

Department of Finance and Administration

Legislative Impact Statement

Bill: SB490

Bill Subtitle: TO IMPROVE THE FAIRNESS OF TAX ADMINISTRATION.

Basic Change : Sponsor: Senator B. Sample

The proposal makes changes to existing Arkansas Code concerning administration of state taxes. The changes would be as follows: Section 1 increases the time allowed from 90 days to 180 days for a taxpayer to report any changes made by the federal Internal Revenue Services to a taxpayer's income. If the taxpayer fails to report the federal changes, DFA has three years to assess any taxes due.

Section 2 allows a refund claim to be filed with DFA within the statute of limitations period for assessment by the director.

Section 3 amends the standard of proof required for exemptions, deductions, and credits. Current law requires the standard of proof to be clear and convincing evidence and the proposal would change the requirement to a preponderance of the evidence. The proposal also provides that the claim be denied only if substantial doubt exists that the exemption, deduction, or credit lawfully applies.

Section 4 requires DFA to publish written legal opinions that are issued on or after January 1, 2016 on DFA's website. It allows DFA to publish a synopsis of the subject matter, facts, and guidance provided in the opinion if a copy of the legal opinion is made available on request. A final determination of a hearing officer or the director issued on or after January 1, 2016 must also be posted.

Section 5 allows a taxpayer to file a lawsuit to challenge a tax assessment within 180 days of the final assessment or determination and remove the requirements that the taxpayer pay the amount of tax if suit is brought within that time period. The proposal requires DFA to pay attorney fees to a taxpayer's attorney if the taxpayer prevails in a contested item under certain circumstances. Collection activities would be stopped during the first 24 months a judicial appeal is pending.

Section 6 reduces the interest rate for a tax deficiency or refund. Current law provides for an interest rate of 10% per annum on tax deficiencies and refunds. Beginning January 1, 2016, DFA would be required to determine an interest rate for each calendar year. To calculate the rate, DFA would determine the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less during the previous fiscal year, plus 3 percentage points, up to a maximum interest rate of 10% per annum. Once a certificate of indebtedness has been filed, interest would continue to be assessed at the rate of 10% in accordance with current law.

Section 7 requires DFA to reimburse a taxpayer who prevails at an administrative hearing for all costs and reasonable fees for expert witnesses; the cost of any study, analysis, report, test, or project necessary to prepare the taxpayer's case; and fees for attorneys or other representatives. The hearing officer would be required to determine if DFA's position was not substantially justified in order for costs and fees to be awarded.

Section 8 extends the due date for corporate income tax returns from March 15 to April 15 for returns covering the previous calendar year. The due date for a return covering a fiscal year would be extended from 2 ½ to 3 ½ months after the closing period of the fiscal year.

Section 9 allows taxpayers to file a claim for local tax rebates for a 3 year period from the date of purchase or 2 years from the date the tax was paid. Currently, local tax rebates can only be claimed for a period of 6 months from the date the tax was paid.

The proposal would become effective 90 days after adjournment.

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Revenue Impact :

FY16 \$5M (Impact from reduced interest collections on assessments and from one-time shift of corporate income tax collections from delayed reporting)

FY17 \$8.7M (Impact from reduced interest rate)

[Based on the available 2-year Treasury note yield, the interest rate would change to 4% versus the current rate of 10% and applying the analysis to 2014 actual interest refunds and interest collections.]

Taxpayer Impact :

Taxpayers would receive less interest on tax overpayments while being assessed less interest on underpayments. Costs related to tax disputes would be reduced with the costs paid through state budgeted funds.

Resources Required :

Development of a web application for the publication of legal opinions. Modification of the tax system for the changes in due dates for tax returns. Modification of the tax system to allow for the change in time period for claiming local tax rebates.

Time Required :

The proposal does not allow adequate time for computer programming changes. It is recommended that the proposal become effective on the first day of a calendar month.

Procedural Changes :

Education of staff in the changes. Drafting and modification of existing rules for the changes.

Legal Analysis :

The provisions of Section 3 concerning denial of a claim if there is substantial doubt after a taxpayer has met the burden of proof is unclear and unnecessary. Simply put, if a taxpayer proved entitlement to a claim of exemption, denial, or credit by a preponderance of the evidence, there would be no basis to deny the claim.

Section 4 of the bill would require DFA to post redacted legal opinions and administrative decisions issued after January 1, 2016 on its website. Publishing legal opinions and administrative decisions in redacted form has the potential to disclose information protected by intellectual property and other laws (i.e. this could result in the inadvertent disclosure of trade secrets). The Arkansas Supreme Court has recognized that portions of opinions might be ineligible for disclosure under the confidentiality provisions of § 26-18-303. It is recommended that the provisions of § 26-18-303 be amended to provide specific guidance to the Department in relation to the information that should be redacted from opinions or decisions prior to posting.

Section 5 of the bill permits the award of reasonable attorney fees if the taxpayer is the prevailing party and the court finds that the final assessment or final determination of the hearing officer or director was without a reasonable basis in law or in fact or both. This will broaden the award of attorney fees and result in increased litigation. The bill does clarify that interest shall not be assessed on attorney fees.

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Section 5 of the bill also amends § 26-18-406 to require a stay of collection activity for the first 24 months that a judicial appeal is pending and permits a taxpayer to request an extension of this stay for good cause shown. It also permits a taxpayer to take voluntary nonsuits. The provisions concerning voluntary nonsuit are designed to permit a taxpayer to avoid the requirements and restrictions of Arkansas Rules of Civil Procedure 41 and 81. Specifically, Rule 41 permits voluntary dismissal without prejudice. Rule 81 bars applicability of the rules to special proceedings.

Section 6 of the bill amends § 26-18-508 to change the interest rate on tax deficiencies and overpayments from 10% per annum to the federal short term rate during the previous state fiscal years plus 3% (rounded to the nearest full percent) up to a maximum annual interest rate of 10%. A single tax debt could have ten different interest rates over the life of the tax debt. DFA will need to perform this calculation annually and maintain that documentation going forward to support any assessed interest if questioned in future proceedings.

Section 7 adds an additional section to the TPA to require DFA to reimburse taxpayers for fees and costs if the Administrative Law Judge or the courts determine that DFA's legal position with regard to a tax assessment was not substantially justified. This section of the bill presents a number of concerns for DFA. First, it is unclear whether an award of fees and costs is discretionary. On page 9, line 18, the bill provides that a taxpayer may be reimbursed for fees and costs while lines 28 through 34 permits denial of such reimbursement only in very narrow circumstances. It is also unclear if this code section would apply to cases that are settled since it applies to any request for relief including the mere protest of an assessment or refund claim denial.

Second, reimbursement of fees and costs is permitted if DFA's position is not substantially justified (as determined by a hearing officer or the director) and if the taxpayer prevails as to the predominant issues. The terms "substantially justified" and "predominant issues" are undefined in the TPA and in this bill and are subject to a variety of interpretations.

Third, this section permits a taxpayer, after conclusion of an administrative proceeding, to present a list of fees and costs to the hearing officer or the director for review and a determination of the fees and costs to be awarded; however, this is outside the scope of a hearing officer's statutory authority under the provisions of the TPA (and is outside the scope of the authority of the director). The bill does not amend the statutory scope of authority provided to the director and to hearing officers under state law nor does it provide a mechanism to permit the Department to investigate or challenge the list of fees and costs other than through a request for revision.

Fourth, this section caps fees and costs at the lesser of the amount spent or \$20,000 and any award of fees and costs are to be paid from funds appropriated to the Revenue Division for this purpose.

Fifth, this section could prevent the transparent and efficient administration of the tax system. The attorney fees and costs provisions creates an incentive for the Department to settle with a taxpayer to avoid fees and costs. Such settlements would deter the issuance of administrative decisions which provide guidance to DFA auditors and staff regarding gray areas of the law. This section would therefore make it less likely that areas of sincere disagreement that could benefit from issuance of an administrative decision on the issues will receive the necessary attention to provide such

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guidance. Alternatively, this section of the bill also has the potential to discourage settlement for the express purpose of garnering attorney's fees.

Sixth, it appears that this section is intended to largely mirror 26 U.S.C. § 7430. However, it should be noted that, while this section largely mirrors the federal law, most provisions implemented at the federal level to control cost have been removed. Provisions that seek to control cost and that have been removed include: provisions that determine such awards to be discretionary, provisions that require taxpayers to exhaust administrative remedies, provisions that exclude litigation and administrative costs that are not allocable to the government but to some other party to the action, and provisions that exclude litigation and administrative costs for portions of administrative or court proceedings (rather than entire proceedings) that are unreasonably protracted by the prevailing party. Lastly, it should be noted that this section of the code is unnecessary since § 26-18-406(e) addresses when an award of attorney fees and costs is justified. This provision of the code could be amended to apply that it would apply to administrative hearings as well. However, the scope of authority of the hearing officer and the director would still need to be extended before either could agree to an award of such fees and costs.

Lastly, this section is unnecessary as current administrative processes are already available to allow taxpayers to discuss issues with audit staff as well as DFA management throughout the administrative process from audit through appeal.

Section 9 of the bill amends § 26-52-523(d) to extend the time period for a taxpayer to seek a rebate of local taxes from the current 6 month limitation period to 3 years. This section has the potential to significantly impact local governments.