

**INITIAL STATEMENT OF REASONS  
FOR THE ADOPTION OF  
REGULATION 19133**

**SPECIFIC PURPOSE OF THE REGULATION**

This proposed regulation clarifies under what circumstances the Franchise Tax Board will impose a notice and demand penalty upon individual taxpayers. Under the proposed regulation, the Franchise Tax Board will impose the notice and demand penalty only upon a "repeat nonfiler."

**NECESSITY**

The primary purpose of the notice and demand penalty, imposed pursuant to Revenue and Taxation Code section 19133, is to bring taxpayers into compliance with their duty to file a tax return.

The Franchise Tax Board's Filing Enforcement program identifies individual taxpayers who have not filed a personal income tax return when a return appears to be required based upon information available to the Franchise Tax Board. The Franchise Tax Board then issues a notice and demand letter that notifies the taxpayer that the Franchise Tax Board has no record of receiving the taxpayer's tax return for a specific tax year. The letter also requires the taxpayer, within a specified time period, to file a tax return or demonstrate why the taxpayer does not have a filing requirement. If a taxpayer fails to respond to the notice and demand letter in the manner and within the time period specified on the letter, then pursuant to Revenue and Taxation Code section 19133, the Franchise Tax Board may impose a notice and demand penalty of 25 percent of either the amount of tax assessed (without regard to any payments or credits) pursuant to Revenue and Taxation Code section 19087 or of any deficiency tax assessed (without regard to any payments or credits) by the Franchise Tax Board.

It has been the practice of the Franchise Tax Board to assess the notice and demand penalty against all taxpayers who fail to respond to the notice and demand letter, without consideration of their past filing history. Many of these nonfilers are first-time nonfilers. Studies and reports have shown that nearly two-thirds of all taxpayers who failed to file a tax return during a specific tax year filed a tax return as required by law in the following tax year. Their failure to file their tax return was an isolated incident.

Because of the manner in which the penalty is calculated (penalty is imposed on the amount of tax, before reduction for any payments or credits) and because of its application to all nonfilers (irrespective of prior filing history), some have viewed the Franchise Tax Board's policy of assessing a notice and demand penalty as unduly harsh. The Franchise Tax Board has received complaints regarding the rigid application of the penalty upon all taxpayers. Furthermore, the notice and demand penalty has been raised several times as an issue at Certified Public Accountant and Enrolled Agent conferences and at annual Taxpayer's Bill of Rights hearings.

Because the notice and demand penalty has been perceived by some as a harsh penalty, the Franchise Tax Board considered whether its policy of issuing a notice and demand letter and assessing a notice and demand penalty against all taxpayers was a fair and reasonable practice, particularly against those taxpayers who are not "repeat nonfilers."

Under this proposed regulation, the Franchise Tax Board defines a repeat nonfiler as an individual who has received a proposed assessment of tax after receiving and failing to respond to either a request for tax return or a demand for tax return within the previous four years. The Franchise Tax Board has also determined that four years is a reasonable period of time to look back in making a determination as to whether a taxpayer is a repeat nonfiler.

Therefore, the Franchise Tax Board will issue a demand for tax return to those taxpayers who are repeat nonfilers. The failure by the repeat nonfiler to respond to a current demand for tax return in the manner and within the time period specified in the demand for tax return will trigger the assessment of the notice and demand penalty on a proposed assessment of tax. On the other hand, the Franchise Tax Board will not assess the notice and demand penalty against those individual taxpayers who are not identified as repeat nonfilers.

#### **TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS RELIED UPON**

The Franchise Tax Board considered the following technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation: Who are California's Nonfilers?; Revenue Loss Estimation Computation; Demand Penalty for Nonfilers; Computations for Demand Penalty Paper; PIT Filing Enforcement Demand Penalty Statistics; Filing Enforcement's Effects on Subsequent Year Compliance; Reminder Letter Issue Paper; Filing Enforcement Taxpayer Satisfaction Survey Results; Failure to File After Notice and Demand Policy Discussion; and Does the Penalty Fit the Crime?

#### **REASONABLE ALTERNATIVES TO THE REGULATION AND THE AGENCY'S REASONS FOR REJECTING THOSE ALTERNATIVES**

The staff of the Franchise Tax Board presented several alternatives to the three-member Board for their consideration prior to noticing this proposed regulation.

The first alternative was to continue with the policy of issuing a notice and demand penalty to all nonfilers who failed to respond to the Franchise Tax Board's notice and demand letter.

The second alternative was to issue a reminder letter to first-time nonfilers prior to issuing a notice and demand letter. If the first-time nonfiler failed to respond to the reminder letter, then the Franchise Tax Board would issue a notice and demand letter, and if the taxpayer failed to respond and file a return, then the Franchise Tax Board would impose a notice and demand penalty.

The three-member Board rejected both of these alternatives because they did not address the perceived undue harshness of the penalty with respect to first time nonfilers and failed to target repeat nonfilers.

In addition, the three-member Board considered and directed the staff of the Franchise Tax Board to sponsor legislation to alter the calculation of the penalty by taking into consideration timely payments of tax and allowing credits against the tax that may be claimed on the return. This legislative proposal was introduced in the first year of the 1999/2000 legislative session as Assembly Bill 296 (Strickland). The bill was held under submission in the Assembly Appropriations Committee by action on May 29, 1999, and then died on February 3, 2000, pursuant to Article 4, Section 10, subdivision (c), of the California Constitution.

The Board authorized resubmission of this legislative proposal. The legislative proposal was re-introduced as Assembly Bill 1320 (Pacheco). On February 7, 2002, the bill died pursuant to Article 4, Section 10, subdivision (c), of the California Constitution.

#### **ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS**

The purpose of this proposed regulation is to provide relief from the notice and demand penalty assessed against taxpayers who are considered to have a good filing history. As such, the proposed regulation effectively reduces the adverse impact on those individual taxpayers with a good filing history and instead targets only repeat nonfilers.

#### **ADVERSE ECONOMIC IMPACT ON BUSINESS**

Sole proprietors are taxpayers who file individual tax returns and are treated as individual taxpayers. Thus, the proposed regulation would affect sole proprietorships in the same manner as it affects individuals. Only those sole proprietors who are repeat nonfilers and who fail to respond to the demand for tax return would be subject to the notice and demand penalty. This regulation is not applicable to any other business entity such as corporations, partnerships or limited liability companies.