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## Assembly Bill No. 347

**- 4/20/2009**

April 20, 2009

*On April 20, 2009, Tax Executives Institute filed the following comments with the Committee on Revenue and Taxation of the California State Assembly about a proposal to impose a 25-percent penalty on taxpayers who fail or refuse to furnish any information requested during a sales and use tax audit. The comments were filed under the aegis of TEI's State and Local Tax Committee, whose chair is Cathlenn Stevens of Brunswick Corporation; Howare Grindle of Tata Communications, (Americas) Inc., vice chair of the committee, contributed materially to the Institute's submission. Daniel B. De Jong, TEI Tax Counsel, serves as legal staff liaison to the committee.*

On behalf of Tax Executives Institute ("TEI" or "the Institute"), I write to urge the defeat of Assembly Bill No. 347, which is scheduled for a hearing on April 27, 2009, before the Committee on Revenue and Taxation. The proposed legislation would impose a 25-percent penalty on taxpayers who fail or refuse to furnish any information requested during a sales and use tax audit. Because the proposed legislation is vague, overbroad, and unnecessary, it cannot achieve its stated purpose of advancing fairer and more efficient tax administration. Should the government conclude action is needed, we recommend the development of comprehensive administrative guidelines in lieu of this statutory amendment; these guidelines could govern all aspects of sales and use tax audits, including defining the types of information to be requested, production guidelines, and reasonable cause standards. TEI would welcome the opportunity to work with the Board of Equalization to develop those guidelines.

### Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including 5 in the State of California. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting sound tax policy, as well as in the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,200 of the largest companies in the world, most of which are either resident or do business in California.

#### I. Assembly Bill No. 347 – Background

Assembly Bill No. 347 ("the Bill") would amend Section 7054 of the California Revenue and Taxation Code to authorize the California State Board of Equalization ("the Board") to impose a 25-percent penalty if, during a sales or use tax audit, a taxpayer fails or refuses to timely furnish any information requested during the audit.

The text of the Bill (with the new language in italics) is, as follows:

SECTION 1. Section 7054 of the Revenue and Taxation Code is amended to read:

7054. (a) The board or any person authorized in writing by it may examine the books, papers, records, and equipment of any person selling tangible personal property and any person liable for the use tax and may investigate the character of the business of the person in order to verify the accuracy of any return made, or, if no return is made by the person, to ascertain and determine the amount required to be paid.

(b) *If, during an examination or audit engagement, any person described in subdivision (a) fails or refuses to furnish any information requested by the date specified in writing by the board and required by this part upon notice and demand by the board, then, unless the failure is due to reasonable cause and not wilful neglect, the board may add a penalty of 25 percent of the amount of tax determined pursuant to Section 6481 or any deficiency of tax determined by the board concerning the assessment for which the information was required.*

The Draft Staff Legislative Bill Analysis ("the Bill Analysis") describes the purpose of the bill as assisting the Board in better allocating its audit resources by reducing the time and expense devoted to individual audits. Additionally, the Bill Analysis states that the 25-percent penalty would discourage taxpayers and their representatives from using delaying tactics and other strategies to prevent the timely conduct of an examination.

## II. Assembly Bill No. 347 is Vague, Overbroad, and Unnecessary

TEI respectfully submits that the proposed legislation is vague, overbroad, unnecessary, and will not achieve its stated purpose of advancing fairer and more efficient tax administration.

### A. *The Bill is Vague and Overbroad*

Under the Bill as drafted, a 25-percent penalty would be imposed when a taxpayer "fails or refuses to furnish any information requested by the date specified in writing by the board." The phrase "any information" requires more than can be provided in some circumstances. If the Bill is enacted in its current form, without exceptions for situations where it is not practical or possible to respond within the time allowed by the Board, taxpayers will be subjected to no-fault penalties even where they have taken all possible and prudent steps to comply. To the extent penalties are appropriate, they should be limited to a taxpayer's failure to produce *material* information rather than *any* information an auditor might request. Additionally, the Bill states that information must be provided "by the date specified in writing by the board," but does not impose any limitations on the Board in setting those dates. To avoid arguments over arbitrarily set response dates, the Bill should limit the penalty to failures to comply within reasonable time periods. Without this change, auditors may be emboldened to use this penalty to improperly extract settlements from taxpayers. Replacing the phrase "any information" with the concept of substantial compliance and inserting a minimum response time of 30 days would minimize the risk of administrative overreach in the administration of California's sales and use tax system.

The Bill Analysis suggests that delays in response times arise primarily from malicious motives. That is simply not the case. A taxpayer's inability to comply with requests for information can be attributable to many causes. For example, if a taxpayer is involved in a merger or acquisition transaction, access to information in remote locations or in legacy information reporting systems will likely require additional effort, expense, and time to retrieve. Employee turnover and the attendant loss of "institutional knowledge" are not unusual and may further contribute to delays. Even where turnover and acquisitions do not occur, large multinational corporations may store records in distant foreign locations that prevent the swift procurement of relevant documentation. Enterprise-wide document management systems used by many corporations may alleviate some of these issues, but computers occasionally "hiccup" causing delays in the retrieval, or even the total loss, of data. These electronic recordkeeping systems may also make retrieval of invoices and purchase orders more difficult since they store data in a wide array of formats that may not correspond with the format requested by an auditor.

Equally troubling is the absence of guidance on the scope of the term "reasonable cause." The principle of fair and equitable administration of California's tax laws demands clarity, but in the absence of clear rules defining the scope of the "reasonable cause" exception taxpayers will be exposed to penalties at worse and significant uncertainty at best. The opacity of the Bill's standard will surely impede audits as taxpayers are forced to contest the assertion of the no-fault penalty with lengthy and costly litigation.

TEI recommends that the reasonable cause standard be included in the statute. Specifically, language should be added to the Bill embracing the generally applied definition of reasonable cause in California — i.e., "ordinary business care and prudence."<sup>1</sup> Additionally, the legislature could provide examples by incorporating extant language in the regulations relating to the penalty for failure to maintain and make available records. Those regulations provide that "[r]easonable cause includes, but is not limited to, destruction as a result of theft, riot, war or by an act of God, such as earthquake, fire, flood, tsunami, or similar natural disaster." Cal. Code Regs. § 19141.6(j) (2)(B)(5). Additional examples such as damage to computer systems, excessive employee

turnover, and the storage of documentation in distant locations would provide critical specificity in the application of reasonable cause in the area of sales and use tax audit responsiveness.

*B. The Bill is Unnecessary*

Assembly Bill 347 is an unnecessary, and possibly counterproductive, tool for engendering quicker responses to audit information requests. Current law already provides the Board with a full arsenal of tools and techniques that can be utilized to facilitate compliance with examination-related information requests, including –

- The ability to issue assessments based on the best available information (in the event the taxpayer does not provide requested data);<sup>2</sup>
- Jeopardy assessments;<sup>3</sup>
- A late payment penalty of 10 percent;<sup>4</sup>
- A negligence penalty of 10 percent;<sup>5</sup>
- A penalty of 40 percent for failure to remit collected taxes;<sup>6</sup> and
- The subpoena *duces tecum*.<sup>7</sup>

Interest also continues to accrue on unpaid tax liabilities, obviating new penalties. These existing mechanisms are more than adequate to encourage timely taxpayer responses to information requests from the Board.

*III. Comprehensive Administrative Sales and Use Tax Guidelines Are Warranted*

In TEI's view, the preferred approach to enhance sales and use tax audit administration is through the development of a comprehensive set of administrative guidelines for sales and use tax examinations in California. Indeed, such a project was initiated by the Board in 2008. The draft regulations issued by the Board in January 2009 as part of that project would have instructed the Board's Audit Division to engage taxpayers in pre-audit conferences at which (1) the scope and nature of information to be requested by the taxpayer would be defined, and (2) the Board could understand whether there may be systems limitations that may inhibit a taxpayer's ability to respond to information requests and how such limitations can be mutually overcome. Regrettably, that project was recently placed on hold. We urge its prompt revitalization.

Through this project, both taxpayers and the Board can focus on enhancing cooperation and collaboration in order to ensure that relevant information is requested and received within reasonable timeframes. Because of the myriad issues that can impede a taxpayer's ability to produce relevant documentation, this more flexible approach sets more accurate expectations for the Board *and* taxpayers with regard to data requests and their related timelines.

**Conclusion**

Effective and efficient audit management is the *sine qua non* of sound tax administration. Regrettably, Assembly Bill 347 would impede rather than enhance sound tax administration. Accordingly, we urge the Committee to reject this unwise effort and instead revitalize and accelerate the administrative sales and use tax project.

TEI appreciates this opportunity to present its views on the Bill. If you have any questions about the Institute's views or desire additional information on this submission, please do not hesitate to contact Cathleen Stevens, Chair of TEI's State and Local Tax Committee, at 847.735.4672 ([cathleen.stevens@brunswick.com](mailto:cathleen.stevens@brunswick.com)) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 ([ddejong@tei.org](mailto:ddejong@tei.org)).

\* \* \*

1 The Board's recent ruling *In the Matter of the Appeal of: Pacific Canopy, Inc.*, 345419 (March 19, 2008), cites earlier rulings stating that "[t]o establish reasonable case, a taxpayer must show that it exercised ordinary business care and prudence."

2 California Revenue and Taxation Code § 6481.

3 *Id.* § 6536.

4 *Id.* § 6591.

5 *Id.* § 6485.

6 *Id.* § 6597.

7 California Government Code § 15613.

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