

California Franchise Tax Board Releases Revised Guidance on the New Twenty-Percent Strict Liability Corporate Understatement Penalty

by Michael J. Cataldo

The California Franchise Tax Board has released FTB Notice 2009-03, revised Frequently Asked Questions ("FAQs"), and a report on a recent interested parties meeting relating to filing amended returns under the cure provision of the large corporate understatement penalty imposed upon corporations with understatements of tax in excess of \$1 million. These materials can be accessed on a newly created webpage dedicated exclusively to the penalty.¹

The Penalty

The large corporate understatement penalty ("Penalty") applies to the entire amount of any corporate understatement of tax if the understatement is in excess of \$1 million. The Penalty applies to taxable years beginning on or after January 1, 2003. For combined reporting groups, the \$1 million threshold is determined on a group basis. For the 2003 through 2007 taxable years, taxpayers may file amended returns and pay the additional tax reported by May 31, 2009, to avoid imposition of the Penalty (the "cure provision").²

The Cure Provision

On March 23, 2009, the Franchise Tax Board ("FTB") held an interested parties meeting ("IPM") to elicit public comment on draft FAQs relating to the cure provision, and subsequently released revised FAQs, Notice 2009-03 ("Notice"), and a report on the IPM ("Report"). The revised FAQs eliminate the

¹ http://www.ftb.ca.gov/businesses/large_corporate_understatement_penalty.shtml

² The revised FAQs note that the May 31, 2009 curative amended return due date is actually due June 1, 2009, since May 31, 2009 falls on a Sunday.

requirement contained in the draft FAQs³ that taxpayers must submit supporting documentation with curative amended returns. The Report confirms that there are no additional requirements for the curative amended return than for any other valid amended return. The revised FAQs further relax the curative amended return requirements set forth in the draft FAQs by allowing taxpayers to use “the best information available at the time the return is filed” to satisfy the requirement that the return provide “a detailed explanation of adjustments.”

The Notice formalizes FTB’s position that the statutory language of the cure provision does not permit tax deposits, and that even a simplified amended return stating “potential future adjustments” is insufficient. The Notice states that the curative amended return “must be sufficiently detailed that it can be determined what item of income, deduction, or credit is being adjusted” and “represent an honest and reasonable attempt to satisfy the requirements of the tax law.” The Notice also states that taxpayers “will be notified and given a reasonable time period to perfect any amended returns that lack such detail.” FTB has yet to provide additional details regarding the amount of time it will provide to taxpayers to perfect such amended returns.

While taxpayers must specify the adjustments on the curative amended returns with sufficient detail, FTB staff stated at the IPM that the computations on the curative amended return are not required to be set out on an issue-by-issue, dollar-for-dollar basis. For example, FTB staff stated that if a taxpayer suspects issues A, B, and C are likely to be adjusted by the Internal Revenue Service (“IRS”), and files a curative amended return with the FTB reflecting the potential IRS adjustments, FTB would consider the curative amended return valid even if the IRS ultimately does not adjust issue A, but does adjust unanticipated issue D. So long as the curative amended return identifies the federal issues “as best as possible under the circumstances at the time,” FTB will consider the curative amended return to be valid. However, the Report states that FTB staff, “upon further consideration” believes building an estimated amount of income into anticipated federal adjustments is “inconsistent with the statute” and that taxpayers should “make a good faith estimate of the nature of each adjustment, and specifically identify the source/reason for each adjustment, and assign a dollar amount to it.”

The Notice also provides limited exceptions to the amended return requirement. Where a current Notice of Proposed Assessment (“NPA”) or Notice of Action (“NOA”) is outstanding on or before May 31, 2009, taxpayers may elect to use FTB Form 650 in lieu of an amended return, but only if the taxpayer either agrees or disagrees entirely with the NPA or NOA and makes full payment by May 31, 2009. The Notice also provides that settlement and closing agreements executed by the taxpayer on or before May 31, 2009, will serve as an amended return for purposes of the cure provision so long as the full amount of tax reflected in the settlement or closing agreement is paid by May 31, 2009.

The Notice and revised FAQs confirm that taxpayers will be permitted to apply overpayments to any taxable year for purposes of avoiding the Penalty, but prior year returns with overpayments previously applied to one tax year may not be re-applied to a different taxable year. Furthermore, pending refund claims or proposed overpayments cannot be applied to satisfy the payment requirement unless the claim is allowed or the overpayment becomes final on or before May 31, 2009.

The revised FAQs note that filing a curative amended return will not trigger a penalty for underpayment of estimated taxes. The amount of tax reported on the curative amended return will be treated as a tax shown on the original return only for purposes of the Penalty, and not for purposes of estimated taxes. The revised FAQs also note that the curative provision does not require payment of interest to avoid the Penalty.



³ Released January 22, 2009.

Curative amended returns may be mailed together with offsetting refund claims. FTB noted at the IPM that even though curative amended returns must be submitted by May 31, 2009, the concurrent receipt of an offsetting refund claim with the curative amended return will not disturb the effect of the amended return for purposes of the curative provision.

Future Returns

The method of filing future original returns to avoid the Penalty was briefly addressed at the IPM. FTB staff stated that taxpayers should estimate any anticipated adjustments and reflect them on the line for "other state adjustments" or on FTB Form 100, line 1, with a detailed explanation, but noted it had not yet fully considered the issue. FTB expects to release further guidance and solicit public comment regarding future tax return compliance to avoid the Penalty in the near future.

Change of Law Provision

The Penalty is inapplicable where the understatement of tax is attributable to a "change of law" that is enacted, promulgated, issued, or becomes final after the date the taxpayer files its return for the taxable year. A "change of law" means a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel, or a published federal or California court decision. FTB has requested interested parties to submit specific examples of where the "change of law" provision should apply.

Concluding Remarks

On April 24, 2009, a Sacramento Superior Court judge overruled the FTB's demurrer in a suit challenging the constitutionality of the Penalty. While the decision did not reach the merits, it does leave open the very real possibility that the Penalty will not be upheld in the courts. In deciding whether to file curative amended returns prior to the May 31, 2009 deadline, taxpayers should consider this possibility.⁴



⁴ *California Taxpayers' Association v. Franchise Tax Board*, Sacramento Superior Court Case No. 34-2009 80000168.

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