

Taxpayers Object to FTB's Interpretation of New California Understatement Penalty

by Michael J. Cataldo

The Franchise Tax Board ("FTB") held an interested parties meeting on Friday, December 5, to elicit public comments on the implementation of California's new understatement penalty. The new penalty applies to corporations with an understatement of tax in excess of \$1 million for taxable years beginning on or after January 1, 2003. For taxable years 2003 through 2007, taxpayers can file an amended return and pay the tax shown on the amended return by May 31, 2009 to reduce or eliminate any potential understatement of tax.

FTB counsel Bruce Langston started the meeting by indicating that FTB was not consulted prior to passage of the new legislation, and there is no legislative history to suggest the legislative intent of the new understatement penalty. However, FTB determined it was the intent of the legislature to encourage taxpayers to file more accurate original tax returns, and not necessarily to raise or accelerate state revenues. Mr. Langston also noted that amended returns filed by May 31, 2009 to avoid imposition of the penalty for taxable years 2003 through 2007 must meet the formal requirements of an amended return, and that any subsequent claim for refund must specify the basis upon which a refund is claimed. Mr. Langston based this on the similarity of the new statute to the substantial understatement penalty provided by Internal Revenue Code section 6664 and the regulations thereunder, which impose specific requirements for filing amended returns. Thus, taxpayers must identify the basis for filing amended returns and refund claims and calculate the tax impact on those returns or claims. Mr. Langston noted that since the penalty is based on the amount of tax reported, the FTB does not support the use of tax deposits to avoid imposition of the penalty.

Taxpayers and practitioners universally objected to the imposition of the new penalty and called for legislative efforts to repeal or amend the penalty statute. Dissatisfaction was also expressed over FTB's narrow interpretation of the statute, and FTB was encouraged to implement the penalty in a fair and administrable manner. Numerous issues were raised by attendees that illustrated the unfairness and inefficiency that would be created by FTB's narrow reading of the statute, including the following:

- Taxpayers would be unfairly subject to the penalty unless they could divine their final California tax liability, including the effects of federal audit adjustments, prior to filing original returns.
- Preparers and taxpayers would face the conundrum of either filing inaccurate returns under penalty of perjury, knowingly overstating tax liability, or being subject to the new penalty should any unforeseeable increases to California tax liability subsequently arise.
- Over-reporting tax on an original return would be problematic because California income is based on federal income, therefore requiring taxpayers to overstate their federal income to avoid the penalty.
- Does over-reporting of tax to avoid the penalty constitute a sufficient basis to file an amended return and claim for refund? Could taxpayers report increases to additional income as "other adjustments" on original or amended returns? Would FTB consider adding a special line on original and amended returns for taxpayers to report additional income to protect themselves against the penalty?
- How would payments of uncontested additional California tax or settlement and closing agreements entered into prior to May 31, 2009, be treated, since neither requires the filing of an amended return? Would taxpayers now be required to file amended California returns to reflect such payments or settlements?

FTB stated it would consider the issues raised at the meeting and issue guidance on its website in the form of "Frequently Asked Questions" ("FAQs"). FTB requested public input on the FAQs, and expects to post the FAQs on its website in early January.

Pillsbury will continue to monitor FTB's implementation of the new penalty. For additional details, please see our Client Alerts dated October 21, 2008, and November 21, 2008.

Live Links

FTB to Hold Interested Parties Meeting on California's New Understatement Penalty; Pillsbury Client Alert; 21-Nov-2008 (PDF, 1 page)

California Imposes New 20% Understatement Penalty on Corporate Taxpayers; Pillsbury Client Alert; 21-Oct-2008 (PDF, 2 pages)

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