

ANALYSIS OF AMENDED BILL

Author:	<u>Bradford</u>	Analyst:	<u>Jessica Deitchman</u>	Bill Number:	<u>SB 375</u>
				Introduced Date	<u>February 14, 2017</u>
Related Bills:	<u>See Legislative History</u>	Telephone:	<u>845-6310</u>	Amended Date:	<u>March 28, 2017</u>
		Attorney:	<u>Bruce Langston</u>	Sponsor:	<u></u>

SUBJECT: First Time Abatement of Timeliness Penalty

SUMMARY

This bill would provide a penalty relief program for timeliness penalties (failure to file or failure to pay) when requested by individual taxpayers filing under the Personal Income Tax Law (PITL).

RECOMMENDATION – NO POSITION

Summary of Amendments

The March 28, 2017, amendments renumbered and recast language that would authorize abatement of certain timeliness penalties as discussed in this analysis.

This is the department’s first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to create a penalty relief process similar to federal law that benefits historically compliant taxpayers, reduces taxpayer confusion and dissatisfaction, and increases compliance.

EFFECTIVE/OPERATIVE DATE

If the bill were enacted during the 2017 legislative session in non-urgency legislation, it would be effective January 1, 2018, and specifically operative for requests for abatement made for taxable years beginning on or after January 1, 2018.

FEDERAL

Current federal law imposes penalties for failing to timely file a tax return or to timely pay tax. The penalties apply to individuals, corporations, partnerships, and S corporations.

Failure-to-File Penalty

The penalty for failure to file an income tax return by the due date is 5 percent of the amount of tax required to be shown on the return, less any earlier payments or credits, for the first month the return is late. The penalty increases by 5 percent, to a maximum of 25 percent, for each additional month the return remains unfiled. The penalty is calculated as the lesser of \$100 or the amount of tax required to be shown on the return for failing to file within 60 days of the due date, including extensions.

Failure-to-Pay Penalty

The penalty for failing to pay the tax shown on an income tax return or an assessed deficiency by the due date is generally one-half percent of the tax due for the first month the payment is late, increasing by one-half percent per month that the balance remains outstanding to a maximum of 25 percent.

First-Time Abatement Penalty Relief

Beginning in 2001, taxpayers requesting abatement of the failure-to-file and the failure-to-pay penalties may be granted relief under the Internal Revenue Service (IRS) administrative practice of abating these penalties for taxpayers with a history of compliance.¹ First-time abatement penalty relief is available under the IRS's general authority, rather than being allowed by statute or regulation.

In the IRS's modified first-time abatement policy, dated April 5, 2013, a reasonable cause explanation provided by the taxpayer will be considered after considering the first-time abatement analysis. If the analysis shows that the taxpayer is not eligible for penalty relief under first-time abatement, then the taxpayer's explanation will be used to determine if reasonable cause penalty relief criteria is met. For a taxpayer that is given relief under the first-time abatement, correspondence sent to the taxpayer states:

"We are pleased to inform you that your request to remove the (use applicable penalty, i.e. failure to file, failure to pay, or failure to deposit) penalty(s) has been granted. However, this action has been taken based solely on your compliance history rather than on the information provided IRS will base decisions on removing any future (failure to file, failure to pay, failure to deposit) penalties on any information you provide that meets reasonable cause criteria."

This relief is generally available for any tax period if the taxpayer:

- Has not previously been required to file a return or has no prior penalties, except the estimated tax penalty, for the preceding three years, and
- Has filed, or filed a valid extension for, all currently required returns and paid, or arranged to pay, any tax due. For example, a taxpayer would be considered current if they have an open installment agreement. If the taxpayer is not currently in compliance with this requirement and all other criteria are met, the taxpayer is provided the opportunity to fully comply before reasonable cause is considered.

A penalty assessed and subsequently reversed in full will generally be considered to show compliance for that period.

¹[Internal Revenue Manual - 20.1.1 Introduction and Penalty Relief.](#)

Penalty relief can only apply to a single tax period. For example, if a request for penalty relief is being considered for two or more tax periods, the earliest tax period that meets the criteria will receive penalty relief, not all the tax periods being considered.

Reasonable Cause Exception

Taxpayers have the right to ask that certain penalties be abated if they can show that there was reasonable cause for failure to comply. In order for a penalty to be canceled, reasonable cause must exist. Reasonable cause means the act occurred despite the exercise of ordinary business care and prudence and the failure was due to events beyond the filer's control. Some examples of reasons provided by a taxpayer that may be accepted as reasonable cause, if substantiated, are 1) the business records were destroyed by fire, 2) the taxpayer was mentally incompetent, and 3) the dishonored payment was due to a bank error.

STATE LAW

Current state law imposes penalties when a taxpayer fails to file a tax return on or before its due date or fails to pay the tax due as shown on their tax return by the due date of the return. The penalties apply to individuals, corporations, partnerships, limited liability companies (LLCs), S corporations, estates, and trusts.

Penalty Relief

The Revenue and Taxation Code (R&TC) explicitly requires the Franchise Tax Board (FTB) to impose penalties for a taxpayer's failure to timely file a return or a taxpayer's failure to timely pay tax, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

The R&TC has no provision similar to the federal first-time abatement policy, nor does the FTB have any formal administrative policy that is similar to the federal policy for abatement of the timeliness penalties based on a taxpayer's history of compliance. Unlike the IRS, the FTB lacks specific legal authority to specify the circumstances of reasonable cause on this basis, without a statutory change, such that a first-time abatement could be applied.

Failure-to-File Penalty

The penalty for failure to file an income tax return by the due date is 5 percent of the amount of tax required to be shown on the return, less any earlier payments or credits, for the first month the return is late. The penalty increases by 5 percent, to a maximum of 25 percent, for each additional month the return remains unfiled. The penalty is calculated as the lesser of \$100 (or \$135 for taxable years beginning on or after January 1, 2010, for individuals or fiduciaries) or the amount of tax required to be shown on the return for failing to file within 60 days of the due date, including extensions.

In case of fraudulent failure to file, the penalty is increased to 15 percent per month, up to a 75 percent maximum.

If a partnership, an LLC that is classified as a partnership, or an S corporation fails to file on time, or files a return that does not give information with respect to gross income, deductions, and persons entitled to distributive shares, a monthly penalty is assessed, not to exceed 12 months at \$18 multiplied by the number of persons who were partners, LLC members, or shareholders during the taxable year.

Failure-to-Pay Penalty

The penalty for failure to pay the tax shown on an income tax return or an assessed deficiency by the due date is generally 5 percent of the tax not paid by the original due date of the return. In addition to the 5 percent underpayment penalty, a monthly penalty will also be charged on the tax unpaid as of the original due date of the return. The monthly penalty is imposed at one-half percent (.005) per month, or fraction of a month that the tax remains unpaid, up to a maximum of 40 months (20 percent). The aggregate amount of penalty shall not exceed 25 percent of the total unpaid tax.

Similar penalties apply for nonpayment of the \$800 annual tax imposed on LLCs and the \$800 tax imposed on limited liability partnerships.

The penalty is not assessed if, for the same year, the sum of any penalties imposed for failing to file a return is equal to or greater than the late-payment penalty. If the penalty for late payment exceeds the failure-to-file penalty, only the excess is due in addition to those penalties.

Reasonable Cause Exception

In general, current state law generally conforms to the federal rules for determining reasonable cause.

THIS BILL

This bill would establish penalty abatement authority similar to the federal first-time abatement procedure, except that it would apply to individual taxpayers only. The abatement would be available for taxable years beginning on or after January 1, 2018.

This bill would require the FTB, upon taxpayer request, to abate a failure-to-file or failure-to-pay penalty when:

- Reasonable cause is either absent or the taxpayer chooses to forgo a reasonable cause review, and at the time the abatement request is made:
 - The taxpayer is otherwise compliant with their income or franchise tax filing requirements;
 - For the calendar year of the request for abatement and the four years immediately prior to the request for abatement, no other timeliness penalty has been imposed; and
 - The taxpayer has paid, or is current on an arrangement to pay, all tax currently due.

“Timeliness penalty” means a penalty imposed under R&TC section 19131 or 19132 with respect to a return filed by an individual.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require changes to the department’s accounting system, and the development of procedures, training materials and other internal and external documents for noticing and tracking of requested relief and the outcome of each request.

TECHNICAL CONSIDERATIONS

The following technical amendments are recommended for clarity and grammatical accuracy:

On page 3, line 4, strike “waiver, or rescission”

On page 3, line 7, strike “waiver, or rescission”

On page 3, line 18, strike “taxable” and insert “calendar”

On page 3, line 26, after “due” insert “to the Franchise Tax Board”

On page 3, lines 26-27, strike “for the required returns pursuant to paragraph (2)”

On page 3, line 35-36, strike “taxpayer or the taxpayer’s spouse” and insert “individual or the individual’s spouse”

LEGISLATIVE HISTORY

AB 1777 (Quirk-Silva, 2013/2014), similar to this bill, would have established penalty abatement authority similar to the federal first-time abatement procedure. This bill would have allowed taxpayers subject to the PITL or Corporation Tax Law to apply for abatement, but specified that a “qualified taxpayer” would mean any corporation with gross receipts of less than one million dollars in the taxable year on which the timeliness penalty is imposed or an individual taxpayer. AB 1777 failed to pass out of the house of origin by the constitutional deadline.

OTHER STATES’ INFORMATION

The states surveyed include *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.

Under *Illinois* law, the failure-to-file and failure-to-pay penalties may be abated for reasonable cause. Additionally, the failure-to-file penalty may be abated in situations where a tax return is due more often than once annually, the late filing is non-fraudulent, and a late filing has not occurred during the two years immediately preceding the normal due date of the late-filed return.

Massachusetts and *New York* laws allow for the abatement of the failure-to-file and failure-to-pay penalties if the failure is due to reasonable cause and not willful neglect. A taxpayer's history of compliance may be included in a reasonable cause determination, but is not by itself reasonable cause.

Michigan and *Minnesota* laws allow for the abatement of the failure-to-file and failure-to-pay penalties if the failure is due to reasonable cause and not willful neglect. Additionally, under *Minnesota* law, a taxpayer that paid 90 percent of the amount due by the normal due date, filed the return by the extended due date, and paid the balance of the tax due when the return was filed is presumed to have reasonable cause to abate the failure-to-pay penalty.

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 SB 375 As Amended March 28, 2017 For Taxable Years Beginning On or After January 1, 2018 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$0	- \$2.2	- \$11

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 FTB penalty data for failure to file a tax return and failure to timely pay the amount due. On average, approximately \$93 million in net penalties are assessed each year. These amounts were adjusted for changes in the economy over time, resulting in an estimated \$98 million in penalties issued in tax year 2018. Of these amounts, it is estimated that approximately 25 percent, or \$25 million, would qualify for penalty relief, as proposed in this bill, and would request abatement in tax year 2019. With each year the program is in place, the amount of qualifying penalties would decrease. The estimated penalty relief request amounts would be \$25 million in 2020, and \$21 million in 2021. Of these amounts, it is estimated that 30 percent would have been collected in the year assessed, 15 percent one year after assessed, and would continue to decline each year thereafter. This results in an estimated revenue loss of \$7 million in 2019 and \$11 million in 2020.

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters could argue that authorizing the FTB to implement first-time abatement penalty relief would reduce taxpayer dissatisfaction, result in increased filing compliance, and decrease the costs incurred by taxpayers and the Board of Equalization.

Opponents: Some could argue that abating a penalty that is assessed based on a taxpayer's voluntary action, or inaction, would reward the noncompliant behavior that the penalty was enacted to prevent.

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