TAXATION SECTION

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A PROPOSAL FOR FIRST-TIME ABATEMENT OF TIMELINESS PENALTIES[1,2,3]

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[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.
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EXECUTIVE SUMMARY

This paper calls for a change in California law to automatically abate penalties imposed on a taxpayer for the failure to timely file a tax return or timely pay tax if the taxpayer has a demonstrated history of filing and paying on time. Federal law already contains an automatic penalty abatement program and our proposal is that California adopt an abatement program that is substantially similar to existing federal law.

The purpose of our proposal is to reduce the cost and distress to taxpayers who have an established history of filing and paying on time, and to reduce the amount of resources the California Franchise Tax Board dedicates to reviewing penalty abatement requests, which are largely dependent on the facts and circumstances of each case. One of the policies underlying civil tax penalties is that they encourage voluntary compliance with tax laws. Imposing a timeliness penalty on a taxpayer that has a long history of filing and paying on time for an isolated incident probably does not do much to encourage voluntary compliance—at least that is one of the reasons supporting the federal program and the proposal here.

Existing California law imposes timeliness penalties on taxpayers who are late in filing tax returns or making tax payments. While such taxpayers may request penalty abatement by showing that the failure was due to reasonable cause and not willful neglect, the large body of existing case law demonstrates that this is a difficult burden to meet. The large body of case law also demonstrates that these penalty abatement determinations generally require taxpayers to present substantial amounts of factual evidence, and also require the FTB to evaluate this evidence and then compare and contrast the taxpayer's facts with case law to make a determination. We think it is safe to say that the amount of FTB resources expended on reviewing penalty abatement requests is not insignificant due to the complexities involved in making those determinations. Our proposal should reduce the amount of FTB resources that are devoted to penalty abatement requests without negatively impacting the FTB's enforcement mission.

DISCUSSION

I. THE NEED FOR FIRST-TIME PENALTY RELIEF IN CALIFORNIA

A. California and Federal Timeliness Penalties

California law imposes penalties when a taxpayer does not timely file an income tax return or pay tax by the required due date, unless the taxpayer shows that the failure was due to reasonable cause and not willful neglect.[4,5] California's penalty regime largely mirrors federal law, which also imposes penalties for late filings of tax returns and late payments of tax, unless the failure was due to reasonable cause and not willful neglect.[6]

The penalty amounts imposed under California law are similar to the penalty amounts imposed under federal law. Under both regimes, the failure to file penalty is generally 5 percent of the tax due every month that the return is late up to a maximum of 25 percent.[7] The failure to pay penalty is generally 5 percent of the unpaid tax plus 0.5 percent each month up to 25 percent of the total unpaid tax under California law, and 0.5 percent each month up to 25 percent of the total unpaid tax under federal law.[8,9]

B. Under Both California And Federal Law, Taxpayers Have The Burden Of Proving That The Failure To File Or Pay On Time Was Due To Reasonable Cause

a. Federal Law And Internal Revenue Policy Recognize The Need For Relief From Strict Enforcement of Civil Tax Penalties

The Internal Revenue Manual, the official compendium of internal guidelines for Internal Revenue Service personnel, indicates that tax penalties "advance the mission of the IRS when they encourage

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[4] Cal. Rev. & Tax. Code § 19131(a).
[5] Cal. Rev. & Tax. Code § 19132(a).
[6] Int. Rev. Code § 6651(a)(1)-(3).
[7] Cal. Rev. & Tax. Code § 19131(a).
[8] Cal. Rev. & Tax. Code § 19132(a).
[9] Int. Rev. Code § 6651(a)(2).

voluntary compliance."[10,11] The IRS further notes that "penalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system."[12] To that end, federal penalties will not apply to taxpayers able to demonstrate "reasonable cause," which is a case-by-case determination based on all the facts and circumstances.[13]

The case-by-case determination requires the IRS and the courts to spend considerable resources when evaluating claims of reasonable cause to such a degree that the U.S. Supreme Court sought in 1985 to create "a rule with as 'bright' a line as can be drawn consistent with the statute and implementing regulations" in *United States v. Boyle*.[14] The Supreme Court in *Boyle* established as close to a "bright-line" test as possible in the context of a taxpayer's reliance on a tax professional to timely file a tax return, which is only one of many reasons why taxpayers fail to timely file a tax return or pay tax. Notwithstanding *Boyle*'s bright-line test, taxpayers continue to make requests for penalty abatement based on reliance on a tax professional, which demonstrates that the existence of a rule that was intended to be as bright as a line as possible fails to halt requests for penalty abatement. The FTB and the courts must continue deciding whether certain sets of facts constitute reasonable cause for penalty relief.

It is with this understanding that the IRS developed its "First-Time Abate" administrative waiver in 2001, which provides relief to qualified taxpayers without the need to show reasonable cause. To qualify for penalty relief under this program, a taxpayer must be compliant with all tax filing and payment obligations and must not have had a similar penalty assessed (or waived) in the prior three years. (While the program is referred to as "first-time abate," qualified taxpayers may seek penalty relief once every three years.)

10 IRM 20.1.1.2.1(5) (11-25-2011).
11 *See*, *generally*, IRM 20.1.1.2.1 (11-25-2011).
12 IRM 20.1.1.2.1(10) (11-25-2011).
13 *See*, IRM 20.1.1.3.2(1) (11-21-2017); *U.S. v. Boyle*, 469 U.S. 241, 247, 254 (1985).
14 *U.S. v. Boyle*, 469 U.S. 241, 248 (1985).

b. California Largely Mirrors Federal Law But Has Not Adopted The IRS's First-Time Penalty Abatement Program

As noted above, California's timeliness penalty regime is very similar to federal law. Like under federal law, a California taxpayer may request that the FTB abate a timeliness penalty if the failure was due to reasonable cause and not willful neglect.[15] Unlike federal law, however, California does not provide relief to taxpayers that have a demonstrated history of voluntary compliance. A similar first-time abatement program in California would not only provide relief to qualified taxpayers, it would also reduce the burden on the FTB in making highly-factual, case-by-case determinations of reasonable cause.

In the absence of a first-time abatement program, California taxpayers must prove up facts that meet their burden of establishing reasonable cause, which tends to be a difficult burden to meet as discussed below.[16] Indeed, when the FTB imposes a timeliness penalty, the law presumes that the penalty was imposed correctly.[17]

In requesting abatement, California taxpayers generally must show that the failure to file or failure to pay occurred despite the exercise of ordinary business care and prudence.[18] In practice, California judicial and administrative decision makers have tended to interpret this rule narrowly. For example, it is generally well-settled that a taxpayer's reliance on a representative to file his tax returns in a timely manner, without more, is not reasonable cause for a late filing.[19] Also, a taxpayer's inability to file a return by the due date because of a lack of necessary information or documents generally does not constitute reasonable cause for a late filing.[20] In other cases, it has been held that the complexity and problems in accumulating the information

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[15] Cal. Rev. & Tax. Code §§ 19131(a), 19132(a).
[16] *Appeal of M.B. and G.M. Scott*, 82-SBE-249, Oct. 14, 1982.
[17] *Todd v. McColgan* (1949) 89 Cal.App.2d 509.
[18] *In re Commerce Avenue, LLC*, California Administrative Decision 663753 (July 17, 2004), *released* Nov. 14, 2014; *Appeal of Michael J. and Diane M. Halaburka*, 85-SBE-025, Apr. 9, 1985.
[19] *Appeal of Thomas K. and Gail G. Boehme*, 85-SBE-134, Nov. 6, 1985; *but see Estate of La Meres v. Comm'r*, 98 T.C. 294 (1992) (filing deadlines can be a substantive area of law appropriate for reasonable cause abatement).
[20] *Appeal of William T. and Joy P. Orr*, 68-SBE-010, Feb. 5, 1968.

necessary to complete a return,[21] a taxpayer's difficulty in resolving accounting problems,[22] a taxpayer's difficulty in determining income with exactitude,[23] a taxpayer's unresolved business matters,[24] or the failure of the taxpayer's accountant to properly account for income,[25] without more, did not constitute reasonable cause for abating penalties.

The difficulties that taxpayers tend to face in establishing reasonable cause in California demonstrates the need for first-time penalty relief to taxpayers with an established history of voluntary compliance.

c. California Taxpayers Face Difficulties Related To California's Lack Of Complete Conformity With The Federal Tax Cuts And Jobs Act

The Tax Cuts and Jobs Act of 2017 ("TCJA") was the largest overhaul of the federal tax code since 1986. California tax law does not automatically conform to those federal changes. Earlier this year, Governor Gavin Newsom signed Assembly Bill 91 into law, which selectively conforms to certain changes made under the TCJA.[26] California law does not conform to many significant federal changes, as it conforms to the federal tax code that was in effect on January 1, 2015.[27] For example, California tax law does not conform to the federal treatment of Global Intangible Low-Taxed Income, Foreign-Derived Intangible Income, IRC section 163(j), IRC section 245A, IRC section 274, and IRC section 451(c).

California taxpayers must account for these federal-state tax differences in determining their California taxable income. More specifically, in computing California taxable income, California taxpayers use federal taxable income as the starting point, and then make modifications for differences between federal and state tax laws. In other words, California returns generally are not prepared until federal returns are

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[21] *Appeal of Incom International, Inc.*, 82-SBE-053, Mar. 31, 1982.
[22] *Appeal of Cerwin-Vega International*, 78-SBE-070, Aug. 15, 1978.
[23] *Appeal of Roger W. Sleight*, 83-SBE-244, Oct. 26, 1983; *Appeal of Avco Financial Services, Inc.*, 79-SBE-084, May 9, 1979.
[24] *Appeal of Bild Industries, Inc.*, 82-SBE-212, Sept. 21, 1982.
[25] *Appeal of M.B. and G.M. Scott*, 82-SBE-249, Oct. 14, 1982.
[26] H.R. 1, Pub. L. No., 115-97 (Dec. 22, 2017); A.B. 91, 2019-2020 Reg. Sess. (Cal. 2019).
[27] *See* Cal. Rev. & Tax Code §§ 17024.5, 23051.5.

prepared. This tends to lead to compliance issues especially because federal and California returns are generally due on the same date.

While we do not have the data to determine if the sweeping federal changes have resulted in an increase in California timeliness penalties, we do know that difficulties with the complexity of federal-state tax differences, or the problems in accumulating the information necessary to complete a return, or a taxpayer's difficulty in resolving accounting problems, have been held to not constitute reasonable cause for penalty abatement. This proposal will provide relief to otherwise compliant taxpayers that are facing difficulties with California's lack of complete conformity to the federal tax reform.

C. First-Time Abatement Will Provide Consistency With Federal Tax Law And Will Reduce The FTB's Presumably Costly Case-by-Case Determinations Of Penalty Abatements Based On Reasonable Cause

Under existing law, California taxpayers may request abatement of a timeliness penalty based on reasonable cause by either formally or informally filing a claim for refund. A formal claim for refund requires that the taxpayer first pay the penalty amount. Many of these penalties are substantial (up to 25 percent of the tax due), which presumably creates significant economic hardship for taxpayers. While taxpayers may file an informal claim for refund without paying the penalty, those claims are considered "unperfected" for purposes of the administrative claims process.[28] In other words, taxpayers do not have protest rights without first paying the penalty.

In submitting these claims, the FTB requests a written statement with supporting documents listing the facts that support the taxpayer's request for penalty abatement. Based on the authors' experiences, this is often a costly process for taxpayers who must review the large body of case law to determine if their facts justify abatement. We presume that this is also a costly process for the FTB, as the FTB must review penalty abatement requests on a case-by-case basis which turn on the facts and circumstances of each case. While we do not have the data to determine the number of penalty requests that the FTB receives each

[28] Cal. Rev. & Tax Code §§ 19322.1, 19335; FTB Notice 2003-5.

year, or the average amount of each penalty request, or the amount of time it takes for the FTB to make each determination, we believe it is reasonable to assert that a first-time abatement program will conserve FTB resources (and free up resources for other efforts), without negatively impacting the purpose of enforcement since, as noted above, the taxpayers eligible for first time abatement generally do not need penalties to encourage them to comply.

II. CALIFORNIA'S PRIOR ATTEMPTS TO IMPLEMENT A FIRST-TIME ABATEMENT POLICY

Over the past decades, we are aware of three bills that have been introduced in the California Legislature to establish a "first-time abatement" program in California. Those three bills are Assembly Bill 1777 (Quirk-Silva) during the 2013-2014 regular session, Senate Bill 375 (Bradford) during the 2017-2018 regular session, and Senate Bill 1082 (Bradford) during the 2017-2018 regular session. While there were some differences between these bills, they all sought to largely mirror the federal first-time abatement policy, which is what we propose here.

Each of these bills ended up in the suspense file. We understand that the primary objection to the proposed abatement program was the loss of General Fund revenue that first-time penalty relief would create. For example, in reference to SB 1082, the FTB indicated that the bill would result in General Fund revenue loss of \$2.3 million in 2019-20, \$9.6 million in 2020-21, and \$8.4 million in 2021-22.[29] However, in the discussion of fiscal impact, the bill analyses did not discuss the cost savings to the FTB. While we do not have data on the number of case-by-case penalty abatement determinations the FTB makes each year (which would be important to have), we think it is reasonable to believe that significant FTB resources are needed for those determinations. The resource savings could substantially offset the loss in General Fund revenue, especially if most penalty abatement requests are for small penalty amounts.

[29] Senate Committee on Governance and Finance Bill Analysis (Hearing on April 18, 2018).

III. A PROPOSAL FOR CHANGE

For the reasons discussed above, we propose that California grant relief of timeliness penalties to otherwise compliant taxpayers. Under this proposal, the FTB would abate a timeliness penalty upon a taxpayer's request if:

1. The taxpayer has not previously been required to file a California return, or has not previously been granted penalty abatement in the calendar year of the request or in the prior four tax years;

2. The taxpayer has filed all returns as of the date of the request; and

3. The taxpayer has paid in full (or arranged to pay) any taxes, fees, penalties, and interest due with the required returns, excluding the penalties to which the request applies.

The first-time penalty abatement program could be codified in a number of ways. For example, the statutory language could be included in Sections 19131 and 19132 of the Revenue and Taxation Code, which are the provisions that provide for failure to file and failure to pay penalties. This abatement program can also be codified in Section 19132.5 of the Revenue and Taxation Code, which presently provides penalty relief to taxpayers that were affected by the Northridge earthquake of January 1994. The following italicized language could be used as a model and is based on the prior three legislative bills:

(a) If a taxpayer requests, either orally or in writing, the abatement of a timeliness penalty pursuant to this section, the timeliness penalty shall be abated if all of the following apply:

(1) The taxpayer has not previously been required to file a California return under Part 10 (commencing with Section 17001), this part, or Part 11 (commencing with Section 23001), or no other timeliness penalty has been abated under this section by the Franchise Tax Board in the calendar year of the request for abatement or in the immediately preceding four taxable years.

(2) The taxpayer has filed all returns required under Part 10 (commencing with Section 17001), this part, or Part 11 (commencing with Section 23001), as of the date of the taxpayer's request for abatement under this section.

(3) Excluding the timeliness penalty that is the subject of the abatement request under this section, the taxpayer has paid in full, or arranged to pay pursuant to an installment agreement, any tax, penalties, fees, and interest due for the required returns pursuant to paragraph (2) and the taxpayer is current with all installment payments.

(b) For purposes of this section, "timeliness penalty" means a penalty imposed under Section 19131 or 19132.

(c) For purposes of this section, a timeliness penalty imposed and subsequently abated due to a determination of reasonable cause and not willful neglect with respect to the taxpayer or the taxpayer's spouse, shall be considered to have not been abated for purposes of determining eligibility for timeliness penalty abatement under this section.

(d) This section shall apply to a timeliness penalty imposed on or after January 1, 2020.

IV. CONCLUSION

Although prior attempts to adopt a first-time abatement policy in California have failed, taxpayers (and their advocates) and the FTB continue to agree that California should adopt a first-time abatement program like the federal program. Not only will this program conserve FTB resources that are needed to make highly-factual, case-by-case determinations of penalty abatement, this program will also provide much-needed relief to taxpayers that have a history of being compliant with their tax filing and payment obligations.

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