

2024 Sacramento Delegation  
California Lawyers Association

**Positive Progress on Penalties to Prevent Perceived Prejudice**

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## Executive Summary

This paper proposed changes to the way California the Franchise Tax Board assesses and reviews penalties. These changes are designed to better harmonize FTB and IRS tax administration with respect to penalties. Harmonization is important because it is the same behavior that causes penalties at both the Federal and State level. Differences between IRS and FTB enforcement of penalties inevitably force taxpayers to compare the two agencies and how they were treated fairly by both agencies. Usually these comparisons are framed in negative terms and focused on if they believed they received procedural due process. Worse treatment is defined as which agency they believe “did not listen” to their request. More often than not, this comparison leaves taxpayers with negative impressions of the FTB if the IRS abates a penalty or offers taxpayer favorable procedures and California applies stricter scrutiny.

In order to reduce this sense of disparity, this paper proposes two changes to the way California administers tax penalties. Each of the changes is based upon real world examples which the author has direct experience in interacting with both the IRS and the FTB and watching client reactions to the outcomes. In each situation the author has had taxpayers’ comment about how the State of California has treated them in a harsher manner than the Federal government did.

These two recommended changes are:

1. Re-evaluating the requirement that penalties, or the underlying tax, must be paid before penalty abatement is considered.
2. Increasing the availability of the first-time abatement program, from one “first time abatement” per taxpayer, to a first-time abatement that closely matches the IRS’s first time abatement program.

Making these modest adjustments is a step in the right direction to increasing horizontal equity across taxing jurisdictions. This horizontal equity allows taxpayers to feel as if they have been treated fairly and consistently when it was the same action that caused the understatement, or the late filing.

This fairness is important in a voluntary compliance system. The more a taxpayer feels as if they were not heard, the more hesitant they may be to fully voluntarily comply in future years. The goal of this paper is to provide mechanisms where taxpayers do not feel as if there is a difference between their due process rights at both the Federal and State levels.

# Discussion

## I. Current Law

California conforms with many of the penalty code sections found in the Internal Revenue Code. For example, the basis of understatement of income penalties for federal purposes is Internal Revenue Code section 6662. California conforms to section 6662 and the Revenue and Taxation code section 19138 contains similar provisions as the federal law. The penalties for late filed and late payment penalties contained IRC section 6651 as the basis for Revenue and Taxation code section 19131.

However, there are administrative differences that modify the practical application of the penalties in a way that makes the penalties operate and feel different even when the behavior that caused the penalties was identical for both Federal and State penalties. Even when the law is the same, the FTB administration of the penalties leaves taxpayers feeling as if the California rules are stricter than the IRS rules and their request for penalty abatement fell on deaf ears at the FTB.

## II. Problems Addressed

The difference in outcomes invariably leads to comparisons. These comparisons are often unkind to the FTB. The taxpayer who is assessed a failure to pay penalty because of a documented economic hardship can reasonably expect to get the penalty abated at the Federal level, however that same taxpayer cannot contest his FTB penalty for failing to pay without having to pay a penalty (plus the tax he was able to unable to afford) and filing a request with the FTB for a refund. Under the current system a taxpayer who requests first time abate in 2024 with the IRS, can request the same relief in 2028. In California that same taxpayer can request first time abate in 2024 but cannot request the same relief in 2028, 2038 or 2050, despite the fact it may have been 10+ years between late returns.

The IRS frequently makes it difficult to obtain penalty relief, but for many taxpayers and their representatives the FTB makes it feel as if it is virtually impossible to get relief. These feelings (right or wrong) have consequences and taxpayers don't remember what the penalty was for, or how much the penalty was, but they remember feeling as if the rules were unfair. This feeling of unfairness can linger for years, or at least anecdotally can lead to taxpayers taking riskier positions in future years or even in extreme situations, factoring into a decision to relocate.

## III. Rethinking Prepayment Required for Penalty Abatement

The first request for modification to penalty procedure is to revisit the FTB's requirement that tax and penalties be paid before abatement can be granted. The prepayment criteria is a significant difference between the IRS and the FTB. Requirement of payment, and the time lag between payment, review and abatement, make a taxpayer who qualifies for penalty relief feel guilty until proven innocent.

Frequently prepayment of the penalty can be difficult for a taxpayer to make even if they have good facts. Taxpayers without representation may struggle to make a distinction between an informal claim for refund and a claim for refund that is processable. This often creates confusion for taxpayers who feel as if they are entitled to relief (perhaps because the IRS has already granted abatement) and do not understand why their request for abatement has not been processed.

Contrasting this to IRS offers insight into how taxpayers can feel like the FTB imposes more rigorous requirements even if the law is similar. The IRS offers many opportunities for penalty abatement. Failure to file, failure to pay, and understatement penalties can be abated pre-payment.

Generally, penalty abatement requires writing, but often this penalty abatement is predictable and can be granted at a low level of authority. Penalties can also be abated at exam, or at a collections hearing. By separating the merits from the ability to pay there is a good chance that a taxpayer who feels

strongly that they tried to do the right thing and either got bad tax advice or was prevented from filing by an unforeseen and unexpected event will eventually get relief. This opportunity to get multiple bites at the apple without making a payment can be difficult to explain to taxpayers who feel as if the facts should warrant abatement at both the State and Federal level

One thing that the FTB could do to remove inequity between the way the IRS administers penalty abatement, and the current system, is to remove the prepayment requirement for certain penalties. The needs of the state to collect revenue could be balanced against equitable factors by creating a modest dollar cap that would delineate between penalties that could be abated in a prepayment setting and those that would still require payment. The initial suggestion is that this cap be set at \$2,500 or \$5,000.

The cap would have several benefits for taxpayers who did not exceed that threshold. The first is that it would be a progressive cap designed to serve people who lack the ability to pay the penalty or hire representation. Currently many taxpayers do not have the means to make any penalty payments to the state. Without payment they cannot have their voice heard no matter the facts and circumstances. Implementing a payment cap would increase procedural due process because payment would not be a barrier to having the merits of the case heard.

It would also increase access to justice for those that cannot afford to hire professional representation. Based upon the complexity of contesting FTB penalties it is highly unlikely that penalties under \$5,000 will have professional representation. This means that these revised procedures are likely to be utilized by taxpayers of modest means who would not otherwise be able to hire a representative to guide them through the differences between informal and formal claims for refund.

Third this cap could help delineate which penalties are serious and which may be more ministerial. As failure to pay and failure to file are percentage of the tax due multiplied by months late, it might help separate out those that were only days or weeks late, rather than the seriously delinquent returns. A college student who misses a deadline for a 540 by a month and wishes to state their case for abatement may not require the same sort of procedural rigor as a serial non filer who would likely have higher penalties.

#### IV. Increased Frequency of First Time Abatement

The second penalty administration difference that can make a significant difference to a taxpayer is the application of the first time abate penalty. The drafter of this paper is grateful for the existence of the first-time abatement procedure. The change in the law that permits a first-time abatement for a timeliness penalty is a welcome change. The author does not want to appear ungrateful for the program, however there is a humble suggestion in how to interpret the code that may improve the administrability of the program.

The starting point for evaluating the program should be the IRS's first time abate program. That program provides relief from a timeliness penalty as long as there have been no prior timeliness penalties in the last three years. Since the statute of limitations is generally three years, this rolling window can be thought of as a one-time abatement for open years.

The FTB should follow that logic and define one time as one time per the open assessment statute years. Using this interpretation the FTB could offer this abatement once every four years. This interpretation would still meet the intent of the statute, which is mistakes happen, life happens, and tax administration should not require taxpayers to be perfect.

The current mismatch between the IRS's program and the FTB's program has created heartburn for taxpayers. There is no downside to requesting first time abatement from the IRS for most taxpayers. In fact, the IRS is considering making first time abate automatic in 2026. The FTB on the other hand requires more thought. A taxpayer who forgot to mail a check on April 15<sup>th</sup> and incurs a \$500 penalty has to weigh the pros and cons of requesting one time abatement now when they might incur a second penalty a decade from now and is there the potential that the second penalty may be larger.

The uniform reaction to this issue being raised with taxpayers is something equivalent to “why is the FTB so strict” or “that is unfair”. Even at the hypothetical \$500 payment the message that may Californian here is that “the FTB doesn’t care about taxpayers, all they want is money.” This message has damaging consequences.

#### V. Merits of Proposal

California has a voluntary compliance tax system. Penalties are designed to encourage voluntary compliance by raising the cost of noncompliance to the point where it is cheaper and easier to file tax returns that are true and complete to the best of a taxpayer’s ability. There is a point where penalties stop encouraging voluntary compliance when taxpayer’s who do use best efforts are penalized and stop believing in the fairness of the tax system. The risk is that taxpayers will start filing returns that represent what they think they can “get away with” rather than reporting honest numbers.

While taxpayers often do not know where that line is based upon legal grounds, they understand equity. If the was an honest mistake, or omission, chances are that the mistake happened at the Federal level as well. If the IRS grants penalty abatement, it is logical for taxpayers to assume that the FTB will as well. If that does not happen, or the process to obtain that relief is more difficult than the IRS process, it feels unfair. Harmonizing the penalty regimes will reduce these feelings of unfairness and improve voluntary compliance.

To do so the author suggests the follow:

1. Create a threshold at which the FTB will consider written penalty abatement without prepayment. This threshold could be relatively small, say \$2,500 or \$5,000, but having some mechanism to contest penalties in a prepayment format would be consistent with the IRS.
2. Allow multiple first-time abatements during the course of a taxpayer’s lifetime. The FTB could either use the IRS’s rational that the abatement could only be granted once per rolling statute period.

#### VI. Feasibility

The vast majority of these adjustments are administrative in nature and could be implemented at an agency level. Statutory changes would be helpful, but these could be implemented via statutory interpretation. The penalties that would not be assessed under these changes are likely to be immaterial from a collections standpoint and it is like that they would lead to increased voluntary compliance.

#### VII.

**The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the California Lawyers Association or of the Taxation Section.**