

**INITIAL STATEMENT OF REASONS
FOR THE AMENDMENT OF
CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 19133**

Pursuant to California Government Code section 11346.2, subdivision (b), the California Franchise Tax Board ("Board") hereby presents an initial statement of reasons for proposing amendments to California Code of Regulations, title 18, ("CCR") section 19133.

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE PROPOSED AMENDMENTS ARE INTENDED TO ADDRESS

The intent of the proposed amendments to CCR section 19133 is to provide clarity to California individual taxpayers, including sole proprietors, by removing possible ambiguity between subsections (b) and (d) of the regulation. The proposed amendments ensure CCR section 19133 consistently reflects its original intent to clarify when the Board imposes the notice and demand penalty ("demand penalty") pursuant to California Revenue and Taxation Code ("RTC") section 19133 upon individual taxpayers.

In 1994, the California Legislature enacted RTC section 19133. RTC section 19133 provides the Board with the discretionary authority to impose a demand penalty upon taxpayers who fail to file a tax return upon notice and demand by the Board.

In 2004, the Board adopted CCR section 19133 to provide clarity and guidance on how the Board administers the demand penalty. Under CCR section 19133, the Board imposes the demand penalty upon individual taxpayers who received a proposed assessment of tax after receiving, and failing to respond to, either a request for tax return or a demand for tax return for one of the four taxable years immediately preceding the subject taxable year. Such an individual is subject to the imposition of the demand penalty. Subsection (b) of CCR section 19133 provides the regulatory framework that controls the Board's consistent application of the demand penalty, as detailed in the examples at subsection (d).

A recent interpretation of the plain meaning of subsection (b)(2) of CCR section 19133 demonstrates an inconsistency with the Board's interpretation of subsection (b)(2) as set forth in an example in subsection (d). Subsection (d) of CCR section 19133 reflects the Board's original intent in adopting CCR section 19133. It is consistent with the Board's long-standing practice of imposing the demand penalty on an individual taxpayer to whom the Board issued a proposed assessment following that taxpayer's failure to file a return in response to a request for a tax return or a demand for a tax return by the Board *for* one of the four taxable years immediately preceding the subject taxable year. Subsection (b) of CCR section 19133 has alternatively been interpreted to apply to any taxable year as long as the proposed assessment is issued *during* one of the four preceding taxable years.

The proposed amendments remove ambiguity in the interpretation of CCR section 19133 and clarify the Board's long-standing administration of CCR section 19133 and imposition of the demand penalty will continue unchanged.

SPECIFIC PURPOSE OF THE AMENDMENTS

The purpose of the proposed amendments to CCR section 19133 is to remove ambiguity within the regulation and reduce confusion. Currently, CCR section 19133 has been interpreted in some cases in a manner that is more expansive than the Board's long-standing interpretation and counter to the original intent of the regulation. Subsection (b) has been alternatively interpreted to allow the Board to impose the demand penalty on a taxpayer for tax years more than four tax years in the past if the taxpayer failed to respond to a request for a tax return or a demand for a tax return for the older tax year and a notice of proposed assessment ("NPA") was issued during the last four years. This interpretation is inconsistent with the Board's intent in adopting CCR section 19133 as it allows a notice to trigger the demand penalty when such notice is issued after failure to respond to a request for a tax return or a demand for a tax return for a year that may not be close in time to the year for which the current demand is issued. This interpretation allows a greater number of previous tax years, beyond the immediately preceding four tax years, to trigger the demand penalty under CCR section 19133, subsection (b). The proposed amendments ensure CCR section 19133 will be consistently applied throughout the administrative tax appeal process.

NECESSITY

The proposed amendments to CCR section 19133 are set forth immediately below, with explanations describing the necessity for the suggested changes within each description.

CCR section 19133, subsection (b)(2), specifies one of the two conditions when the Board will impose the demand penalty. CCR section 19133, subsection (b)(2), is amended to ensure the demand penalty is imposed when a taxpayer fails to respond to a request for tax return or demand for tax return and an NPA is issued for one of the four-taxable-year periods immediately preceding the subject taxable year. Without this proposed amendment, it may not be clear to taxpayers which previous taxable years can trigger the demand penalty because subsection (b)(2) has been interpreted to apply to tax years prior to the four taxable years immediately preceding the subject taxable year.

CCR section 19133, subsection (d), provides examples to illustrate the provisions of the regulation. CCR section 19133, subsection (d), is amended to clarify in Example 2 that the Board issues a demand for a tax return because the taxpayer received a proposed assessment for not filing a tax return for the 1999 taxable year, one of the four taxable years immediately preceding the 2001 taxable year. The proposed amendment to Example 2 is necessary to add additional clarity as to which taxable year triggered the demand for tax return. This proposed amendment is in harmony with the specificity added to subsection (b)(2). Without such amendment, taxpayers may still experience

confusion as to which tax year can trigger the demand penalty, as the current language of Example 2 contains the phrase "within the previous four years," which is the same language that has caused confusion through its use in the current language of subsection (b)(2).

CCR section 19133, subsection (e), creates an applicability date provision, and is proposed to be adopted to provide that the proposed amendments to subsections (b) and (d) of the regulation are applicable to demand penalties issued on NPAs on and after January 1, 2020. Without the addition of an applicability date provision, it may be unclear as to when the new amendments to CCR section 19133 will apply.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting the proposed amendments, the Board relied on RTC section 19133. In addition, the Board relied on the rulemaking file from the original adoption of CCR section 19133 and on suggestions from members of the public obtained through the Interested Parties Meeting ("IPM") process. The Board did not rely upon any other technical, theoretical, or empirical studies, reports, or documents in proposing the revisions.

BENEFITS OF THE REGULATION

The proposed amendments will benefit individual California taxpayers by removing ambiguity in CCR section 19133 and providing greater clarity as to the taxable years evaluated under subsection (b)(2) when the Board considers a taxpayer's recent filing history for purposes of evaluating imposition of the demand penalty. The proposed amendments will ensure the language of CCR section 19133 follows the Board's long-standing interpretation and practice for imposition of the demand penalty. The proposed amendments are expected to reduce taxpayer confusion and compliance costs, which may include the direct costs for preparing and reviewing tax documents.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

In accordance with the requirement of Government Code section 11346.2, subdivision (b)(5), that the Board consider alternatives to the proposed regulatory action, Board staff conducted an IPM on November 13, 2019, whereby the Board solicited feedback regarding the proposed language. The Board made a summary of the IPM available to the public.

The alternative to adopting the proposed amendments to the regulation is the status quo, which would not resolve ambiguity within the regulation and would not provide clarity to taxpayers as to when the demand penalty can be imposed. The Board has determined that no alternative has been identified or been brought to the attention of the Board that would be more effective in resolving the ambiguity in the regulation. The Board is not aware of alternative action that would be as effective as the proposed

amendments and less burdensome to affected private persons or small businesses than the proposed regulatory action or would be more cost-effective to affected private persons or small businesses and equally effective in implementing the statutory policy or other provisions of law.

Accordingly, the Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed amendments, or would be less burdensome with respect to affected private persons or small businesses than the proposed regulation amendments.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the proposed amendments to CCR section 19133 will not have a significant impact on business. Based on analysis of the last three years of demand penalty appeals before the Office of Tax Appeals (OTA), it is estimated that less than five appeals annually would involve sole proprietors (business owners). The proposed amendments are likely to result in a decrease in the number of abated demand penalty matters under appeal. However, since the average dollar amount on appeal is below \$800, the Board has determined in an economic impact statement, and relies on the conclusion therein, that the adverse economic impact on business will not be significant.

ECONOMIC IMPACT ASSESSMENT

The Creation or Elimination of Jobs in California:

No jobs are anticipated to be created or eliminated by the proposed regulation amendments. The Board estimates that, of the average annual total of 56 appeals where OTA decisions would be affected by the proposed regulation amendments, less than five appeals annually would be related to sole proprietors. However, it is determined that the average demand penalty amounts assessed would be minor in relation to the costs a business faces when deciding whether to add or eliminate jobs. As such, it is highly unlikely that the proposed regulation amendments would result in a net impact on jobs within the state.

The Creation of New Businesses or Elimination of Existing Businesses:

It is not expected that businesses will be created or eliminated by the proposed amendments. As stated above, of the total annual demand penalty appeals affected by the proposed regulation, less than five appeals annually, would be related to sole proprietors. Since the average demand penalty appeal is below \$800, the economic impact on a business due to loss of the penalty appeal would be minor. Therefore, the Board has determined in an economic impact statement, and relies on the conclusion therein, that it is not likely that businesses will be created or eliminated by the proposed amendments.

The Expansion of Businesses Currently Doing Business in California:

There is no expected expansion of business as a result of the proposed amendments. Any imposed demand penalties upheld after appeal would be a small share of their total income. Additionally, on an annual basis there is expected to be only a handful of sole proprietors affected by the proposed amendments. Therefore, the Board has determined in an economic impact statement, and relies on the conclusion therein, that there is no expected expansion of business as a result of the proposed amendments.

Benefits to the Health and Welfare, Worker Safety, and Environment:

The purpose of the proposed amendments to CCR section 19133 is to provide clarification by ensuring all subsections of the regulation are consistent. The proposed amendments do not alter how the Board currently interprets and applies the regulation. The proposed amendments would provide the benefit of giving clarity to taxpayers and tax preparers regarding the process for imposition of the demand penalty; however, there is no expected significant direct change to the health and welfare of California residents, worker safety, or California's environment as a result of the proposed amendments.