

Tax

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California Franchise Tax Board Releases Draft FAQs for New 20 Percent California Corporate Understatement Penalty

by Michael J. Cataldo

The California Franchise Tax Board ("FTB") has released draft Frequently Asked Questions ("FAQs") relating to the implementation and administration of the cure provision of the large corporate understatement penalty imposed upon corporations with understatements of tax in excess of \$1 million, and has requested public comments by March 12, 2009.

The understatement penalty ("Penalty") applies to corporate understatements of tax in excess of \$1 million for 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").

The draft FAQs address only some of the issues relating to the cure provision, as follows:

- Amended returns should include in red at the top of Form 100X, "Amended under R&TC section 19138(b)." The amended return will not satisfy the cure provision unless it provides a detailed explanation of adjustments (a "valid amended return").
- Tax deposits without a valid amended return will not serve to decrease a potential understatement of tax upon which the Penalty is measured. Payments made with blank or insufficiently explained adjustments, including federal adjustments, on the amended return will be treated as tax deposits, and will not mitigate a potential understatement of tax subject to the Penalty.
- Even taxpayers under federal audit who are unaware of the federal issues that may ultimately be adjusted are not excused from explaining the basis of those unknown adjustments on their amended return.

- Taxpayers who submit an invalid amended return under the cure provision will be notified by FTB and given an opportunity to perfect it by providing a detailed explanation of the adjustments. Payments made with amended returns without a sufficiently detailed explanation of adjustments will be treated as tax deposits.
- If taxpayers do not fully agree with the amended returns filed pursuant to the cure provision, they may file refund claims after May 31, 2009, on a Form 100X. In red at the top of this Form 100X, taxpayers should write "Claim filed after R&TC section 19138(b) amended return." These claims for refund must provide a detailed explanation of the claimed adjustments and specify the grounds for filing the claim.
- Alternatively, taxpayers may submit amended returns pursuant to the cure provision together with corresponding claims for refund. The signature date on the amended return should be before that on the refund claim to assure the amended return is processed before the refund claim.
- FTB will treat a taxpayer's agreement with and full payment of a final deficiency assessment on or before May 31, 2009, as a payment to reduce any understatement subject to the Penalty for purposes of the cure provision without the filing of a valid amended return. Rather, FTB will permit such taxpayers to elect, on a form soon to be released by the FTB ("Election Form") to treat the final deficiency assessment as a self-assessed tax shown on an amended return. The Election Form and payment must be submitted to FTB no later than May 31, 2009.
- If a taxpayer disagrees with all adjustments on a Notice of Proposed Assessment ("NPA"), it may file the Election Form (rather than a valid amended return), remit payment in full, and file a formal claim for refund by May 31, 2009, to avail itself of the cure provision. To reduce exposure to the Penalty for amounts currently under protest, taxpayers may submit an Election Form (in lieu of an amended return) with full payment by May 31, 2009.
- The Election Form may not be substituted for an amended return where the taxpayer seeks to pay only a portion of the NPA under the cure provision, or seeks to make other adjustments not reflected on the NPA.
- Taxpayers currently under state or federal audit who have not received an NPA must file amended returns reflecting anticipated adjustments and pay any anticipated additional tax by May 31, 2009, to reduce Penalty exposure.

An earlier set of FAQs released by FTB noted the following:

- Pending refund claims filed before May 31, 2009, will not reduce the amount of the self-reported tax subject to the Penalty.
- The Penalty will not be imposed on credit or net operating loss carryover adjustments.
- For any understatement of tax in excess of \$1 million, the entire understatement is subject to the Penalty. The Penalty is not limited to the amount of the understatement that exceeds \$1 million.
- The Penalty will be assessed after an NPA becomes final, and will be reflected on a Notice of Tax Due, with total tax, penalties and interest.

- If a refund claim is sustained, thereby reducing the amount of tax upon which a Penalty was imposed and paid, FTB will refund the Penalty (in whole or in part), since the Penalty is computed as a percentage of the understatement of tax.
- Tax deposits alone are insufficient to avoid imposition of the Penalty. Tax deposits currently on account with FTB will be automatically applied to self-assessed amounts reported on amended returns filed before May 31, 2009. Taxpayers may transfer tax deposits on account from different tax years by filing FTB Form 3581 before May 31, 2009, in conjunction with filing an amended return to avoid an understatement of tax triggering the Penalty.
- FTB will continue its practice of sharing amended return information with the Internal Revenue Service.

The earlier FAQs further noted that the imposition of the Penalty cannot be protested, and there is no reasonable cause exception to the Penalty. Only a change of law or reasonable reliance on an FTB Chief Counsel Ruling can avoid imposition of an otherwise applicable Penalty. For example:

- Even if FTB grants a petition under R&TC section 25137, FTB will not consider such petition as a basis to avoid imposition of the Penalty. FTB notes that if the facts are the same during subsequent tax years, reliance on a 25137 petition granted in a prior year should not result in an understatement of tax attributable to the 25137 variation.
- Any increase in California tax as a result of final federal adjustments will be subject to the Penalty.
- Related adjustments and credits covering two different tax years will be treated separately. Thus, overpayments from one year will not offset understatements from another year, and a dispute solely concerning the timing of an item may result in imposition of the Penalty. FTB suggests filing an amended return for the year of the potential understatement and paying the additional amount to avoid the Penalty.

For additional details on the Penalty, please see our Client Alerts dated October 21, 2008, November 21, 2008, and December 10, 2008. Pillsbury will continue to monitor forthcoming FTB guidance on the Penalty.

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