ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Calderon	Analyst:	Gail Hall	Bill Number:	AB 697
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	June 1, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Repeal 20 Percent Corporation Understatement Penalty

SUMMARY

This bill revises the operative date for the Corporation Understatement Penalty (CUP) and adds a repeal date.

SUMMARY OF AMENDMENTS

The June 1, 2009, amendments removed the provisions pertaining to the penalty for underpayment of a tax installment and added provisions relating to the CUP.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to eliminate a significant administrative burden for taxpayers. Moreover, as a strict liability penalty the CUP is unprecedented; neither the federal government nor any other states impose a similar penalty on taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2010, and would be operative with respect to taxable years beginning on or after January 1, 2008, for which the statute of limitations on assessment has not expired. In addition, this bill would repeal the CUP on December 1, 2010.

POSITION

Pending.

ANALYSIS

STATE LAW

The CUP is a strict liability penalty that is assessed against any corporation that has an understatement of tax in excess of $1 million in any open taxable year beginning on or after January 1, 2003. In the case of taxpayers that are required or authorized to be included in a combined report, the $1 million threshold would apply to the aggregate amount of tax liability for all taxpayers that are required or authorized to be included in the combined report.

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The penalty is calculated at 20 percent of the understatement of tax. For purposes of this penalty, understatement of tax means the difference between what is shown on the original return (or amended return, if filed on or before the extended due date of the original return) and what is subsequently determined to be the correct amount of tax owed. For any taxable year beginning before January 1, 2008, amounts paid on or before May 31, 2009, and reported on an amended return filed on or before May 31, 2009, are treated as the amount of tax shown on an original return. Taxpayers may file an amended return for pre-2008 taxable years by May 31, 2009, self-assess and pay any additional tax that might be due, thereby increasing the amount of tax treated as paid with the original return for those year(s).

The CUP provisions specify that the penalty is in addition to any other applicable penalty and is a strict liability penalty. A credit or refund for any amounts paid to satisfy the penalty may be allowed only on the grounds that the amount of the penalty was not properly computed by FTB.

There is limited relief from the CUP in the following circumstances:

- The understatement of tax is attributable to a change in law, a regulation, a legal ruling of counsel, or a published federal or California court decision that occurs after the earlier of either the date the taxpayer files the return for the taxable year for which the change is operative or the extended due date for the return of the taxpayer for the taxable year for which the change is operative.
- The understatement of tax is attributable to a taxpayer's reasonable reliance on written advice of the Franchise Tax Board, but only if the written advice was a legal ruling by the Chief Counsel (within the meaning of the Taxpayer's Bill of Rights).

Underpayment of Tax – R&TC 19132

The underpayment penalty is assessed if a corporation fails to pay the amount of the tax due by the original return due date. (Note that the automatic seven-month extension of time to file a return is not an extension of time to pay the tax due).

The underpayment penalty will not be assessed if ALL of the following requirements are met:

- An extension of time to file has been granted.
- At least 90 percent of the tax due is timely paid by the original return due date.
- The remainder of the tax due is paid by the extended due date.

Underpayment of Estimated Tax – R&TC 19142

A penalty is imposed on an underpayment of tax if an installment is not paid in the correct amount, or in a timely manner. The penalty is computed on the underpayment of estimated tax from the date of the payment to the earlier of the date of payment or the original due date of the return. The underpayment of estimated tax is the difference between the amount due for each installment of the estimated tax and the amount actually paid or credited on or before the due date of that installment.

The penalty for underpayment of estimated tax may not be waived for reasonable cause. The penalty may be waived if the underpayment of estimated tax is due to a change in law that was chaptered during and operative the taxable year of the underpayment. In addition, the underpayment of estimated tax penalty may be waived if the installment of estimated tax was made timely, and the payment meets the prior year tax, annualized income, or seasonal income exceptions.

Accuracy-Related Penalty – R&TC section 19164

The Accuracy-Related Penalty may be imposed on the portion of any underpayment of tax that should be shown on the return. The penalty is generally equal to 20 percent of the portion of the underpayment (40 percent in the case of amnesty-eligible years beginning before January 1, 2003, unless the taxpayer was under audit, in protest, settlement, or appeal, or in judicial proceedings as of February 1, 2005) caused by one or more of the following:

- Negligence or disregard of rules or regulations;
- Substantial understatement of income tax;
- Substantial valuation misstatement;
- Substantial overstatement of pension liabilities; or
- Substantial estate or gift tax valuation understatement.

The statute provides relief provisions or exceptions for each of these situations. FTB will consider the relief provisions for each situation prior to assessing the penalty. A taxpayer may raise three common defenses (relief provisions) to avoid assessment of the penalty. The defenses are:

1. **Substantial Authority** - Substantial Authority exists for the tax treatment of an item on the return [Internal Revenue Code (IRC) section 6662(d)(2)(B)];
2. **Adequate Disclosure** - Adequate Disclosure of the transaction has been made on the original return [IRC Sec. 6662(d)(2)(B)]; and
3. **Reasonable Cause** - The taxpayer, in regards to the underpayment, has showed Reasonable Cause and good faith [IRC Sec. 6664(c)(1)].

Depending on the situation causing the understatement, meeting any one of these three defenses will preclude the assessment of the accuracy-related penalty. In addition, an existing FTB regulation provides that a taxpayer's good faith determination of the components which are a part of one or more unitary businesses and amounts that are attributable to classifying an item as business or non-business income will not be included in computing the amount of any understatement for purposes of the accuracy-related penalty.

THIS BILL

This bill would revise the operative date for the CUP in the following manner:

Current law: Operative for taxable years beginning on or after January 1, 2003, for which the statute of limitations on assessment has not expired.

Proposed: Operative for taxable years beginning on or after January 1, 2003, and before January 1, 2008, for which the statute of limitations on assessment has not expired.

In addition, this bill would repeal the CUP as of December 1, 2010. Consequently, no penalty may be imposed on or after December 1, 2010.

LEGISLATIVE HISTORY

SBX1 28 (Senate Budget Committee, Stats. 2008, Ch. X1-01) enacted the CUP along with provisions pertaining to estimated tax payments, Amnesty, and the operative date for the Limited Liability Company fee due date.

LEGAL BACKGROUND

In *California Taxpayer's Association* v *California Franchise Tax Board*, Case No. 34-2009-80000 168, the Superior Court of California, Sacramento County, orally denied the petition for writ of mandate, request for injunctive relief, and request for an award of attorney's fees filed by the California Taxpayer's Association finding Revenue and Taxation Code Section 19138 (the CUP provisions) constitutional and enforceable on its face.

PROGRAM BACKGROUND

The CUP provisions provide that for any taxable year beginning before January 1, 2008, amounts paid on or before May 31, 2009, and reported on an amended return filed on or before May 31, 2009, are treated as the amount of tax shown on an original return. Taxpayers could file an amended return for pre-2008 taxable years by May 31, 2009, self-assess and pay any additional tax that might be due, thereby increasing the amount of tax treated as paid with the original return for those year(s).

Preliminary results show that certain taxpayers did file amended returns on or before May 31, 2009, and paid approximately $2.7 billion in additional tax that might be due for pre-2008 taxable years.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses beginning in 2009-10.

Estimated Revenue Impact of AB 697as amended June 1, 2009 Effective for tax years BOB January 1, 2008 Enactment Assumed After 6/30/09 ($ In millions)		
2008-09	2009-10	2011-12
-$105	-$310	-$265
In subsequent fiscal years, revenue losses will be approximately $80 million annually through 2013-14 decreasing to around $50 million in 1214-15 and subsequent years.		

Revenue Discussion

The revenue loss from repealing the CUP prospectively would depend upon the amount of accelerated revenue that would have been paid on original returns if the CUP had been operational, the amount of CUP that would have been imposed, and the amount of revenue from audit issues that would have been identified by taxpayers on their original returns.

FTB estimated that taxpayers would accelerate and report an additional $5.4 billion in tax on original tax returns for taxable years 2009 through 2016 in order to avoid the CUP. These payments would be made on the original returns with the penalty in place. Absent the penalty, it is unlikely that taxpayers will pay this money until a final audit assessment is made. The timing of that assessment could range from two to seven years, or even longer, therefore the $5.4 billion would be accelerated from two to seven years. For example, it is estimated that for 2009 returns, over $500 million in tax revenue would be paid on original returns in the 2009-10 fiscal year, over what would be paid in the absence of the penalty. This loss of accelerated revenue is the primary cause of the significant revenue loss associated with repeal of the CUP.

In addition, the revenue loss includes lost penalties, which are estimated to range from approximately $40 to $50 million starting in the 2010-11 fiscal year. Finally, the revenue loss arises from a permanent loss of revenue in the audit of corporate tax returns. It is expected that FTB will be better able to identify audit issues on corporate returns, under the CUP, in which taxpayers filed conservatively and then subsequently filed a claim for refund, versus if the CUP is repealed and taxpayers file their original returns that include potentially controversial positions. It is estimated that the additional revenue associated with this improvement in information would be in the range of approximately $30 to $40 million per tax year.

This revenue estimate considers additional amounts paid on original returns, penalties, and offsets that would occur when refunds are paid. Revenue received on original returns (under current law) is counted, in the table above, in the year in which the return is received. Penalty revenue (under current law), refund offsets (under current law), and audit assessments (under proposed law) are all accrued back one year prior to the year the revenue is received (paid out).

ARGUMENTS/POLICY CONCERNS

This bill would not allow a CUP to be imposed for taxable years 2003-2007 on or after December 1, 2010. To provide equal treatment to all taxpayers subject to the CUP for taxable years 2003-2007, the author should consider removing or extending the December 1, 2010, repeal date because the department's examinations of tax returns filed for taxable years beginning on or after January 1, 2003, and before January 1, 2008, may not be complete by December 1, 2010. Therefore, any $1 million understatement from an assessment not yet finalized by December 1, 2010, would escape the CUP.

LEGISLATIVE STAFF CONTACT

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