

REQUEST FOR PERMISSION TO PROCEED INTO THE FORMAL REGULATORY PROCESS ON
PROPOSED REGULATION SECTION 19131, RELATING TO PENALTY RELIEF FOR TAXPAYERS
WITH COMPLIANT TAX HISTORY

The Revenue and Taxation Code requires the Franchise Tax Board to impose penalties for a taxpayer's failure to timely file a return (sections 19131, 19172, and 19172.5) or a taxpayer's failure to timely pay tax (section 19132) (hereinafter "timeliness penalties"), unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

These sections generally conform to Internal Revenue Code sections 6651 (19131 and 19132), 6698 (19172) and 6699 (19172.5). The Internal Revenue Service has an administrative policy in the Internal Revenue Manual (section 20.1.1.3.6.1) that provides for a "first-time" abatement procedure. Pursuant to the "first-time" abatement procedure, the IRS will abate timeliness penalties, based on compliance history without making a separate reasonable cause determination, if the taxpayer had not previously been required to file a return or if no prior penalties (except the estimated tax penalty imposed under IRC section 6655(a)) have been assessed in the prior three years. The Revenue and Taxation Code has no provision similar to this federal first-time abate policy, nor does the Franchise Tax Board have any formal administrative policy that is similar to the federal policy.

The proposed Regulation section 19131 would establish a penalty abatement procedure for these timeliness penalties similar to the federal first-time abate procedure.

On December 3, 2010, an Interested Parties Meeting was held to solicit input from the public on two proposed regulations under Revenue and Taxation Code sections 19131 (failure to timely file) and 19132 (failure to timely pay) which would allow for abatement of these penalties under standards similar to the federal first-time abatement procedure.

Following this Interested Parties Meeting, staff determined that the federal first-time abate procedure also extended to the failure to timely file penalties related to partnerships and S Corporations. In order to extend the Franchise Tax Board's penalty relief to partnerships and S Corporations, and to avoid issuing four separate, yet substantially-identical, regulations, it was decided to consolidate the Franchise Tax Board's procedures for the first-time abatement of these timeliness penalties under a single new Regulation section 19131.

On November 1, 2011, a second Interested Parties Meeting was held to discuss the draft language of the proposed regulation and the scope of the federal procedure.

After the meeting, department staff considered the public comments and determined that the federal procedure related to calendar years and not tax years, and the proposed draft of the regulation language was revised to reflect this change. Attached hereto is a description of the changes that were made to the regulation's proposed language following the second Interested Parties Meeting.

The proposed Regulation section 19131 regarding these timeliness penalties further conforms California law to the corresponding federal rules and encourages and rewards taxpayer compliance.

Staff requests permission to begin the formal regulatory process to adopt this regulation.
December 1, 2011

Description of Changes in the Language of the Proposed Regulation

(a)(3) – "limited liability company (LLC)" was added to clarify that the penalty applies to LLCs taxed as partnerships, as well as to partnerships.

(b)(2)(A) – Language was added to clarify that prior timeliness penalties that had been imposed, but subsequently abated due to a determination of reasonable cause and not due to willful neglect, would not preclude application of the proposed regulation.

(b)(2)(A) and (b)(2)(B) - Language was modified to clarify that the requisite time period is the year of the request for abatement and the prior four (4) calendar years – not taxable years.

(c) – Language was added to specify that if a request for abatement is allowed, either under the first-time abate procedures in this regulation or upon a finding of reasonable cause, then the taxpayer will be notified and the taxpayer's account will be noted and adjusted accordingly.

(d) – Language was added to clarify that notice will be provided to a taxpayer making an abatement request if the request is to be denied, and also that this denial determination does not confer any protest or appeal rights upon the taxpayer other than those rights that exist under current law.

(e) – A new subsection was added to provide that if an abatement request is made for multiple tax years, only the earliest tax year is eligible for abatement under this regulation.

(f) [This subsection was renumbered from (e) to (f).] - Examples 1 through 5 were modified to reflect that the requisite time period for review of a taxpayer's compliance history is the year of the request for abatement and the prior four (4) calendar years.

Example 6 was read into the record and discussed at the second Interested Parties Meeting. Subsequently, it has been revised to reflect that the requisite time period for review of a taxpayer's compliance history is the year of the request for abatement and the prior four (4) calendar years.

Example 7 was added to illustrate operation of the regulation for taxpayers who have had no previous California filing requirement.

(g) [This subsection was renumbered from (f) to (g).]– This section was read into the record and discussed at the second Interested Parties Meeting. This section provides a clear operative date of the regulation and was revised following the second Interested Parties Meeting to clarify that requests for abatement will be considered by the Franchise Tax Board provided that the statute of limitations is open for the relevant tax year at the time of the taxpayer's request for abatement.

Report on Interested Parties Meeting Regulation Section 19131, Timeliness Penalty Relief

Administration

On November 1, 2011 at 2:30 p.m., members of the public attended a second interested parties meeting at the Franchise Tax Board central office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and telephone participants introduced themselves. The session was audio recorded for reference, but there will be no attribution of comments and no transcript. Representing the department was Karen Smith of the Legal Division.

Background

The Franchise Tax Board imposes timeliness penalties under Revenue and Taxation Code sections 19131, 19132, 19172, and 19172.5 for a taxpayer's failure to timely file a return (sections 19131, 19172, and 19172.5) or a taxpayer's failure to timely pay tax (section 19132). All of these penalties are imposed unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

These sections generally conform to Internal Revenue Code sections 6651 (19131 and 19132), 6698 (19172) and 6699 (19172.5). The Internal Revenue Service has an administrative policy in the IRS Penalty Manual (section 20.1.1.3.6.1) that provides for a "first-time" abatement procedure. This policy applies if the taxpayer had not previously been required to file a return or if no prior late filing or underpayment penalties had been imposed in year of the request for abatement or the prior three years. If a taxpayer meets the requirements for this first-time abate procedure, the Internal Revenue Service abates the federal failures to file and failure to pay tax penalties without considering any reasonable cause argument. The Revenue and Taxation Code has no provision similar to this federal first-time abate policy, nor does the Franchise Tax Board have any formal administrative policy that is similar to the federal policy.

The proposed Regulation section 19131 would establish a penalty abatement procedure for these timeliness penalties similar to the federal first-time abate procedure.

Staff Commentary

The Hearing Officer, Karen Smith, explained that the original Interested Parties Meeting discussed two separate regulations under sections 19131 and 19132 providing for a California first-time abate process similar to the federal policy, but that the new proposed regulation section 19131 would be applicable to all timeliness penalties (sections 19131, 19132, 19172 and 19172.5) that had a federal equivalent and were subject to the first-time abate procedure at the federal level. She referenced the provided copy of the proposed language of the regulation and further explained that the information provided in the examples would illustrate how the regulation would be applied. Additionally, she read into the record the subject matter of an additional example six that had been drafted for further clarification. She also read into the record subsection (f) [renumbered to (g)] regarding the intended effective date of the regulation. The forum was then opened up for questions, comments or concerns.

Attendee Commentary

Some questions were asked regarding specific fact patterns and the availability of penalty relief. Staff answered the questions and also referenced that the situations were covered in the examples as listed in subsection (e) [renumbered to (f)] of the proposed regulation.

Additionally, a question was elicited regarding the need for subsection (b)(2)(B) and it was explained by staff that this subsection was necessary as the penalty relief is not available if the taxpayer already received the benefit of the provision in the prior four (4) years.

Written Commentary

Prior to the meeting, the following questions were received and the following answers provided:

1. *What will be the effective date of the regulation?*

The effective date" of this regulation will be the date specified in the Government Code, which is 30 days after OAL files it with the Secretary of State. In regards to an operative date, we are anticipating that the regulation will be drafted to apply to requests for abatement filed on or after the effective date, without regard to taxable year, so that it can apply to filings that occurred before the effective date.

2. *Is the FTB currently abating penalties for taxpayers who fit this criteria?*

No, the FTB is not currently abating penalties that fit this criteria.

3. *Why was the regulation proposed?*

Unlike the IRS, the FTB does not have specific legal authority to specify the circumstances of reasonable cause on this basis, without a duly-adopted regulation under the APA, such that a first-time abatement could be applied.

4. *Why does the regulation not have its own separate number instead of the title reference to section 19131 only, as taxpayers will not realize that it will apply to other code sections?*

Renumbering the regulation under a non-existing section will not solve the issue. CCH and other publishers will be asked to publish the regulation under each of the affected penalty code sections.

Subsequent Action

At the conclusion of the meeting, staff reiterated its interest in hearing and receiving additional comments.

Section 19131 is adopted to read:

§ 19131. Timeliness Penalties.

(a) *In general.* The following timeliness penalties, relating to either a taxpayer's failure to timely file a return on or before the original or extended due date of the return, or to timely pay tax on or before the original due date, shall be eligible for abatement under the provisions of this regulation:

- (1) Revenue and Taxation Code section 19131, relating to failure to timely file a return;
- (2) Revenue and Taxation Code section 19132, relating to failure to timely pay tax;
- (3) Revenue and Taxation Code section 19172, relating to failure of a partnership or limited liability company (LLC) taxed as a partnership to timely file a return; and
- (4) Revenue and Taxation Code section 19172.5, relating to failure of an S corporation to timely file a return.

(b) *Presumption of Reasonable Cause.* If a taxpayer makes a request for abatement of a timeliness penalty, reasonable cause may be presumed and a timeliness penalty specified in subsection (a) may be abated if either:

- (1) the taxpayer has not previously been required to file a California return under the Revenue and Taxation Code; or
- (2)(A) no prior timeliness penalties have been imposed by the Franchise Tax Board, or were imposed and subsequently abated due to a determination of reasonable cause and not due to willful neglect, with respect to the same taxpayer, or the taxpayer's spouse if filing a joint return, in the year of request for abatement or in the prior four (4) years; or
- (B) no prior timeliness penalties have been abated pursuant to this regulation for the same taxpayer, or the taxpayer's spouse if filing a joint return, in the year of request for abatement or in the prior four (4) years.

(c) *Requests for Abatement.* A request for abatement under the provisions of this regulation may be made in any manner, whether written or oral, by a taxpayer or the taxpayer's duly authorized representative. If a request for abatement, either under the provisions of this regulation or on the basis of reasonable cause and not willful neglect, is allowed, the taxpayer will be so notified and the taxpayer's account will be noted and adjusted accordingly.

(d) *Denial of Request for Abatement; Reasonable Cause Determination.* If a taxpayer is not entitled to relief under subsection (b), then:

- (1) The Franchise Tax Board will treat the taxpayer's request for abatement as a request to abate the applicable penalty on the basis of reasonable cause and not due to willful neglect.
- (2) The Franchise Tax Board will notify the taxpayer of its determination.
- (3) There shall be no independent protest or appeal rights from the notification in subsection (d)(2).

(e) *Multiple Tax Years.* If a taxpayer requests abatement under this regulation for multiple taxable years as part of the same request and at least two taxable years would independently be eligible for abatement under this regulation, then only the earlier taxable year shall be eligible for abatement under this regulation.

(f) *Examples.* The following examples illustrate the provisions of this regulation:

Example 1. Assume Individual X filed a California personal income tax return for the 2007 taxable year after the required due date for the return and a penalty for failure to timely file is imposed. In 2012, X makes a request for abatement of the failure to timely file penalty for the 2007 taxable year under the provisions of this regulation. Review of X's accounts indicates that no other previous timeliness penalties had been imposed or abated by the Franchise Tax Board in 2008, 2009, 2010, 2011, or 2012. Because no previous timeliness penalties had been imposed or abated in the year of the request for abatement or the prior four (4) years, the timeliness penalty for failure to timely file will be abated for the 2007 taxable year.

Example 2. Assume the same facts as in Example 1, except that the Franchise Tax Board had also imposed a penalty for failure to timely pay tax for X's 2009 California taxable year. In 2012, X makes a request for abatement of the failure to timely file penalty for the 2007 taxable year. Because review of X's accounts for 2008, 2009, 2010, 2011, and 2012 indicates that another timeliness penalty had been imposed by the Franchise Tax Board in these years, the penalty for failure to timely file for the 2007 taxable year will not be abated under this regulation, but the penalty may be abated if the Franchise Tax Board determines that X's late filing for 2007 was due to reasonable cause and not due to willful neglect.

Example 3. Assume Partnership Y filed a California partnership return for the 2009 taxable year after the required due date for the return and a penalty for failure to timely file is imposed under Revenue and Taxation Code section 19131. Assume also that a partnership late filing penalty under Revenue and Taxation Code section 19172 is also imposed for the 2009 taxable year for Y's failure to timely file the tax return. In 2012, Y makes a request for abatement of both penalties for the 2009 taxable year under this regulation. Review of Y's accounts indicates that no other timeliness penalties were imposed or abated by the Franchise tax Board in 2008, 2009, 2010, 2011, or 2012;

however, the Internal Revenue Service imposed a federal penalty for failure to timely file a return for Y's 2008 taxable year. Because review of Y's California accounts indicates that no other previous timeliness penalties had been imposed or abated by the Franchise Tax Board in this period, both the timeliness penalty for failure to timely file a return and the timeliness penalty for failure to timely file a partnership return will be abated for the 2009 taxable year. Although there are two timeliness penalties being abated in 2012, the penalties are for the same year. Neither subsection (b)(2)(A) nor (b)(2)(B) would preclude the abatement of both penalties under this regulation in this situation. Further, the fact that a federal timeliness penalty had been imposed for the year of the request for abatement or the prior four (4) years is not relevant in determining whether the abatement procedures of this regulation shall apply.

Example 4. Assume Individual Z filed a California personal income tax return for the 2009 taxable year and a penalty for failure to timely pay tax is imposed because Z failed to timely pay the amount of tax as shown on the return. In 2012, Z makes a request for abatement of the failure to timely pay tax penalty for the 2009 taxable year under this regulation. Review of Z's accounts indicates that no other timeliness penalties were imposed or abated by the Franchise Tax Board in 2008, 2009, 2010, 2011, or 2012; however, the Franchise Tax Board imposed an accuracy-related penalty for Z's 2008 California taxable year. Because no previous timeliness penalties had been imposed or abated by the Franchise Tax Board in the year of the request for abatement or the prior four (4) years, the timeliness penalty for failure to timely pay tax will be abated for the 2009 taxable year. Further, the fact that an accuracy-related penalty had been imposed for the year of the request for abatement or the prior four (4) years is not relevant in determining whether the abatement procedures of this regulation shall apply.

Example 5. Assume the same facts as in Example 4 except the Franchise Tax Board did not impose an accuracy-related penalty for Z's 2008 taxable year. Further assume Z filed a California personal income tax return for the 2010 taxable year after the required due date for the return and a penalty for failure to timely file is imposed. In 2012, after the penalty for failure to timely pay tax was abated for the 2009 taxable year, Z makes a request for abatement of the failure to timely file penalty for the 2010 taxable year. Because review of Z's accounts for 2008, 2009, 2010, 2011 and 2012 indicates that the penalty for failure to timely pay tax was abated under this regulation for the 2009 taxable year, the penalty for failure to timely file a 2010 return will not be abated under this regulation, but the penalty may be abated if the Franchise Tax Board determines that Z's late filing for 2010 was due to reasonable cause and not due to willful neglect.

Example 6. Assume Corporation XYZ, Inc. filed a California corporate franchise tax return for the 2009 taxable year after the required due date for the return and a penalty for failure to timely file is imposed. In 2012, XYZ makes a request for abatement of the failure to timely file penalty for the 2009 taxable year under the provisions of this regulation. Review of XYZ's accounts for 2008, 2009, 2010, 2011, and 2012 indicates that a penalty for failure to timely pay tax was imposed by the Franchise Tax Board for the 2006 taxable year, but was abated in 2008 based upon a determination of reasonable cause. Because the penalty for failure to timely pay tax for the 2006 taxable year was abated in 2008 based upon a determination of reasonable cause and not

under the provisions of this regulation and no other timeliness penalties had been imposed or abated by the Franchise Tax Board for the year of the request for abatement or the prior four (4) years, the timeliness penalty for failure to timely file will be abated for the 2009 taxable year.

Example 7. Assume Individuals H and W moved into California on January 1, 2011. H and W filed a joint California personal income tax return for the 2011 tax year after the required due date for the return and a penalty for failure to timely file is imposed. In 2012, H and W make a request for abatement of the failure to timely file penalty for the 2011 taxable year. Because H and W did not have a California filing requirement prior to the 2011 tax year, the penalty for failure to timely file will be abated under the provisions of this regulation.

(g) This regulation shall apply to requests for abatement made on or after the effective date of this regulation, without regard to taxable year. Requests for abatement will be considered under the provisions of this regulation as long as the statute of limitations for the taxpayer to contest the penalty through protest, claim for refund, administrative appeal, or in a judicial proceeding, is open at the time the request for abatement is filed.

NOTE: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 19131, Revenue and Taxation Code.