



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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September 9, 2016

To Interested Parties:

Notice of Proposed Regulatory Action

**The State Board of Equalization Proposes to Adopt Amendments to
California Code of Regulations, Title 18,
Section 1703, *Interest and Penalties***

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to California Code of Regulations, title 18, section (Regulation or Reg.) 1703, *Interest and Penalties*. The proposed amendments clarify in subdivision (c)(3)(A) the Board's long-standing policy that a negligence penalty should not generally be imposed on a deficiency determined in the first audit of a taxpayer, unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot reasonably be explained by the taxpayer's inexperience. The proposed amendments also make Regulation 1703 consistent with the current provisions of RTC sections 6480.1, 6480.3, and 6480.4 regarding prepayments of tax on fuel, 7076.4 regarding unpaid tax liabilities determined under the Managed Audit Program, and 7153.6 which imposes a new criminal penalty, and make other minor grammatical and formatting changes to Regulation 1703.

PUBLIC HEARING

The Board will conduct a meeting in Room 121 at 450 N Street, Sacramento, California on October 25-27, 2016. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on October 25, 26, or 27, 2016. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1703.

AUTHORITY

RTC section 7051

REFERENCE

RTC sections 6071, 6072, 6073, 6074, 6077, 6094.5, 6207, 6291-6294, 6422.1, 6452, 6455, 6459, 6476-6478, 6479.3, 6480.4, 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, 7076.4, 7101, 7152-7153, 7153.5, 7153.6, and 7155.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Summary of Existing Laws and Regulations

California imposes sales tax on retailers for the privilege of selling tangible personal property at retail. (Rev. & Tax. Code (RTC), § 6051.) Unless an exemption or exclusion applies, the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California. (RTC, §§ 6012, 6051.) The term "gross receipts" means the total amount of the sale price without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (RTC, § 6012, subd. (a).) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (Regulation or Reg.) 1700.)

When sales tax does not apply, use tax is imposed on the use of tangible personal property purchased from a retailer for storage, use, or other consumption in California. (RTC, §§ 6201, 6401.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the property is liable for the tax. (RTC, §§ 6201, 6202.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6203, 6204; Reg. 1684.)

Negligence Penalty Applicable to Deficiency Determinations

Under the Sales and Use Tax Law (RTC, § 6001 et seq.), persons who owe sales and use tax (i.e., retailers and consumers) are required to file returns reporting the taxes they owe and pay the amounts owed to the Board. (RTC, §§ 6451, 6452, 6452.1, 6453, 6454.) Such persons must also maintain adequate records to support the amount of tax reported on their returns, and the Board has the authority to examine the books, papers, records, and equipment of such persons to verify the accuracy of any return made, or, if no return is made, to ascertain and determine the amount required to be paid. (RTC, §§ 7053, 7054; Reg. 1698, *Records*.)

When the Board is not satisfied with the amount of tax reported as being owed on a return or the amount of tax paid by a person, it may compute the amount required to be paid by the person, determine the deficiency between the amount of tax reported or paid and the amount required to be paid, and issue a Notice of Determination to the person to collect the deficiency. (RTC, §§ 6481, 6486.) Additionally, if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the Sales and Use Tax Law, a penalty of 10 percent of the amount of the determination shall be added thereto (RTC, § 6484), and interest shall be imposed on the amount of the deficiency determination, exclusive of penalties. (RTC, § 6482.) Regulation 1703, *Interest and Penalties*, lists, summarizes, and clarifies the various sales and use tax statutes relating to penalties and interest, and subdivision (c)(3)(A) of the regulation describes the negligence penalty.

Generally, Board staff conducts audits to perform examinations of taxpayers' books and records and determine the accuracy of the amounts that they have reported and paid to the Board. During an audit, Board staff must determine whether any error found was due to the taxpayer's negligence in keeping records or preparing returns. Though there is no definition of negligence in the RTC, negligence is commonly defined to mean "[t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation" or "the failure to do what [a reasonable and prudent] person would do under the circumstances." (Black's Law Dict. (10th ed. 2014), negligence; see also the Board's Audit Manual (AM) § 506.10 [providing that negligence may be defined as the failure to exercise the care that a reasonable and prudent person would exercise under similar circumstances].) Therefore, the Board's general guidance to staff is to determine whether a taxpayer has kept the type of records ordinarily maintained by a reasonable and prudent businessperson with a business of a similar kind and size that are adequate to meet the business's tax requirements, and exercised 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, in order to determine if the taxpayer's deficiency was due to the taxpayer's negligence in keeping records or preparing returns. (AM §§ 507.10-507.20, 508.10.)

In addition, some taxpayers make a reasonable effort to comply with their recording-keeping and reporting requirements, in good faith, but still make errors due to their lack of experience. Therefore, a taxpayer's first audit (first-time audit) often plays a vital role in educating that taxpayer on the relevant laws and regulations applicable to its activities, providing instruction to that taxpayer on proper record-keeping practices and proper reporting, and correcting any recording-keeping and reporting errors the taxpayer may be making due to inexperience. Consequently, a taxpayer who has not been subject to audit generally does not have the same level of experience and knowledge as a taxpayer who has been audited, and generally cannot be said to be in the same or similar circumstances as a more experienced taxpayer that has been audited. Accordingly, it has been the long-standing policy of the Board to not impose a negligence penalty on a deficiency determined in a first-time audit, unless the taxpayer's bookkeeping or reporting errors cannot reasonably be explained by the taxpayer's inexperience. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321 [upholding a negligence penalty imposed after a second audit disclosed that the taxpayer

continued to make the same errors the Board found in its first audit and noting “that the Board seldom, if ever, imposes a negligence penalty for errors discovered on a first audit”].) For instance, a negligence penalty may be imposed after a first-time audit if a taxpayer has advanced knowledge of and experience complying with the Sales and Use Tax Law despite never having been subject to audit itself, or the nature and degree of the taxpayer’s error indicates that the taxpayer failed to exercise the standard of care that a reasonably prudent person with the taxpayer’s experience would have exercised, as is the case when a taxpayer maintains no records of any kind or extremely poor records, the Board obtains other evidence indicating that the taxpayer has a substantial deficiency, and the taxpayer cannot reasonably explain why the deficiency was due to the taxpayer’s inexperience.

Late Prepayments of Sales and Use Tax on Fuel

As relevant here, Regulation 1703, subdivision (a), currently lists RTC sections 6480.4, 6480.8, and 6480.19 as statutes that impose interest and penalties for “[f]ailure to pay tax within required time (except determinations).” Regulation 1703, subdivision (b)(2), currently explains how interest applies to late prepayments of tax on fuel and provides that:

Interest applies to amounts due but not paid by any distributor or broker of motor vehicle 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.

Also, Regulation 1703, subdivision (c)(1)(A)5 and 6, currently explains the penalties that apply to late prepayments of tax on fuel and provides that:

5. A penalty of 25% shall apply to the amount of prepayment due but not paid by any distributor or broker of motor vehicle 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 producer, importer, or jobber knowingly or intentionally fails to make a timely remittance.

However, RTC sections 6480.8, 6480.10, 6480.16, 6480.18, and 6480.19 were all repealed (Stats.2001, ch. 429, operative Jan. 1, 2002) so that distributors and brokers of motor vehicle fuel are no longer required to collect and remit prepayments of tax on motor vehicle fuel. RTC sections 6480.1 and 6480.3 were amended so that they now currently require suppliers and wholesalers to collect and remit prepayments of sales tax on sales of motor vehicle fuel, aircraft jet fuel, and diesel fuel. RTC section 6480.4 was amended so it currently requires suppliers and wholesalers that fail to timely remit such prepayments to pay a 10 percent penalty, plus interest, and provides that the penalty “shall be 25 percent if the supplier or wholesaler knowingly or intentionally fails to make a timely remittance.” And, RTC sections 6480.1, 6480.3, and 6480.4 no longer apply to distributors and brokers of motor vehicle fuel.

RTC sections 7076.4, 7076.5, and 7153.6

As relevant here, Regulation 1703, subdivision (a), lists RTC section 7076.5 as the statute that imposes interest on unpaid tax liabilities determined under the Managed Audit Program. However, RTC sections 7076.4 and 7076.5 (referred to in the regulation) were repealed (Stats. 2000, ch 1052, operative Jan. 1, 2003) and a new version of RTC section 7076.4 was enacted (Stats. 2003, ch. 87, effective January 1, 2004) that currently imposes interest on unpaid tax liabilities determined under the Managed Audit Program. Also, section 7153.6 was added to the RTC effective January 1, 2014 (Stats.2013, ch. 532), to impose new criminal penalties related to a person’s sale or use of an “automated sales suppression device or zapper or phantom-ware,” under the Sales and Use Tax Law.

Effects, Objective, and Benefit of the Proposed Amendments to Regulation 1703

Board staff determined that there is an issue (or problem) because none of the Board’s regulations prescribe or provide notice regarding the Board’s long-standing policy regarding whether to impose a negligence penalty on a deficiency determined in a first-time audit. Board staff determined that it would be best to amend Regulation 1703, subdivision (c)(3)(A), which relates to the negligence penalty set forth in RTC section 6484, to address the issue. Board staff drafted proposed amendments incorporating the Board’s long-standing policy and practice that a negligence penalty should not be applied in a first-time audit, unless the taxpayer’s bookkeeping or reporting errors cannot reasonably be due to the taxpayer’s inexperience, and clarifying that this means a negligence penalty should not be applied in a first-time audit, unless evidence establishes that the taxpayer did not have a good faith and reasonable belief that its practices were in compliance with the Sales and Use Tax Law. The proposed amendments were intended to create clear and consistent regulatory guidance for staff when conducting a first-time audit.

Board staff distributed an Initial Discussion Paper with the draft of the proposed amendments attached as Exhibit 1 on January 8, 2016. Staff’s draft proposed amendments to Regulation 1703, subdivision (c)(3)(A), 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."

In addition, in Exhibit 1 to the Initial Discussion Paper, Board staff included other draft amendments to make Regulation 1703 consistent with the RTC. Specifically, Board staff's draft amendments proposed to:

- Delete the references to repealed RTC section 6480.8 from subdivisions (a), (b)(1)(E) and (8), and (c)(8) of the regulation and the regulation's reference note;
- Delete the references to repealed RTC section 6480.19 from subdivision (a) of the regulation and the regulation's reference note;
- Add references to RTC section 7153.6, which imposes a criminal penalty, to subdivision (a) of the regulation and regulation's reference note;
- Replace the references to repealed RTC section 7076.5 with references to RTC section 7076.4, which currently imposes interest on unpaid tax liabilities determined under the Managed Audit Program, in subdivision (a) of the regulation and the regulation's reference note; and
- Make subdivisions (b)(2) and (c)(1)(A) of the regulation consistent with the repeal of RTC sections 6480.8, 6480.10, 6480.16, 6480.18, and 6480.19, and the amendments to RTC sections 6480.1, 6480.3, and 6480.4 regarding interest and penalties imposed on suppliers' and wholesalers' late prepayments of tax on fuel.

Board staff held an interested parties meeting on January 19, 2016, to discuss the Initial Discussion Paper and draft amendments. At the meeting, there was general agreement that the draft amendments to Regulation 1703, subdivision (c)(3)(A), would provide clarity with respect to the Board's policy regarding the imposition of a negligence penalty on a deficiency determined in a first-time audit. However, a concern was raised with the use of the phrase "experience and/or knowledge" in the draft amendments, specifically that when a taxpayer completely lacks either experience or knowledge, an auditor may overly focus on the other element to justify imposing the penalty.

Following the interested parties meeting, staff received comments from Mr. James Dumler of McClellan Davis, LLC, in a letter dated January 29, 2016. Mr. Dumler also 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 suggested that the word "or" be removed because a taxpayer may have experience operating a business, but not the requisite knowledge.

Board staff agreed that in most circumstances where it is appropriate to impose a negligence penalty on a deficiency determined in 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 regarding restaurants' sales and use tax compliance obligations through consultation with its restaurant clients, yet have no experience actually operating a restaurant. Board staff therefore did not recommend replacing the phrase "and/or" with "and," but appreciated 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 bookkeeping or reporting 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, to avoid confusion and provide more clear direction to audit staff, Board staff revised its proposed regulatory language for subdivision (c)(3)(A) (quoted above) to delete the phrase "that a taxpayer possessed experience and/or knowledge such."

Subsequently, Board staff prepared Formal Issue Paper 16-03 and distributed it to the Board Members for consideration at the Board's March 30, 2016, Business Taxes Committee (BTC) meeting. Formal Issue Paper 16-03 recommended that the Board propose to adopt Board staff's draft amendments to Regulation 1703 discussed above to provide clear and consistent guidance to Board staff and taxpayers in subdivision (c)(3)(A) that a negligence penalty should not generally be applied to a deficiency determined in the first audit of a taxpayer, unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief in its compliance with the Sales and Use Tax Law. The formal issue paper also recommended that the Board propose to adopt the other draft amendments to make Regulation 1703 consistent with the current provisions of RTC sections 6480.1, 6480.3, 6480.4, 7076.4, and 7153.6 (discussed above), and propose to make other minor grammatical and formatting changes to Regulation 1703.

The Board discussed Formal Issue Paper 16-03 during its March 30, 2016, BTC meeting. At the conclusion of the discussion, the Board Members unanimously voted to propose to adopt the amendments to Regulation 1703 recommended by staff.

The Board determined that the proposed amendments to Regulation 1703 are reasonably necessary to have the effect and accomplish the objective of addressing the issue or problem), discussed above, by providing clear and consistent guidance to Board staff and taxpayers clarifying that a negligence penalty should not generally be applied to a deficiency determined in the first audit of a taxpayer unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief in its compliance with the Sales and Use Tax Law. The Board also determined that the proposed amendments are reasonably necessary to have the effects and accomplish the objectives of ensuring that the regulation is consistent with the RTC, grammatically correct, and properly formatted.

The Board anticipates that the proposed amendments to Regulation 1703 will promote fairness and benefit taxpayers, Board staff, and the Board by providing clarity with regard to the application of negligence penalties to deficiencies determined in first-time audits.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1703 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because there are no other sales and use tax regulations that prescribe the application of the negligence penalty set forth in RTC section 6484, or prescribe the interest and penalties that apply to late prepayments of tax on fuel. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1703 or the proposed amendments to Regulation 1703.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1703 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO ANY STATE AGENCY, LOCAL AGENCY, OR SCHOOL DISTRICT

The Board has determined that the adoption of the proposed amendments to Regulation 1703 will result in no direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1703 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1703 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

**RESULTS OF THE ECONOMIC IMPACT ASSESSMENT REQUIRED BY
GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

The Board has determined that the proposed amendments to Regulation 1703 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1703 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create new businesses or expand businesses currently doing business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1703 will not affect the benefits of Regulation 1703 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of the proposed amendments to Regulation 1703 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed amendments should be directed to Scott Claremon, Tax Counsel III, by telephone at (916) 323-3184, by e-mail at Scott.Claremon@boe.ca.gov, or by mail at State Board of Equalization, Attn: Scott Claremon, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080. Mr. Bennion is the designated backup contact person to Mr. Claremon.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on October 25, 2016, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1703 during the October 25-27, 2016, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1703. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an underscored and strikethrough version of the text of Regulation 1703 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1703, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed amendments and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Regulation 1703 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Regulation 1703, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,


Joann Richmond, Chief
Board Proceedings Division

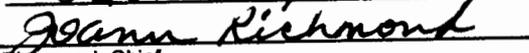
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STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the October 25, 2016 Board Meeting


Joann Richmond, Chief
Board Proceedings Division

**Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations,
Title 18, Section 1703, *Interest and Penalties***

SPECIFIC PURPOSES, PROBLEM INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFIT

Current Law

California imposes sales tax on retailers for the privilege of selling tangible personal property at retail. (Rev. & Tax. Code (RTC), § 6051.) Unless an exemption or exclusion applies, the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California. (RTC, §§ 6012, 6051.) The term "gross receipts" means the total amount of the sale price without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (RTC, § 6012, subd. (a).) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (Regulation or Reg.) 1700.)

When sales tax does not apply, use tax is imposed on the use of tangible personal property purchased from a retailer for storage, use, or other consumption in California. (RTC, §§ 6201, 6401.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the property is liable for the tax. (RTC, §§ 6201, 6202.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6203, 6204; Reg. 1684.)

Negligence Penalty Applicable to Deficiency Determinations

Under the Sales and Use Tax Law (RTC, § 6001 et seq.), persons who owe sales and use tax (i.e., retailers and consumers) are required to file returns reporting the taxes they owe and pay the amounts owed to the Board. (RTC, §§ 6451, 6452, 6452.1, 6453, 6454.) Such persons must also maintain adequate records to support the amount of tax reported on their returns, and the Board has the authority to examine the books, papers, records, and equipment of such persons to verify the accuracy of any return made, or, if no return is made, to ascertain and determine the amount required to be paid. (RTC, §§ 7053, 7054; Reg. 1698, *Records*.)

When the Board is not satisfied with the amount of tax reported as being owed on a return or the amount of tax paid by a person, it may compute the amount required to be paid by the person, determine the deficiency between the amount of tax reported or paid and the amount required to be paid, and issue a Notice of Determination to the person to collect the deficiency. (RTC, §§ 6481, 6486.) Additionally, if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the Sales and Use Tax Law, a penalty of 10 percent of the amount of the determination shall be added thereto (RTC, § 6484), and interest shall be imposed on the amount of the deficiency determination, exclusive of penalties. (RTC, §

6482.) Regulation 1703, *Interest and Penalties*, lists, summarizes, and clarifies the various sales and use tax statutes relating to penalties and interest, and subdivision (c)(3)(A) of the regulation describes the negligence penalty.

Generally, Board staff conducts audits to perform examinations of taxpayers' books and records and determine the accuracy of the amounts that they have reported and paid to the Board. During an audit, Board staff must determine whether any error found was due to the taxpayer's negligence in keeping records or preparing returns. Though there is no definition of negligence in the RTC, negligence is commonly defined to mean "[t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation" or "the failure to do what [a reasonable and prudent] person would do under the circumstances." (Black's Law Dict. (10th ed. 2014), negligence; see also the Board's Audit Manual (AM)¹ § 506.10 [providing that negligence may be defined as the failure to exercise the care that a reasonable and prudent person would exercise under similar circumstances].) Therefore, the Board's general guidance to staff is to determine whether a taxpayer has kept the type of records ordinarily maintained by a reasonable and prudent businessperson with a business of a similar kind and size that are adequate to meet the business's tax requirements, and exercised 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, in order to determine if the taxpayer's deficiency was due to the taxpayer's negligence in keeping records or preparing returns. (AM §§ 507.10-507.20, 508.10.)

In addition, some taxpayers make a reasonable effort to comply with their recording-keeping and reporting requirements, in good faith, but still make errors due to their lack of experience. Therefore, a taxpayer's first audit (first-time audit) often plays a vital role in educating that taxpayer on the relevant laws and regulations applicable to its activities, providing instruction to that taxpayer on proper record-keeping practices and proper reporting, and correcting any recording-keeping and reporting errors the taxpayer may be making due to inexperience. Consequently, a taxpayer who has not been subject to audit generally does not have the same level of experience and knowledge as a taxpayer who has been audited, and generally cannot be said to be in the same or similar circumstances as a more experienced taxpayer that has been audited. Accordingly, it has been the long-standing policy of the Board to not impose a negligence penalty on a deficiency determined in a first-time audit, unless the taxpayer's bookkeeping or reporting errors cannot reasonably be explained by the taxpayer's inexperience. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321 [upholding a negligence penalty imposed after a second audit disclosed that the taxpayer continued to make the same errors the Board found in its first audit and noting "that the Board seldom, if ever, imposes a negligence penalty for errors discovered on a first audit"].) For instance, a negligence penalty may be imposed after a first-time audit if a taxpayer has advanced knowledge of and experience complying with the Sales and Use Tax Law despite never having been subject to audit itself, or the nature and degree of the taxpayer's error indicates that the taxpayer failed to exercise the standard of care that a reasonably prudent person with the taxpayer's experience would have exercised, as is the case when a taxpayer maintains no records of any kind or extremely poor records, the Board obtains other evidence indicating that the

¹ The AM "is a guide in conducting sales and use tax audits. It incorporates procedures and techniques that have evolved over a period of years and have proved to be sound and practical." (AM § 0101.5.)

taxpayer has a substantial deficiency, and the taxpayer cannot reasonably explain why the deficiency was due to the taxpayer's inexperience.

Late Prepayments of Sales and Use Tax on Fuel

As relevant here, Regulation 1703, subdivision (a), currently lists RTC sections 6480.4, 6480.8, and 6480.19 as statutes that impose interest and penalties for “[f]ailure to pay tax within required time (except determinations).” Regulation 1703, subdivision (b)(2), currently explains how interest applies to late prepayments of tax on fuel and provides that:

Interest applies to amounts due but not paid by any distributor or broker of motor vehicle 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.

Also, Regulation 1703, subdivision (c)(1)(A)5 and 6, currently explains the penalties that apply to late prepayments of tax on fuel and provides that:

5. A penalty of 25% shall apply to the amount of prepayment due but not paid by any distributor or broker of motor vehicle 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 producer, importer, or jobber knowingly or intentionally fails to make a timely remittance.

However, RTC sections 6480.8, 6480.10, 6480.16, 6480.18, and 6480.19 were all repealed (Stats.2001, ch. 429, operative Jan. 1, 2002) so that distributors and brokers of motor vehicle fuel are no longer required to collect and remit prepayments of tax on motor vehicle fuel. RTC sections 6480.1 and 6480.3 were amended so that they now currently require suppliers and wholesalers to collect and remit prepayments of sales tax on sales of motor vehicle fuel, aircraft jet fuel, and diesel fuel. RTC section 6480.4 was amended so it currently requires suppliers and wholesalers that fail to timely remit such prepayments to pay a 10 percent penalty, plus interest, and provides that the penalty “shall be 25 percent if the supplier or wholesaler knowingly or

intentionally fails to make a timely remittance.” And, RTC sections 6480.1, 6480.3, and 6480.4 no longer apply to distributors and brokers of motor vehicle fuel.

RTC sections 7076.4, 7076.5, and 7153.6

As relevant here, Regulation 1703, subdivision (a), lists RTC section 7076.5 as the statute that imposes interest on unpaid tax liabilities determined under the Managed Audit Program. However, RTC sections 7076.4 and 7076.5 (referred to in the regulation) were repealed (Stats. 2000, ch 1052, operative Jan. 1, 2003) and a new version of RTC section 7076.4 was enacted (Stats. 2003, ch. 87, effective January 1, 2004) that currently imposes interest on unpaid tax liabilities determined under the Managed Audit Program. Also, section 7153.6 was added to the RTC effective January 1, 2014 (Stats.2013, ch. 532), to impose new criminal penalties related to a person’s sale or use of an “automated sales suppression device or zapper or phantom-ware,” under the Sales and Use Tax Law.

Proposed Amendments

Board staff determined that there is an issue (or problem within the meaning of Gov. Code, 11346.2, subd. (b)) because none of the Board’s regulations prescribe or provide notice regarding the Board’s long-standing policy regarding whether to impose a negligence penalty on a deficiency determined in a first-time audit. Board staff determined that it would be best to amend Regulation 1703, subdivision (c)(3)(A), which relates to the negligence penalty set forth in RTC section 6484, to address the issue. Board staff drafted proposed amendments incorporating the Board’s long-standing policy and practice that a negligence penalty should not be applied in a first-time audit, unless the taxpayer’s bookkeeping or reporting errors cannot reasonably be due to the taxpayer’s inexperience, and clarifying that this means a negligence penalty should not be applied in a first-time audit, unless evidence establishes that the taxpayer did not have a good faith and reasonable belief that its practices were in compliance with the Sales and Use Tax Law. The proposed amendments were intended to create clear and consistent regulatory guidance for staff when conducting a first-time audit.

Board staff distributed an Initial Discussion Paper with the draft of the proposed amendments attached as Exhibit 1 on January 8, 2016. Staff’s draft proposed amendments to Regulation 1703, subdivision (c)(3)(A), 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.”

In addition, in Exhibit 1 to the Initial Discussion Paper, Board staff included other draft amendments to make Regulation 1703 consistent with the RTC. Specifically, Board staff’s draft amendments proposed to:

- Delete the references to repealed RTC section 6480.8 from subdivisions (a), (b)(1)(E) and (8), and (c)(8) of the regulation and the regulation’s reference note;
- Delete the references to repealed RTC section 6480.19 from subdivision (a) of the regulation and the regulation’s reference note;
- Add references to RTC section 7153.6, which imposes a criminal penalty, to subdivision (a) of the regulation and regulation’s reference note;
- Replace the references to repealed RTC section 7076.5 with references to RTC section 7076.4, which currently imposes interest on unpaid tax liabilities determined under the Managed Audit Program, in subdivision (a) of the regulation and the regulation’s reference note; and
- Make subdivisions (b)(2) and (c)(1)(A) of the regulation consistent with the repeal of RTC sections 6480.8, 6480.10, 6480.16, 6480.18, and 6480.19, and the amendments to RTC sections 6480.1, 6480.3, and 6480.4 regarding interest and penalties imposed on suppliers’ and wholesalers’ late prepayments of tax on fuel.

Board staff held an interested parties meeting on January 19, 2016, to discuss the Initial Discussion Paper and draft amendments. At the meeting, there was general agreement that the draft amendments to Regulation 1703, subdivision (c)(3)(A), would provide clarity with respect to the Board’s policy regarding the imposition of a negligence penalty on a deficiency determined in a first-time audit. However, a concern was raised with the use of the phrase “experience and/or knowledge” in the draft amendments, specifically that when a taxpayer completely lacks either experience or knowledge, an auditor may overly focus on the other element to justify imposing the penalty.

Following the interested parties meeting, staff received comments from Mr. James Dumler of McClellan Davis, LLC, in a letter dated January 29, 2016. Mr. Dumler also 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 suggested that the word “or” be removed because a taxpayer may have experience operating a business, but not the requisite knowledge.

Board staff agreed that in most circumstances where it is appropriate to impose a negligence penalty on a deficiency determined in 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 regarding restaurants’ sales and use tax compliance obligations through consultation with its restaurant clients, yet have no experience actually operating a restaurant. Board staff therefore did not recommend replacing the phrase “and/or” with “and,” but appreciated 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 bookkeeping or reporting 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, to avoid confusion and provide more clear direction to audit staff, Board staff revised its proposed regulatory language for subdivision (c)(3)(A) (quoted above) to delete the phrase “that a taxpayer possessed experience and/or knowledge such.”

Subsequently, Board staff prepared Formal Issue Paper 16-03 and distributed it to the Board Members for consideration at the Board's March 30, 2016, Business Taxes Committee (BTC) meeting. Formal Issue Paper 16-03 recommended that the Board propose to adopt Board staff's draft amendments to Regulation 1703 discussed above to provide clear and consistent guidance to Board staff and taxpayers in subdivision (c)(3)(A) that a negligence penalty should not generally be applied to a deficiency determined in the first audit of a taxpayer, unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief in its compliance with the Sales and Use Tax Law. The formal issue paper also recommended that the Board propose to adopt the other draft amendments to make Regulation 1703 consistent with the current provisions of RTC sections 6480.1, 6480.3, 6480.4, 7076.4, and 7153.6 (discussed above), and propose to make other minor grammatical and formatting changes to Regulation 1703.

The Board discussed Formal Issue Paper 16-03 during its March 30, 2016, BTC meeting. At the conclusion of the discussion, the Board Members unanimously voted to propose to adopt the amendments to Regulation 1703 recommended by staff.

The Board determined that the proposed amendments to Regulation 1703 are reasonably necessary for the specific purpose of addressing the issue (or problem), discussed above, by providing clear and consistent guidance to Board staff and taxpayers clarifying that a negligence penalty should not generally be applied to a deficiency determined in the first audit of a taxpayer unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief in its compliance with the Sales and Use Tax Law. The Board also determined that the proposed amendments are reasonably necessary for the specific purpose of ensuring that the regulation is consistent with the RTC, grammatically correct, and properly formatted.

The Board anticipates that the proposed amendments to Regulation 1703 will promote fairness and benefit taxpayers, Board staff, and the Board by providing clarity with regard to the application of negligence penalties to deficiencies determined in first-time audits.

In addition, the Board has determined that the proposed amendments are not mandated by federal law or regulations, and there are no federal regulations or statutes that are identical to Regulation 1703 or the proposed amendments to Regulation 1703.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 16-03, the exhibits to the issue paper and the comments made during the Board's discussion of the issue paper during its March 30, 2016, BTC meeting in deciding to propose the amendments to Regulation 1703 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1703 recommended by staff at this time or whether to take no action

at this time. The Board decided to begin the formal rulemaking process to propose to adopt staff's recommended amendments to Regulation 1703 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1703 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As previously explained in more detail above, the proposed amendments incorporate and clarify in Regulation 1703, subdivision (c)(3)(A), the Board's long-standing policy that a negligence penalty should not generally be applied to a deficiency determined in the first audit of a taxpayer, unless the evidence indicates that the taxpayer's bookkeeping or reporting errors cannot reasonably be explained by the taxpayer's inexperience. The other proposed amendments make Regulation 1703 consistent with the current provisions of RTC sections 6480.1, 6480.3, 6480.4, 7076.4, and 7153.6 (as discussed above), and make other minor grammatical and formatting changes to Regulation 1703.

The proposed amendments provide guidance about how negligence penalties currently apply to deficiencies determined in first-time audits, but do not change the Board's long-standing policy regarding the application of negligence penalties to deficiencies determined in first-time audits. As a result, there is nothing in the proposed amendments to Regulation 1703 that would significantly change how retailers and consumers would generally behave in the absence of the proposed amendments. In addition, the amendments to Regulation 1703 do not require that individuals and businesses do anything that is not currently required and do not impose any costs on any persons. And, the Research and Statistics Section of the Board's Legislative and Research Division determined that there is nothing in the proposed amendments that would impact revenue. (See Exhibit 1 to Formal Issue Paper 16-03.) Therefore, the Board estimates that the proposed amendments will not have a measurable economic impact on individuals and business. The Board has determined that the proposed amendments to Regulation 1703 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period. And, the Board anticipates that the proposed amendments to Regulation 1703 will promote fairness and benefit taxpayers, Board staff, and the Board by providing clarity with regard to the application of negligence penalties to deficiencies determined in first-time audits.

Further, based on these facts and all of the information in the rulemaking file, the Board has also determined that the adoption of the proposed amendments to Regulation 1703 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create new businesses or expand businesses currently doing business in the State of California.

Furthermore, Regulation 1703 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1703 will not affect the benefits of Regulation 1703 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1703 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1703 may affect small businesses.

**Text of Proposed Amendments to
California Code of Regulations, Title 18, Section 1703**

1703. Interest and Penalties

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

	<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, 6591, 7051.2
Failure to file a timely return		6479.3, 6591, 6479.3
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, 6514 (fraud), 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; 6072
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		7073, 7074

Beginning Before January 1, 2003)		
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(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.

Note: Authority cited: Section 7051, Revenue and Taxation Code. 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, 7076.5~~4~~, 7101, 7152-7153, 7153.5, 7153.6 and 7155, Revenue and Taxation Code.

Regulation History

Type of Regulation: Sales and Use Tax

Regulation: 1703

Title: *Interest and Penalties*

Preparation: Scott Claremon

Legal Contact: Scott Claremon

The State Board of Equalization proposes to clarify the Board's long-standing policy that a negligence penalty should not generally be imposed on a deficiency determined in a taxpayer's first audit.

History of Proposed Regulation:

October 25-27, 2016	Public Hearing
September 9, 2016	OAL publication date; 45-day public comment period begins; Interested Parties mailing
August 30, 2016	Notice to OAL
March 30, 2016	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA

Support: NA

Oppose: NA