 2006/7 will, on average, earn interest for 21 months, and refunds issued in 2007/8 will, on average, earn interest for 33 months. The current interest rate differential between overpayments and underpayments of 3% was applied, with compounding of interest where appropriate, to the amounts anticipated to be refunded in each fiscal year (e.g., for refunds issued in 2005-6: $525 million x 3% x .75 years = $12 million in interest). It should be noted that the assumption above that all of these issues will be resolved within three years may be too short in two cases: 1) for taxpayers whose issues require resolution at the federal level before their state assessments become final, and 2) for a taxpayer for whom the proposed increase in interest rate proves to be beneficial. If cases are not all resolved within three years, the total revenue loss from this proposal would increase, but the revenue losses in the first year or two would decrease. Under the state's accruing methods, revenues from these refunds are recognized in the fiscal year prior to the year in which the refund is actually issued.

Policy Consideration

By adjusting the interest rate on overpayments for only the class of corporate taxpayers that paid and filed protective claims to avoid the amnesty penalty and not corporate taxpayers with overpayments outside of amnesty, this proposal could raise a constitutional challenge based on the argument that preferential treatment is given to an identified class of taxpayers.

Other States

A review of *Illinois, Michigan, Massachusetts, Minnesota,* and *New York* laws found these states conform to the federal interest overpayment and underpayment rates. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO MR 05-31

AMENDMENT 1

Section 1. Section 19521 of the Revenue and Taxation Code is amended to read:

Section 19521. 19521. (a) The rate established under this section (referred to in other code sections as "the adjusted annual rate") shall be determined in accordance with Section 6621 of the Internal Revenue Code, except that:

(1) (A) For taxpayers other than corporations, the overpayment rate specified in Section 6621(a)(1) of the Internal Revenue Code shall be modified to be equal to the underpayment rate determined under Section 6621(a)(2) of the Internal Revenue Code.

(B) In the case of any corporation, for purposes of determining interest on overpayments for periods beginning before July 1, 2002, the overpayment rate specified in Section 6621(a)(1) of the Internal Revenue Code shall be modified to be equal to the underpayment rate determined under Section 6621(a)(2) of the Internal Revenue Code.

(C) Except as provided in Section 19734, in ~~In~~ the case of any corporation, for purposes of determining interest on overpayments for periods beginning on or after July 1, 2002, the overpayment rate specified in Section 6621(a)(1) of the Internal Revenue Code shall be modified to be the lesser of 5 percent or the bond equivalent rate of 13-week United States Treasury bills, determined as follows:

(i) The bond equivalent rate of 13-week United States Treasury bills established at the first auction held during the month of January shall be utilized in determining the appropriate rate for the following July 1 to December 31, inclusive. Any such rate shall be rounded to the nearest full percent (or, if a multiple of one-half of 1 percent, that rate shall be increased to the next highest full percent).

(ii) The bond equivalent rate of 13-week United States Treasury bills established at the first auction held during the month of July shall be utilized in determining the appropriate rate for the following January 1 to June 30, inclusive. Any such rate shall be rounded to the nearest full percent (or, if a multiple of one-half of 1 percent, that rate shall be increased to the next highest full percent).

(2) The determination specified in Section 6621(b) of the Internal Revenue Code shall be modified to be determined semiannually as follows:

(A) The rate for January shall apply during the following July through December, and

(B) The rate for July shall apply during the following

January through June.

(b) (1) For purposes of this part, Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), and any other provision of law referencing this method of computation, in computing the amount of any interest required to be paid by the state or by the taxpayer, or any other amount determined by reference to that amount of interest, that interest and that amount shall be compounded daily.

(2) Paragraph (1) shall not apply for purposes of computing the amount of any addition to tax under Section 19136 or 19142.

(c) Section 6621(c) of the Internal Revenue Code, relating to increase in underpayment rate for large corporate underpayments, is modified as follows:

(1) The applicable date shall be the 30th day after the earlier of either of the following:

(A) The date on which the proposed deficiency assessment is issued.

(B) The date on which the notice and demand is sent.

(2) This subdivision shall apply for purposes of determining interest for periods after December 31, 1991.

(3) Section 6621(c)(2)(B)(iii) of the Internal Revenue Code shall apply for purposes of determining interest for periods after December 31, 1998.

(d) Section 6621(d) of the Internal Revenue Code, relating to the elimination of interest on overlapping periods of tax overpayments and underpayments, shall not apply.

SEC. 2. Section 19734 of the Revenue and Taxation Code is amended to read:

19734. (a) Notwithstanding any other provision of this chapter, if any overpayment of tax shown on an original or amended return filed under this article is refunded or credited within 180 days after the return is filed, no interest shall be allowed under Section 19340 on that overpayment.

(b)(1) In the case of any corporation, for purposes of determining interest on overpayments attributable to payments made on or after January 1, 2005, and before April 1, 2005, that were not paid to satisfy an existing final liability, including final deficiencies and self-assessed amounts, the overpayment rate specified in Section 6621(a)(1) of the Internal Revenue Code shall be modified to be equal to the underpayment rate determined under Section 6621(a)(2) of the Internal Revenue Code.

(2) The change in overpayment rate under paragraph (1) shall apply as of the date the overpayment or overpayments specified in paragraph (1) become effective.

REVENUE ESTIMATE

Title

Proposed Solution #1 – Eliminate Amnesty Penalty For Taxpayers That Made Protective Claims

Description of Proposal

This provision would eliminate the post-amnesty penalty for all taxpayers that paid and filed a protective claim for amnesty-eligible years to the extent amounts paid were less than liabilities that become final after amnesty.

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact Eliminate Penalties on Deficiencies For Protective Claim Taxpayers (in millions)		
2004-05	2005-06	2006-07
- $22	- $8	- $4

Tax Revenue Discussion

It has been previously estimated that amnesty penalties will generate $168 million over three years. This estimate assumes that approximately 20% of these penalties will be paid by taxpayers that filed protective claims, but whose protective claims were insufficient to cover their liabilities. The remaining penalties will be paid by taxpayers that did not file protective claims. The timing of the revenue impact is based on the earlier estimate for all amnesty penalties. This estimate is presented on an accrual basis.

REVENUE ESTIMATE

Title

Proposed Solution #13 – Exception To The Amnesty Penalty For Taxpayers Under Audit, Protest, Appeal, Settlement Negotiation, Or Litigation

Description of Proposal

This proposal would create an exception to the amnesty penalty for taxpayers under audit, protest, appeal, settlement negotiation, or litigation at the start of amnesty.

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following foregone penalty collections and potential refunds of protective claim payments.

Estimated Revenue Impact Eliminate The Penalty If Under Audit, Protest, Appeal, Settlement, or Litigation At Start Of Amnesty (in millions)			
	2004-05	2005-06	2006-07
Reduction in Penalties	-$48	-$20	-$10
Refund and Eventual Collection of Protective Claims	-$515	$245	$270

Tax Revenue Discussion

The revenue effects of this proposal would be determined by (1) the amount of foregone amnesty penalty assessments and collections, and (2) the potential refund and eventual collection in subsequent years of protective claim payments by taxpayers under audit, protest, appeal, settlement negotiation, or litigation at the start of the amnesty period.

This provision provides an exception for amnesty penalties assessed in future years for taxpayers that either did not apply for amnesty or that underpaid their franchise or income tax liabilities. It is assumed that creating such an exception to the amnesty penalty for such taxpayers would reduce penalty assessments and collections by up to 50% of estimated amnesty penalty revenue.

Of the $3.5 billion in protective claim payments, $950 million is attributed to taxpayers that were under protest, appeals, or settlement negotiation at the start of amnesty. Creating an exception to the amnesty penalty would result in many of these taxpayers requesting the immediate return of their protective claim payments. The estimate assumes that 80% of the $950 million, or $760 million, of protective claim payments would be withdrawn. As cases are resolved, it is anticipated that payments refunded would be collected over a three-year period. The total outflow for 2005/06 (on a cash-flow basis) would be $760 million. Collections of $245 million in the same fiscal year would flow back in, resulting in a net outflow for 2005/06 of $515 million ($760 million - $245 million = $515 million). Remaining collections would produce revenue gains of $245 million and $270 million in 2006/07 and 2007/08, respectively ($245 million + $245 million + $270 million = $760 million). The estimates are presented on an accrual basis. .

REVENUE ESTIMATE

Title

Proposed Solution #14 – Eliminate Post-Amnesty Penalty For Certain Individual Taxpayers

Description of Proposal

This proposal would eliminate the amnesty penalty for individual taxpayers with adjusted gross income (AGI) less than $100,000 (married filing joint) or $50,000 (single, married filing separate).

Tax Revenue Estimate

Based on data and assumptions discussed below, the personal income tax (PIT) revenue loss from this bill would be as follows:

Estimated Revenue Impact Eliminate Penalty for PIT AGI Limitation (in millions)		
2004-05	2005-06	2006-07
- $8	- $3	- $2

Tax Revenue Discussion

The revenue impact is dependent on the percentage of penalties issued to taxpayers that meet the $50,000/100,000 AGI limitation. Based on their share of tax liability, FTB estimates that taxpayers in this group will incur 15% of PIT amnesty penalties.

Previously, FTB estimated the total revenue impact of the amnesty penalty to be $168 million over three fiscal years. Assuming 50% of this total is PIT, the revenue impact for this proposal is estimated to be a total loss of approximately $13 million ($168 x 50%x 15%) over three fiscal years (- $8 million + - $3 million + - $2 million = - $13 million). This revenue loss is distributed across years in proportion to the earlier penalty estimate and presented on an accrual basis.