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SUBJECT: Mandatory E-File Noncompliance Penalty

QUESTIONS PRESENTED

(1) Does the reasonable cause exception to the mandatory e-file noncompliance penalty affect the Franchise Tax Board's (FTB's) administration and enforcement of the penalty under section 19170 of the Revenue and Taxation Code?

(2) What is the evidence required to show that the reasonable cause exception has been met:

a. Is the filing of a paper return sufficient to show that a tax preparer has met the opt out exception in section 19170?

b. Can the FTB require use of the opt-out form (Form 8454) and production of the form upon demand when the statute does not specifically require the form?

(3) In imposing the penalty, can the FTB choose which class of tax preparers against whom to impose the penalty (all nonconforming tax preparers or just large volume offenders)?

(4) How will the State Board of Equalization (SBE) treat the penalty if a tax preparer pays the penalty and appeals from a claim denial?

CONCLUSION

Section 19170 contains a rather broad reasonable cause exception to the penalty for failing to file electronically. As a result, a tax preparer can easily establish reasonable cause to avoid imposition of the penalty. However, just because there is a broad reasonable cause exception

does not mean that the tax preparer does not need to meet the burden of proof to establish reasonable cause for failing to e-file. The question then becomes what evidence is required to establish reasonable cause? We do not believe that the FTB should accept the mere filing of a paper return as sufficient evidence that a taxpayer opted out of the e-file requirements. Instead, we believe that we may request production of the opt-out form or other competent evidence from the tax preparer to show that the exception has been met.

Concerning imposition of the penalty, the language of section 19170 does not provide for the mandatory imposition of the penalty, but instead provides that the nonconforming tax preparer "is liable" for the penalty. This language suggests that if there is a cost benefit analysis based upon resources that leads to imposing the penalty only against large volume offenders, such analysis may be considered.

Because the penalty is a new penalty, and we have not had any experience with this penalty before the SBE, we cannot predict how the SBE would respond to the penalty if a tax preparer challenged the penalty before the SBE.

ANALYSIS AND DISCUSSION

Section 18621.9 of the Revenue and Taxation Code sets forth the mandatory e-file requirements as follows:

> (a) If an income tax return preparer prepared more than 100 timely original individual income tax returns that were filed during any calendar year that began on and after January 1, 2003, and if in the current calendar year that income tax preparer prepares one or more acceptable individual income tax returns using tax preparation software, then, for that calendar year and for each subsequent calendar year thereafter, all acceptable individual income tax returns prepared by that income tax preparer shall be filed using electronic technology . . .

Section 19170 provides for a preparer penalty of $50.00 per return that is not filed electronically:

> (a) An income tax preparer that is subject to section 18621.9 is liable for a penalty in the amount of fifty dollars ($50) for each acceptable individual income tax return prepared by that income tax preparer that is not electronically filed, unless it is shown that the failure to electronically file that acceptable individual income tax return is due to reasonable cause and not due to willful neglect.
> (b) For purposes of this section, reasonable cause includes, but is not limited to, a taxpayer's election not to electronically file an acceptable individual income tax return in compliance with section 18621.9.
> (c) This section shall apply to acceptable individual income tax returns required to be filed on or after January 1, 2005.

The FTB analysis of AB 1756, as amended June 26, 2003, stated that the FTB received approximately five to seven million tax returns annually that were prepared by tax professionals using computer and tax preparation software. The analysis then states that although these returns

were prepared electronically, they were submitted to FTB on paper through the mail. The cost to process these returns was greater than the cost to process returns received electronically because paper returns must be scanned or manually keyed.

As of the date of the analysis, the FTB received approximately three million e-filed returns that were prepared by tax professionals. These returns were less expensive to process because the information was already in electronic format, and because the information could be validated before the return was accepted as filed, the return was less likely to contain errors that required a notice to the taxpayer. I have seen recent reports indicating that the FTB has received for the 2004 tax year between 4.6 and 5.1 million e-filed returns.

Finally, FTB's bill analysis of AB 1756, as amended July 27, 2003, stated that out of the estimated 40,000 tax professionals in California, the FTB anticipated that 10,000 tax professionals who annually prepared more than 100 tax returns using tax preparation software did not e-file tax returns.

With respect to the penalty aspect of the law, the FTB analysis of the bill, as amended June 26, 2003, stated the following:

> As written, this bill would give FTB the authority to assess a $50 penalty for each tax return that is prepared by a tax preparer but is not e-filed as required by this bill. However, the bill provides that the tax preparer would not be subject to the penalty if the taxpayer elects not to e-file the tax return. As a result, FTB would have no basis to impose the penalty provided in this bill since the basis of the penalty is the receipt of a tax return that is filed using any method other than electronic filing. The receipt of a tax return filed using a method other than e-file would almost certainly be considered evidence of the taxpayer's election not to e-file their tax return. Hence, FTB could be unable to assess a penalty. As a result, the penalty in this bill would have no effect, and this would create an opt-out provision that changes the intent of this bill from a mandated program to a voluntary program.

FTB's bill analysis of AB 2480, as amended April 15, 2004, indicated that the bill amended section 19170 by delaying imposition of the penalty and making it operative for returns required to be filed on or after January 1, 2005. The analysis further provided that since the enactment of AB 1756, and as of August 2003, approximately 11,400 tax professionals had enrolled in FTB's e-file program. However, the department could not tell how many of those enrollees did so as a result of the new legislation.

In response to the mandatory e-file legislation, the FTB developed Form 8454 "e-file Opt-Out Record" for practitioners. The form has a box for the taxpayer to check if the taxpayer elects not to file electronically and an explanation line that is optional. The bottom of the form has a box for the tax preparer to check if the tax preparer is not e-filing the return due to reasonable cause and a line for an explanation. The form instructs the tax preparer to keep the opt-out form in the tax preparer's records, but there is no express requirement in section 19170 that the tax preparer maintain the opt-out form or to produce the form to the FTB should the FTB question the tax preparer's failure to file the return electronically.

Administration and Enforcement of the Penalty

California is not alone in mandating e-filing of returns. However, it appears that California's law is the most stringent in its intended enforcement against tax practitioners who fail to e-file. Most states do not have a penalty, and as shown in the attached appendix, only Massachusetts has a penalty that is greater than the $50.00 penalty under California law, but that penalty is imposed against the taxpayer who made the decision to file a paper return without reasonable cause.

Although the penalty is rather significant per return, the penalty has a broad reasonable cause exception that can be met by a taxpayer's election not to electronically file a return. Because of the sizeable penalty and the ease in establishing reasonable cause, we believe that most tax preparers who do not file electronically will obtain their clients' authorization to file a paper return, either at the time of filing or even at a later date if the FTB subsequently imposed the penalty against the nonconforming tax preparer. The FTB does not have the resources to question whether the clients' authorization was legitimate or even contemporaneous with the filing of the return.

Despite these realities, we believe that a tax preparer who does not file electronically should be required to establish reasonable cause as mandated under the law.

Evidence Necessary to Establish Reasonable Cause

Because the penalty can be waived for reasonable cause, the issue is what evidence we should require from a tax preparer to establish reasonable cause, and particularly what evidence we should require when the claim is that the taxpayer opted not to file electronically.

The filing of a paper return, in and of itself, is insufficient to establish reasonable cause. Merely accepting a filed paper return as evidence of reasonable cause based upon the taxpayer's election does not place any responsibility on the tax preparer or encourage compliance with the e-file mandates. Moreover, the statute provides, in describing the reasonable cause exception, that it must be "shown" that the failure to electronically file was due to reasonable cause and not due to willful neglect. This provision seems to clearly support FTB requiring that the tax preparer demonstrate affirmatively by some evidence their entitlement to the reasonable cause exception.

Instead, FTB should request that the tax preparer provide a signed opt-out form or some other written statement from the taxpayer as evidence of a taxpayer's election not to e-file. It is true that there is no requirement under section 19170 that the tax preparer maintain an opt-out record for each taxpayer who did not want to file electronically or that the tax preparer produce the form upon request from the FTB. However, the law does provide that reasonable cause for failing to file electronically is established by the taxpayer's election to opt-out. And, the form instructs the tax preparer to maintain the form. The opt-out form is merely evidence to establish reasonable cause, the burden of proof of which is, by law, on the tax preparer.

If a tax preparer had another reasonable cause argument unrelated to the taxpayer opting out, we would likewise require evidence from the tax preparer to support reasonable cause. The mere fact that the law does not require the production upon demand of the opt-out form does not

prevent the FTB from requiring the tax preparer to produce evidence supporting a claim of reasonable cause, and if the reasonable cause argument is based on the taxpayer opting out, then it is reasonable to request the tax preparer to provide evidence of this claim.

Because the tax preparer has the burden to establish reasonable cause for failing to e-file, we propose that for the first year, when we identify a tax preparer who qualified for the mandatory e-file requirements under section 18621.9 of the Revenue and Taxation Code, that we write to the tax preparer and request that they state under penalty of perjury whether they have signed opt-out forms for all the paper returns that they prepared that were filed with the FTB. If they represent that they have the opt-out records to establish reasonable cause under the law, then we should accept the statement under penalty of perjury and not pursue the matter any further. In other words, we should accept this statement as sufficient evidence to establish reasonable cause.

If they fail to respond to the letter or if they state that they do not have the necessary opt-out forms, then we should impose the penalty.

For the second year, we propose that Form 8454 and any other necessary instructions be changed to require that the opt-out form be attached to the paper return. We also suggest that we place language on the opt-out form to advise the taxpayer that processing paper returns is more expensive for the State than processing e-filed returns.[1] Although failure to attach the form would not be prima facie evidence that the tax preparer failed to comply with section 19170, it could be grounds for imposing the penalty and placing the burden on the tax preparer to establish reasonable cause for abatement of the penalty.

Imposition of Penalty

A guiding principle in the enforcement and administration of penalties should be that similar cases and similarly situated taxpayers should be treated alike. Statutes that mandate the imposition of a penalty enforce this principle because they do not allow for any discretion in imposing the penalty. For example, the late filing penalty under section 19131 is mandatory, requiring that the 5 percent per month penalty "shall be added" to the tax for each month the return is late up to five months.

Section 19170 does not contain similar mandatory language, but instead provides that the nonconforming tax preparer "is liable" for the penalty. Because section 19170 does not contain mandatory language, in determining whether we should impose the penalty against all nonconforming tax preparers or just against large volume offenders, if there is a cost benefit analysis based upon resources that leads to imposing the penalty only against large volume offenders, then such an analysis may be considered. The standard for imposing the penalty against large volume offenders only would need to be very clear and well supported to avoid potential criticism of why the FTB distinguished between tax preparers in imposing the penalty. We should be careful that we are not using some other arbitrary standard for imposing the penalty.

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[1] If this proposal is adopted, we suggest that the FTB advise the public and particularly the tax professionals of the requirement through an FTB Notice.

SBE Consideration of Penalty

The FTB would impose the penalty on a bill, and a tax preparer would have appeal rights after paying the penalty and claiming a refund. ********** ********** ********** ********** **********. Nevertheless, the statute is clear that the penalty is against nonconforming tax preparers, and there should be some burden upon the tax preparer to establish reasonable cause in defense of the penalty beyond merely pointing to the taxpayer's paper return.

Tax Counsel

APPENDIX

Other States' E-File Requirements

Alabama – Requires e-filing for practitioners who prepare 250 or more individual income tax returns during 2004. The requirement decreases to 100 returns filed in 2005, and 50 in 2006. (Reg. 810-3-27.09(1)(a)(b).) According to Regulation 810-3-27.10, the tax preparer may be subject to a random audit of each return that is not electronically filed unless it is shown that the failure to file electronically was due to reasonable cause and not due to willful neglect. Reasonable cause can be shown by the taxpayer's election not to electronically file.

There is no penalty in the regulation for failing to file electronically. I spoke with the person that wrote the regulation and he indicated that there is some movement in the Alabama legislature to consider a preparer penalty for failing to file electronically under the circumstances identified above, but presently it is a mandatory program without any stick for failing to comply. Alabama's web site on e-filing also states that a signed paper original individual income tax return is evidence that the taxpayer opted out of the e-filing requirements for purposes of establishing reasonable cause.

Connecticut – Has a pending regulation that requires preparers who prepare 200 or more 2004 individual tax returns to e-file 2005 individual returns. The regulation is scheduled to become effective January 1, 2006. The summary of the regulation did not mention penalties for failing to comply.

Massachusetts – For tax years beginning on or after January 1, 2004, income tax return preparers who completed 200 or more returns the previous year are required to e-file, unless the taxpayer specifically directs on the paper form that filing be on paper. The threshold changes to 100 returns after January 1, 2005. Massachusetts has e-file requirements for business entities as well. According to Massachusetts' Department of Revenue webpage, recent legislation authorized the department to impose a penalty for failure to e-file of up to $100 for each improper return. The penalty is imposed on the taxpayer, as opposed to the tax preparer. (Tech. Info. Release 04-12.) The penalty can be waived for reasonable cause and lack of willful neglect.

Michigan – Tax practitioners who prepare 200 or more individual income tax returns must e-file and single business tax returns must be e-filed if computer software is used to prepare the return. Michigan's Department of Treasury's website on e-filing for tax preparers does not indicate that penalties apply for failing to comply.

Minnesota – Personal income tax returns must be e-filed by a tax preparer that prepared more than 100 returns in the previous year. However, a paper return may be filed for a $5 fee if the return was eligible for e-filing. The fee applies even if the taxpayer elects not to file electronically. The tax preparer is required to keep a tally of the number of returns he or she prepares and determine how many were filed electronically and how many were filed with paper and then remit the fee for the paper returns.

New Jersey – All practitioners who prepared 200 or more individual returns in 2003, must e-file 2004 individual resident returns. Taxpayers can opt-out by signing a form. Practitioners are required to maintain the forms. The New Jersey Division of Taxation has a list of FAQs, dated January 1, 2005, which state that there are no penalties for failing to comply, but the legislature is considering legislation to provide penalties for non-compliance.

Oklahoma – If a tax preparer prepared more than 50 individual returns for the prior year, the tax preparer must e-file all individual returns for the current tax year. The requirement does not apply to taxpayers who do not want to file electronically. There is no information about tax preparer penalties on Oklahoma's Tax Commission website.

Virginia – Tax preparers who prepared at least 100 individual returns for a taxable year beginning on or after January 1, 2004, must file all subsequent returns using electronic means. According to Virginia's Department of Taxation website, there is no monetary penalty for failing to comply.

Wisconsin – Practitioners who prepared 100 or more individual returns in a prior year must e-file. Administrative Rule section Tax 2.08 provides that a practitioner may ask for a waiver from the electronic filing requirement by showing hardship. In addition, if the taxpayer does not want to file electronically, the practitioner is not required to comply with e-filing. The Wisconsin Department of Revenue website for practitioners states that currently there is no penalty for failing to comply, but the department is watching to see if practitioners will voluntarily file the returns electronically.