

Report on Interested Parties Meeting
Revenue and Taxation Code Section 19138(b)
Large Corporate Understatement Penalty
March 23, 2009

Administration

The interested parties meeting was held on March 23, 2009, at 10:00 a.m., at the Franchise Tax Board office in Sacramento. Approximately 50 representatives of major corporations, law firms, and accounting firms attended in person and by telephone. Representing the department were Bruce Langston, Douglas Powers, and Anne Mazur of the Legal Division and Jeanne Harriman of the Audit Division.

Background

Revenue and Taxation Code section 19138 was added by SB X1 28 (Stats. 2008, 1st Ex. Sess. 2007-2008, Ch. 1), and is effective December 19, 2008. This statute created a new penalty that applies to corporations for taxable years beginning on or after January 1, 2003, where the corporation has an understatement of tax in excess of \$1 million. The penalty is 20% of the understatement, which is measured by the difference between the correct tax liability and the tax reported on the original return or on an amended return filed on or before the extended due date.

For the 2003-2007 taxable years, a taxpayer can file an amended return and pay the tax shown on the amended return by May 31, 2009, in order to treat the tax shown on this amended return as tax shown on the original return for purposes of the penalty (hereinafter, "the cure provision"). This action will increase the taxpayer's self-assessed tax base against which the understatement is measured to reduce the likelihood of incurring this penalty for the 2003-2007 taxable years.

An interested parties meeting was held on December 5, 2008, to solicit public input on issues related to the cure provision. General informal guidance in the form of frequently asked questions (FAQs) was released to the public on January 22, 2009. Additional FAQs were distributed in draft form for public comment on February 26, 2009, which prescribe procedures for (1) filing amended returns, (2) making an election in lieu of filing an amended return in certain situations, and (3) paying the tax shown on those returns. Comments were received by the March 12, 2009 deadline.

The purpose of the interested parties meeting was to solicit public input regarding the draft second set of FAQs relating to the implementation and administrations of the cure provision of the large corporate understatement penalty pursuant to section 19138(b).

Staff Commentary

FTB staff opened the meeting by explaining that the purpose of this meeting was to discuss and obtain further input on the draft FAQs relating to the cure provision for the 2003-2007 tax years. In addition to written comments, staff provided participants with Form 100X, Amended Corporation Franchise or Income Tax Return, and the instructions thereto, for the purpose of presenting the structure and requirements for that form that were available to the Legislature at the time section 19138 was enacted.

FTB staff explained that when a Form 100X is processed, FTB systems ensure that the entries on certain lines balance and correspond to amounts previously reported or adjusted. Form 100X instructions require an explanation in detail of any changes shown on the amended return.

Summary of Discussion

FTB staff presented each draft FAQ consecutively and asked for questions, comments, and recommendations. Staff summarized comments previously received and attendees expressed, in writing and orally, the following questions, concerns, and recommendations and, in some cases, proposed modifications or additions to the FAQs in response to those comments.

Comments on existing draft FAQs 22 - 38

FAQ 22

No comments.

FAQ 23

Participant Comment (C): *Substantiation requirement is not supported by authorities/100X instructions and is inconsistent with §19138(b) goal of giving taxpayers an opportunity to mitigate potential penalty. It discourages rather than encourages filing amended returns under the cure provision.*

C: *FTB's approach for what constitutes a reasonable return is baseless.*

C: *Amended return should be based on the best information available at the time the return is filed.*

Staff Response (R): Propose to revise FAQs 23 and 29 to indicate supporting documentation should be maintained and made available upon request, rather than a minimum requirement for a valid return. Explanation of adjustments on the amended return must be based on the best information available at the time the return is filed. See also response to FAQ 24.

C: FTB should add a separate line on original and amended tax returns to allow taxpayers to state an amount in excess of what they believe they owe without overstating their actual tax liability.

R: The Legislature appears to have intentionally inserted the amended return requirement to distinguish this penalty from the 2005 amnesty program wherein tax deposits without issue identification were accepted for the purpose of avoiding the penalty for failure to participate in amnesty.

FAQ 24

C: FTB is requiring detailed amended returns. How can taxpayers provide detail of adjustments on an amended return if they are unaware of potential audit adjustments?

C: Taxpayers will have trouble accurately identifying areas of potential disagreement and providing detailed explanations of adjustments because the IRS/FTB are constantly developing new audit theories/policies, many of which are not formally announced. In addition, audit issues are determined on a case-by-case basis (citing FTB Notice 2006-3 and Appeal of Home Depot after Microsoft).

C: It is often impossible to know with precision what the final liability will be determined to be, because "resolution of tax liability is a process resulting from give and take compromise between tax authorities and the taxpayer attempting to reconcile often complex and sometimes confusing fact to often ambiguous provisions of the law."

C: The IRS might adjust different issues than those reported on the amended return.

R: There may be circumstances where the taxpayer is in the midst of a federal examination and knows IRS is looking at certain issues, but does not necessarily know the exact dollar amount of a proposed adjustment. If an audit is ongoing, but too early to determine with precision the potential adjustments, 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. Supporting documentation, such as correspondence or schedules from IRS, would be helpful in this situation.

An amended return without detail (e.g., "additional tax of \$5 million is being paid to cover any potential additional tax owed as result of fed action") fails to satisfy the normal standard of an amended return. Form 100X instructions require taxpayers to "explain in detail any changes...Include in the explanation the line number references for both the original and amended returns and any detailed computations..."

With regard to reporting federal changes, §18622(c) states in part "...an amended return must be sufficiently detailed to allow computation of the resulting California tax change and shall be reported in the form and manner as prescribed..."

C: Case law supporting what constitutes a valid return "overwhelmingly... involve tax protesters and/or tax shelters and not efforts by responsible taxpayers to satisfy their filing and payment obligations."

R: FTB Notice 2009-3 cites authority for attributes required for a valid return. A valid return in the context of this penalty should meet the same standard—not more or less—than any other return.

FAQ 25

C: The May 31, 2009, deadline for the cure provision falls on a Sunday.

R: Propose to revise to state that returns filed and payments received on June 1, 2009, will be treated as timely pursuant to Government Code rules for filing or payment deadlines that fall on a weekend or holiday.

FAQ 26

C: Is there any special designation to use for EFT payment?

R: Propose to modify FAQ to state that EFT payments should be identified using the same code as for a "notice of proposed assessment" or "NPA" payment type (02512).

FAQ 27

C: Provide instructions to designate an overpayment for the 2008 tax year to a prior year.

R: Propose to modify to instruct taxpayers to write at the bottom of page 1 of 2008 Form 100, "overpayment to be applied to TYE MM/DD/YY."

FAQ 28

No comments.

FAQ 29

C: Requiring taxpayers to file an amended return and then immediately file a claim for refund is burdensome and wasteful.

R: §19138(b) requires a self-assessment of additional tax to increase the self-assessed tax base for measuring an understatement. If a taxpayer later determines that the increase is in error, the taxpayer must file a claim for refund pursuant to §19322 within the applicable time period.

R: See also response to FAQ 23.

FAQ 30

No comments.

FAQ 31

No comments.

FAQ 32

C: What address should be used if both amended return and claim for refund are included in same package to FTB?

R: Propose to modify to state address shown in FAQ 28.

FAQ 33

No comments.

FAQ 34

No comments.

FAQ 35

No comments.

FAQ 36

No comments.

FAQ 37

C: If taxpayer has an NPA in dispute and chooses to make the election to treat the tax shown on the NPA as additional tax on an amended return and continue the dispute, the taxpayer may need to set forth additional grounds if the dispute is converted to a claim for refund.

R: Submit any specific questions regarding conversion of a dispute to a claim for refund for consideration for new FAQ.

FAQ 38

No comments.

Comments resulting in new draft FAQs

FAQ 39

C: Whether less than the full amount of an NPA can be paid when making the election in lieu of filing an amended return.

R: No—only the amount both paid and shown will increase penalty base. The unpaid amount becomes due and payable, but does not increase the penalty base if not paid by May 31, 2009.

FAQ 40

C: Whether taxpayer must file a claim for refund for previously paid penalty amount if the understatement is reduced or eliminated due to some later action.

R: No—FTB will automatically recompute the penalty and will refund/credit any resulting overpayment of penalty.

FAQ 41

C: Whether a self-assessment of additional tax that is treated as tax shown on an original return can trigger an underpayment of estimated tax.

R: No, because the tax shown on the amended return is treated as tax shown on an original return only in the context of this penalty.

FAQ 42

C: Will the payment of tax, but not interest or penalty, with the election satisfy the cure provision?

R: Yes. §19138(b) requires the payment of the tax shown on an amended return. However, the taxpayer will be billed for any interest due.

FAQ 43

C: How are cases in settlement handled?

R: Unless pending approval (i.e., signed by taxpayer and paid before 5/31/09), the same rules apply as for other ongoing disputes.

Comments not relating to existing FAQs or resulting in new FAQs

C: Guidance is still needed on what FTB will interpret as a "change of law," including whether federal policy changes, rulings, and RARs could constitute a change of law, and specifically what FTB considers a change of law applicable to 2003-2007. (e.g., rule relating to dividend ordering.)

R: Because it is difficult to contemplate all possible scenarios, the public is urged to submit fact patterns as examples for staff to consider for future FAQs.

C: The penalty is not scalable; thus, a large corporation that misjudged its final liability by only a few percentage points could be subject to the penalty.

C: Protective payments should be allowed in the event of future federal action.

C: Permit taxpayer to make tax deposits.

C: FTB is strongly encouraged to be as reasonable as possible in the implementation and administration of the penalty pursuant to §19138(f)(3).

C: Penalty is invalid and violates the US and California Constitutions, and is therefore unenforceable.

C: FTB's approach to implementing the cure provision is unreasonable.

C: FTB should join taxpayers in amending §19138 to add a scalability element and reasonable cause exception.

Comments regarding post-2007 tax years

C: How can taxpayers protect themselves from the penalty if they have filed an original return based on the best information available when the return is filed?

C: If a taxpayer is unable to determine the nature of future adjustments, can the taxpayer build an estimated additional amount of income into an IRC §482 adjustment for the purpose of increasing the penalty base?

C: Provide additional FAQs for mechanics of return preparation.

C: Will state adjustments to federal amounts be shared with the IRS?

R: There was some discussion of how post-2007 tax year returns could be filed, and staff provided some preliminary responses addressing the above issues. Specifically, there was discussion on whether a taxpayer that is unable to determine the nature of future adjustments can build an estimated additional amount of income into an IRC §482 adjustment for the purpose of increasing the penalty base for post-2007 tax year returns. Staff is aware that its response may have appeared conclusive that this manner of reporting is acceptable. Upon further consideration, however, staff believes such treatment is inconsistent with the statute. As suggested for the amended returns, if a taxpayer is unable to determine the nature of future adjustments, the taxpayer 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.

Generally, the same rules that govern the filing of amended returns under the cure provision (2003-2007 taxable years) apply for post-2007 tax year filings, and thus returns should be filed based on the best information available at the time the return is filed. Tax positions that are controversial in nature and result in an understatement of over \$1 million dollars would trigger the corporate understatement penalty. Therefore, staff acknowledges that a taxpayer may choose to file the original return taking more conservative positions on those issues and then may determine it to be appropriate to submit a subsequent claim for refund. Specific instructions regarding how to report such an issue on the original return are difficult to provide as facts and circumstances of the issue will dictate how it is mechanically

reported on the original return. A subsequently filed claim for refund should clearly identify the issue because any claim for refund must specifically identify the grounds for such claim. Clear identification of the issue on the original return will permit staff's subsequent examination of the claim to be resolved in an expeditious manner.

Subsequent Action

At the conclusion of the meeting, staff reiterated its interest in hearing and receiving additional comments, and agreed to provide further guidance to the extent possible in April 2009. Staff will invite public comment on the FAQs as they are posted on the department's website. Comments will be considered in subsequent guidance.

FTB Notice 2009-3 was issued on March 27, 2009. The notice provides formal guidance regarding payment and amended return requirements relating to the cure provision. The Notice also introduces FTB 650, Election in Lieu of Filing an Amended Return, that may be used when a taxpayer has received an NPA that is final, in the dispute process, or pending a protest decision.

The draft FAQs were revised and new FAQs were added based on comments received in writing and at the meeting. Staff requested public comment on those new and modified FAQs by April 10, 2009. Staff will continue to develop new FAQs as the need arises. In particular, staff requested the public to provide examples for purposes of providing guidance on the penalty exception relating to understatements attributable to a change of law.

Staff is considering filing issues relating to tax years beginning on or after 2008 and anticipates that it will hold another interested parties meeting in the near future to further obtain public input for future FAQs relating to post-2007 tax year filing questions.