

Author: Calderon Analyst: Jessica Deitchman Bill Number: AB 449  
Related Bills: See Legislative History Telephone: 845-6310 Introduced Date: February 13, 2017  
Attorney: Bruce Langston Sponsor: \_\_\_\_\_

**SUBJECT:** Modify Failure-to-Furnish Penalty

**SUMMARY**

This bill would modify the failure or refusal to file return or furnish information requested in writing after notice and demand penalty.

**RECOMMENDATION – NO POSITION**

**REASON FOR THE BILL**

The reason for the bill is to make the assessment of the penalty more equitable and reasonable by calculating the penalty based on the amount of tax due and reducing the penalty percentage.

**EFFECTIVE/OPERATIVE DATE**

This bill would be effective and operative on or after January 1, 2018.

**PROGRAM BACKGROUND**

The purpose of the demand penalty is to penalize a taxpayer who fails to file a return or respond to a notice and demand, rather than a taxpayer's failure to pay the proper tax.

*Individuals*

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

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

---

<sup>1</sup> Cal. Code of Regs., tit. 18, section 19133.

Under the regulation, the FTB will issue a Request for Tax Return to a first-time individual nonfiler instead of a Demand for Tax Return. The Request for Tax Return will not trigger a demand penalty unless the taxpayer fails to respond. A taxpayer will only be assessed the demand penalty where the taxpayer fails to timely respond to a current Demand for Tax Return and the taxpayer had also failed to timely respond to a Request for Tax Return or a Demand for Tax Return after a notice of proposed assessment has been issued at any time during the four-taxable-year period preceding the taxable year at issue.

### *Business Entities*

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

### **FEDERAL/STATE LAW**

The failure to furnish or failure to file demand penalty has no federal counterpart.

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

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

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

### **THIS BILL**

This bill would do the following:

- Reduce the demand penalty from 25 to 15 percent and,
- Modify the penalty calculation by replacing “tax determined pursuant to Section 19087” (meaning, the estimated tax due as based upon available information) with “the amount of unpaid tax” as a basis for the calculation.

### **IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concern. Department staff is available to work with the author’s office to resolve this and other concerns that may be identified.

The bill states that the penalty would be based on the amount of “unpaid tax” or the deficiency amount. However, the bill fails to define what “unpaid tax” means. The absence of definitions to clarify this phrase could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend the bill to clearly define the phrase.

### LEGISLATIVE HISTORY

AB 1450 (Chang, 2015/2016), would have authorized the FTB to impose a variable rate demand penalty of up to 10 percent. When determining the amount of the penalty, the FTB would have been required to consider whether the taxpayer made a good faith effort to comply with the information request or notice and demand. AB 1450 failed to pass out of the Assembly by the constitutional deadline.

### OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Although *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws provide for timeliness penalties (failure-to-pay and failure-to-file), none have a penalty comparable to the penalty this bill would modify. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

### FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

### ECONOMIC IMPACT

#### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 449 As Introduced February 13, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
-\$12	-\$32	-\$47

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

## Revenue Discussion

This estimate is based on current penalties assessed and collected by the FTB for failure to furnish information in response to a written request and failure to file a return upon notice and demand. In 2016, approximately \$155 million in penalties were assessed on an estimated tax basis of \$620 million.

Penalties issued were recalculated at the proposed 15 percent rate on an estimated tax basis of \$520 million, resulting in an estimated revenue loss of \$78 million from the decrease in the penalty percentage and the change in the penalty basis. It is assumed the “total unpaid tax” as specified in the bill language, used as the basis to calculate the failure to file a return upon notice and demand penalty would be reduced by timely payments. It is assumed this would reduce the tax basis used to calculate the penalty by 20 percent. The 2016 loss was adjusted to reflect changes in the economy over time resulting in an estimated revenue loss of \$80 million in taxable year 2018. It is estimated that \$16 million of the total penalty assessments in 2018 would be paid upon notification and \$64 million would be referred to FTB collections. It is assumed that 50 percent of penalties would be collected within the first 3 years of assessment. This results in a revenue loss of \$21 million in 2018, \$16 million from the reduction in penalty rate and change in the penalty basis and approximately \$5 million from taxpayer compliance.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the estimates shown in the table above.

## SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

## ARGUMENTS

Proponents: Some may argue the existing demand penalty is excessive and does not take into account whether or not a taxpayer has pre-paid their entire tax due.

Opponents: Some may argue that by lowering the penalty percentage, the incentive for a taxpayer to respond to a notice and demand may negatively impact filing compliance and compliance with the FTB’s requests for information.

## LEGISLATIVE STAFF CONTACT

Jessica Deitchman  
Legislative Analyst, FTB  
(916) 845-6310  
[jessica.deitchman@ftb.ca.gov](mailto:jessica.deitchman@ftb.ca.gov)

Jame Eiserman  
Revenue Manager, FTB  
(916) 845-7484  
[jame.eiserman@ftb.ca.gov](mailto:jame.eiserman@ftb.ca.gov)

Diane Deatherage  
Legislative Director, FTB  
(916) 845-6333  
[diane.deatherage@ftb.ca.gov](mailto:diane.deatherage@ftb.ca.gov)