

**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 zipper 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.