

# California Enacts New FTB and BOE Penalties Affecting Pending Audits, Protests, Appeals, and Settlements

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## Introduction

California corporate and individual taxpayers with pending audits, protests, appeals, or settlement proceedings with the California Franchise Tax Board (FTB), or with comparable proceedings pending with the California State Board of Equalization (BOE) should pay particular attention to new penalties recently enacted by the Legislature and Gov. Arnold Schwarzenegger (R) as part of California's new amnesty program.

The last tax amnesty program in California was in 1984-85. However, amnesty bills have been pending in the California Legislature for the last several sessions, but none have been enacted -- until now. The amnesty bill being watched this legislative session was AB 2203, authored by Assembly member Judy Chu (D), which was introduced in February. However, as part of the discussions between Schwarzenegger and the legislature as part of the funding of the fiscal 2005 Budget Act, language to implement an amnesty program was included in SB 1100, which was authored by the Senate Budget and Fiscal Committee. SB 1100, in part, enacts a tax amnesty program to be administered by the FTB and the BOE.<sup>1</sup> SB 1100 was enrolled and sent

on August 2 to the governor, who signed it on August 16 as Stats 2004, Ch. 226. The bill is an urgency statute, which means it went into immediate effect when signed by the governor.<sup>2</sup> The FTB estimates a total revenue impact of \$555 million from the amnesty in fiscal 2005, consisting of \$200 million in new revenue and \$355 million in accelerated revenue.<sup>3</sup> The BOE estimates revenue collections of approximately \$82 million in fiscal 2006 from the amnesty program.<sup>4</sup>

As summarized by the Legislative Counsel, SB 1100 requires the BOE and the FTB to administer a tax amnesty program beginning February 1, 2005, and ending on March 31, 2005, inclusive, or during any other two-month period ending before June 30, 2005, as provided.<sup>5</sup> The BOE-administered program covers sales and use taxes. The FTB-administered program covers personal and corporate taxes. In general, the program applies to tax liabilities due and payable for tax years and tax reporting periods beginning before January 1, 2003.<sup>6</sup> Under the amnesty, the FTB or the BOE will waive all penalties (but not tax or interest) for the tax reporting periods or tax years for which tax amnesty is allowed for the nonreporting or underreporting of tax liabilities or the nonpayment of any taxes previously determined or proposed to be assessed.<sup>7</sup> Amnesty is not available to taxpayers on notice of a criminal investigation or criminal prosecution; does not apply if a court proceeding has already been initiated; and does not apply to tax shelters that would have been eligible for the FTB's Voluntary Compliance Initiative (VCI) program earlier this year, or the federal Offshore VCI program.<sup>8</sup> A taxpayer eligible for amnesty must file a completed application form with the FTB or BOE, file the appropriate amended returns, and pay the amounts due.<sup>9</sup>

## **The New Penalties**

What the Legislative Counsel's summary does not highlight are new penalties of potentially broad application that were included in the amnesty legislation in SB 1100. This article does not attempt to summarize all the provisions of the new amnesty program.<sup>10</sup> Instead, we discuss only the new penalty provisions, which may have a substantial effect even on taxpayers who do not participate in the amnesty program.

### **Increased FTB Accuracy-Related Penalty**

This penalty pertains only to the FTB. SB 1100 amends California Revenue and Taxation Code section 19164, which sets forth the accuracy-related penalty. Section 19164(a)(1)(B)(i) is amended to substitute "40 percent" for "20 percent" in the current version of the statute. (Earlier versions of the proposed amnesty legislation would have increased the penalty to 50 percent instead of to 40 percent.) The amendment applies in the case of any proposed deficiency assessment issued after the last date of the amnesty period (that is March 31, 2005)<sup>11</sup> for any tax year beginning before January 1, 2003. Section 19164(a)(1)(B)(i), as amended, also provides that the increased penalty does not apply to understatements relating to tax shelter items.

The legislation provides that the increased accuracy-related penalty will not apply to any

taxpayer for taxable years in audit, protest, appeal, settlement, or litigation as of the start (that is, February 1, 2005) of the amnesty period.<sup>12</sup> That "carve-out" for protests, appeals, settlements, and litigation pending as of February 1, 2005, was not found in AB 2203, the earlier version of the amnesty legislation. It was added as part of the budget negotiations that produced SB 1100 as a budget trailer bill.

Accordingly, taxpayers with FTB audits, protests, appeals, settlement negotiations, or litigation pending as of February 1, 2005, need not be concerned with the increased accuracy-related penalty found in section 19164 for taxable years subject to such proceedings. For other FTB taxpayers (not involving tax shelters), the increased penalty applies for any tax year beginning before January 1, 2003, for which the proposed deficiency assessment is issued after March 31, 2005.<sup>13</sup>

### **New FTB and BOE 50 Percent Interest 'Penalty'**

Section 12 of SB 1100 also enacts a new amnesty "penalty" that applies to FTB-administered taxes and is equal to (1) 50 percent of the existing unpaid interest amount on any tax year for a taxpayer that failed to take advantage of amnesty and (2) 50 percent of the unpaid interest subsequently assessed on deficiency amounts when the taxpayer could have, but failed to take part in amnesty.<sup>14</sup> Those penalty provisions are in addition to any other penalties imposed. Specifically, section 19777.5(a)(1) is enacted to provide that there shall be added to the tax for each tax year for which amnesty could have been requested (that is, tax reporting periods beginning before January 1, 2003), for amounts that are due and payable on the last date of the amnesty period (that is, March 31, 2005), an amount equal to 50 percent of the accrued interest payable under section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the last day of the amnesty period specified in section 19731 (that is, March 31, 2005).

Also, section 19777.5(a)(2) is enacted to provide that there shall be added to the tax for each tax year for which amnesty could have been requested (that is, tax reporting periods beginning before January 1, 2003), for amounts that became due and payable after the last date of the amnesty period (that is, March 31, 2005), an amount equal to 50 percent of the accrued interest payable under section 19101 on any final amount, including final deficiencies and self-assessed amounts, for the period beginning on the last date prescribed by law for the payment of that tax for the year of the deficiency (determined without regard to extensions) and ending on the last day of the amnesty period (that is, March 31, 2005).

The limitation on the 50 percent penalty "for which amnesty could have been requested" is an extremely narrow limitation, thus providing for a very broad category of taxpayers eligible for the penalty. Regarding time periods, amnesty "could" be requested for all tax reporting periods beginning before January 1, 2003. And unlike some state tax amnesty programs, the California amnesty program for the BOE and FTB under SB 1100 is not limited to only those taxpayers who have not previously been contacted by the tax agency. The fact that a taxpayer has been contacted, or is under audit, or has received an assessment and is in the midst of an administrative challenge of that assessment does not preclude in any way the taxpayer from

being eligible for the amnesty program.

Amnesty participants can file returns and submit full payment within 60 days after the conclusion of the amnesty period and still avoid the new 50 percent end-of-amnesty penalty that applies to amounts not actually paid during the tax amnesty period.<sup>15</sup> Specifically, the new statutory provisions provide that the full amount due shall be treated as paid during the amnesty period if "the full amount due is paid within [15 calendar days] . . . after the date the Franchise Tax Board mails a notice resulting from the filing of an amnesty application or the full amount is paid within 60 days after the conclusion of the tax amnesty period."<sup>16</sup> In essence, those provisions deem the payments as having been made during the amnesty period, and thus there is no balance due for the penalty to attach to.

Also, the new 50 percent amnesty penalty would not apply to a taxpayer that (1) initiates and is compliant with an installment agreement, as specified, to pay amounts due under the amnesty program,<sup>17</sup> or (2) has an existing installment payment agreement under Revenue and Taxation Code section 19008 (personal income tax only) as of the start of the amnesty program and who does not participate in the amnesty program.<sup>18</sup>

Note that in comparison with the increased accuracy-related penalty, there is no carve-out for protests, appeals, settlements, and litigation pending as of February 1, 2005, for the 50 percent penalty. What that means is that the 50 percent penalty, by its terms, will apply to taxpayers, for tax years for which amnesty could have been requested, for amounts that are due and payable on the last date of the amnesty period (that is, March 31, 2005), even if protests, appeals, or settlements are pending.

This is a nonwaivable penalty. Taxpayers may not file a claim for refund for any penalty amount paid.<sup>19</sup>

Several options are available to taxpayers with cases currently pending with FTB in protest, appeal, settlement, or litigation. Those options may include the following.

First, a taxpayer who prevails on the underlying tax deficiency will avoid the 50 percent penalty, because the penalty is a function of the underlying tax deficiency. If there is no tax deficiency, there is no interest on that deficiency, and thus no basis for the 50 percent interest penalty.

Second, a taxpayer can avoid the 50 percent penalty by paying, before March 31, 2005, all tax and interest amounts due and payable. Payment during the pendency of a protest automatically converts the protest to a claim for refund.<sup>20</sup> In the alternative, a claim for refund for tax and interest paid can be filed within 12 months of the date of payment.<sup>21</sup> However, a taxpayer would not want to enter the amnesty program in connection with any such payment made purely to avoid the new 50 percent interest penalty because a taxpayer that takes advantage of amnesty waives its right to file a claim for refund for amounts paid in connection with amnesty.<sup>22</sup> An issue presented by that option is the age-old concern of taxpayers and tax practitioners<sup>23</sup> that a state is less likely (perhaps far less likely) to return money in hand to a taxpayer, as opposed to reducing or abating a deficiency of that taxpayer.

Third, a taxpayer can strive, to the extent within its control, to have the protest/appeal/settlement/litigation proceeding successfully concluded on or before March 31, 2005, so that no amounts are "due and payable" as of that date, and thus avoid the 50 percent

penalty.

Fourth, a taxpayer could challenge the legality of the legislation applying the penalty to back years for which the statute of limitations for a tax assessment is now closed. The fact SB 1100 went into immediate effect, can apply to closed tax years, and imposes increased interest in the form of a "penalty" raises a number of interesting legal issues. State or federal constitutional challenges may lie on due process, equal protection, retroactivity, and/or ex post facto grounds. However, be aware that the FTB and the BOE, as California administrative agencies, have no power to refuse to enforce any of the provisions of SB 1100 on the grounds they are unconstitutional, absent a decision by a court of appeal.<sup>24</sup> Accordingly, any such challenge would necessarily involve litigation through the California trial court level and at least through the California Court of Appeal.

Fifth, a taxpayer might choose to ignore the new penalty as long as possible, in hopes that someone else will successfully challenge the legality of the legislation, and then hope to benefit from that challenge.

SB 1100 also enacts a comparable 50 percent penalty on the BOE side with the addition of Revenue and Taxation Code section 7074. Section 7074 provides that (except for taxpayers who have entered into certain installment payments) there shall be added to the tax for each period for which amnesty could have been requested (that is, tax reporting periods beginning before January 1, 2003): (1) an amount equal to 50 percent of the accrued interest payable under section 6591 for the period beginning on the date in which the tax was due and ending on the last day of the amnesty period (that is, March 31, 2005) for amounts due and payable on the last day of the amnesty period (that is, March 31, 2005); and (2) an amount equal to 50 percent of the interest computed under section 6591 on any final amount, including final deficiencies and self-assessed amounts, for the period beginning on the date in which the tax was due and ending on the last day of the amnesty period (that is, March 31, 2005).

We understand the BOE two-part 50 percent penalty language under section 7074 is intended to be parallel to the FTB's two-part 50 percent penalty language under section 19777.5. However, note the exact wording used in the two statutes is not parallel, and many key terms in section 7074 are not defined. It is our understanding that the BOE is in the process of addressing the meaning of that section.

As with the FTB's 50 percent interest penalty, there is *no* express carve-out for petitions for redetermination, appeals, settlements, and litigation pending as of February 1, 2005, regarding the 50 percent BOE penalty. As with the FTB's 50 percent penalty, the BOE penalty is imposed in addition to any other penalty.<sup>25</sup>

In general, and assuming parallel statutory construction, taxpayers' options to address the BOE's 50 percent penalty are comparable to the options for the penalty on the FTB side that are discussed above.

### **New BOE 'Double Penalties'**

In addition to the new BOE 50 percent interest penalty discussed above, SB 1100 imposes "double penalties" on certain deficiencies. Specifically, under section 7073(c), the BOE shall impose penalties "at a rate that is double the rate of penalties described in law" on a "deficiency determination" that is based on (1) any amount that is underreported on a return filed under the amnesty program, or (2) any amount not reported or underreported by any person who could have otherwise been eligible for amnesty.<sup>26</sup> "Deficiency determination" is not a defined term under the new legislation. However, we understand from the BOE, which is currently reviewing the issue, that that term is intended to be limited to new deficiency determinations<sup>27</sup> issued after the last day of the amnesty period, and should be so interpreted. If the BOE issues a deficiency assessment under that "double penalties" provision, an extended statute of limitations is provided, and the BOE may do so "within 10 years from the last day of the calendar month following the quarterly period for which in the amount is proposed to be determined."<sup>28</sup> While not explicitly stated in the legislation, the new "double penalties" provisions would arguably apply to the new 50 percent interest penalty under section 7074.

## Conclusion

As of the date of this article, there remain many, many unanswered questions regarding the implementation of these new penalty provisions found in SB 1100. Both the FTB and the BOE hope to anticipate and address on their Web sites, by sometime this fall, many of the "FAQs" regarding the new penalties and the amnesty programs in general. (Indeed, the FTB is to be complimented on its similar efforts on its Web site earlier this year in connection with the Voluntary Compliance Initiative.) Taxpayers with FTB and/or BOE audits or administrative proceedings pending should pay extremely close attention to how the new penalties will be implemented.

## FOOTNOTES

<sup>1</sup> AB 2114 contains the identical amnesty language. When this article was printed, AB 2114 was still pending in the legislature.

<sup>2</sup> SB 1100, section 14.

<sup>3</sup> FTB Bill Analysis of SB 1100, dated August 4, 2004.

<sup>4</sup> BOE Bill Analysis of SB 1100, dated July 29, 2004.

<sup>5</sup> SB 1100, Legislative Counsel's Digest; Cal. Rev. and Tax. Code sections 7071, 19731.

<sup>6</sup> SB 1100, section 6, 11; Cal. Rev. and Tax. Code sections 7071, 19731.

<sup>7</sup> SB 1100, sections 6, 11; Cal. Rev. and Tax. Code sections 7072(a)(1), 19732(a).

<sup>8</sup> SB 1100, sections 6, 11; Cal. Rev. and Tax. Code sections 7072(b), 19732(b)-(c).

<sup>9</sup> SB 1100, sections 6, 11; Cal. Rev. and Tax. Code sections 7073, 19733.

<sup>10</sup> For a more comprehensive discussion of the history and details of the amnesty legislation, see Chris Micheli, "Details of Amnesty for Personal, Corporate, and Sales Taxpayers," *State*, or Doc 2004-15731 [[PDF](#)].

<sup>11</sup> The FTB's Web site says that amnesty applications must be postmarked by March 31, 2005. However, since March 31 is a state holiday, the FTB will accept applications postmarked April 1, 2005. (See <http://www.ftb.ca.gov/amnesty/faq.html>.)

<sup>12</sup> Specifically, section 19164(B)(ii) is amended to read:

(ii) Clause (i) shall not apply to any taxable year of a taxpayer beginning prior to January 1, 2003, if, as of the start date of the amnesty program period specified in Section 19731, the taxpayer is then under audit by the Franchise Tax Board, or the taxpayer has filed a protest under Section 19041, or the taxpayer has filed an appeal under Section 19045, or the taxpayer is engaged in settlement negotiations under Section 19442, or the taxpayer has a pending judicial proceeding in any court of this state or in any federal court relating to the liability of the taxpayer for that taxable year.

<sup>13</sup> SB 1100, section 9; Cal. Rev. and Tax. Code section 19164(a)(1)(B)(i).

<sup>14</sup> Cal. Rev. and Tax. Code section 19777.5.

<sup>15</sup> SB 1100, section 11; Cal. Rev. and Tax. Code section 19733(a)(3)-(4).

<sup>16</sup> SB 1100, section 11; Cal. Rev. and Tax. Code sections 19101(c)(3), 19733(a)(4).

<sup>17</sup> SB 1100, sections 11, 12; Cal. Rev. and Tax. Code sections 19733(b)(1); 19777.5(c).

<sup>18</sup> SB 1100, section 11; Cal. Rev. and Tax. Code section 19738.

<sup>19</sup> SB 1100, section 12; Cal. Rev. and Tax. Code section 19777.5(e).

<sup>20</sup> See Cal. Rev. and Tax. Code section 19335.

<sup>21</sup> See Cal. Rev. and Tax. Code section 19306.

<sup>22</sup> SB 1100, section 11; Cal. Rev. and Tax. Code section 19732(e).

<sup>23</sup> In the words of our New York partner, Paul Frankel, "Don't pay, don't pay, don't pay. . . ."

<sup>24</sup> Cal. Const. Art III, section 3.5.

<sup>25</sup> SB 1100, section 6; Cal. Rev. and Tax. Code section 7074(b).

<sup>26</sup> SB 1100, section 6; Cal. Rev. and Tax. Code section 7073(c).

<sup>27</sup> Thus, the provision should only apply to a "notice of determination" issued after March 31, 2005.

<sup>28</sup> SB 1100, section 6; Cal. Rev. and Tax. Code section 7073(d).

**END OF FOOTNOTES**