

# LEGAL SERVICES

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## MEMORANDUM

October 22, 2007

**SUBJECT:** Magnitude of civil penalties for failing to produce information and documents relating to the imposition of a tax (Work Order No. 25-LS1161)

**TO:** Senator Hollis French  
Chair of the Senate Judiciary Committee

**FROM:**   
Donald M. Bullock Jr.  
Legislative Counsel

You told me that you were interested in exploring the use of penalties to encourage the production of information required under AS 43.55. You asked for examples of penalties imposed in similar situations and about limitations applicable to civil penalties in general.

Unfortunately, I am unable to advise you concerning the maximum civil penalty a court would accept. However, I offer the following regarding factors to be considered when deciding what action or inaction should be penalized and the amount of the penalty.

There are penalties in current law applicable to the late filing of a return or report, or late payment of a tax under AS 43. AS 43.05.220(a) provides:

(a) Five percent shall be added to a tax for each 30-day period or fraction of the period during which the taxpayer fails to file at the time or times required by law or regulation a return or report, or pay the full amount of the tax, or a portion or a deficiency of the tax, as finally determined by the department and required by this title, unless it is shown that the failure is due to a reasonable cause and not to wilful neglect. The penalty may not exceed 25 percent in the aggregate. The penalty is computed only on the unpaid balance of the tax liability as determined by the department. The department shall prescribe by regulation circumstances which constitute reasonable cause for purposes of this section.

The amount of the penalty in AS 43.05.220(a) above is a percentage of the tax or a portion or deficiency of the tax; if there is no tax there is no penalty. Thus, the penalty is inapplicable to a requirement that a taxpayer submit information that is not part of a tax-related return or report.

SB 2001 proposes a penalty for failing to file a report under AS 43.55 and the proposed penalty is unrelated to the amount of tax. If enacted, AS 43.55.030(d), as amended in sec. 47 of the bill, provides authority for a penalty in the amount of \$1,000 a day for each day a person fails to file a report after the time the report is due.<sup>1</sup> This penalty is in addition to other applicable penalties and is not related to the amount of tax due. This flat-rate penalty is the type you may want to consider to encourage the timely provision of information under AS 43.55. Other flat-rate penalties in Alaska law that relate to filing an information statement or report include: AS 06.01.035(h) (\$100 a day), AS 15.13.390(a) (\$50 and \$500 a day), AS 24.45.141 (\$10 a day), AS 24.60.240 (\$10 a day), and AS 39.50.135 (\$10 a day).

The Internal Revenue Code provides for the assessment of penalties against a person who fails to file information returns as required under the code. Information returns include form 1099 that is furnished to a taxpayer receiving interest or other payment, such as the Permanent Fund Dividend. Under 26 U.S.C. 6721, a person that files an information return late is subject to a penalty of up to \$50 a return and a total penalty for a calendar year of up to \$250,000, with higher penalties if the failure to file was through the intentional disregard of the filing requirement. Similar penalties are imposed under 26 U.S.C. 6722 if a person fails to provide a payee with a statement, and under 26 U.S.C. 6723 for failing to comply with other specified reporting requirements.

Challenges to penalties as being excessive are brought under the eighth and fourteenth amendments of the United States Constitution. Under the eighth amendment, the challenge is that the penalty violates the excessive fines clause. However, unless the fine is considered a punishment, the fine is not subject to review under that amendment. In the case of tax penalties, federal courts have concluded that the impositions are not considered "punishment" and are therefore not subject to the limitation in the amendment.<sup>2</sup> Unsuccessful challenges were waged under the eighth amendment against penalties imposed for underpayment, negligence, and fraud, as well as the 10 percent tax imposed on certain withdrawals from an individual retirement account.

Under the fourteenth amendment, alleged excessive penalties are challenged as being invalid under the due process clause. For a civil penalty to run afoul of the due process clause, the penalty must be grossly excessive. In *Long v. Board of Governors of the Fed. Reserve System*, the 10th Circuit Court of appeals upheld a penalty of \$717,941 against a person who "knowingly and intentionally entered into an unlawful transaction . . . [and] deliberately concealed this transaction and refused to reverse it for almost five years."<sup>3</sup> In

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<sup>1</sup> Before amendment to this subsection in 2006, AS 43.05.030(d) provided for a penalty of \$25 a day for each lease or property upon which the report is not filed. The \$25 a day penalty was deleted by sec. 20, ch. 2, TSSLA 2006.

<sup>2</sup> E.g. *United States v. Alt*, 83 F.3d 779, 784 (6th Cir. 1996).

<sup>3</sup> 117 F.3d 1145, 1156 (10th Cir. 1997).

the case of the penalty in *Long*, part of the basis for the court's approval of the imposition was the intentional and deliberate conduct by Long.

Cases in which the level of punitive damages were challenged are helpful for determining the type and amount of civil penalties that may be imposed. Both punitive damages and civil penalties are not generally characterized as compensation, but serve the purpose of deterrence and retribution. In *State Farm Mut. Auto. Ins. Co. v. Campbell*, the United States Supreme Court instructed courts that review punitive damages to consider civil penalties as one guidepost. The court wrote:<sup>4</sup>

In light of these concerns, in *Gore supra*.<sup>[5]</sup> we instructed courts reviewing punitive damages to consider three guideposts: (1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases. We reiterated the importance of these three guideposts in *Cooper Industries*<sup>[6]</sup> and mandated appellate courts to conduct de novo review of a trial court's application of them to the jury's award.

When considering the enactment of a penalty, the third of the three guideposts from *State Farm* probably would be of little help. However, the legislative record accompanying the enactment of a penalty for failing to provide information relevant to the state's interest in levying and collecting taxes on the oil and gas industry should include a discussion of the importance of the information sought, the damage to the state if the information is not provided, and the reprehensibility of a taxpayer or other person holding information that opts not to provide it to the state.

In my opinion, a significant penalty for the failure to provide timely information, required by statute, would survive a challenge under either the eighth or fourteenth amendment if the amount of the penalty is reasonable in light of the importance of the information to the state in administering the tax. Since the state's dependence on revenue from the oil and gas industry is significant, a significant penalty would be justifiable. The \$1,000 a day penalty proposed in sec. 47 of SB 2001 would most likely survive a due process challenge, based on the importance of the information to the accurate determination of the tax liability and the loss to the state when the proper determination of the tax is delayed.

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<sup>4</sup> 538 U.S. 408, 418 (U.S. 2003) (citations omitted).

<sup>5</sup> *BMW of America v. Gore*, 517 U.S. 559; 116 S. Ct. 1589; 134 L. Ed. 2d 809 (1996).

<sup>6</sup> *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 149 L. Ed. 2d 674, 121 S. Ct. 1678 (2001).

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In closing, and with regard to your determination of the appropriate penalty amount, consider the following quote from *State Farm*: "In sum, courts must ensure that the measure of punishment is both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered."<sup>7</sup> In the tax context, the cost to the state of either not receiving necessary information or not receiving the information timely could be used as a basis for determining the appropriate penalty.

If I may be of further assistance, please advise.

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<sup>7</sup> 538 U.S. at 426.