

## LAW SUMMARY NONFILER - FRIVOLOUS ARGUMENTS

### 1. It is the Taxpayer's Responsibility to File a Tax Return.

Every individual subject to tax under the California Personal Income Tax Law and realizing a specified amount of gross income or adjusted gross income must make a return specifically stating items of gross income received from all sources and the deductions and credits allowable. (Revenue and Taxation Code section 18501.) The required return must be made under penalty of perjury and in a form that the Franchise Tax Board may from time to time prescribe. (Revenue and Taxation Code section 18621.)

In assessing income taxes, the government relies upon a taxpayer's disclosure of the relevant facts. The disclosure is required in an annual return, and sanctions are imposed to ensure full and honest disclosure and discourage fraudulent attempts to evade the tax (*Helvering v. Mitchell* (1938) 303 U.S. 391, 399; and *United States v. Richards* (8<sup>th</sup> Cir. 1983) 723 F.2d 646, 648). The filing of an income tax return is not optional; and the average citizen knows this (*Schiff v. United States* (2<sup>nd</sup> Cir. 1990) 919 F.2d 830, 834).

Once a taxpayer realizes the statutory amount of gross or adjusted gross income, he or she has a clear, fixed, and non-delegable duty to file a valid California income tax return by the return due date. (Revenue and Taxation Code section 18501; *Appeal of Thomas K. and Gail G. Boehme*, 85-SBE-134, Nov. 6, 1985; and *Appeal of Roger D. and Mary Miller*, 86-SBE-056, Mar. 4, 1986.)

### 2. The Franchise Tax Board's Assessment Authority.

Article IV, section 1 of the Constitution of the State of California confers the legislative power of the state upon the California Legislature. The prerogative to tax, including tax amounts and methods, is within the Legislature's inherent authority. The Legislature grants the Franchise Tax Board the authority to administer and enforce the California Personal Income Tax Law (Revenue and Taxation Code sections 19252 and 19501). The Franchise Tax Board reserves the authority provided under Part 10.2, Div. 2, Art. 3, of the Revenue and Taxation Code, commencing with section 19031 to determine the correct amount of tax for a tax year and, in the absence of a return providing the information necessary to accurately determine a tax

liability, the authority provided under Revenue and Taxation Code section 19087 to estimate a taxpayer's net income from "any available information" and assess the amount of tax, interest, and penalties due.

For example, each year, the Franchise Tax Board through an automated program matches income information obtained from various reporting sources against filed California income tax returns in order to identify potential non-filers. As part of this automated program, the Franchise Tax Board obtains information such as salary/wage income information reported to the Employment Development Department (EDD) by California employers and from professional and occupational licensing authorities identifying the holders of professional and occupational licenses, who may have conducted business and earned sufficient income during the tax year to prompt a return-filing requirement. In addition, the Franchise Tax Board obtains payment information reported by payors on federal information returns (Form 1099 series) and information reported on federal Form 1098 that a taxpayer had paid significant mortgage interest.

### 3. The Franchise Tax Board's Proposed Assessments are Presumed Correct.

It is well settled that, in appeals before the State Board of Equalization, the Franchise Tax Board's findings when proposing an assessment of additional tax are *prima facie* correct. (*Appeals of Fred R. Dauberger, et al.* 82-SBE-082, Mar. 31, 1982; *Appeal of Michael E. Meyers*, 2001-SBE-020, May 31, 2001; and *Appeals of Robert E. Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005, .) The Franchise Tax Board's initial burden is to show that the proposed assessment is reasonable and rational; if it satisfies this burden, the proposed assessment is presumed to be correct. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509 [201 P.2d 414]; *Appeal of Myron E. and Alice Z. Gire*, 69-SBE-029, Sept. 10, 1969; and *Appeal of Ismael R. Manriquez*, 79-SBE-077, Apr. 10, 1979.) Once established, the presumption of correctness places the burden of proof on the taxpayer. (Cal. Code Regs., tit. 18, section 5541; *Rapp v. Commissioner* (9<sup>th</sup> Cir. 1985) 774 F.2d 932; *Appeal of Myron E. and Alice Z. Gire*, 69-SBE-029, Sept. 10, 1969; and *Appeal of Harold and Lois Livingston*, 71-SBE-038, Dec. 13, 1971.)

**4. The Burden of Proof is on the Taxpayer to Establish that He or She Does Not Have a Filing Obligation.**

A taxpayer may not merely allege that the Franchise Tax Board's proposed assessment is arbitrary (*Appeal of Peter F. and Betty H. Eastman*, 78-SBE-031, May 4, 1978; and *Appeal of Alfons Castillo*, 92-SBE-020, July 20, 1992). Absent any specific information contradicting the proposed assessment, the taxpayer clearly has failed to carry his or her burden of proof (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983). A taxpayer's failure to produce evidence that is within his or her control gives rise to the presumption that such evidence is unfavorable to his or her case (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983).

**5. Frivolous Arguments have been Consistently Rejected.**

Over the years, the State Board of Equalization, the courts, the Internal Revenue Service and the Franchise Tax Board have rejected frivolous arguments consistently and emphatically and have found them to be without any significant merit. (*Appeals of Robert E. Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005; *Appeal of LaVonne A. Hodgson*, 2002-SBE-001, Feb. 6, 2002; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001; *Appeal of Alfons Castillo*, 92-SBE-020, Jul. 30, 1992; *Appeal of Walter R. Bailey*, 92-SBE-001, Feb. 20, 1992; *Appeals of Fred R. Dauberger, et al.*, 82-SBE-082, Mar. 31, 1982.)

For purposes of imposing the frivolous return or frivolous submission penalty pursuant to Internal Revenue Code section 6702 (California's corresponding statute is Revenue and Taxation Code section 19179), the Internal Revenue Service (IRS) has published a list of identified frivolous positions. In accordance with Revenue and Taxation Code Section 19179(c)(1), FTB has adopted the U.S. Secretary of the Treasury's list of frivolous positions. (IRS Notice 2008-14 for submissions filed between January 14, 2008 and April 7, 2010, IRS Notice 2010-33 for submissions after April 7, 2010, and IRS publication, *The Truth About Frivolous Tax Arguments*). This Notice is updated by the IRS at least once a year. In conjunction with these notices, the Internal Revenue Service has issued "The Truth about Frivolous Tax Arguments" which elaborates on the frivolous positions providing further explanation and authority for why these positions are frivolous in order to give guidance to taxpayers. This document is updated by the Internal Revenue Service at least annually. Additionally, for submissions after April 26, 2010, FTB identified as a frivolous position any claim or assertion that the

Information Practices Act (commencing with Section 1798.35 of the Civil Code) applies, directly or indirectly, to the requirement to make and file a valid tax return or to the determination of the existence or possible existence of liability (or the amount thereof) of any person for any tax, penalty, or fee authorized under Part 10 or Part 10.2 of the Revenue and Taxation Code.

**6. Taxpayers Frequently Make Arguments. Which Have Been Determined to be Frivolous.**

a. *Taxpayers have argued that wages are not taxable.*

However, it is clear that wages are taxable. Revenue and Taxation Code section 17071 defines gross income, the starting point for determining taxable income, by reference to section 61 of the Internal Revenue Code which states that gross income means, "gross income from whatever source derived," and gives a non-exhaustive list of the types of income incorporated in the definition. In part, the types of income include compensation for services, gross business income, gain from dealings in property, interest, and dividends.

The courts have held that compensation, earned income, portfolio income and passive income are all taxable despite arguments to the contrary (*Eisner v. Macomber* (1919) 252 U.S. 189, 207; *United States v. Buras* (9<sup>th</sup> Cir. 1980) 63 F.2d 1356, 1361; *Schiff v. Commissioner*, T.C. Memo 1992-183; *Abrams v. Commissioner* (1984) 82 T.C. 406; and *United States v. Connor, Jr.* (3<sup>rd</sup> Cir. 1990) 898 F.2d 942). The general rule is that all income is included in gross income, unless specifically excluded by statute.

The State Board of Equalization and the courts have held that such an argument is frivolous and groundless (*Appeals of Fred R. Dauberger, et al.*, 82-SBE-082, Mar. 31, 1982; and *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001). In *United States v. Romero* (9<sup>th</sup> Cir. 1981) 640 F.2d 1014, the court stated, "Compensation for labor or services, paid in the form of wages and salary, has been universally held by the courts of this republic to be income, subject to the income tax laws currently applicable."

In *United States v. Koliboski* (7<sup>th</sup> Cir. 1984) 732 F.2d 1328, 1329, fn. 1, the court, in affirming criminal convictions for failures to file, and seeking to preempt future claims that wages or salaries are not taxable, stated, "Nonetheless, the defendant still insists that no case holds that wages are income. Let us now put that to rest: WAGES ARE INCOME." (Emphasis in original.)

b. *Constitutional arguments are frequently offered to avoid filing tax returns and paying taxes.*

Article III, section 3.5 of the California Constitution prohibits state administrative agencies from determining if statutes are constitutional. Also, the State Board of Equalization has established a policy of not considering constitutional issues, because, in the case of deficiency assessments, the Franchise Tax Board is not authorized to obtain judicial review of an adverse decision, even on a question of constitutional importance (*Appeal of Aimor Corporation*, 83-SBE-221, Oct. 26, 1983; and *Appeals of Robert E. Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005).

The State Board of Equalization has found that constitutional arguments are not properly brought in the administrative appeals process, but rather belong in the courts or with the Legislature. Further, the State Board of Equalization has previously interpreted sections 19045 and 19047 as providing taxpayers the right to file an administrative appeal solely for the purpose of determining the correct amount of tax (*Appeals of Fred R. Dauberger, et al.*, 82-SBE-082, Mar. 31, 1982; and *Appeals of Robert E. Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005).

The State Board of Equalization's Rules for Tax Appeals, California Code of Regulations, Title 18, Chapter 4, section 5412(b) states:

(b) Issues that will not be considered. The Board's jurisdiction is limited to determining the correct amount owed by, or due to, the appellant for the year or years at issue in the appeal. The Board has determined that it does not have jurisdiction to consider the following issues:

(1) Whether a California statute or regulation is invalid or unenforceable under the Federal or California Constitutions, unless a federal or California appellate court has already made such a determination.

(2) Whether a provision of the California Constitution is invalid or unenforceable under the Federal Constitution, unless a federal or California appellate court has already made such a determination.

(3) Whether a liability has been or should have been discharged in bankruptcy.

(4) Whether the Franchise Tax Board violated the Information Practices Act (Civil Code sections

1798 et seq.), the Public Records Act (Government Code sections 6250 et seq.), or any similar provision of the law.

(5) Whether the appellant is entitled to a remedy for the Franchise Tax Board's actual or alleged violation of any substantive or procedural right, unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal.

Consequently, the State Board of Equalization has determined by regulation that any arguments based on alleged violations of substantive or procedural rights, or based on law that does not apply to the assessment of tax, are issues that it will not consider, because the issues are beyond its jurisdiction.

In addition, most of these arguments are identified in Internal Revenue Service – Notice 2008-14 and 2010-33.

*c. Violations of the Information Practices Act are asserted as reasons for avoiding the payment of taxes and the filing of returns.*

In a due process complaint that has been asserted repeatedly before the State Board of Equalization, taxpayers contend that the Franchise Tax Board's Notices of Proposed Assessment (NPA) and Notices of Action are null and void because the form of the initial Request for Tax Return did not comply with provisions of the Information Practices Act (Civ. Code section 1798.17). Thereby, taxpayers have asserted that the alleged technical deficiencies in the Franchise Tax Board's request with respect to the Information Practices Act somehow excuse their failure to file an otherwise legally required tax return.

However, the Legislature did not condition a person's duty to file a tax return on FTB's compliance with the Information Practices Act. When an individual has a clear duty to file a tax return, the individual may not evade the duty by complaining that the Franchise Tax Board violated a provision of the Information Practices Act.

In an opinion in *Appeals of Robert E. Wesley et al.*, 2005-SBE-002, November 15, 2005, the State Board of Equalization rejected the argument that the Franchise Tax Board failed to comply with the Information Practices Act. The Board cited to *Bates v. Franchise Tax Board* (2004) 124 Cal.App. 4th 367 (*Bates*), in which the court clearly stated that the California Revenue and

Taxation Code expressly authorized the use of non-personal information to estimate income for taxpayers who decline to provide information by way of a tax return, and the Franchise Tax Board is one of the agencies authorized to use that information to estimate income. Further, Revenue and Taxation Code section 19570 prohibits the application of the Information Practices Act to the determination of any liability under the Personal Income Tax law.

*d. Taxpayers have argued that procedural defects allow them to avoid paying taxes and filing tax returns.*

Taxpayers frequently complain that the Franchise Tax Board did not provide an administrative evidentiary hearing. They overlook the fact that the formal hearing procedure of the Administrative Procedure Act (Government Code section 11340, et seq.) does not apply to the Franchise Tax Board's oral protest hearings. Government Code section 11501, subd. (a) states in pertinent part: "This chapter applies to any agency as determined by the statutes relating to that agency."

With respect to the Franchise Tax Board, the "statutes relating to that agency" are those contained in the Revenue and Taxation Code. Section 19044 provides only for an "oral hearing" on a protest. The Revenue and Taxation Code does not contain a prescription that the Administrative Procedure Act applies to the Franchise Tax Board's oral protest hearings, which may be conducted by a hearing officer authorized by the Franchise Tax Board. In other words, the Franchise Tax Board is not an agency described in Government Code section 11501(b) that is authorized to provide administrative hearings before an administrative judge pursuant to Government Code section 11500.

Where the hearing officer has scheduled a hearing and the taxpayer fails to appear, the State Board of Equalization has noted that there has been no violation of due process (*Appeal of Walter R. Bailey*, 92-SBE-001, Feb. 20, 1992).

Taxpayers that wish to have a hearing before a judge of the State Superior Court may pay the amount due and file a claim for refund with the Franchise Tax Board. If the claim for refund is denied, they may sue for refund in State Superior Court.

*e. Arguments have been made that the creation of a "straw man" by a taxing authority would allow taxpayers to avoid filing a tax return and paying income tax.*

Taxpayers have argued that the Franchise Tax Board created a corporate entity separate from them, because

the Franchise Tax Board addressed notices to them using upper case letters to print their names. However, the printing of an individual's name in all upper-case letters is common in computer-generated government documents. The use of all upper-case letters facilitates the printing and processing of mass mailings. No authority supports a claim that an individual may avoid California income tax obligations by referring to a separate legal entity created by the printing of the individual's name in all upper-case letters on the Franchise Tax Board's notices. The formatting of a person's name in all upper-case letters on notices has no significance whatsoever for income tax purposes (*Boyce v. Commissioner*, T.C. Memo 1996-439; aff'd, (9<sup>th</sup> Cir. 1997) 122 F.3d 169). In *United States v. Furman* (E.D. La. 2001) 168 F.Supp.2d 609, the court rejected a criminal defendant's contention that he was improperly identified in federal government documents that printed his name in all upper-case letters. In Revenue Ruling 2005-21, the IRS emphasized that a taxpayer cannot avoid income tax on the erroneous theory that the government has created a "straw man," stating that the argument "has no merit and is frivolous."

#### **7. The Frivolous Appeal Penalty may be Imposed.**

The State Board of Equalization may impose a penalty, not to exceed \$5,000.00, when an administrative appeal is instituted and maintained primarily for delay, a taxpayer's position on appeal is frivolous or groundless, or a taxpayer unreasonably fails to pursue administrative remedies (section 19714). In *Neufeld v. State Board of Equalization* (2004) 124 Cal.App.4th 1471, 1478, the court held that imposition of a penalty pursuant to section 19714 is not a violation of free speech protections.

In the *Appeal of Alfons Castillo*, 92-SBE-020, July 20, 1992, the State Board of Equalization held that a taxpayer's prior pattern and practice of conduct is relevant when determining whether to impose a frivolous appeal penalty and in what amount.