

**MISCELLANEOUS REQUEST 05-32
EXECUTIVE SUMMARY**

- **Title:** Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments
- **Problem Statement:** Taxpayers that made a good-faith effort to estimate their post-amnesty liabilities are nevertheless subject to the post-amnesty penalty if their estimate was understated.
- **Proposed Solution:** Amend the law to eliminate all or a portion of the amnesty penalty for those taxpayers that made a protective claim payment. The amount of penalty relief would be 10% of the protective claim payment made before the end of amnesty.
- **Revenue:** This proposal would result in the following revenue losses.

Estimated Revenue Impact Post-Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments Assumes Enactment After June 30, 2006 (in millions)		
2005-06	2006-07	2007-08
- \$5	- \$5	- \$1

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Title

Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments

Introduction

This proposal would eliminate all or a portion of the amnesty penalty for taxpayers that made protective claim payments for anticipated additional post-amnesty tax liabilities.

Current 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 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 (R&TC) 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 program period, (March 31, 2005). This penalty applied to balances outstanding on March 31, 2005.

The post-amnesty penalty imposed under R&TC 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.

Certain taxpayers made "protective claim" payments based on their estimate of amounts that might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. Taxpayers that chose not to apply for amnesty made these payments by the end of the amnesty program period to avoid imposition of the amnesty penalty, as provided under R&TC section 19777.5(a)(2), on any resulting deficiencies. As of September 2005, 830 individuals and business entities made these payments totaling approximately \$3.5 billion.

Problem

Taxpayers that made a good-faith effort to estimate their post-amnesty liabilities are nevertheless subject to the post-amnesty penalty if their estimate was understated.

Proposed Solution

Amend the law to eliminate all or a portion of the amnesty penalty for those taxpayers that made a protective claim payment. The amount of penalty relief would be 10% of the protective claim payment made before the end of amnesty.

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) after the March 31, 2005, end date of the amnesty program period.

Justification

A taxpayer should not be penalized for making a low, but good faith estimate of their post-amnesty liability. This proposal allows for a 10% margin of error before the penalty would be imposed.

Implementation

Implementing this proposal would require programming changes to both the individual and the business entity accounting systems to compute the portion of any additional post-amnesty deficiency or self-assessed amount that would be excused from the amnesty penalty under this proposal.

Fiscal Impact

This proposal would require the department to incur costs to reprogram the individual and business entity accounting systems to compute the portion of any additional post-amnesty deficiency or self-assessed amount that would not be subject to the amnesty penalty under this proposal. Such costs would be approximately \$270,000 and would require a budget augmentation.

Economic Impact

Revenue Estimate

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

Estimated Revenue Impact Post-Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments Assumes Enactment After June 30, 2006 (in millions)		
2005-06	2006-07	2007-08
- \$5	- \$5	- \$1

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Revenue Discussion

Department staff has 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 made tax deposit payments and filed protective claims, but such payments were insufficient to cover their additional post-amnesty liabilities fully. Under this proposal, these taxpayers would be forgiven all or a portion of the post-amnesty penalty. This component of the estimate is derived by assuming that a quarter of post-amnesty penalties that would otherwise be assessed against these taxpayers would be relieved. [$\$168 \text{ million} \times 20\% \times \frac{1}{4} = \8.4 million.]

A second component of this estimate is comprised of taxpayers that made pre-payments for amnesty-eligible years outside of amnesty. Under the proposal, this group of taxpayers also would be forgiven all or a portion of the amnesty penalty. This group is included in a limited but unknown number of taxpayers that would be paying the remaining 80% of \$168 million or \$134 million. For purposes of this estimate, it is assumed that these taxpayers represent 10% of the \$134 million or \$13.4 million. It is assumed that a quarter of post-amnesty penalties that would otherwise be assessed against these taxpayers would be relieved. [$\$13.4 \text{ million} \times \frac{1}{4} = \3.4 million.]

Component estimates were summed and spread across fiscal years in the same proportion and timing of estimated future amnesty penalty assessments and collections. [$\$8.4 \text{ million} + \$3.4 \text{ million} = \$11.8 \text{ million.}$] Estimates are rounded to the nearest million and accrued back one year.

Policy Considerations

Pro:

This proposal recognizes that a reasonable estimate of potential future tax liability is often difficult to determine and that the imposition of the amnesty penalty in these cases would be unfair and inconsistent with the policy behind the post-amnesty penalty. However, this proposal limits that relief to 10% above the protective claim payments to prevent taxpayers who made nominal tax deposit payments from receiving blanket relief from the amnesty penalty under this proposal.

Con:

Many taxpayers relied on the existing 100% test in determining how much to pay in their protective claim.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS FOR MR 05-32

AMENDMENT 1

SECTION 1. Section 19777.X of the Revenue and Taxation Code is added to read:

19777.X. The penalty imposed under paragraph (2) of subdivision (a) of Section 19777.5 shall only apply to the extent the aggregate of final amounts described in that paragraph exceed one hundred ten percent (110%) of the sum of any tax deposits made by a taxpayer within the meaning of section 19041.5 on or before the end of the tax amnesty program period specified in Section 19731.

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 terms of the amnesty program, it is necessary that this act take effect immediately.

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

MISCELLANEOUS REQUEST 05-33 EXECUTIVE SUMMARY

- **Title:** Exception To The Amnesty Penalty For Taxpayers Under FTB Audit, Protest, Appeal, Settlement Negotiation, Or Litigation At The Start Of Amnesty
- **Problem Statement:** The accuracy-related penalty, which was increased for amnesty, includes an express exception for taxpayers in the administrative process at the beginning of amnesty, but no similar exception is afforded for the post-amnesty penalty.
- **Proposed Solution:** Amend the law to eliminate that portion of the amnesty penalty that results from final administrative action for those taxpayers that, as of the February 1, 2005, start date of amnesty, were under audit by the department or were in protest, appeal, administrative settlement negotiation, or litigation for the year at issue.

For purposes of determining whether taxpayers were “under FTB audit” on the start date of amnesty, department staff would rely on the “first contact” standard provided in federal regulations under the accuracy-related penalty provisions. Generally, taxpayers that were first contacted by the FTB for audit on or before February 1, 2005, with respect to an amnesty year would be eligible for relief under this proposal on assessments resulting from that audit for that year.

- **Revenue:** This proposal 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 Assumes Enactment After June 30, 2006 (in millions)			
	2005-06	2006-07	2007-08
Reduction in Penalties	-\$35	-\$35	-\$10
Outflow and Eventual Inflow of Protective Claim Payments	-\$1,570	\$515	\$740

2005 Miscellaneous Legislative Request MR 05-33

Title

Exception To The Amnesty Penalty For Taxpayers Under FTB Audit, Protest, Appeal, Settlement Negotiation, Or Litigation At The Start Of Amnesty

Introduction

This proposal would establish an exception to the amnesty penalty for those taxpayers that were under FTB audit, protest, appeal, settlement negotiation, or litigation at the February 1, 2005, start date of the amnesty program period.

Current 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 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 (R&TC) section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under R&TC 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 applied to balances outstanding on March 31, 2005.

The post-amnesty penalty imposed under R&TC section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in R&TC 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.

For proposed deficiency assessments issued after the end of amnesty relating to amnesty-eligible years, the accuracy-related penalty assessed under R&TC section 19164 is computed based on 40% of the underpayment rather than 20% and applies, generally, as specified in Internal Revenue Code (IRC) section 6662. The 40% rate will not apply to any amnesty-eligible taxable year if, as of the February 1, 2005, start date of amnesty and relating to the tax liability of the taxpayer for that taxable year the taxpayer:

- was under audit by the FTB,
- had filed a protest under R&TC section 19041,
- had filed an appeal under R&TC section 19045,
- was engaged in administrative settlement negotiations under R&TC section 19442, or
- had a pending judicial proceeding in any California court or in any federal court.

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Certain taxpayers made "protective claim" payments based on their estimate of amounts that might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. Taxpayers that chose not to apply for amnesty made these payments by the end of the amnesty period to avoid imposition of the amnesty penalty. As of September 2005, 830 taxpayers made these payments in the amount of approximately \$3.5 billion.

Problem

The accuracy-related penalty, which was increased for amnesty, includes an express exception for taxpayers in the administrative process at the beginning of amnesty, but no similar exception is afforded for the post-amnesty penalty.

Proposed Solution

Amend the law to eliminate that portion of the amnesty penalty that results from final administrative action for those taxpayers that, as of the February 1, 2005, start date of amnesty, were under audit by the department or were in protest, appeal, administrative settlement negotiation, or litigation for the year at issue.

For purposes of determining whether taxpayers were "under FTB audit" on the start date of amnesty, department staff would rely on the "first contact" standard provided in federal regulations under the accuracy-related penalty provisions. Generally, taxpayers that were first contacted by the FTB for audit on or before February 1, 2005, with respect to an amnesty year would be eligible for relief under this proposal on assessments resulting from that audit for that year

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) after the March 31, 2005, end date of the amnesty program period on final amounts that are a direct result of FTB audit, protest, appeal, settlement negotiation or litigation.

Justification

This proposal would provide for consistent treatment of taxpayers in the administrative process at the beginning of amnesty for both the enhanced accuracy-related penalty and the post-amnesty penalty.

Implementation

This proposal would be implemented as a manual workload and would not significantly impact the department's operations.

Fiscal Impact

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

Economic Impact

Revenue Estimate

Based on data and assumptions discussed below, this proposal 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 Assumes Enactment After June 30, 2006 (in millions)			
	2005-06	2006-07	2007-08
Reduction in Penalties	-\$35	-\$35	-\$10
Outflow and Eventual Inflow of Protective Claim Payments	-\$1,570	\$515	\$740

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 return 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 proposal 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, \$2.3 billion is attributed to taxpayers that were under audit, protest, appeals, or settlement negotiation at the start of amnesty. Many of these taxpayers would request return of their protective claim payments under this proposal. The estimate assumes that 80%, or \$1.8 billion, of protective claim payments would be withdrawn by taxpayers. [\$2.3 billion x 80% + \$1.8 billion.] As cases are resolved, it is anticipated that payments returned to taxpayers would flow back in over a six-year period. The outflow for 2005-06 (on a cash-flow basis) would be \$1.83 billion reduced by \$260 million in collections that flow back in later during that fiscal year for a net outflow of \$1.57 billion. Over the succeeding five years, the \$1.57 billion would flow back in. Estimates were then accrued back one year.

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS FOR MR 05-33

AMENDMENT 1

SECTION 1. Section 19777.X of the Revenue and Taxation Code is added to read:

19777.X. (a) The penalty imposed under paragraph (2) of subdivision (a) of Section 19777.5 shall not apply to any amounts that become final after the last day of the amnesty program period specified in Section 19731 for any taxable year of a taxpayer beginning before to January 1, 2003, if, as of the start date of the amnesty program period, the taxpayer is then under audit by the Franchise Tax Board, or the taxpayer has filed a protest under Section 19041, or the taxpayer has filed an appeal under Section 19045, or the taxpayer is engaged in settlement negotiations under Section 19442, or the taxpayer has a pending judicial proceeding in any court of this state or in any federal court relating to the tax liability of the taxpayer for that taxable year, and the amounts that become final are attributable to that FTB audit, protest, appeal, settlement negotiation, or judicial proceeding.

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 terms of the amnesty program, it is necessary that this act take effect immediately.

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