



STATE BOARD OF EQUALIZATION

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State Controller

CYNTHIA BRIDGES
Executive Director

March 18, 2016

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for proposed amendments to Regulation 1703, *Interest and Penalties*, and Audit Manual Chapter 5, *Penalties*, which will be presented at the Board's March 30, 2016 Business Taxes Committee meeting. The proposed amendments provide guidance with respect to the imposition of a negligence penalty on a taxpayer's first audit liability.

Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:00 a.m.** on **March 30, 2016** in Room 121 at the address shown above.

Sincerely,

Susanne Buehler, Chief
Tax Policy Division
Business Tax and Fee Department

SB:rsw

Enclosures

cc: (all with enclosures, via email and/or hardcopy as requested)
Honorable Fiona Ma, CPA, Chairwoman
Honorable Diane L. Harkey, Vice Chair
Honorable George Runner, Member, First District
Honorable Jerome E. Horton, Member, Third District
Honorable Betty T. Yee, State Controller, c/o Ms. Yvette Stowers (MIC 73)

Ms. Genevieve Jopanda, Board Member's Office, Second District
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Mr. Tim Morland, Board Member's Office, Second District
Mr. Russell Lowery, Board Member's Office, Fourth District
Mr. Ted Matthies, Board Member's Office, Fourth District
Ms. Lisa Renati, Board Member's Office, Fourth District
Mr. Clifford Oakes, Board Member's Office, Fourth District
Mr. Sean Wallentine, Board Member's Office, First District
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Mr. Alfred Buck, Board Member's Office, First District
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Ms. Jaclyn Zumaeta, Board Member's Office, Third District
Mr. Chris Armenta, Board Member's Office, Third District
Mr. Ramon Salazar, State Controller's Office (MIC 73)
Ms. Cynthia Bridges (MIC 73)
Mr. Randy Ferris (MIC 83)
Mr. David Gau (MIC 101)
Ms. Lynn Bartolo (MIC 43)
Mr. Todd Gilman (MIC 70)
Mr. Wayne Mashihara (MIC 47)
Mr. Kevin Hanks (MIC 49)
Mr. Mark Durham (MIC 67)
Mr. Robert Tucker (MIC 82)
Mr. Jeff Vest (MIC 85)
Mr. Jeff Angeja (MIC 85)
Mr. David Levine (MIC 85)
Ms. Dana Brown (MIC 85)
Ms. Casey Tichy (MIC 85)
Ms. Linda Cheng (MIC 85)
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Mr. Rick Zellmer (MIC 85)
Mr. Bradley Heller (MIC 82)
Mr. Lawrence Mendel (MIC 82)
Mr. John Thiella (MIC 73)
Mr. Scott Claremon (MIC 82)
Ms. Kirsten Stark (MIC 50)
Mr. Marc Alviso (MIC 101)
Mr. Chris Lee (MIC 101)
Ms. Laureen Simpson (MIC 70)
Ms. Karina Magana (MIC 47)
Mr. Bradley Miller (MIC 92)
Mr. Bill Benson (MIC 67)
Ms. Tracy McCrite (MIC 50)
Mr. Robert Wilke (MIC 50)

AGENDA —March 30, 2016 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1703, *Interest and Penalties*, and Audit Manual Chapter 5, *Penalties*

<p>Action 1 — Agreed Upon Items</p> <p>Proposed Amendments to Regulation 1703 Agenda, pages 2-15</p>	<p>Alternative 1</p> <p>Approve and authorize publication of staff’s proposed amendments to Regulation 1703, <i>Interest and Penalties</i>, to clarify the Board of Equalization’s long-standing policy of generally not imposing a negligence penalty on a taxpayer’s first audit liability.</p> <p align="center">OR</p> <p>Alternative 2</p> <p>Do not approve proposed amendments to Regulation 1703.</p>
<p>Action 2 — Agreed Upon Items</p> <p>Proposed Revisions to Audit Manual Chapter 5 Agenda, pages 16-22</p>	<p>Alternative 1</p> <p>Approve proposed revisions to AM Chapter 5, <i>Penalties</i>, to explain the circumstances and provide examples of when a negligence penalty may apply to a taxpayer’s first audit liability.</p> <p align="center">OR</p> <p>Alternative 2</p> <p>Do not approve proposed revisions to AM Chapter 5.</p>

AGENDA —March 30, 2016 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1703, *Interest and Penalties*, and Audit Manual Chapter 5, *Penalties*

<p>Action 1 — Staff Recommendation</p> <p>Proposed Amendments to Regulation 1703</p>	<p>Regulation 1703. Interest and Penalties.</p>																																
	<p>Reference: Sections 6071, 6072, 6073, 6074, 6077, 6094.5, 6207, 6291-6294, 6422.1, 6452, 6455, 6459, 6476-6478, 6479.3, 6480.4, 6480.8, 6480.19, 6482, 6484, 6485, 6485.1, 6511-6514, 6514.1, 6537, 6565, 6591, 6591.5, 6591.6, 6592, 6593, 6593.5, 6596, 6597, 6901, 6907, 6908, 6936, 6964, 7051.2, 7073, 7074, 7076.54, 7101, 7152-7153, 7153.5, <u>7153.6</u> and 7155, Revenue and Taxation Code.</p>																																
	<p>(a) Statutory Provisions. Interest and penalties are prescribed in various sections of the Sales and Use Tax Law as follows:</p>																																
	<table border="1" style="width:100%; border-collapse: collapse;"> <thead> <tr> <th style="width:60%;"></th> <th colspan="2" style="text-align:center;"><i>Sections</i></th> </tr> <tr> <th style="text-align:left;"><i>Subject</i></th> <th style="text-align:center;"><i>Interest</i></th> <th style="text-align:center;"><i>Penalties</i></th> </tr> </thead> <tbody> <tr> <td style="vertical-align:top;">Failure to pay tax within required time (except determinations)</td> <td style="vertical-align:top;">6480.4, 6480.8 6480.19, 6591</td> <td style="vertical-align:top;">6476, 6477, 6478, 6479.3, 6480.4, 6480.8, 6480.19, 7051.2, 6591</td> </tr> <tr> <td style="vertical-align:top;">Failure to file a timely return</td> <td></td> <td style="vertical-align:top;">6479.3, 6591</td> </tr> <tr> <td style="vertical-align:top;">Deficiency determinations</td> <td style="vertical-align:top;">6482</td> <td style="vertical-align:top;">6484 (negligence) 6485 (fraud) 7051.2</td> </tr> <tr> <td style="vertical-align:top;">Determinations—Sales tax reimbursement or use tax collected but not timely remitted</td> <td></td> <td style="vertical-align:top;">6597</td> </tr> <tr> <td style="vertical-align:top;">Determination—failure to make return</td> <td style="vertical-align:top;">6513</td> <td style="vertical-align:top;">6511, 7051.2 6514 (fraud)</td> </tr> <tr> <td style="vertical-align:top;">Jeopardy determinations</td> <td style="vertical-align:top;">6537</td> <td style="vertical-align:top;">6537, 7051.2</td> </tr> <tr> <td style="vertical-align:top;">Extensions of time</td> <td style="vertical-align:top;">6459</td> <td></td> </tr> <tr> <td style="vertical-align:top;">Determinations—Nonpayment of</td> <td></td> <td style="vertical-align:top;">6565, 7051.2</td> </tr> </tbody> </table>				<i>Sections</i>		<i>Subject</i>	<i>Interest</i>	<i>Penalties</i>	Failure to pay tax within required time (except determinations)	6480.4, 6480.8 6480.19 , 6591	6476, 6477, 6478, 6479.3, 6480.4, 6480.8 , 6480.19 , 7051.2, 6591	Failure to file a timely return		6479.3, 6591	Deficiency determinations	6482	6484 (negligence) 6485 (fraud) 7051.2	Determinations—Sales tax reimbursement or use tax collected but not timely remitted		6597	Determination—failure to make return	6513	6511, 7051.2 6514 (fraud)	Jeopardy determinations	6537	6537, 7051.2	Extensions of time	6459		Determinations—Nonpayment of		6565, 7051.2
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Offsets	6512	6512
Refunds and credits	6901, 6907,6908	6901
Suits for refund	6936	
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Criminal Penalties		6073, 6094.5, 6422.1 7152, 7153, 7153.5, 7153.6
Failure to make timely application for registration of motor vehicle, mobilehome, aircraft or undocumented vessel	6291-6294	6291-6294
Registration of vehicle, vessel or aircraft out of state		6485.1, 6514.1 (intent to evade)
Advertising that use tax will be absorbed		6207
Any violation of Sales and Use Tax Law		7153, 7153.5
Failure to collect use tax		6207
Failure to display use tax separately		6207
Failure to furnish return or other data		6452, 6455
Improper use of resale certificates	6072	6072, 6094.5
Making false return		7152
Misuse of vehicle use tax exemption certificates		6422.1
Operating as seller without permit		6071, 6077
Failure to obtain valid permit		6077, 7155
Relief from interest or penalty	6593, 6596	6592, 6596
Modified adjusted daily rate	6591.6	

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Modified adjusted rate	6591.5	
Failure to obtain evidence that operator of catering truck holds valid permit		6074
Improper allocation of local tax by direct payment permitholder		7051.2
Managed Audit Program	7076. 54	
Failure to pay tax due to an error or delay by an employee of the Board or Department of Motor Vehicles	6593.5	
Erroneous refund	6964	
Tax Amnesty Program (Reporting Periods Beginning Before January 1, 2003)		7073, 7074

(b) Interest.

(1) Interest Rates.

(A) In General. Interest is computed at the modified adjusted rate per month, or fraction thereof. “Modified adjusted rate per month, or fraction thereof” means the modified adjusted rate per annum divided by 12.

(B) Underpayments. “Modified adjusted rate per annum” for underpayments of tax is the rate for underpayments determined in accordance with the provisions of section 6621 of the Internal Revenue Code plus three percentage points. Such rate is subject to semiannual modification pursuant to the provisions of subparagraph (c) of section 6591.5 of the Revenue and Taxation Code.

(C) Overpayments. Except as provided below, “modified adjusted rate per annum” for overpayments of tax is the bond equivalent rate of 13-week treasury bills auctioned, rounded to the nearest full percent (or to the next highest full percent if .50%), subject to semiannual modification

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	<p>pursuant to the provisions of subparagraph (d) of section 6591.5 of the Revenue and Taxation Code. For the period July 1, 1991, through June 30, 1992, the modified adjusted rate per annum for overpayments is equal to the bond equivalent rate of 13-week treasury bills auctioned on July 1, 1991, rounded to the nearest full percent (or to the next highest full percent if .50%).</p> <p>(D) Managed Audit Program. Upon completion of the managed audit and verification by the Board, interest shall be computed at one-half the rate that would otherwise be imposed for liabilities covered by the audit period.</p> <p>(E) Error or Delay by Employee of Board or Department of Motor Vehicles. For tax liabilities that arise during taxable periods commencing on or after July 1, 1999, this subdivision is limited to interest imposed by sections 6480.4, 6480.8, 6513, 6591, and 6592.5 of the Revenue and Taxation Code. Effective January 1, 2002, this subdivision applies to interest imposed by any provision of the Sales and Use Tax Law. All or any part of such interest imposed may be relieved by the Board, in its discretion, under either of the following circumstances:</p> <ol style="list-style-type: none">1. Where the failure to pay tax is due in whole or in part to an unreasonable error or delay by an employee of the Board acting in his or her official capacity.2. Where failure to pay use tax on a vehicle or vessel registered with the Department of Motor Vehicles was the direct result of an error by the Department of Motor Vehicles in calculating the use tax. <p>For the purposes of this subdivision, an error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or a failure to act by, the taxpayer.</p> <p>Any person seeking relief under this subdivision shall file with the Board a statement under penalty of perjury setting forth the facts on which the claim for relief is based and any other information which the Board may require.</p> <p>(F) Erroneous Refund. Operative for any action for recovery under Revenue and Taxation Code section 6961 on or after July 1, 1999, no interest shall be imposed on the amount of an erroneous refund by the Board until 30 days after the date on which the Board mails a notice of determination for repayment of the erroneous refund if the Board finds that neither the person liable for payment</p>
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of tax nor any party related to that person had in any way caused an erroneous refund for which an action for recovery is provided under section 6961 of the Revenue and Taxation Code. The act of filing a claim for refund shall not be considered as causing the erroneous refund.

(2) Late Payments Generally. Interest applies to the amount of all taxes, except prepayments of amounts of tax due and payable pursuant to section 6471 of the Revenue and Taxation Code, not paid within the time required by law from the date on which the amount of tax became due and payable until the date of payment.

Interest applies to amounts due but not paid by any supplier or wholesaler ~~distributor or broker~~ of motor vehicle fuel, aircraft jet fuel, or diesel fuel who fails to make a timely remittance of the prepayment of tax required pursuant to sections 6480.1 and 6480.3 of the Revenue and Taxation Code.

~~Operative January 1, 1992, interest applies to amounts due but not paid by any producer, importer, or jobber of fuel as defined in section 6480.10 of the Revenue and Taxation Code who fails to make a timely remittance of the prepayment of tax required pursuant to sections 6480.16 and 6480.18 of the Revenue and Taxation Code.~~

(3) Determinations. Except as otherwise provided in subdivisions (b)(1)(E) and (b)(1)(F) above, interest applies to all determinations from the date on which the amount of tax becomes due and payable until the date of payment.

(4) Extensions of Time. In cases in which an extension of time for the filing of a return and the payment of tax has been granted, interest applies from the date on which the tax would have been due and payable had the extension not been granted until the date of payment. In cases in which an extension of time has been granted for making a prepayment of tax pursuant to section 6471 of the Revenue and Taxation Code, interest applies to the unpaid amount of the required prepayment at the same rate.

(5) Electronic Payments Made One Day Late.

(A) For the period of January 1, 2011, through January 1, 2016, if the Board finds, taking into account all facts and circumstances, that it is inequitable to compute interest at the modified

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	<p>adjusted rate per month or fraction thereof, as defined in subdivision (b)(1)(A) above, interest shall be computed at the modified adjusted daily rate from the date on which the tax or prepayment was due until the date of payment, if all of the following occur:</p> <ol style="list-style-type: none">1. A payment or prepayment of tax was made one business day after the due date.2. The person was granted relief from all penalties that applied to that payment of tax or prepayment.3. The person filed a request for an oral hearing before the Board. <p>(B) For purposes of this paragraph:</p> <ol style="list-style-type: none">1. “Modified adjusted daily rate” means the modified adjusted rate per annum, as defined in subdivision (b)(1)(B) above, determined on a daily basis by dividing the modified adjusted rate per annum by 365.2. “Board” means the members of the State Board of Equalization meeting as a public body.3. “Business day” means any day other than a Saturday, Sunday, or any day designated as a state holiday. <p>(C) This paragraph only applies to electronic payments or prepayments of taxes and does not apply to any payment made pursuant to a deficiency determination, a determination where no return has been filed, or a jeopardy determination.</p> <p>(6) Refunds and Credits.</p> <p>(A) In General. If an overpayment is credited on amounts due from any person or is refunded, interest will be computed on the overpayment from the first day of the calendar month following the month during which the overpayment was made. A refund or credit shall be made of any interest imposed upon the person making the overpayment with respect to the amount being refunded or credited. Interest will be paid in the case of a refund, to the last day of the calendar month following the date upon which the person making the overpayment, if he or she has not already filed a claim, is notified by the Bboard that a claim may be filed or the date upon which the</p>
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refund is approved by the **B**oard, whichever date is the earlier; and in the case of a credit, to the same date as that to which interest is computed on the tax or amount against which the credit is applied.

(B) Intentional or Careless Overpayments. Credit interest will be allowed on all overpayments, except when statutorily prohibited or in cases of intentional overpayment, fraud, negligence, or carelessness. Carelessness occurs if a taxpayer makes an overpayment which: 1) is the result of a computational error on the return or on its supporting schedules or the result of a clerical error such as including receipts for periods other than that for which the return is intended, failing to take allowable deductions, or using an incorrect tax rate; and 2) is made after the taxpayer has been notified in writing by the Board of the same or similar errors on one or more previous returns.

(C) Waiver of Interest as Condition of Deferring Action on Claim. If any person who has filed a claim for refund requests the Board to defer action on the claim, the Board, as a condition to deferring action, may require the claimant to waive interest for the period during which the person requests the Board to defer action.

(7) Improper Use of Resale Certificate. Interest applies to the taxes imposed upon any person who knowingly issues a resale certificate for personal gain or to evade the payment of taxes while not actively engaged in business as a seller. The interest is computed from the last day of the month following the quarterly period for which a return should have been filed and the amount of tax or any portion thereof should have been paid.

(8) Untimeliness Caused by Disaster. A person may be relieved of the interest imposed by sections 6459, 6480.4, ~~6480.8~~, 6513, and 6591 of the Revenue and Taxation Code if the **B**oard finds that the person's failure to make a timely return or payment was occasioned by a disaster and was neither negligent nor willful. Such person shall file with the **B**oard a statement under penalty of perjury setting forth the facts upon which the claim for relief is based.

For purposes of this section, “disaster” means fire, flood, storm, tidal wave, earthquake or similar public calamity, whether or not resulting from natural causes.

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(c) Penalties.

(1) Late Payments Generally.

(A) Prepayments.

1. Any person required to make a prepayment who fails to make a prepayment before the last day of the monthly period following the quarterly period in which the prepayment became due and who files a timely return and payment for that quarterly period shall pay a penalty of 6 percent of the amount equal to 90 percent or 95 percent of the tax liability, as prescribed in section 6471 of the Revenue and Taxation Code, for each of the periods during that quarterly period for which a required prepayment was not made.

2. If the failure to make a prepayment as described in (c)(1)(A)1. above is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations, the penalty shall be 10 percent instead of 6 percent.

3. Any person required to make a prepayment who fails to make a timely prepayment, but who makes such prepayment before the last day of the monthly period following the quarterly period in which the prepayment became due, shall pay a penalty of 6 percent of the amount of the prepayment.

4. If any part of a deficiency in prepayment is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations, a penalty of 10 percent of the deficiency shall be paid.

The penalties provided in subparagraphs 2 and 4 of this subsection shall not apply to amounts subject to the provisions of sections 6484, 6485, 6511, 6514, and 6591 of the Revenue and Taxation Code (subparagraphs (c)(1)(B), (c)(2)(A) and (c)(2)(B) of this regulation).

5. A penalty of ~~25%~~10 percent shall apply to the amount of prepayment due but not paid by any supplier or wholesaler~~distributor or broker~~ of motor vehicle fuel, aircraft jet fuel, or diesel fuel who fails to make a timely remittance of the prepayment as required pursuant to sections 6480.1 and 6480.3 of the Revenue and Taxation Code.

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~~6. Operative January 1, 1992, a penalty of 10 percent shall apply to the amount of prepayment due but not paid by any producer, importer, or jobber of fuel as defined in section 6480.10 of the Revenue and Taxation Code who fails to make a timely remittance of the prepayment as required pursuant to sections 6480.16 and 6480.18 of the Revenue and Taxation Code.~~ This penalty shall be 25 percent if the supplier or wholesaler~~producer, importer, or jobber~~ knowingly or intentionally fails to make a timely remittance.

(B) Other Late Payments. A penalty of 10 percent of the amount of all unpaid tax shall be added to any tax not paid in whole or in part within the time required by law.

(C) Vehicles, Vessels and Aircraft. A purchaser of a vehicle, vessel or aircraft who registers it outside this state for the purpose of evading the payment of sales or use taxes shall be liable for a penalty of 50 percent of any tax determined to be due on the sales price of the vehicle, vessel or aircraft.

(2) Late Return Forms Generally.

(A) Any person who fails to file a return in accordance with the due date set forth in section 6451 of the Revenue and Taxation Code or the due date established by the Board in accordance with section 6455 of the Revenue and Taxation Code, shall pay a penalty of 10 percent of the amount of taxes, exclusive of prepayments, with respect to the period for which the return is required.

(B) Any person remitting taxes by electronic funds transfer shall, on or before the due date of the remittance, file a return for the preceding reporting period in the form and manner prescribed by the Board. Any person who fails to timely file the required return shall pay a penalty of 10 percent of the amount of taxes, exclusive of prepayments, with respect to the period for which the return is required.

(3) Determinations.

(A) Negligence or Intentional Disregard. A penalty of 10 percent of the amount of the tax specified in the determination shall be added to deficiency determinations if any part of the deficiency for which the determination is imposed is due to negligence or intentional disregard of the Sales and

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	<p>Use Tax Law or authorized regulations.</p> <p><u>Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations.</u></p> <p>(B) Failure to Make Return. A penalty of 10 percent of the amount of tax specified in the determination shall be added to all determinations made on account of the failure of any person to make a return as required by law.</p> <p>(C) Fraud or Intent to Evade. A penalty of 25 percent of the amount of the tax specified in a deficiency determination shall be added thereto if any part of the deficiency for which the determination is made is due to fraud or intent to evade the Sales and Use Tax Law or authorized regulations. In the case of a determination for failure to file a return, if such failure is due to fraud or an intent to evade the Sales and Use Tax Law or authorized regulations, a penalty of 25 percent of the amount required to be paid, exclusive of penalties, shall be added thereto in addition to the 10 percent penalty for failure to file a return. Fraud or intent to evade shall be established by clear and convincing evidence.</p> <p>A penalty of 50 percent applies to the taxes imposed upon any person who, for the purpose of evading the payment of taxes, knowingly fails to obtain a valid permit prior to the date in which the first tax return is due. The 50 percent penalty applies to the taxes determined to be due for the period during which the person engaged in business in this state as a seller without a valid permit and may be added in addition to the 10 percent penalty for failure to file a return. However, the 50 percent penalty shall not apply if the measure of tax liability over the period during which the person was engaged in business without a valid permit averaged <u>one thousand dollars (\$1,000)</u> or less per month. Also, the 50 percent penalty shall not apply to the amount of taxes due on the sale or use of a vehicle, vessel, or aircraft, if the amount is subject to the penalty imposed by section 6485.1 or 6514.1 of the Revenue and Taxation Code.</p> <p>(D) Failure to timely remit collected sales tax reimbursement or use tax. With respect to Board-assessed determinations, except as provided below, for periods beginning on or after January 1,</p>
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	<p>2007, a person who knowingly collects sales tax reimbursement or use tax, and who fails to timely remit that sales tax reimbursement or use tax to the Board, shall be liable for a penalty of 40 percent of the amount not timely remitted. The penalty shall not apply if:</p> <ol style="list-style-type: none">1. the person's liability for the unremitted sales tax reimbursement or use tax averages one thousand dollars (\$1,000) or less per month, or does not exceed 5 percent of the total amount of tax liability for which the tax reimbursement was collected for the period in which tax was due, whichever is greater; or2. the person's failure to make a timely remittance of sales tax reimbursement or use tax is due to a reasonable cause or circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. <p>For purposes of this penalty, “reasonable cause or circumstances beyond the person's control” includes, but is not limited to, any of the following:</p> <ol style="list-style-type: none">a. the occurrence of a death or serious illness of the person or the person's next of kin that caused the person's failure to make a timely remittance;b. the occurrence of an emergency, as defined in section 8558 of the Government Code, that caused the person's failure to make a timely remittance;c. a natural disaster or other catastrophe directly affecting the business operations of the person that caused the person's failure to make a timely remittance;d. the Board's failure to send returns or other information to the correct address of record that caused the person's failure to make a timely remittance;e. the person's failure to make a timely remittance occurred only once over a three-year period, or once during the period in which the person was engaged in business, whichever time period is shorter; orf. the person voluntarily corrected errors in remitting sales tax reimbursement or use tax collected that were made in previous reporting periods, and remitted payment of the liability owed as a result of those errors prior to being contacted by the Board regarding possible
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	<p style="text-align: center;">errors or discrepancies.</p> <p>For purposes of this penalty, “sales tax reimbursement” is defined in section 1656.1 of the Civil Code, and also includes any sales tax that is advertised, held out, or stated to the public or any customer, directly or indirectly, that the tax or any part thereof will be assumed or absorbed by the retailer.</p> <p>This penalty applies to determinations made by the Board pursuant to Article 2 (commencing with section 6481), Article 3 (commencing with section 6511), and Article 4 (commencing with section 6536) of Chapter 5, Part 1, Division 2 of the Revenue and Taxation Code.</p> <p>(E) Nonpayment of Determinations. A penalty of 10 percent of the amount of the tax specified in the determination shall be added to any determination not paid within the time required by law.</p> <p>(4) Improper Use of Resale Certificate.</p> <p>A penalty of 10 percent applies to the taxes imposed upon any person who knowingly issues a resale certificate for personal gain or to evade the payment of taxes while not actively engaged in business as a seller.</p> <p>The penalty is 10 percent of the amount of tax or <u>five hundred dollars (\$500)</u>, whichever is greater, if the purchase is made for personal gain or to evade payment of taxes.</p> <p>(5) Direct Payment Permits. Every holder of a direct payment permit who gives an exemption certificate to a retailer for the purpose of paying that retailer's tax liability directly to the Board must make a proper allocation of that retailer's local sales and use tax liability and also its district transactions and use tax liability if applicable. Such allocation must be made to the cities, counties, city and county, redevelopment agencies, and district to which the taxes would have been allocated if they had been reported by that retailer. Allocations must be submitted to the Board in conjunction with the direct payment permit holder's tax return on which the taxes are reported. If the local and district taxes are misallocated due to negligence or intentional disregard of the law, a penalty of 10 percent of the amount misallocated shall be imposed.</p> <p>(6) Failure to Obtain Evidence that Operator of Catering Truck Holds Valid Seller's Permit. Any</p>
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person making sales to an operator of a catering truck who has been required by the Board pursuant to section 6074 of the Revenue and Taxation Code to obtain evidence that the operator is the holder of a valid seller's permit issued pursuant to section 6067 of the Revenue and Taxation Code and who fails to comply with that requirement shall be liable for a penalty of five hundred dollars (\$500) for each such failure to comply.

(7) Failure of Retail Florist to Obtain Permit. Any retail florist (including a mobile retail florist) who fails to obtain a seller's permit before engaging in or conducting business as a seller shall, in addition to any other applicable penalty, pay a penalty of five hundred dollars (\$500). For purposes of this regulation, "mobile retail florist" means any retail florist who does not sell from a structure or retail shop, including, but not limited to, a florist who sells from a vehicle, pushcart, wagon, or other portable method, or who sells at a swap meet, flea market, or similar transient location. "Retail florist" does not include any flower or ornamental plant grower who sells his or her own products.

(8) Relief from Penalty for Reasonable Cause. If the Board finds that a person's failure to make a timely return, payment, or prepayment, or failure to comply with the provisions of section 6074 of the Revenue and Taxation Code is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, the person may be relieved of the penalty provided by sections 6074, 6476, 6477, 6480.4, ~~6480.8~~, 6511, 6565, 6591, and 7051.2 of the Revenue and Taxation Code for such failure.

Any person seeking to be relieved of the penalty shall file with the Board a statement under penalty of perjury setting forth the facts upon which the claim for relief is based. Section 6592 of the Revenue and Taxation Code, providing for the relief of certain penalties does not apply to the 10 percent penalty imposed for failure to make a timely prepayment under section 6478 of the Revenue and Taxation Code.

(9) Tax Amnesty Program (Reporting Periods Beginning Before January 1, 2003).

(A) If on or after April 1, 2005, the Board issues a deficiency determination upon a return filed under the amnesty program or upon any other nonreporting or underreporting of tax liability by a person who could have otherwise been eligible for amnesty as specified in sections 7071, 7072 and 7073 of the Revenue and Taxation Code, the Board shall impose penalties at a rate that is double the rate of penalties normally applicable.

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	<p>(B) Any taxpayer who could have applied for amnesty as specified in sections 7071, 7072 and 7073 of the Revenue Taxation Code but fails to do so, will be subject to a penalty of 50 percent of the interest computed under section 6591 of the Revenue and Taxation Code for the period beginning on the date the tax was due and ending on March 31, 2005.</p>
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<p>Action 2 — Staff Recommendation</p> <p>Proposed Revisions to Audit Manual Chapter 5</p>	<p align="center">PENALTY COMMENTS ON AUDIT REPORTS OR FIELD BILLING ORDERS</p> <p align="right">0506.35</p> <p>A comment should be made on any area which will be of value in connection with making a determination or with making decisions regarding future audits (AM section 0206.03). Penalty recommendations are frequently a source of disagreement between staff and taxpayers. To ensure that both staff and taxpayers understand why a negligence penalty was or was not recommended, a penalty comment using the following guidelines <i>must</i> be made in the “General Audit Comments” section of Form BOE-414-A or Form BOE-414-B. The <i>sole</i> exception is when the tax liability is less than \$2,500 and no penalty is recommended.</p> <p>The factors which constitute negligence in keeping records (AM section 0507.00), negligence in preparing returns (AM section 0508.00), and evasion penalties (AM section 0509.00), must be carefully considered before determining whether a negligence or evasion penalty should be imposed. If a negligence penalty is being recommended, the auditor must provide in clear and concise terms the rationale for imposing a penalty. An explanation of the evidence and facts upon which the auditor relies to support the recommendation for imposition of a penalty must be given. The explanation must enable supervisors, reviewers, the taxpayer and/or taxpayer’s representative to determine whether the recommendation is consistent with the facts established by the audit. The comments must be factual, not merely the auditor’s opinion, and must not be stated in a manner derogatory to the taxpayer or the taxpayer’s employees. All penalty comments must be sufficiently clear to provide information that may be useful in subsequent audits of the taxpayer.</p> <p>If the auditor believes the imposition of a penalty is inappropriate, he or she must use the same penalty comment guidelines as when recommending a negligence penalty. That is, the comments must be clear and concise to enable supervisors and other readers of the audit working papers to determine whether the recommendation is consistent with the facts established in the audit, and to provide information that may be useful in a subsequent audit. “Canned comments” such as “Negligence not noted;” “No negligence noted;” or “No penalty recommended,” do not provide enough information and are not acceptable.</p>
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If an evasion (fraud) penalty is being recommended, the comment on the audit report must include “Penalty pursuant to RTC section 6485 is recommended”. In addition, a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division (see AM section 0509.75 for contents of this memo).

~~Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer’s background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. Criteria that should be considered, among others, are the taxpayer’s prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns. A penalty may be appropriate in any of the following circumstances: the taxpayer has no records of any kind, the taxpayer has a history of prior permits or business experience, analysis shows that purchases have exceeded reported sales, or the taxpayer has two sets of books. The comment “Taxpayer’s first audit” should only be used in conjunction with a detailed explanation for the penalty recommendation.~~

To promote consistency in the application of penalties and the writing of penalty comments, all comments must be reviewed by the auditor’s supervisor. In addition, special procedures will be used for the following reviews:

- Audit tax deficiency over \$25,000 — Reviewed and approved by the auditor’s supervisor.
- Audit tax deficiency over \$50,000 — Reviewed and approved by the District Principal Auditor subsequent to the review and approval by the auditor’s supervisor.

This review and approval must be noted by the supervisor (and DPA if applicable) by commenting and signing directly below the auditor’s penalty comment in the “General Audit Comments” section of Form BOE-414-A or Form BOE-414-B. This may be a handwritten comment or incorporated as the last line of the penalty comment (e.g., “Reviewed and approved. _____, Supervisor; _____, DPA.”) See AM section 0206.45.

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NEGLIGENCE PENALTIES IN A TAXPAYER’S FIRST AUDIT

0506.40

Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer’s background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. (See Regulation 1703(c)(3)(A).) If a negligence penalty is recommended on the first audit, the comment “Taxpayer’s first audit” should be made in conjunction with a detailed explanation for the penalty recommendation. Criteria that should be considered, among others, are the taxpayer’s prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns.

Circumstances in which a negligence penalty may be appropriate in a first-time audit include, but are not limited to, the following:

- The business is controlled by a person or persons that control (or controlled) a substantially similar business that was previously subject to audit. In that earlier audit, staff documented audit issues which resulted in the understatement of taxable sales. These same issues are present in the current audit and resulted in a substantial understatement of taxable sales. (For purposes of this and the following circumstances, “controlled” or “control” means any person having control or supervision of, or who is charged with the responsibility for, the filing of returns or the payment of tax or who has a duty to act for the entity in complying with any provision of the Sales and Use Tax Law.); or
- The business received written advice from the BOE regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales. (For the purpose of this and the following circumstance, “written advice” does not include publications provided to a taxpayer upon registration for a seller’s permit or certificate of registration – use tax.); or

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- The business is controlled by a person or persons that control (or controlled) a similar business which received written advice from the BOE regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or
- The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business has no records of any kind or extremely poor records, which resulted in substantial underreporting. The evidence indicates that it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting; however, the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business is controlled by a CPA or former CPA who has prior experience advising businesses of the same type on compliance with the Sales and Use Tax Laws. The audit results in a substantial liability despite the controlling person's extensive experience advising clients of the same type of business on record keeping and in preparing sales and use tax returns.

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The following examples illustrate when a negligence penalty may apply in a taxpayer's first audit.

Example 1

Shep Bartlett owned and operated a restaurant serving breakfast, lunch and dinner as well as beer and wine. During an audit of the restaurant, Mr. Bartlett provided BOE staff with monthly sales summaries but had not maintained any source documentation like purchase invoices, sales receipts or cash register z-tapes. BOE staff found that taxable sales were understated. In the audit work papers, it was documented that Mr. Bartlett had been advised that he was required to maintain source documents and provide them upon audit. Subsequently, Mr. Bartlett formed a corporation, Bartlett, Inc., with himself as the president and sole shareholder. Bartlett, Inc. opened another restaurant which was managed by Mr. Bartlett. During the first audit of Bartlett Inc., BOE staff found that it did not maintain any source documentation such as purchase invoices, sales receipts or cash register z-tapes, and, upon examination, calculated a substantial understatement of taxable sales. Because the same audit issue was documented in the earlier audit of Mr. Bartlett's other restaurant and documentation showed that BOE staff had advised Mr. Bartlett regarding proper record keeping, and because Mr. Bartlett managed the operation of both restaurants, BOE staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 2

Tony Leo owned and operated a retail store selling antiques to customers both within and outside of California. Mr. Leo wrote to the BOE requesting advice regarding what documentation was necessary to support sales in interstate commerce. BOE staff provided him a written response stating that sales where the property was delivered to the customer in California were subject to sales tax while sales where documentation showed that the property was to be shipped and was shipped to a location outside California by common carrier were not subject to tax. During the first audit of the antique store, BOE staff discovered that Mr. Leo was claiming as exempt sales in interstate commerce sales where the property was delivered to the customer in California. Because Mr. Leo had previously received written advice on this issue and was reporting sales contrary to the specific written advice, BOE staff recommended that a 10 percent negligence penalty be added to the audit determination.

Note: The recommendation to impose a 10 percent negligence penalty would also apply in the first audit

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of a business which is controlled by a person or persons that control (or controlled) a similar business which received written advice from the BOE regarding a record keeping or reporting issue.

Example 3

Ace's Automobiles is a seller of used vehicles. It was opened and originally operated under a seller's permit taken out by Charlotte Dealer. After two years, the business was closed and Ms. Dealer opened King's Automobiles, also selling used vehicles. Ms. Dealer closed King's Automobiles after two years and opened Jack's Automobiles, again selling used vehicles. Ms. Dealer managed all three businesses. Based on an audit lead, staff commenced an audit of Jack's Automobiles after it had been in business only two years. This was the first audit of any of Ms. Dealer's businesses. Audit staff found that many of the Reports of Sale were missing and the records they did obtain appeared to have been prepared just for the audit and indicated unrealistically low selling prices based on the make and model of vehicles sold. As a result, staff estimated that taxable sales were substantially understated. Although this was Ms. Dealer's first audit, because Ms. Dealer had been operating used vehicle lots for many years and her past business practices indicated a conscious effort to avoid being audited, staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 4

Kurt Vaughn owned and operated a company in the business of selling musical instruments. Mr. Vaughn did not report any taxable sales, claiming that all property was shipped out of state via common carrier pursuant to the sales contracts. During the first audit of the business, Mr. Vaughn provided annual sales summaries but did not maintain purchase invoices, sales contracts or receipts, shipping invoices, bills of lading or any other source documentation. Furthermore, records obtained from the common carriers indicated that very few sales were shipped out of state, while a substantial number of shipments were to locations in California. The audit resulted in substantially underreported taxable sales but BOE staff concluded that there was insufficient evidence to impose a penalty for fraud. However, given the significant understatement, the records from common carriers, and the complete lack of source documentation, staff recommended that a 10 percent negligence penalty be added to the audit determination.

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Example 5

Mr. Smith is a CPA whose practice, for the last three years, has involved advising and assisting business owners, including numerous restaurants, regarding best practices in running their businesses and record keeping and assisting them in preparing sales and use tax returns. Mr. Smith decided to close his CPA practice and open a sushi restaurant, something he always dreamed of doing. In the first audit of Mr. Smith’s restaurant, staff found that Mr. Smith had failed to keep complete purchase invoices, had no guest checks or z tapes, and did not keep records showing any cold food sold “to go.” However, Mr. Smith reported 30 percent of his sales as exempt sales of cold food “to go.” The audit resulted in a substantial liability involving both unreported total sales and unsupported claimed exempt sales of cold food “to go.” Although this was Mr. Smith’s first audit, staff included a 10 percent negligence penalty because of Mr. Smith’s extensive experience with the record keeping and reporting requirements for restaurants.

Issue Paper Number 16-03



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

Imposition of a Penalty for Negligence or Intentional Disregard on a Taxpayer's First Audit Liability

I. Issue

Whether the Board should amend Regulation 1703, *Interest and Penalties*, and Audit Manual (AM) Chapter 5, *Penalties*, to provide guidance with respect to the imposition of a penalty for negligence or intentional disregard on a taxpayer's first audit liability (first-time audit).

II. Alternative 1 – Staff Recommendation

Staff recommends the Board approve and authorize publication of the proposed amendments to Regulation 1703, *Interest and Penalties*, as set forth in Exhibit 2. Staff's proposed amendments to Regulation 1703 clarify the Board of Equalization's (BOE) long-standing policy of generally not imposing a negligence penalty on a taxpayer's first-time audit.

Staff also recommends that the Board approve revisions to AM Chapter 5, *Penalties*, as set forth in Exhibit 3. The proposed revisions to AM Chapter 5 explain the circumstances and provide examples of when a negligence penalty may apply to a first-time audit.

Staff's proposed amendments are supported by Mr. James Dumler, of McClellan Davis, LLC. For a more detailed explanation of Alternative 1 - Staff Recommendation, refer to section VI of this paper.

III. Other Alternatives Considered

Do not approve proposed amendments to Regulation 1703 or AM Chapter 5.

IV. Background

Revenue and Taxation Code (RTC) section 6484

RTC section 6484 states that “[i]f any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of this part or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto.”

Regulation 1703

Regulation 1703 provides guidance regarding interest and penalties imposed under the Sales and Use Tax Law. With respect to penalties and determinations, Regulation 1703, subdivision (c)(3)(A), *Negligence or Intentional Disregard*, states that “[a] penalty of 10 percent of the amount of the tax specified in the determination shall be added to deficiency determinations if any part of the deficiency for which the determination is imposed is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations.”

Audit Manual

The AM is a guide to be used by staff in conducting sales and use tax audits in a uniform manner consistent with approved tax auditing practices. Negligence and evasion penalties are discussed in AM Chapter 5, sections 506.00 through 509.75. AM section 0506.10 defines negligence as the failure to do what a reasonable and prudent person would do under the same or similar circumstances. AM section 0506.35 states that, generally, a negligence penalty should not be recommended in a first time audit.

V. Discussion

General

When staff finds that a taxpayer has a sales and use tax liability during an audit, the staff must analyze whether or not such error was due to the taxpayer’s negligence in keeping records or preparing returns. Taxpayers must keep the type of records ordinarily maintained by a reasonable and prudent businessperson with a business of a similar kind and size. Taxpayers must also exercise the degree of care exercised by an ordinary prudent businessperson who is engaged in a business of a similar kind and size, and who in good faith has attempted to prepare returns with a reasonable degree of accuracy.

It has been the long-standing policy of the BOE that it does not generally impose a negligence penalty on a first-time audit; however, there are circumstances where a penalty would be appropriate. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321 [noting “that the board seldom, if ever, imposes a negligence penalty for errors discovered on a first audit”].) This long-standing policy is consistent with the definition of negligence based on what a reasonable and prudent person would do under the same or similar circumstances, recognizing that the circumstances for a person who has never been audited before may not be the same or similar to that of a person who has been previously audited. Staff recognizes that first-time audits educate taxpayers on the relevant laws and provide instruction on proper record-keeping practices and proper reporting obligations and only recommend the imposition of a negligence penalty when the facts show that the underreporting cannot reasonably be explained by the taxpayer’s inexperience. The decision whether to impose a negligence penalty must be based on an objective evaluation of the audit findings, the general state of the books and records, and the taxpayer’s background and prior business experience.

Interested Parties Meeting

Staff held an interested parties meeting on January 19, 2016, to discuss the Initial Discussion Paper and proposed amendments distributed on January 8, 2016. At the meeting, there was general

agreement that the proposed amendments to Regulation 1703 and AM Chapter 5 would bring clarity with respect to the BOE policy regarding the imposition of negligence penalties on a first-time audit.

Following the interested parties meeting, staff received comments from Mr. James Dumler, of McClellan Davis, LLC, in a letter dated, January 29, 2016 (Exhibit 4). Mr. Dumler's comments reiterate concerns expressed during the interested parties meeting and are further addressed below.

Staff's Proposed Regulatory Amendments

Staff proposed amendments that will clarify that negligence penalties should not be applied in the first audit of a taxpayer unless the evidence indicates that the underreporting cannot reasonably be explained by the taxpayer's inexperience. Staff believes that the proposed guidance is consistent with the definition of negligence as stated in the AM and reflects the BOE's long-standing policy with regard to first time audits. Staff's proposed amendments to Regulation 1703, subdivision (c)(3)(A), attached as Exhibit 1 to the Initial Discussion Paper stated the following:

“Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that a taxpayer possessed experience and/or knowledge such that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that it's [sic] bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations.”

Mr. Dumler expressed concern with the “use of the word ‘and/or’ . . . as it respects the taxpayer's experience *and/or* knowledge of the reporting or recording issue in question.” He suggests that the word “or” be removed because a taxpayer may have experience operating a business, but not the requisite knowledge. A concern was also expressed at the interested parties meeting that when a taxpayer completely lacks either experience or knowledge, an auditor may overly focus on the other element to justify imposing the penalty. Staff agrees that in most circumstances where it is appropriate to impose a negligence penalty on a first time audit, the taxpayer will have both experience and knowledge regarding the particular type of business to some degree. However, there are circumstances where a taxpayer may have the requisite knowledge of its compliance obligations yet lack any experience operating the type of business in question. For example, a CPA may gain significant knowledge of the Sales and Use Tax compliance obligations through consultation with its restaurant clients, yet have no experience actually operating a restaurant. Staff therefore does not recommend replacing the phrase “and/or” with “and,” but appreciates the concern that audit staff may narrowly focus on knowledge or experience, instead of on whether the totality of the evidence establishes that a taxpayer's errors cannot be attributed to its good faith and reasonable belief that it is in substantial compliance with the Sales and Use Tax Law. Accordingly, staff revised its proposed regulatory language to delete the phrase “that a taxpayer possessed experience and/or knowledge such” as shown below:

“Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing ~~that a taxpayer possessed experience and/or knowledge such~~ that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations.”

Update to the Audit Manual

Staff recommends adding detailed guidance to the AM regarding the proposed regulatory language. Specifically, staff proposes adding the description of circumstances and examples of when a negligence penalty may be appropriate in a first-time audit. As noted, the proposed circumstances and examples are a non-exhaustive list of situations in which a negligence penalty may apply.

Examples of situations in which a negligence penalty may be appropriate in a first-time audit include, but are not limited to, the following circumstances:

- The business is controlled by a person or persons that control (or controlled) a substantially similar business that was previously subject to audit. In that earlier audit, staff documented audit issues, which resulted in the understatement of taxable sales. These same issues are present in the current audit and resulted in a substantial understatement of taxable sales. (For purposes of this and the following circumstances, “controlled” or “control” means any person having control or supervision of, or who is charged with the responsibility for, the filing of returns or the payment of tax or who has a duty to act for the entity in complying with any provision of the Sales and Use Tax Law.); or
- The business received written advice from the BOE regarding a record-keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or
- The business is controlled by a person or persons that control (or controlled) a similar business which received written advice from the BOE regarding a record-keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or
- The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business has no records of any kind or extremely poor records, which resulted in substantial underreporting. The evidence indicates that it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting; however, the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business is controlled by a CPA or former CPA who has prior experience advising businesses of the same type on compliance with the Sales and Use Tax Laws. The audit results in a substantial liability despite the controlling person’s extensive experience advising clients of the same type of business on record keeping and in preparing sales and use tax returns.

The definition of the term “control,” as set forth in the first bulleted scenario, mirrors the language used to define a responsible person with regard to liability under section 6829. (See AM 764.140.) Staff believes using this definition limits these scenarios to when the business or businesses could properly be charged with the knowledge or experience of the controlling person or persons.

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During the interested parties meeting, there were concerns that the term “written advice,” as used in the second and third bulleted circumstances, could be misconstrued to mean written advice in the form of publications provided to taxpayers at the time of registration. Mr. Dumler expresses similar concern in his written comments and suggests that the proposed AM revision specify that the taxpayer requested the written advice. In response to the concern, staff now proposes to add clarifying language to the proposed AM revisions to specify that the term “written advice,” as used in the second and third bullet points, does not include publications provided to a taxpayer upon registration. However, staff believes that a taxpayer could receive advice that it did not request or receive advice in the form of a publication under circumstances other than upon registration which may provide taxpayer with sufficient knowledge such that a subsequent error as to the same issue was not based on a good faith and reasonable belief that it was in substantial compliance. Therefore, staff does not recommend defining written advice to only include advice requested by the taxpayer or to exclude publications generally.

With respect to the fourth bulleted circumstance and corresponding Example 3 pertaining to a taxpayer repeatedly opening and closing permits, Mr. Dumler suggests adding language to the effect that the taxpayer “had no valid business purpose or reasonable explanation for doing so.” Staff believes the proposed additional language would add a requirement that does not relate to the proposed regulatory standard, i.e., lack of a good faith and a reasonable belief that its bookkeeping and reporting practices are in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations; this may exist, as a result of taxpayer’s cumulative experience in running those businesses, irrespective of taxpayer’s purpose or purposes in closing the businesses. The requirement would also put staff in the position of proving a negative, i.e., the non-existence of a “valid purpose,” with regard to closed-out businesses for which it may have little to no information. Staff also notes that the proposed AM revisions are intended to provide circumstances and examples to serve as guidance to determine whether a penalty may apply; rather than describe circumstances in which a penalty must apply. Therefore, staff does not recommend adding the additional language suggested by Mr. Dumler.

Staff had a follow-up discussion with Mr. Dumler regarding his concerns and staff’s recommended amendments to Regulation 1703 and AM Chapter 5. Mr. Dumler expressed support for staff’s recommendation and appreciation for staff’s consideration.

Unrelated Proposed Amendments to Regulation 1703

Staff also proposes other technical and non-substantive amendments to reflect that certain sections of the RTC referenced in the regulation have been repealed or amended, including sections related to the imposition of interest and penalties on the late prepayment of sales tax on motor vehicle fuel, aircraft jet fuel, and diesel fuel.

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Staff recommends the Board approve and authorize publication of the proposed amendments to Regulation 1703, *Interest and Penalties*, as provided in Exhibit 2, to:

- Establish regulatory guidance to clarify that negligence penalties should not be applied to a taxpayer’s first audit in the absence of evidence indicating that the underreporting cannot reasonably be explained by the taxpayer’s good faith and reasonable belief that it is complying with the Sales and Use Tax Law.

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- Make technical and non-substantive updates to reflect changes to the RTC.

Staff also proposes to revise AM Chapter 5, as provided in Exhibit 3, to:

- Add detailed guidance to the AM regarding the proposed regulatory language.
- Specify circumstances as well as examples to provide guidance to audit staff on when a negligence penalty may be appropriate in a first-time audit, contrary to the general rule.

B. Pros of Alternative 1

- Provides regulatory guidance reflecting long-standing BOE policy.
- Promotes efficiency with respect to the administration of the Sales and Use Tax Law.
- Establishes a non-exhaustive list, within the AM, of the circumstances that may warrant the imposition of a negligence penalty in a first-time audit.
- Adds illustrative examples in the AM to serve as additional guidance to staff and taxpayers.

C. Cons of Alternative 1

None.

D. Statutory or Regulatory Change for Alternative 1

No statutory change is required. However, staff's recommendation does require a regulatory change.

E. Operational Impact of Alternative 1

Staff will publish the proposed amendments to Regulation 1703 and update the AM with the approved revisions to Chapter 5, *Penalties*.

F. Administrative Impact of Alternative 1**1. Cost Impact**

The workload associated with publishing the amended regulation and updating the AM is considered routine. Any corresponding costs will be absorbed within the BOE's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 1

While the overall impact on taxpayers is minimal, the proposed amendments provide additional guidance and clarification to BOE staff and taxpayers with respect to a first-time audit. This clarification creates efficiency with respect to the administration of the Sales and Use Tax Law.

H. Critical Time Frames of Alternative 1

None.

VII. Alternative 2

A. Description of Alternative 2

Do not approve the proposed amendments to Regulation 1703 or AM Chapter 5.

B. Pros of Alternative 2

The BOE will not incur the workload associated with publishing the amended regulation or AM sections.

C. Cons of Alternative 2

There will be no regulatory guidance emphasizing long-standing BOE policy and no additional guidance in the AM.

D. Statutory or Regulatory Changes for Alternative 2

None.

E. Operational Impact of Alternative 2

None.

F. Administrative Impact of Alternative 2

1. Cost Impact

None.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 2

While the overall impact is minimal, taxpayers subject to a first-time audit will not have additional guidance regarding the imposition of a negligence penalty.

H. Critical Time Frames for Alternative 2

None.

Preparer/Reviewer Information

Prepared by the Tax Policy Division, Business Tax and Fee Department.

Current as of: March 10, 2016

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



Imposition of a Penalty for Negligence or Intentional Disregard on a Taxpayer's First Audit Liability

I. Issue

Whether the Board should amend Regulation 1703, *Interest and Penalties*, and Audit Manual (AM) Chapter 5, *Penalties*, to provide guidance with respect to the imposition of a penalty for negligence or intentional disregard on a taxpayer's first audit liability (first-time audit).

II. Alternative 1 - Staff Recommendation

Staff recommends the Board approve and authorize publication of the proposed amendments to Regulation 1703, *Interest and Penalties*. Staff's proposed amendments to Regulation 1703 clarify the Board of Equalization's (BOE) long-standing policy of generally not imposing a negligence penalty on a taxpayer's first-time audit.

Staff also recommends that the Board approve revisions to AM Chapter 5, *Penalties*. The proposed revisions to AM Chapter 5 explain the circumstances and provide examples of when a negligence penalty may apply to a first-time audit.

III. Other Alternative(s) Considered

Do not approve proposed amendments to Regulation 1703 or AM Chapter 5.

Background, Methodology, and Assumptions

Alternative 1 – Staff Recommendation

There is nothing in the staff recommendation that would impact revenue. The proposed amendments will:

- Provide regulatory guidance to clarify long-standing BOE policy.
- Promote efficiency with respect to the administration of the Sales and Use Tax Law.
- Establish a non-exhaustive list, within the AM, of the circumstances that may warrant the imposition of a negligence penalty in a first-time audit.

- Add illustrative examples in the AM to serve as additional guidance to staff and taxpayers.

Other Alternatives Considered

There is nothing in Alternative 2 that would impact revenue. However, there will be no regulatory guidance clarifying long-standing BOE policy and no additional guidance in the AM.

Revenue Summary

Alternative 1 – staff recommendation does not have a revenue impact.

The other alternative considered does not have a revenue impact.

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. This estimate has been reviewed by Mr. Mark Durham, Chief, Research and Statistics Section, Legislative and Research Division, and by Ms. Susanne Buehler, Chief, Tax Policy Division, Business Tax and Fee Department. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of March 11, 2016.

Regulation 1703. Interest and Penalties.

Reference: Sections 6071, 6072, 6073, 6074, 6077, 6094.5, 6207, 6291-6294, 6422.1, 6452, 6455, 6459, 6476-6478, 6479.3, 6480.4, ~~6480.8, 6480.19~~, 6482, 6484, 6485, 6485.1, 6511-6514, 6514.1, 6537, 6565, 6591, 6591.5, 6591.6, 6592, 6593, 6593.5, 6596, 6597, 6901, 6907, 6908, 6936, 6964, 7051.2, 7073, 7074, 7076.54, 7101, 7152-7153, 7153.5, 7153.6 and 7155, Revenue and Taxation Code.

(a) Statutory Provisions. Interest and penalties are prescribed in various sections of the Sales and Use Tax Law as follows:

<i>Subject</i>	<i>Sections</i>	
	<i>Interest</i>	<i>Penalties</i>
Failure to pay tax within required time (except determinations)	6480.4, 6480.8 6480.19 , 6591	6476, 6477, 6478, 6479.3, 6480.4, 6480.8 , 6480.19 , 6591, 7051.2
Failure to file a timely return		6479.3, 6591
Deficiency determinations	6482	6484 (negligence) 6485 (fraud) 7051.2
Determinations—Sales tax reimbursement or use tax collected but not timely remitted		6597
Determination—failure to make return	6513	6511, 7051.2 6514 (fraud)
Jeopardy determinations	6537	6537, 7051.2
Extensions of time	6459	
Determinations—Nonpayment of		6565, 7051.2
Offsets	6512	6512
Refunds and credits	6901, 6907,6908	6901
Suits for refund	6936	
Disposition of interest and penalties	7101	7101
Criminal Penalties		6073, 6094.5, 6422.1 7152, 7153, 7153.5, <u>7153.6</u>

Failure to make timely application for registration of motor vehicle, mobilehome, aircraft or undocumented vessel	6291-6294	6291-6294
Registration of vehicle, vessel or aircraft out of state		6485.1, 6514.1 (intent to evade)
Advertising that use tax will be absorbed		6207
Any violation of Sales and Use Tax Law		7153, 7153.5
Failure to collect use tax		6207
Failure to display use tax separately		6207
Failure to furnish return or other data		6452, 6455
Improper use of resale certificates	6072	6072, 6094.5
Making false return		7152
Misuse of vehicle use tax exemption certificates		6422.1
Operating as seller without permit		6071, 6077
Failure to obtain valid permit		6077, 7155
Relief from interest or penalty	6593, 6596	6592, 6596
Modified adjusted daily rate	6591.6	
Modified adjusted rate	6591.5	
Failure to obtain evidence that operator of catering truck holds valid permit		6074
Improper allocation of local tax by direct payment permitholder		7051.2
Managed Audit Program	7076. 54	
Failure to pay tax due to an error or delay by an employee of the Board or Department of Motor Vehicles	6593.5	
Erroneous refund	6964	
Tax Amnesty Program (Reporting Periods Beginning Before January 1, 2003)		7073, 7074

(b) Interest.

(1) Interest Rates.

(A) In General. Interest is computed at the modified adjusted rate per month, or fraction thereof. "Modified adjusted rate per month, or fraction thereof" means the modified adjusted rate per annum divided by 12.

(B) Underpayments. "Modified adjusted rate per annum" for underpayments of tax is the rate for underpayments determined in accordance with the provisions of section 6621 of the Internal Revenue Code plus three percentage points. Such rate is subject to semiannual modification pursuant to the provisions of subparagraph (c) of section 6591.5 of the Revenue and Taxation Code.

(C) Overpayments. Except as provided below, "modified adjusted rate per annum" for overpayments of tax is the bond equivalent rate of 13-week treasury bills auctioned, rounded to the nearest full percent (or to the next highest full percent if .50%), subject to semiannual modification pursuant to the provisions of subparagraph (d) of section 6591.5 of the Revenue and Taxation Code. For the period July 1, 1991, through June 30, 1992, the modified adjusted rate per annum for overpayments is equal to the bond equivalent rate of 13-week treasury bills auctioned on July 1, 1991, rounded to the nearest full percent (or to the next highest full percent if .50%).

(D) Managed Audit Program. Upon completion of the managed audit and verification by the Board, interest shall be computed at one-half the rate that would otherwise be imposed for liabilities covered by the audit period.

(E) Error or Delay by Employee of Board or Department of Motor Vehicles. For tax liabilities that arise during taxable periods commencing on or after July 1, 1999, this subdivision is limited to interest imposed by sections 6480.4, ~~6480.8~~, 6513, 6591, and 6592.5 of the Revenue and Taxation Code. Effective January 1, 2002, this subdivision applies to interest imposed by any provision of the Sales and Use Tax Law. All or any part of such interest imposed may be relieved by the Board, in its discretion, under either of the following circumstances:

1. Where the failure to pay tax is due in whole or in part to an unreasonable error or delay by an employee of the Board acting in his or her official capacity.
2. Where failure to pay use tax on a vehicle or vessel registered with the Department of Motor Vehicles was the direct result of an error by the Department of Motor Vehicles in calculating the use tax.

For the purposes of this subdivision, an error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or a failure to act by, the taxpayer.

Any person seeking relief under this subdivision shall file with the Board a statement under penalty of perjury setting forth the facts on which the claim for relief is based and any other information which the Board may require.

(F) Erroneous Refund. Operative for any action for recovery under Revenue and Taxation Code section 6961 on or after July 1, 1999, no interest shall be imposed on the amount of an erroneous refund by the Board until 30 days after the date on which the Board mails a notice of determination for repayment of the erroneous refund if the Board finds that neither the person liable for payment of tax nor any party related to that person had in any way caused an erroneous refund for which an action for recovery is provided under section

6961 of the Revenue and Taxation Code. The act of filing a claim for refund shall not be considered as causing the erroneous refund.

(2) Late Payments Generally. Interest applies to the amount of all taxes, except prepayments of amounts of tax due and payable pursuant to section 6471 of the Revenue and Taxation Code, not paid within the time required by law from the date on which the amount of tax became due and payable until the date of payment.

Interest applies to amounts due but not paid by any supplier or wholesaler distributor or broker of motor vehicle fuel, aircraft jet fuel, or diesel fuel who fails to make a timely remittance of the prepayment of tax required pursuant to sections 6480.1 and 6480.3 of the Revenue and Taxation Code.

~~Operative January 1, 1992, interest applies to amounts due but not paid by any producer, importer, or jobber of fuel as defined in section 6480.10 of the Revenue and Taxation Code who fails to make a timely remittance of the prepayment of tax required pursuant to sections 6480.16 and 6480.18 of the Revenue and Taxation Code.~~

(3) Determinations. Except as otherwise provided in subdivisions (b)(1)(E) and (b)(1)(F) above, interest applies to all determinations from the date on which the amount of tax becomes due and payable until the date of payment.

(4) Extensions of Time. In cases in which an extension of time for the filing of a return and the payment of tax has been granted, interest applies from the date on which the tax would have been due and payable had the extension not been granted until the date of payment. In cases in which an extension of time has been granted for making a prepayment of tax pursuant to section 6471 of the Revenue and Taxation Code, interest applies to the unpaid amount of the required prepayment at the same rate.

(5) Electronic Payments Made One Day Late.

(A) For the period of January 1, 2011, through January 1, 2016, if the Board finds, taking into account all facts and circumstances, that it is inequitable to compute interest at the modified adjusted rate per month or fraction thereof, as defined in subdivision (b)(1)(A) above, interest shall be computed at the modified adjusted daily rate from the date on which the tax or prepayment was due until the date of payment, if all of the following occur:

1. A payment or prepayment of tax was made one business day after the due date.
2. The person was granted relief from all penalties that applied to that payment of tax or prepayment.
3. The person filed a request for an oral hearing before the Board.

(B) For purposes of this paragraph:

1. "Modified adjusted daily rate" means the modified adjusted rate per annum, as defined in subdivision (b)(1)(B) above, determined on a daily basis by dividing the modified adjusted rate per annum by 365.

2. "Board" means the members of the State Board of Equalization meeting as a public body.

3. "Business day" means any day other than a Saturday, Sunday, or any day designated as a state holiday.

(C) This paragraph only applies to electronic payments or prepayments of taxes and does not apply to any payment made pursuant to a deficiency determination, a determination where no return has been filed, or a jeopardy determination.

(6) Refunds and Credits.

(A) In General. If an overpayment is credited on amounts due from any person or is refunded, interest will be computed on the overpayment from the first day of the calendar month following the month during which the overpayment was made. A refund or credit shall be made of any interest imposed upon the person making the overpayment with respect to the amount being refunded or credited. Interest will be paid in the case of a refund, to the last day of the calendar month following the date upon which the person making the overpayment, if he or she has not already filed a claim, is notified by the Board that a claim may be filed or the date upon which the refund is approved by the Board, whichever date is the earlier; and in the case of a credit, to the same date as that to which interest is computed on the tax or amount against which the credit is applied.

(B) Intentional or Careless Overpayments. Credit interest will be allowed on all overpayments, except when statutorily prohibited or in cases of intentional overpayment, fraud, negligence, or carelessness. Carelessness occurs if a taxpayer makes an overpayment which: 1) is the result of a computational error on the return or on its supporting schedules or the result of a clerical error such as including receipts for periods other than that for which the return is intended, failing to take allowable deductions, or using an incorrect tax rate; and 2) is made after the taxpayer has been notified in writing by the Board of the same or similar errors on one or more previous returns.

(C) Waiver of Interest as Condition of Deferring Action on Claim. If any person who has filed a claim for refund requests the Board to defer action on the claim, the Board, as a condition to deferring action, may require the claimant to waive interest for the period during which the person requests the Board to defer action.

(7) Improper Use of Resale Certificate. Interest applies to the taxes imposed upon any person who knowingly issues a resale certificate for personal gain or to evade the payment of taxes while not actively engaged in business as a seller. The interest is computed from the last day of the month following the quarterly period for which a return should have been filed and the amount of tax or any portion thereof should have been paid.

(8) Untimeliness Caused by Disaster. A person may be relieved of the interest imposed by sections 6459, 6480.4, ~~6480.8~~, 6513, and 6591 of the Revenue and Taxation Code if the Board finds that the person's failure to make a timely return or payment was occasioned by a disaster and was neither negligent nor willful. Such person shall file with the Board a statement under penalty of perjury setting forth the facts upon which the claim for relief is based.

For purposes of this section, “disaster” means fire, flood, storm, tidal wave, earthquake or similar public calamity, whether or not resulting from natural causes.

(c) Penalties.

(1) Late Payments Generally.

(A) Prepayments.

1. Any person required to make a prepayment who fails to make a prepayment before the last day of the monthly period following the quarterly period in which the prepayment became due and who files a timely return and payment for that quarterly period shall pay a penalty of 6 percent of the amount equal to 90 percent or 95 percent of the tax liability, as prescribed in section 6471 of the Revenue and Taxation Code, for each of the periods during that quarterly period for which a required prepayment was not made.
2. If the failure to make a prepayment as described in (c)(1)(A)1. above is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations, the penalty shall be 10 percent instead of 6 percent.
3. Any person required to make a prepayment who fails to make a timely prepayment, but who makes such prepayment before the last day of the monthly period following the quarterly period in which the prepayment became due, shall pay a penalty of 6 percent of the amount of the prepayment.
4. If any part of a deficiency in prepayment is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations, a penalty of 10 percent of the deficiency shall be paid.

The penalties provided in subparagraphs 2 and 4 of this subsection shall not apply to amounts subject to the provisions of sections 6484, 6485, 6511, 6514, and 6591 of the Revenue and Taxation Code (subparagraphs (c)(1)(B), (c)(2)(A) and (c)(2)(B) of this regulation).

5. A penalty of ~~25%~~ 10 percent shall apply to the amount of prepayment due but not paid by any supplier or wholesaler ~~distributor or broker~~ of motor vehicle fuel, aircraft jet fuel, or diesel fuel who fails to make a timely remittance of the prepayment as required pursuant to sections 6480.1 and 6480.3 of the Revenue and Taxation Code.

~~6. Operative January 1, 1992, a penalty of 10 percent shall apply to the amount of prepayment due but not paid by any producer, importer, or jobber of fuel as defined in section 6480.10 of the Revenue and Taxation Code who fails to make a timely remittance of the prepayment as required pursuant to sections 6480.16 and 6480.18 of the Revenue and Taxation Code. This penalty shall be 25 percent if the supplier or wholesaler ~~producer, importer, or jobber~~ knowingly or intentionally fails to make a timely remittance.~~

(B) Other Late Payments. A penalty of 10 percent of the amount of all unpaid tax shall be added to any tax not paid in whole or in part within the time required by law.

(C) Vehicles, Vessels and Aircraft. A purchaser of a vehicle, vessel or aircraft who registers it outside this state for the purpose of evading the payment of sales or use taxes shall be liable for a penalty of 50 percent of any tax determined to be due on the sales price of the vehicle, vessel or aircraft.

(2) Late Return Forms Generally.

(A) Any person who fails to file a return in accordance with the due date set forth in section 6451 of the Revenue and Taxation Code or the due date established by the Board in accordance with section 6455 of the Revenue and Taxation Code, shall pay a penalty of 10 percent of the amount of taxes, exclusive of prepayments, with respect to the period for which the return is required.

(B) Any person remitting taxes by electronic funds transfer shall, on or before the due date of the remittance, file a return for the preceding reporting period in the form and manner prescribed by the Board. Any person who fails to timely file the required return shall pay a penalty of 10 percent of the amount of taxes, exclusive of prepayments, with respect to the period for which the return is required.

(3) Determinations.

(A) Negligence or Intentional Disregard. A penalty of 10 percent of the amount of the tax specified in the determination shall be added to deficiency determinations if any part of the deficiency for which the determination is imposed is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized regulations.

Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations.

(B) Failure to Make Return. A penalty of 10 percent of the amount of tax specified in the determination shall be added to all determinations made on account of the failure of any person to make a return as required by law.

(C) Fraud or Intent to Evade. A penalty of 25 percent of the amount of the tax specified in a deficiency determination shall be added thereto if any part of the deficiency for which the determination is made is due to fraud or intent to evade the Sales and Use Tax Law or authorized regulations. In the case of a determination for failure to file a return, if such failure is due to fraud or an intent to evade the Sales and Use Tax Law or authorized regulations, a penalty of 25 percent of the amount required to be paid, exclusive of penalties, shall be added thereto in addition to the 10 percent penalty for failure to file a return. Fraud or intent to evade shall be established by clear and convincing evidence.

A penalty of 50 percent applies to the taxes imposed upon any person who, for the purpose of evading the payment of taxes, knowingly fails to obtain a valid permit prior to the date in which the first tax return is due. The 50 percent penalty applies to the taxes determined

to be due for the period during which the person engaged in business in this state as a seller without a valid permit and may be added in addition to the 10 percent penalty for failure to file a return. However, the 50 percent penalty shall not apply if the measure of tax liability over the period during which the person was engaged in business without a valid permit averaged one thousand dollars (\$1,000) or less per month. Also, the 50 percent penalty shall not apply to the amount of taxes due on the sale or use of a vehicle, vessel, or aircraft, if the amount is subject to the penalty imposed by section 6485.1 or 6514.1 of the Revenue and Taxation Code.

(D) Failure to timely remit collected sales tax reimbursement or use tax. With respect to Board-assessed determinations, except as provided below, for periods beginning on or after January 1, 2007, a person who knowingly collects sales tax reimbursement or use tax, and who fails to timely remit that sales tax reimbursement or use tax to the Board, shall be liable for a penalty of 40 percent of the amount not timely remitted. The penalty shall not apply if:

1. the person's liability for the unremitted sales tax reimbursement or use tax averages one thousand dollars (\$1,000) or less per month, or does not exceed 5 percent of the total amount of tax liability for which the tax reimbursement was collected for the period in which tax was due, whichever is greater; or
2. the person's failure to make a timely remittance of sales tax reimbursement or use tax is due to a reasonable cause or circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

For purposes of this penalty, "reasonable cause or circumstances beyond the person's control" includes, but is not limited to, any of the following:

- a. the occurrence of a death or serious illness of the person or the person's next of kin that caused the person's failure to make a timely remittance;
- b. the occurrence of an emergency, as defined in section 8558 of the Government Code, that caused the person's failure to make a timely remittance;
- c. a natural disaster or other catastrophe directly affecting the business operations of the person that caused the person's failure to make a timely remittance;
- d. the Board's failure to send returns or other information to the correct address of record that caused the person's failure to make a timely remittance;
- e. the person's failure to make a timely remittance occurred only once over a three-year period, or once during the period in which the person was engaged in business, whichever time period is shorter; or
- f. the person voluntarily corrected errors in remitting sales tax reimbursement or use tax collected that were made in previous reporting periods, and remitted payment of the liability owed as a result of those errors prior to being contacted by the Board regarding possible errors or discrepancies.

For purposes of this penalty, “sales tax reimbursement” is defined in section 1656.1 of the Civil Code, and also includes any sales tax that is advertised, held out, or stated to the public or any customer, directly or indirectly, that the tax or any part thereof will be assumed or absorbed by the retailer.

This penalty applies to determinations made by the Board pursuant to Article 2 (commencing with section 6481), Article 3 (commencing with section 6511), and Article 4 (commencing with section 6536) of Chapter 5, Part 1, Division 2 of the Revenue and Taxation Code.

(E) Nonpayment of Determinations. A penalty of 10 percent of the amount of the tax specified in the determination shall be added to any determination not paid within the time required by law.

(4) Improper Use of Resale Certificate.

A penalty of 10 percent applies to the taxes imposed upon any person who knowingly issues a resale certificate for personal gain or to evade the payment of taxes while not actively engaged in business as a seller.

The penalty is 10 percent of the amount of tax or five hundred dollars (\$500), whichever is greater, if the purchase is made for personal gain or to evade payment of taxes.

(5) Direct Payment Permits. Every holder of a direct payment permit who gives an exemption certificate to a retailer for the purpose of paying that retailer's tax liability directly to the Board must make a proper allocation of that retailer's local sales and use tax liability and also its district transactions and use tax liability if applicable. Such allocation must be made to the cities, counties, city and county, redevelopment agencies, and district to which the taxes would have been allocated if they had been reported by that retailer. Allocations must be submitted to the Board in conjunction with the direct payment permit holder's tax return on which the taxes are reported. If the local and district taxes are misallocated due to negligence or intentional disregard of the law, a penalty of 10 percent of the amount misallocated shall be imposed.

(6) Failure to Obtain Evidence that Operator of Catering Truck Holds Valid Seller's Permit. Any person making sales to an operator of a catering truck who has been required by the Board pursuant to section 6074 of the Revenue and Taxation Code to obtain evidence that the operator is the holder of a valid seller's permit issued pursuant to section 6067 of the Revenue and Taxation Code and who fails to comply with that requirement shall be liable for a penalty of five hundred dollars (\$500) for each such failure to comply.

(7) Failure of Retail Florist to Obtain Permit. Any retail florist (including a mobile retail florist) who fails to obtain a seller's permit before engaging in or conducting business as a seller shall, in addition to any other applicable penalty, pay a penalty of five hundred dollars (\$500). For purposes of this regulation, “mobile retail florist” means any retail florist who does not sell from a structure or retail shop, including, but not limited to, a florist who sells from a vehicle, pushcart, wagon, or other portable method, or who sells at a swap meet, flea market, or similar transient location. “Retail florist” does not include any flower or ornamental plant grower who sells his or her own products.

(8) Relief from Penalty for Reasonable Cause. If the Board finds that a person's failure to make a timely return, payment, or prepayment, or failure to comply with the provisions of section 6074 of the Revenue and Taxation Code is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, the person may be relieved of the penalty provided by sections 6074, 6476, 6477, 6480.4, ~~6480.8~~, 6511, 6565, 6591, and 7051.2 of the Revenue and Taxation Code for such failure.

Any person seeking to be relieved of the penalty shall file with the Board a statement under penalty of perjury setting forth the facts upon which the claim for relief is based. Section 6592 of the Revenue and Taxation Code, providing for the relief of certain penalties does not apply to the 10 percent penalty imposed for failure to make a timely prepayment under section 6478 of the Revenue and Taxation Code.

(9) Tax Amnesty Program (Reporting Periods Beginning Before January 1, 2003).

(A) If on or after April 1, 2005, the Board issues a deficiency determination upon a return filed under the amnesty program or upon any other nonreporting or underreporting of tax liability by a person who could have otherwise been eligible for amnesty as specified in sections 7071, 7072 and 7073 of the Revenue and Taxation Code, the Board shall impose penalties at a rate that is double the rate of penalties normally applicable.

(B) Any taxpayer who could have applied for amnesty as specified in sections 7071, 7072 and 7073 of the Revenue Taxation Code but fails to do so, will be subject to a penalty of 50 percent of the interest computed under section 6591 of the Revenue and Taxation Code for the period beginning on the date the tax was due and ending on March 31, 2005.

**PENALTY COMMENTS ON AUDIT REPORTS
OR FIELD BILLING ORDERS**

0506.35

A comment should be made on any area which will be of value in connection with making a determination or with making decisions regarding future audits (AM section 0206.03). Penalty recommendations are frequently a source of disagreement between staff and taxpayers. To ensure that both staff and taxpayers understand why a negligence penalty was or was not recommended, a penalty comment using the following guidelines *must* be made in the "General Audit Comments" section of Form BOE-414-A or Form BOE-414-B. The *sole* exception is when the tax liability is less than \$2,500 and no penalty is recommended.

The factors which constitute negligence in keeping records (AM section 0507.00), negligence in preparing returns (AM section 0508.00), and evasion penalties (AM section 0509.00), must be carefully considered before determining whether a negligence or evasion penalty should be imposed. If a negligence penalty is being recommended, the auditor must provide in clear and concise terms the rationale for imposing a penalty. An explanation of the evidence and facts upon which the auditor relies to support the recommendation for imposition of a penalty must be given. The explanation must enable supervisors, reviewers, the taxpayer and/or taxpayer's representative to determine whether the recommendation is consistent with the facts established by the audit. The comments must be factual, not merely the auditor's opinion, and must not be stated in a manner derogatory to the taxpayer or the taxpayer's employees. All penalty comments must be sufficiently clear to provide information that may be useful in subsequent audits of the taxpayer.

If the auditor believes the imposition of a penalty is inappropriate, he or she must use the same penalty comment guidelines as when recommending a negligence penalty. That is, the comments must be clear and concise to enable supervisors and other readers of the audit working papers to determine whether the recommendation is consistent with the facts established in the audit, and to provide information that may be useful in a subsequent audit. "Canned comments" such as "Negligence not noted," "No negligence noted," or "No penalty recommended," do not provide enough information and are not acceptable.

If an evasion (fraud) penalty is being recommended, the comment on the audit report must include "Penalty pursuant to RTC section 6485 is recommended". In addition, a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division (see AM section 0509.75 for contents of this memo).

~~Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer's background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. Criteria that should be considered, among others, are the taxpayer's prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns. A penalty may be appropriate in any of the following circumstances: the taxpayer has~~

~~no records of any kind, the taxpayer has a history of prior permits or business experience, analysis shows that purchases have exceeded reported sales, or the taxpayer has two sets of books. The comment "Taxpayer's first audit" should only be used in conjunction with a detailed explanation for the penalty recommendation.~~

To promote consistency in the application of penalties and the writing of penalty comments, all comments must be reviewed by the auditor's supervisor. In addition, special procedures will be used for the following reviews:

- Audit tax deficiency over \$25,000 — Reviewed and approved by the auditor's supervisor.
- Audit tax deficiency over \$50,000 — Reviewed and approved by the District Principal Auditor subsequent to the review and approval by the auditor's supervisor.

This review and approval must be noted by the supervisor (and DPA if applicable) by commenting and signing directly below the auditor's penalty comment in the "General Audit Comments" section of Form BOE-414-A or Form BOE-414-B. This may be a handwritten comment or incorporated as the last line of the penalty comment (e.g., "Reviewed and approved. _____, Supervisor; _____, DPA.") See AM section 0206.45.

NEGLIGENCE PENALTIES IN A TAXPAYER'S FIRST AUDIT

0506.40

Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer's background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. (See Regulation 1703(c)(3)(A).) If a negligence penalty is recommended on the first audit, the comment "Taxpayer's first audit" should be made in conjunction with a detailed explanation for the penalty recommendation. Criteria that should be considered, among others, are the taxpayer's prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns.

Circumstances in which a negligence penalty may be appropriate in a first-time audit include, but are not limited to, the following:

- The business is controlled by a person or persons that control (or controlled) a substantially similar business that was previously subject to audit. In that earlier audit, staff documented audit issues which resulted in the understatement of taxable sales. These same issues are present in the current audit and resulted in a substantial understatement of taxable sales. (For purposes of this and the following circumstances, "controlled" or "control" means any person having control or supervision of, or who is charged with the responsibility for, the filing of returns or the payment of tax or who has a duty to act for the entity in complying with any provision of the Sales and Use Tax Law.); or

- The business received written advice from the BOE regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales. (For purposes of this and the following circumstance, "written advice" does not include publications provided to a taxpayer upon registration for a seller's permit or certificate of registration – use tax.); or
- The business is controlled by a person or persons that control (or controlled) a similar business which received written advice from the BOE regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or
- The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business has no records of any kind or extremely poor records, which resulted in substantial underreporting. The evidence indicates that it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting; however, the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business is controlled by a CPA or former CPA who has prior experience advising businesses of the same type on compliance with the Sales and Use Tax Laws. The audit results in a substantial liability despite the controlling person's extensive experience advising clients of the same type of business on record keeping and in preparing sales and use tax returns.

The following examples illustrate when a negligence penalty may apply in a taxpayer's first audit.

Example 1

Shep Bartlett owned and operated a restaurant serving breakfast, lunch and dinner as well as beer and wine. During an audit of the restaurant, Mr. Bartlett provided BOE staff with monthly sales summaries but had not maintained any source documentation like purchase invoices, sales receipts or cash register z-tapes. BOE staff found that taxable sales were understated. In the audit work papers, it was documented that Mr. Bartlett had been advised that he was required to maintain source documents and provide them upon audit. Subsequently, Mr. Bartlett formed a

corporation, Bartlett, Inc., with himself as the president and sole shareholder. Bartlett, Inc. opened another restaurant which was managed by Mr. Bartlett. During the first audit of Bartlett Inc., BOE staff found that it did not maintain any source documentation such as purchase invoices, sales receipts or cash register z-tapes, and, upon examination, calculated a substantial understatement of taxable sales. Because the same audit issue was documented in the earlier audit of Mr. Bartlett's other restaurant and documentation showed that BOE staff had advised Mr. Bartlett regarding proper record keeping, and because Mr. Bartlett managed the operation of both restaurants, BOE staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 2

Tony Leo owned and operated a retail store selling antiques to customers both within and outside of California. Mr. Leo wrote to the BOE requesting advice regarding what documentation was necessary to support sales in interstate commerce. BOE staff provided him a written response stating that sales where the property was delivered to the customer in California were subject to sales tax while sales where documentation showed that the property was to be shipped and was shipped to a location outside California by common carrier were not subject to tax. During the first audit of the antique store, BOE staff discovered that Mr. Leo was claiming as exempt sales in interstate commerce sales where the property was delivered to the customer in California. Because Mr. Leo had previously received written advice on this issue and was reporting sales contrary to the specific written advice, BOE staff recommended that a 10 percent negligence penalty be added to the audit determination.

Note: The recommendation to impose a 10 percent negligence penalty would also apply in the first audit of a business which is controlled by a person or persons that control (or controlled) a similar business which received written advice from the BOE regarding a record keeping or reporting issue.

Example 3

Ace's Automobiles is a seller of used vehicles. It was opened and originally operated under a seller's permit taken out by Charlotte Dealer. After two years, the business was closed and Ms. Dealer opened King's Automobiles, also selling used vehicles. Ms. Dealer closed King's Automobiles after two years and opened Jack's Automobiles, again selling used vehicles. Ms. Dealer managed all three businesses. Based on an audit lead, staff commenced an audit of Jack's Automobiles after it had been in business only two years. This was the first audit of any of Ms. Dealer's businesses. Audit staff found that many of the Reports of Sale were missing and the records they did obtain appeared to have been prepared just for the audit and indicated unrealistically low selling prices based on the make and model of vehicles sold. As a result, staff estimated that taxable sales were substantially understated. Although this was Ms. Dealer's first audit, because Ms. Dealer had been operating used vehicle lots for many years and her past business practices indicated a conscious effort to avoid being audited, staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 4

Kurt Vaughn owned and operated a company in the business of selling musical instruments. Mr. Vaughn did not report any taxable sales, claiming that all property was shipped out of state via common carrier pursuant to the sales contracts. During the first audit of the business, Mr. Vaughn provided annual sales summaries but did not maintain purchase invoices, sales contracts or receipts, shipping invoices, bills of lading or any other source documentation. Furthermore, records obtained from the common carriers indicated that very few sales were shipped out of state, while a substantial number of shipments were to locations in California. The audit resulted in substantially underreported taxable sales but BOE staff concluded that there was insufficient evidence to impose a penalty for fraud. However, given the significant understatement, the records from common carriers, and the complete lack of source documentation, staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 5

Mr. Smith is a CPA whose practice, for the last three years, has involved advising and assisting business owners, including numerous restaurants, regarding best practices in running their businesses and record keeping and assisting them in preparing sales and use tax returns. Mr. Smith decided to close his CPA practice and open a sushi restaurant, something he always dreamed of doing. In the first audit of Mr. Smith's restaurant, staff found that Mr. Smith had failed to keep complete purchase invoices, had no guest checks or z tapes, and did not keep records showing any cold food sold "to go." However, Mr. Smith reported 30 percent of his sales as exempt sales of cold food "to go." The audit resulted in a substantial liability involving both unreported total sales and unsupported claimed exempt sales of cold food "to go." Although this was Mr. Smith's first audit, staff included a 10 percent negligence penalty because of Mr. Smith's extensive experience with the record keeping and reporting requirements for restaurants.



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January 29, 2016

Ms. Susanne Buehler, Chief
Board of Equalization
Tax Policy Division
Sales and Use Tax Department
450 N Street
Sacramento, CA 94279-0092

VIA: Email: Susanne.Beuhler@boe.ca.gov

Re: Proposed language for California Code of Regulations, title 18, section 1703, *Interest and Penalties*.¹ Audit Manual Chapter 5, *Penalties*.

Dear Ms. Buehler,

This submission is being made in response to the Initial Discussion Paper and the interested parties' meeting held on January 19, 2016, regarding the proposed amendments to Regulation 1703 and Audit Manual Chapter 5. This submission only addresses the negligence penalty portions of the proposed amendments.

We want to thank you, the Tax Policy Division and all of the other participants for the opportunity to provide this proposed language. We have recognized some confusion from the audit staff as it respects the application of negligence penalties for first-time audits, and we believe the proposed revisions will provide some needed clarification.

¹ All references to Regulations hereafter are to California Code of Regulations, title 18, unless otherwise noted.

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Regulation 1703, subdivision (c)(3)(A), Negligence or Intentional Disregard

Subsection (c)(3)(A) of the proposed revision to Regulation 1703 addresses when a penalty for negligence or intentional disregard should *not* be added to a deficiency determination associated with the first audit of a taxpayer:

*(c)(3)(A)- Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that a taxpayer possessed experience **and/or** knowledge such that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that it's bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (emphasis added)*

We are concerned with the use of the word “and/or” in this subsection as it respects the taxpayer’s experience *and/or* knowledge of the reporting or recording issue in question. We feel that the word “or” should be removed from this proposed language, because a taxpayer may have experience operating a business, but not the requisite knowledge.

For Example: a taxpayer purchases a widget company, and the predecessor informs the taxpayer to retain copies of sales invoices, listing the out-of-state address of the customer, to support claimed exempt sales in interstate commerce. The taxpayer/successor operates the business for 10 years, but it doesn’t retain support for claimed exempt sales in interstate commerce based on the direction provided by the predecessor. The taxpayer is subsequently selected for audit and a large deficiency is established for disallowed claimed exempt sales in interstate commerce. The auditor assesses a negligence penalty and cites the taxpayer’s 10 years of experience in support of the assessment.

The above example, which is based on one of our prior client’s cases, highlights our concern with the use of the word “and/or” in the proposed language. In this example, based on the taxpayer’s 10 years of operating experience, the auditor felt the assessment of a negligence penalty was appropriate, even though the experience made no relevant difference in the taxpayer’s knowledge of what was required to support sales in interstate commerce.

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To clarify the matter and to ensure proper assessment of the penalty, we suggest removing the word “or” from the proposed language. Doing so will help ensure that taxpayers are not unnecessarily punished, unless they actually have the necessary experience *and* knowledge.

Audit Manual Section 0506.40

Bullet Point Examples

The proposed language contained within the second and fourth bullet points of Audit Manual section 0506.40 presents examples of when a penalty should apply to a determination associated with the first audit of a taxpayer’s business:

- Second Bullet Point: *The business received written advice from the BOE regarding a recordkeeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales;*
 - o We feel language should be incorporated which makes it clear that the taxpayer requested the written advice. The concern is that an auditor may mistakenly consider items such as BOE Publications that are available to the general public, as representing written advice from the BOE. In reality, even when publications are provided to taxpayers at the time they obtain permits, or during the course of an audit, our impression is that they’re not thoroughly reviewed (if at all) and not well understood by many taxpayers; notwithstanding the taxpayer’s good intentions. Requiring written advice to come in response to a request by the taxpayer, will help prevent confusion over what is considered “written advice.”

- Fourth Bullet Point: *The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient*

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to meet the clear and convincing evidence standard required to impose a fraud penalty;

- We feel that language should be added to the first sentence of the forgoing example stating that there is no valid business purpose or reasonable explanation for the continual opening and closing of businesses. The proposed first sentence in the example would read as follows:
 - *The owner of the business has a history of opening and closing businesses with no valid business purpose or reasonable explanation for doing so.*
- We also feel that similar language should be added to proposed Example #3, stating that there was no reasonable explanation or valid business purpose for the continual opening and closing of the businesses in question.

We thank you for providing us with the opportunity to submit these suggestions. Please feel free to contact me with any questions or comments.

Sincerely,
James R. Dumler
Senior Tax Specialist

JD:jwm