



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/18/10	Bill Number:	<a href="#">AB 2195</a>
Tax:	Sales and Use Special Taxes and Fees Property Taxes	Author:	Silva
Related Bills:			

## BILL SUMMARY

This bill would:

- (1) Add a new provision to the Evidence Code to specify that the burden of proof is with the Board of Equalization (Board) in any assertion of penalties for intent to evade or fraud and require a clear and convincing evidence standard for such assertions, as specified; and
- (2) Add a new provision to the Government Code to shift the burden of proof from taxpayers to the Board and the Franchise Tax Board (FTB) collecting taxes or fees in any court or administrative tax proceeding as specified, under certain conditions.

## ANALYSIS

### *EVIDENCE CODE – STANDARD OF PROOF*

#### **Current Law**

Under existing law, Evidence Code Section 115 provides, in part, “Except as otherwise provided by *law*, the burden of proof requires proof by a preponderance of the evidence.” (Emphasis added.) Evidence Code Section 160 defines “*law*” to include constitutional, statutory, and decisional law.

The Revenue and Taxation Code allows for civil penalties and even criminal sanctions for persons committing fraud or intent to evade the tax. California’s Evidence Code does not specifically provide for the standard of proof with regard to civil tax fraud. However, the standard of proof has been defined through decisional (case) law. Specifically, the California Court of Appeal in *Marchica v. State Board of Equalization* (1951) 107 Cal.App.2d 501 determined that the standard of proof in civil tax fraud cases was the **clear and convincing evidence standard**. A 2002 decision of the Ninth Circuit Court of Appeals, *California State Board of Equalization v. Renovizor’s, Inc.*, 282 F.3d 1233, relied on the *Marchica* decision in concluding that “clear and convincing evidence must be shown to establish civil tax fraud under California law.” Effective January 9, 2003, the Board amended its Regulation 1703(c)(3)(C) to state this agency’s existing standard of proof: “Fraud or intent to evade shall be established by clear and convincing evidence.” The 2002 *Renovizor’s* decision was the impetus for the Board’s amendment of Regulation 1703(c)(3)(C). However, the *Renovizor’s* opinion, as a federal court decision, is not controlling on matters of state law. (See, e.g., *Howard Contracting v. G.A. MacDonald Constr. Co* (1998) 71 Cal.App. 4<sup>th</sup> 38, 52.)

#### **Proposed Law**

This bill would add Section 524 to the Evidence Code to provide that in any civil proceeding to which the Board is a party, the Board shall have the burden of proof by clear and convincing evidence in sustaining its assertion of penalties for intent to evade

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or fraud against a taxpayer, with respect to any factual or legal issue relevant to ascertaining the liability of a taxpayer.

This provision would become effective January 1, 2011.

### **In General**

As a matter of law, fraud is never presumed, but must be proven and the burden of proof is on the Board. (*Marchica v. Board of Equalization, supra*, 107 Cal.App.2d 501.)

However, the standard of proof in administrative and civil tax cases is not “beyond a reasonable doubt,” as it is in a criminal prosecution. (See *Helvering v. Mitchell* (1938) 303 U.S. 391.) Rather, the standard of proof is the “clear and convincing” standard as set forth in the Board’s Regulation 1703(c)(3)(C). It is rare to find direct evidence that fraud has occurred, and thus it is often necessary and appropriate to make the determination based on circumstantial evidence. In addition, it would be difficult and unreasonable for the Board to assert fraud and then require the taxpayer to prove it never occurred.

### **Background**

Similar measures were introduced in the 2007-08 Legislative Session (AB 1600 and AB 2727, La Malfa) and in 2009 (AB 1387, Tran). The Assembly Revenue and Taxation Committee held all three measures.

Also, during the 2005-06 Legislative Session, a similar bill was introduced (SB 633, Dutton). That measure was never heard in committee.

In the 1997-98 Legislative Session (after the California Court of Appeal’s 1951 decision in *Marchica*, but before the Ninth Circuit Court of Appeals’ 2002 decision in *Renovizor’s*), AB 1631 (Sweeney, et al.) was amended on April 15, 1998, to, among other things, clarify that the FTB and Board have the burden of proof by “clear and convincing evidence” regarding penalties for intent to evade or fraud cases against the taxpayer. This measure died in the Assembly Appropriations Committee.

### **COMMENTS**

1. **Sponsor and purpose.** The author is sponsoring this provision of the bill in order to codify the clear and convincing standard set forth in the Board’s Regulation 1703.
2. **This Evidence Code change is consistent with the Board’s current practice as well as case law, and makes sense.** It is appropriate that the standards for asserting penalties for fraud or intent to evade be the same at both the administrative and judicial levels. This bill would codify the decision in the *Marchica* case so that the Evidence Code is clear that in the case of civil tax fraud, the standard of proof shall be the clear and convincing standard. It would also codify the Board’s Regulation 1703(c)(3)(C), which states the Board’s existing practice that, in asserting fraud, the Board has to prove fraud or intent to evade by clear and convincing evidence.

### **GOVERNMENT CODE –BURDEN OF PROOF WITH COOPERATING TAXPAYERS**

#### **Current Law**

Under existing law, as a general rule, in civil cases involving the potential loss of money or property, the burden of proof is on the party in control of the facts. California law generally provides that taxpayers, like plaintiffs in other civil actions, have the burden of proving that the government’s action was incorrect and establishing the merits of their

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claims by a preponderance of the evidence. The burden of proof is placed on the taxpayer since the taxpayer is the party who has control of the records and documents.

*Under Federal law*, the Internal Revenue Service Restructuring and Reform Act of 1998, as added by Public Law 105-206, added Section 7491 to the Internal Revenue Code to place the burden of proof on the Internal Revenue Service (IRS) in any *court proceeding* involving a factual issue, if the taxpayer introduced credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's tax liability. Under this provision, the burden of proof shifts to the IRS if the taxpayer:

- (1) Complies with all the substantiation requirements of the Code,
- (2) Maintains all the records required by the Code,
- (3) Cooperates with the IRS' reasonable requests for witnesses, information, documents, meetings, and interviews, and
- (4) Meets the net worth requirements (the shift in burden of proof shift does *not* apply to partnerships, corporations, or trusts whose net worth is more than \$7 million; no net worth limitation is applicable to individuals).

### **Proposed Law**

This bill would add Part 10.1 (commencing with Section 15706) to Division 3 of Title 2 of the Government Code to provide that the Board and the FTB shall have the burden of proof in any court or administrative tax proceeding, with respect to a factual issue related to ascertaining the tax liability of a taxpayer that has established that it is a cooperating taxpayer.

The bill would define the following:

- "Cooperating taxpayer" - a taxpayer that has both complied with all statutory, regulatory, or case law substantiation requirements to substantiate any item on a return or claim filed with the Board or the FTB; has maintained all records required by law or regulation, and has provided those records to the state agency, upon a reasonable request; has provided credible evidence with respect to any factual issue relevant to ascertaining the tax liability.
- "Tax liability" - any tax or fee assessed or determined by the Board or FTB, including any interest accrued or penalties levied in association with the tax or fee.
- "Administrative tax proceeding" - the oral hearing before the Members of the Board concerning taxes and fees collected by the Board and taxes collected by the FTB.

The bill would also provide that, unless provided otherwise, the burden of proof upon the Board and FTB for purposes of this part shall be by a preponderance of the evidence, and that these provisions would not apply to an adjustment proposed and made to a taxpayer's federal income tax return by the federal government, nor to specified appeals under the personal income tax and corporation tax laws.

These provisions would only apply to court and administrative proceedings involving determinations issued on or after the date the bill becomes effective.

The bill would become effective January 1, 2011.

### **In General**

Under the current Sales and Use Tax Law, it is presumed that all gross receipts are subject to the sales and use tax unless the taxpayer can prove otherwise (Revenue and Taxation Code Section 6091.) Under the Motor Vehicle Fuel Tax Law and the Diesel

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Fuel Tax Law, there is a presumption that fuel has been “removed” under certain circumstances, and when those circumstances occur, the fuel is subject to tax. (Revenue and Taxation Code Sections 7360, 7362-7364, 7373, 60050-60052, 60058, and 60064.) Other similar provisions that provide for the presumption of taxability are included in various tax and fee laws administered by the Board.

Under current Sales and Use Tax Law (and other various tax and fee laws administered by the Board), the Board may require a taxpayer or feepayer to furnish satisfactory supporting documentation for items reported on returns or claims for refund. At any point throughout the administrative process, the Board may concur with the taxpayer. However, the Board may also determine that the documentation is not adequate to support taxpayer’s the position. If the taxpayer fails to file a return, the Board may issue a deficiency determination, based upon any information in the Board’s possession. If the Board believes that the collection of any tax or fee will be jeopardized by delay, it will issue a jeopardy determination, whereby the amount determined is immediately due and payable.

A taxpayer who disagrees with the Board’s determination of taxes may file a petition for redetermination. This petition prevents collection of the amount determined, except in the case of jeopardy determinations. All of the taxpayer’s contentions, including substantiating evidence in the form of books, records, or other documentation, are addressed by the auditor or other appropriate Board staff. If Board staff confirms the legitimacy of the determination, a Notice of Decision on the Petition for Redetermination is issued. The taxpayer may request an Appeals conference, at which the taxpayer may present facts and documentation in support of its position. After the taxpayer’s information is examined and authorities are researched, a Decision and Recommendation is issued by an Appeals attorney or auditor. If a taxpayer does not agree with the Decision and Recommendation, the taxpayer may request a hearing with the Members of the Board.

The Board’s role in appeals of FTB cases is different from that for sales and use taxes or other taxes and fees administered by Board. The taxpayer’s forum for appealing an FTB action on a protest is a hearing with the Members of the Board.

A Board hearing is typically not scheduled until all other opportunities for resolution are exhausted, so that every attempt to resolve cases at the lowest possible level is afforded. In this regard, the five elected Board Members serve as the administrative appellate body for review of final actions of the FTB; and a Board hearing is generally the last step in the administrative appeals process for review of Board actions. In the independent review by the Board Members, there is a rebuttable presumption that the FTB or Board determination or redetermination was correct. Hence, taxpayers have the burden of proving that the determination or redetermination was incorrect and establishing the merits of their claims which is by a preponderance of the evidence. This administrative review is performed without extensive evidentiary rules, designed to provide an environment that lessens the need for professional representation.

In the event of a final adverse Board decision, the taxpayer must pay the tax or fee in full before filing a suit for refund in Superior Court. In litigation, as with administrative appeals, there is a rebuttable presumption that the government’s action was correct.

## Background

A similar measure was introduced last year (AB 1387 Tran) and in the 2007-08 Legislative Session (AB 1600 and AB 2727, La Malfa). All three measures were held in the Assembly Revenue and Taxation Committee.

During the 2005-06 Legislative Session, a similar bill was introduced (SB 633, Dutton). That measure was never heard in committee.

Numerous bills on this same issue, however, were considered in the past when the "Internal Revenue Service Restructuring and Reform Act" was pending before Congress. Among them:

**AB 1631 (Sweeney, et al.)**, as amended April 15, 1998, would have, among other things, declared the intent of the Legislature to conform state law to federal law to shift the burden of proof in connection with taxes paid by taxpayers. This measure died in the Assembly Appropriations Committee.

**SB 1478 (Rainey, et al.)**, as amended March 19, 1998, would have provided that the Board, FTB, EDD, and any other state agency that collects taxes shall have the burden of proof in any court or administrative tax proceeding with respect to any factual issue relevant to ascertaining the tax liability of a taxpayer, but only if certain requirements are met. This measure died in the Senate Revenue and Taxation Committee.

## COMMENTS

1. **Purpose.** This provision would incorporate into the California tax laws the same protections that federal law provides to taxpayers. According to the author's office, the placement of the general burden of proof on the taxpayers creates a perception of guilt until proven innocent and that a better balance would place the burden of proof on the government to show an increase in liability if the taxpayer complied with the procedural and recordkeeping requirements of the tax laws. That is, if the taxpayer is generally law-abiding, it should be the government's responsibility to show that the taxpayer's determination of liability was not correct. Also, the shift would not impose an unreasonable obstruction to the State in determining the correct tax liability. Instead, good auditing practices should ordinarily produce sufficient evidence to sustain the burden of proof regardless of the shift.
2. **The Government Code provision is broader than Federal law.** Federal law shifts the burden of proof to the IRS for all cooperating individuals, but restricts it to partnerships, corporations and trusts that have less than \$7 million in net worth. This bill would shift the burden of proof with respect to all cooperating taxpayers regardless of size. The argument in favor of limiting the federal provision to "small" businesses was that larger businesses are arguably capable of defending themselves in court proceeding disputes with the IRS without additional assistance. Opponents argue that the state equivalent to a federal tax court proceeding is actually the equivalent to a taxpayer's hearing in a California superior court. The administrative hearing before the Board Members bears little resemblance to a true judicial hearing.
3. **Who decides whether a taxpayer qualifies as a "cooperating taxpayer," and when do they decide it?** Would the Board have to decide this issue at the beginning of its administrative hearing, to determine whether the taxpayer or the staff had the burden of proof? Would a court have to decide this issue at the beginning of a trial, to determine the burden of proof?

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Also, except for purely legal disputes, under what circumstances would a "cooperating taxpayer" have a contested tax liability? If a taxpayer has complied with all substantiation requirements and provided all records, it is not clear how there would be any remaining factual dispute. It appears that the decision on this issue would in effect determine the outcome of the hearing or trial.

Another issue relates to "credible evidence." The bill defines a "cooperating taxpayer" as one that, among other things, has provided credible evidence with respect to any factual issue relevant to ascertaining the tax liability. Several cases have arisen with the IRS dealing with the issue as to what constitutes "credible evidence," and if this bill were to become law, it is likely that similar issues would arise at the oral hearing before the Board.

4. **Board's current record keeping requirements are general.** Currently, the rules for required records tend to be general. For example, Regulation 1698, *Records*, requires taxpayers to maintain and make available for examination on request by the Board or its authorized representative all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax return. If this bill were to become law, the Board would be required to amend the regulation to clearly identify the specific records taxpayers must maintain in order for the Board to determine whether a taxpayer would be regarded as cooperating.

#### **COST ESTIMATE**

This bill could result in additional costs to the Board to draft regulations identifying the specific records taxpayers would be required to maintain. Other costs would likely be incurred in support of the state's position in most, if not all cases, to the extent that additional supporting evidence would be required on all cases – including evidence that reflects the degree of taxpayers' cooperation. However, it is difficult to quantify these costs.

#### **REVENUE ESTIMATE**

If this legislation results in fewer determinations upheld by the Board, there could be a loss of revenues. However, the magnitude of the loss, if any, is difficult to determine.

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