



Bill Analysis

Author: Bradford	Sponsor: Franchise Tax Board	Bill Number: SB 1374
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SUBJECT

One-time Abatement of Timeliness Penalties

SUMMARY

This bill, under the Revenue and Taxation Code (R&TC), would establish penalty abatement authority similar to the federal first-time abatement procedure, except that it would apply to individuals subject to the Personal Income Tax Law (PITL) only and would be a one-time abatement.

RECOMMENDATION

Support.

On December 10, 2018, the three-member Franchise Tax Board voted in favor of sponsoring this language.

SUMMARY OF AMENDMENTS

The March 25, 2020, amendments removed provisions of the bill related to the Streets and Highways Code, and replaced them with the provisions 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 authorize the Franchise Tax Board (FTB) to grant penalty relief that is similar to the Internal Revenue Service (IRS) practice of granting administrative relief to compliant taxpayers that could reduce taxpayer dissatisfaction and result in increased filing compliance.

ANALYSIS

This bill, under the R&TC, would establish penalty abatement authority similar to the federal first-time abatement procedure, except that it would apply to individuals subject to the PITL only and would be a one-time abatement.

This bill would require the FTB, upon taxpayer request, either orally or in writing, 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 tax filing requirements;
- The taxpayer has not previously been granted abatement under this new section; and
- The taxpayer has paid, or is current on an arrangement to pay, any tax, penalties, fees, and interest currently due.

This bill would define "timeliness penalty" to mean a penalty imposed under Sections 19131 (failure-to-file) or 19132 (failure-to-pay) for one taxable year with respect to a return filed by an individual for that taxable year. (Please see "State Law" below for additional detail on these penalties).

This bill also would provide the following:

- A timeliness penalty imposed and subsequently abated due to a determination of reasonable cause, or reasonable cause and not willful neglect, with respect to the taxpayer or the taxpayer's spouse, would not affect eligibility for the timeliness penalty abatement this bill would allow.
- A timeliness penalty would be considered imposed on the original due date of the return for the taxable year for which the penalty was imposed.

This bill would exempt from the Administrative Procedures Act any rule, guideline, or procedure prescribed by the FTB pursuant to the section that would be added by this bill.

Effective/Operative Date

Assuming enactment by September 30, 2020, this bill would be effective January 1, 2021, and specifically operative for requests for abatement with respect to penalties incurred for taxable years beginning on or after January 1, 2021.

Federal/State Law

Federal Law

Current federal law imposes penalties for failing to timely file a tax return or to timely pay tax. The relevant penalties that apply to individuals are:

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 IRS administrative practice of abating these penalties for taxpayers with a history of compliance. 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 you provided. This type of penalty removal is a one-time consideration available for a first-time penalty charge. 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. You should receive a notice of penalty adjustment within the next few weeks."

The federal first-time abatement relief is generally available for any tax period if the taxpayer:

- Has not previously been required to file an income tax 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.

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 canceled 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. Per the IRS website, some examples of what may be reasonable cause are:

- Fire, casualty, natural disaster or other disturbances;
- Inability to obtain records;
- Death, serious illness, incapacitation or unavoidable absence of the taxpayer or a member of the taxpayer's immediate family; and
- Other reason which establishes that you used all ordinary business care and prudence to meet your federal tax obligations but were nevertheless unable to do so.

State Law

Delinquent Payment Penalty/Late Payment Penalty (Section 19131)

The R&TC explicitly requires the 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 authority, 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.

Delinquent Filing Penalty/Late Filing Penalty (Section 19132)

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 \$135 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 maximum of 75 percent.

Reasonable Cause Exception

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

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

None noted.

Policy Concerns

None noted.

LEGISLATIVE HISTORY

SB 1082 (Bradford, 2017/2018), substantially similar to this bill, would have established a one-time penalty abatement authority similar to the federal first-time abatement procedure for individual taxpayers. SB 1082 failed to pass out of the house of origin by the constitutional deadline.

SB 375 (Bradford, 2017/2018), would have established penalty abatement authority similar to the federal first-time abatement procedure for taxpayers subject to the PITL to apply for abatement up to every 4 years. SB 375 failed to pass out of the house of origin by the constitutional deadline.

AB 1777 (Quirk-Silva, 2013/2014), a prior FTB sponsored 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.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

Staff estimates a cost of approximately \$177,000 in fiscal year 2021-2022 and ongoing annual costs of \$289,000 to develop and administer a first-time abatement program, program systems, and test revisions to existing systems.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB1374, Amended, March 25, 2020
Assumed Enactment after June 30, 2020

(\$ in Millions)

Fiscal Year	Revenue
2021-2022	\$0.0
2022-2023	-\$2.1
2023-2024	-\$8.8

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Because the impact of current economic conditions is unknown, this estimate is subject to change.

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 \$79 million in net penalties are assessed each year. These amounts were adjusted for changes in the economy over time, resulting in an estimated \$82 million in penalties to be issued in tax year 2021. Of these amounts, it is estimated that approximately 30 percent, or \$24 million, would qualify for penalty relief and request abatement in tax year 2023. With each year the program is in place, the amount of qualifying penalties would decrease. The estimated penalty relief request amounts would be \$14 million in 2024, and \$9 million in 2025. 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 \$7.1 million in 2023, and \$7.7 million in 2024.

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

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Support

The Three-Member Franchise Tax Board.

Opposition

To be determined.

ARGUMENTS

To be determined.

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