

FORGIVE AND FORGET - -

THE CALIFORNIA EMPLOYMENT TAX AMNESTY

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© March, 1995

INTRODUCTION

Should a taxing authority be able to forgive and forget - - that is, grant amnesty to taxpayers who have not complied with the tax laws. This question has been debated over the years, and there is substantial disagreement among policy makers as to whether a tax amnesty is appropriate. Advocates of tax amnesty programs argue that giving taxpayers a chance to get into the system - - by forgiving and forgetting - - promotes voluntary compliance and increased tax revenue. Opponents argue that amnesty programs are an inducement for taxpayers not to comply and are unfair to taxpayers who have complied with the tax laws./1 California had experience in the early 1980's with an income tax penalty amnesty. While California generally viewed the income tax penalty amnesty as a success, there is little reliable data concerning the effect that amnesty had on future taxpayer compliance and increased revenue collection./2

California is taking another crack at it - - this time with employment taxes, albeit in a limited way. On September 28, 1994, Governor Wilson signed into law AB 2664 (Burton) which is generously described as an "Employment Tax Amnesty."/3 The legislation requires the Employment Development Department (the "Department") to develop and administer an amnesty program./4 The amnesty program is to be conducted for a period of three calendar months commencing April 1, 1995 and ending June 30, 1995./5 The Department is required to publicize the employment tax amnesty so as to maximize public awareness and participation in the program./6 The Department has estimated that it will collect approximately \$12.5 million dollars over the next three years as a result of the amnesty./7

WHAT IS COVERED UNDER THE AMNESTY

The Department is responsible for the administration and collection of California employment taxes, which includes personal income tax withholding, unemployment insurance tax, disability insurance tax, and the worker training tax. While the legislation is not a model of clarity, the amnesty provisions fall into the following categories:

- (1) Unpaid employment taxes, penalties and interest relating to "product demonstrators;"
- (2) Unpaid penalties and interest of all employers which have not yet been imposed;
- (3) Unpaid penalties of all employers which have already been imposed and interest on those penalties; and

(4) Criminal liability of all employers under the California Unemployment Insurance Code.

The amnesty applies only to unpaid liabilities. Except for very limited circumstances relating to voluntary disability insurance payments by self-employed persons, the amnesty will not cause or require any refunds to be issued./8

FULL AMNESTY - PRODUCT DEMONSTRATORS

While AB 2664 is called an employment "tax" amnesty, there is only a small group of employers who will be relieved of an actual tax liability, as opposed to just interest and penalties. The legislation was primarily aimed at the "product demonstrator" industry and arose from a dispute concerning whether product demonstrators should be characterized as employees or independent contractors. A product demonstrator is an individual who distributes coupons or who demonstrates or gives away samples of products as part of an advertising or sales promotion./9 As set forth in the legislation:

"The legislature finds and declares that ambiguities and uncertainties in the application of the common law test for employment status to the product demonstrator industry has historically resulted in a lack of uniform enforcement, and unpredictable and inequitable employment tax deficiencies being levied against taxpayers making a good faith effort to comply with the law. The legislature further finds and declares that the implementation of Section 4304-7 of Title 22 of the California Code of Regulations, on March 17, 1992, has greatly clarified the proper application of existing common law to the product demonstration industry. In order to alleviate the inequitable assessments arising prior to the implementation of the clarifying regulation, and to further encourage prospective treatment of product demonstrators as employees, the legislature finds and declares that an amnesty for employment taxes, interest and penalties arising prior to the effective date of the regulation is appropriate. Finally, in order to insure that the problems of inconsistent treatment of workers and the resultant unfair competitive advantage in the product demonstration industry have been adequately addressed, the legislature finds and declares that post-amnesty enforcement in this area by the Employment Development Department should be increased and that a report on the results of this increase in enforcement activities should be made to the legislature."/10

The new legislation provides that the Department shall waive all penalties, interest and taxes that may be due for wages paid prior to March 17, 1992, as a result of the misclassification of product demonstrators as independent contractors./11 The amnesty applies to product demonstrators classified as employees as a result of the "clarification of common law rules applicable in determining the employer/employee relationship specified in Section 4304-7 of Title 22 of the California Code of Regulations/12 and only where the employer has treated those workers as employees and has paid all contributions, taxes, penalties and interest for wages paid on or after March 17, 1992./13

The legislation also provides that the personal income tax portion of the tax assessment/14 will be waived only if the employer issued an information return pursuant to Section 6041(a) of the Internal Revenue Code (e.g., a Form 1099), reporting the payment or if the worker certifies that the tax has been paid or that he or she has reported to the Franchise Tax Board the income against which the tax would have been imposed./15 Finally, the application for amnesty must contain the following certification:/16

"The payments made to workers whose names and social security numbers are provided with this application were made under a good faith belief that the workers were independent contractors. The undersigned still believes that the workers were independent contractors. However, it is now clear under Section 4304-7 of Title 22 of the California Code of Regulations that the workers are now employees."

PARTIAL AMNESTY - NON-PRODUCT DEMONSTRATOR LIABILITIES

While the "tax" amnesty focuses on the product demonstrator industry, the legislation provides a partial amnesty for penalties and interest for other California employers. The legislation distinguishes between liabilities which have already been imposed or assessed by the Department and those which have not yet been imposed or assessed.

PENALTIES AND INTEREST WHICH HAVE NOT YET BEEN IMPOSED

The legislation provides that the Department shall waive all penalties and interest that may be imposed for tax reporting periods for which amnesty is requested, that are owed as a result of the non-reporting or under reporting of tax liabilities or failure to file reports for periods ended on or before December 31, 1993./17 The waiver of interest and penalties under this provision does not apply to liabilities established as a result of an assessment issued by the Department prior to the amnesty application being filed./18

Any penalty imposed under Section 1114 of the Unemployment Insurance Code ("UIC") for failure to report wages will not be waived unless complete quarterly reports are filed on the date of the application for amnesty. Similarly, penalties imposed under UIC Sections 13051 and 13054 for failure to file wage information reports will not be waived for reporting periods in which statements and annual returns required by UIC Sections 13050 and 13053 are not received by the Department./19

This portion of the legislation should benefit those employers who are not yet under audit by the Department or whose audit has not proceeded to the imposition of a liability as a result of an assessment. If the Department has already issued a notice of assessment, but the employer has filed a petition for redetermination with the Unemployment Insurance Appeals Board ("Board"), it is not clear whether the employer will be entitled to relief under this provision. Since a redetermination by the Board can cancel the assessment issued by the Department, the legislation

would seem to permit amnesty for cases pending before the Board. The Department has indicated it will endeavor to generously interpret the legislation and has stated that assessments which are canceled can fall within this provision. If the Department interprets the provision in this manner, it could provide substantial relief for the many cases pending before the Board.

Even though this provision does not provide for a waiver of the actual tax liability, it may provide close to complete relief in those circumstances where the employer is able to demonstrate the worker paid tax on the income or the worker reported the income to the California Franchise Tax Board. Under long established administrative provisions, when an employer can demonstrate the worker reported the wages on a California income tax return, the Department will abate the personal income tax portion of the assessment.^{/20} Since the personal income tax portion is normally a very significant portion of the total tax assessed, when combined with the penalties and interest which can be waived under the amnesty, almost complete amnesty can be obtained. The employer however would continue to be liable for the unemployment insurance, disability and worker training tax.

Responsible Person Liability - When a corporate employer fails to pay employment taxes, UIC Section 1735 provides for personal liability of "responsible persons of the corporate employer." This liability is similar to the liability imposed on "responsible persons" under section 6672 of the Internal Revenue Code.

While the legislation indicates that the amnesty only applies to an "employer,"^{/21} and UIC Section 1735 is not one of the enumerated penalties subject to waiver, the Department has indicated the penalty and interest portions of the responsible person liability are subject to the amnesty provision. Under UIC Section 1735, responsible persons are not only liable for the unpaid taxes, but also for all penalties and interest.^{/22} Thus, responsible persons may find the amnesty available to reduce their personal exposure.

PENALTIES WHICH HAVE ALREADY BEEN IMPOSED

The legislation also provides for a more limited amnesty for penalties which have already been imposed or assessed. It provides that the Department shall waive unpaid penalties and interest accrued on unpaid penalties (as opposed to interest on tax) which is imposed on or before December 31, 1993, that are owed as a result of the non-payment or the underpayment of tax liabilities or the failure to file returns.^{/23} Penalties imposed or assessed after December 31, 1993 may not be covered by the amnesty even if they relate to taxable periods prior to December 31, 1993. The Department recognizes this as a drafting error in the legislation since the amnesty was intended to cover penalties relating to taxable periods prior to December 31, 1993, even though assessed in 1994, but believes it is bound by the language of the statute.^{/24} As with the unassessed penalties and interest which have not yet been imposed, penalties imposed under UIC

Sections 1114, 13051 and 13054 will not be waived unless all applicable information reports are filed with the Department./25

This provision would appear to benefit all employers who have unpaid penalties for taxable periods prior to December 31, 1993. The Department views this portion of the legislation as applicable to the largest group of potential amnesty candidates and has estimated 196,000 employers could qualify./26 As a general matter, any employer who has unpaid penalties should be able to obtain a waiver of those penalties, if other outstanding liabilities (tax and interest) are paid and all appropriate returns and reports are filed.

CRIMINAL LIABILITY

The legislation also provides, importantly, that there will be an amnesty with respect to potential criminal liability. The statute provides that "no criminal action shall be brought against the employer, for the tax reporting periods for which the amnesty is requested, for the non-reporting or under reporting of tax liabilities except for violations described in Section 2119" of the Unemployment Insurance Code./27 Section 2119 involves criminal prosecutions for the willful furnishing of a false or fraudulent wage withholding statement (Form W2) or the willful failure to provide such wage statement.

Employers and other responsible persons who violate the California employment tax laws are subject to prosecution under a number of criminal statutes./28 UIC Section 2119 is but one of the sections under which an employer (or responsible person of that employer) can be prosecuted. It is not clear why violations described in UIC Section 2119 are omitted, but it seems unlikely that this exception should be an impediment to obtaining criminal amnesty.

Since the criminal amnesty literally extends only to "employers,"/29 it is not clear under the legislation that the criminal amnesty extends to individuals who are responsible for the "employer's" conduct and who can be held criminally liable under these statutes. Given the Department's position concerning the application of the amnesty to responsible persons, however, and the fact that most Department criminal proceedings are brought against individuals, it is likely the criminal amnesty will extend to individuals even though they may not technically be "employers." Defense counsel representing persons with potential criminal exposure should obtain clarification from the Department on this issue.

OTHER LIMITATIONS ON THE AMNESTY - BAD BOYS NEED NOT APPLY

Employers Subject to Civil Fraud Penalties. The legislation provides that no employer will be eligible for amnesty if for any period prior to the date of the application, a penalty was charged pursuant to UIC Section 1128 for civil fraud, which is "final," or if the employer has admitted that any part of the unpaid amounts for which amnesty relief has been requested were due to

fraud or intent to evade the reporting requirements. If a fraud penalty is not "final" on the date of application for the amnesty, amnesty will not be allowed unless the penalty is reversed by the California Unemployment Insurance Appeals Board.^{/30} Employers under audit should clearly keep this limitation in mind. The assertion of the penalty by the auditor could effectively preclude eligibility under the amnesty program.

Pending Criminal Investigations. The legislation provides that amnesty will not apply if, as of the starting date of the amnesty program (April 1, 1995), (1) the employer is on notice of a criminal investigation by a complaint having been filed or by written notice having been mailed that he or she is under criminal investigation, or (2) a court proceeding has already been initiated.^{/31}

PROCEDURES FOR OBTAINING AMNESTY

Filing Requirements. Amnesty will be available only if the employer timely files a prescribed application for amnesty and other required reports and information with the Department. The application must be filed by June 30, 1995.^{/32} The employer is required to file all contribution returns reporting unreported wages and taxes for the quarters for which amnesty is being applied.^{/33} Amnesty will not be available if the employer has any delinquent quarters for which liabilities have not been established as of the date of the application for amnesty.^{/34} Thus, it appears all unfilled and delinquent contribution returns must be filed as of the date of the amnesty. In practice, the Department may establish an administrative guideline which limits the number of prior years for which returns must be filed. If a practitioner has a client with many years of unfiled returns, the Department should be approached for specific guidance.

Payment of Amount Due/Installment Payments. As a condition for amnesty, the employer must pay the full amount that is due, exclusive of the amounts which are waived pursuant to the amnesty.^{/35} The Department may enter into an installment payment agreement in lieu of full payment.^{/36} In its public information release, the Department has indicated that payment in full must accompany the application or if an installment payment arrangement is requested, at least 15% of the amount due must accompany the application.^{/37} The amnesty application also indicates that the installments must be paid within a one (1) year period. However, Karl Grossenbacher, Deputy Director of the Tax Branch of the EDD has recently stated that the 15% down payment and the one (1) year payout requirement are just guidelines and that the Department will consider amnesty applications with less than a 15% down payment and which propose installment payments over a period longer than one (1) year.^{/38} Payments with the application will not be refunded if the amnesty request is denied, but will be applied to the outstanding tax liability.^{/39} The installment payment arrangement will include interest at the rates prescribed under the Unemployment Insurance Code and interest will be charged beginning on the date following the end of the period of the amnesty program (June 30, 1995).^{/40} Failure of the employer, without good cause, to comply with the terms of the installment payment agreement will render the waiver of tax, interest and penalties void and the total amount will be immediately due and payable.^{/41}

Information About Amnesty. The Department has established an Amnesty Information Line to answer inquiries about the amnesty and obtain applications. The phone number is (916) 464-0845.

Post-Amnesty Deficiency Determinations. In the event the Department issues a deficiency assessment with respect to a return filed pursuant to the amnesty, interest will be charged from the deficiency assessment date and the Department will have the authority to impose penalties.⁴² Additionally, a criminal action may be brought with respect to the difference between the amount shown on the return and the correct amount of the tax.⁴³ Interestingly, the legislation provides that the issuance of a deficiency assessment with respect to one of the amnesty period returns will not invalidate the amnesty.⁴⁴

Refund of Disability Insurance. Product demonstrators who have been treated as independent contractors and who have paid elective disability insurance contributions under UIC Section 708.5 will be allowed a refund of those amounts paid if the employer, pursuant to the amnesty, reports these individuals as employees.⁴⁵

Administrative Review. The legislation provides that employers of product demonstrators may file a petition with the Unemployment Insurance Appeals Board to review a Department determination that the employer does not qualify for amnesty.⁴⁶ Presumably, the Unemployment Insurance Appeals Board will have plenary authority to determine whether the product demonstrator-employer qualifies for amnesty. Unfortunately, the administrative review provided for in the legislation is limited to product demonstrator-employers and there does not appear to be any provision for administrative review of determinations concerning other employers.

EFFECT ON FEDERAL REPORTING

Under agreements between the Department and the Internal Revenue Service, the Department provides information to the Internal Revenue Service concerning filings and audit adjustments. An employer that comes forward under the amnesty provisions, under circumstances where there is also a significant Internal Revenue Service exposure, could be creating a significant Federal problem.

In some cases, it is possible the employer could feel sufficiently comfortable that the workers will not be treated as employees for Federal purposes, because of differences in California and Federal law concerning the treatment of these workers.⁴⁷ On the other hand, where the employee-independent contractor issue is significant for Federal purposes, or where the non-reporting or underreporting does not involve an employee-independent contractor issue, the prospect of Federal adjustments cannot be discounted.

The Department has indicated that it will do everything within its control to protect the interests of the California employer community, and as a general matter, information received under the amnesty will not be shared with the Internal Revenue Service.⁴⁸ However, there is no guarantee that the Internal Revenue Service will not receive information related to taxable periods for which amnesty has been granted and any employer or practitioner advising an employer should review the impact on the employer's Federal tax exposure and have a game plan in mind to deal with the issue.

CONCLUSION

The goal of any tax amnesty should be to bring taxpayers back into the system and foster voluntary compliance. The recent legislation should have that effect with the product demonstrator industry, especially in light of the regulatory clarification of the common law standards used in determining whether a product demonstrator is an employee or an independent contractor. The limitations of the amnesty for other employers, however, may be too great and the amnesty too narrow to induce employers who otherwise would not be inclined to come forward. While all employers who are not in compliance should consider clearing up their act, the inducement provided for by this legislation may not be sufficient to alter the conduct of many non-compliant employers - - the ultimate goal of the amnesty legislation. Perhaps with the experience of this amnesty as it relates to product demonstrators, the Department will approach the legislature in the future for a broader based amnesty - - with the goal of achieving greater compliance among all California employers.

1. See Moran, "Tax Amnesty: An Old Debate as Viewed From Public Choices," 1 Fla. Tax Rev. Vol. 5 (1993); Martinez, "Federal Tax Amnesty: Crime and Punishment Revisited," 10 Va. Tax Rev. 535 (Winter, 1991).

2. See "Amnesty, a Tool for Closing the California Tax Gap or 'Get to Us Before We Get to You,'" Statement of Ernest J. Dronenburg, Jr., Member, State Board of Equalization, Before the Commerce, Consumer and Monetary Affairs Subcommittee of the Committee on Government Operations, Washington, D.C., July 25, 1990.

3. AB 2664, Section 2 (Chapter 999 of Statutes of 1994).

4. UIC Section 1150.

5. UIC Section 1151(a).

6. UIC Section 1156.

7. "State Law Giving Some Tax Cheats a Break," Sacramento Bee, Metro Final, February 6, 1995.

8. UIC Sections 1151(b); 1154.
9. EDD Information Sheet; Employment Tax Amnesty DE 2664 (12-94).
10. AB 2664, Section 1 (Chapter 999 of Statutes of 1994).
11. UIC Section 1152(a)(3)(A).
12. Id.
13. UIC Section 1152(a)(3).
14. UIC Sections 13020 and 13070.
15. UIC Section 1152(a)(4).
16. UIC Section 1152(a)(3)(D).
17. UIC Section 1152(a)(2).
18. Id.
19. UIC Section 1152(a)(1)(B) and (C).
20. See Form DE 938 P Rev. 7 (6-91), Claim for Adjustment or Refund of Personal Income Tax; Form DE 2664, Request for Employment Tax Amnesty.
21. UIC Section 1152(a).
22. This is different from liability under section 6672 of the Internal Revenue Code, which is limited to the trust fund portion of the liability and excludes any liability for pre-assessment interest or penalties.
23. UIC Section 1152(a)(1)(A).
24. Comments of Karl Grossenbacher, Deputy Director, Tax Branch, Employment Development Department, before the Procedure and Litigation Committee of the Taxation Section of the Los Angeles County Bar Association, March 10, 1995.
25. UIC Section 1152(a)(1)(B) and (C).
26. "State Law Giving Some Tax Cheats a Break," n. 5.

27. UIC Section 1152(a)(5).
28. See UIC Sections 2101 through 2128.
29. UIC Section 1152(a)(5).
30. UIC Section 1152(b).
31. UIC Section 1152(c).
32. UIC Section 1151(a).
33. UIC Section 1153(a)(1)(A).
34. UIC Section 1153(a)(1)(B).
35. UIC Section 1153(a)(2)(A).
36. UIC Section 1153(a)(2)(B).
37. EDD Information Sheet, n. 9.
38. Comments of Karl Grossenbacher, n. 24.
39. EDD Information Sheet, n.9.
40. UIC Section 1153(a)(2)(B).
41. Id.
42. UIC Section 1153(b).
43. Id.
44. Id.
45. UIC Section 1154.
46. UIC Section 1157.
47. For example, the Federal Safe Harbor, Section 530 of the Revenue Act of 1978, might be applicable, preventing the IRS from recharacterizing these particular workers. Also, the particular workers involved might be considered statutory employees for California purposes.
48. Comments of Karl Grossenbacher, n. 24.