LEGISLATIVE PROPOSAL B
EXECUTIVE SUMMARY

Title

Modify The Six-Year Statute of Limitations for Understatement of Gross Income in Excess of 25 percent of Gross Income

Problem/Recommended Solution

Generally, Federal and California tax law applies a six-year Statute of Limitations (SOL) for the substantial omission of gross income. In circumstances when the substantial omission of income is due to an overstatement of unrecovered cost or other basis, the six-year SOL applies for Federal purposes and the standard four-year period applies for California. This proposal would statutorily align California tax law with federal law for all substantial omissions of gross income regardless of the underlying reason.

Fiscal Impact

This proposal would not significantly impact the department's cost.

Economic Impact

Revenue Estimate

Overstatement of Unrecovered Cost or Basis as Trigger for Six-Year SOL.
Operative for returns filed after the effective date of the proposal and returns filed on or before the effective date of the proposal where the SOL is still open.
Assumed Enactment after June 30, 2020.

($ in Millions)

Fiscal Year	Revenue
2019-2020	n/a
2020-2021	+$5.3
2021-2022	+$4.1
2022-2023	+$4.6

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This estimate is based on a proration of the Joint Committee on Taxation (JCT) estimate for clarifying the six-year statute of limitations in the case of overstatement of basis. In July 2015, the JCT estimated the federal revenue impact of the limitation to be a gain of $110 million in federal fiscal year 2019-20. Based on data from the IRS's Statistics of Income, it is estimated that 17 percent of nationally reported capital gains income was from California, and that the state tax rate on this income is 59 percent of the federal tax rate. This suggests a revenue impact to California of approximately $11 million. It is further assumed that taxpayer behavioral response to the federal law change would reduce the revenue impact by 70 percent. Thus, the revenue gain to California is estimated to be $3 million in tax year 2020.

The tax year estimates are converted to fiscal years, rounded and reflected in the above table.

Title

Modify The Six-Year Statute of Limitations for Understatement of Gross Income in Excess of 25 percent of Gross Income

Introduction

This proposal would realign state law with federal law by including substantial omissions of gross income as a result of the overstatement of unrecovered cost or basis as a trigger for the six-year SOL.

Problem/Recommended Solution

Generally, Federal and California tax law applies a six-year SOL for the substantial omission of gross income. In circumstances when the substantial omission of income is due to an overstatement of unrecovered cost or other basis the six-year SOL applies for Federal purposes and the standard four-year period applies for California. This proposal would statutorily align California tax law with federal law for all substantial omissions of gross income regardless of the underlying reason.

Current State/Federal Law

The SOL is the time allowed under current law for taking specified action, including assessing tax or claiming a refund.

Generally the Internal Revenue Service has three years after a taxpayer's return is filed to issue a proposed assessment for federal purposes.[1] For California purposes, the Franchise Tax Board has four years from the date the return was filed or four years after the due date (including extensions), whichever is later [2] to issue a proposed assessment. There are several circumstances under which these general limitations periods are extended.

Under federal and California law, a six-year SOL applies to substantial omissions of items from gross income. An omission from gross income is substantial if the omission exceeds 25 percent of the gross income reported on the return, as specified.

Current Federal Law

In July 2015, Internal Revenue Code (IRC) section 6501 was amended to specify that an understatement could result from an overstatement of unrecovered costs or basis. Specifically, it states, "An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income." Based on this amendment, a taxpayer's overstatement of its unrecovered costs or basis upon the sale or disposition of an asset that results in a substantial understatement of gross income will trigger an extended six-year SOL period for that assessment or proceeding.

[1] IRC section 6501(a).
[2] Revenue and Taxation Code (R&TC) Section 19057.

This provision was added to the IRC in response to the Supreme Court's decision in US v. Home Concrete & Supply, LLC, ET Al., 109AFTR 2d 2012-1692(132S. Ct. 1836). In this case, the court followed an earlier decision, Colony, Inc. v. Commissioner. 357 U.S. 28 [1AFTR 2d 1894] (1958), which held that under IRC Section 6501(e)(1)(A), the SOL is not extended to six years if there is an overstatement of basis.

The court also invalidated Treasury Regulation Section 301-6501(e) (1). This regulation in essence stated that an understatement of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income. The court held that this regulation departed from the Colony decision and was not a permissible construction of the statute. Due to these developments, IRC section 6501 was amended. Under current federal law, IRC section 6501, provides a six-year SOL for omissions from gross income in excess of 25 percent of gross income, including an omission resulting from the overstatement of unrecovered costs or basis.

Current State Law

California does not conform to IRC section 6501, but instead has stand-alone law that generally parallels federal law under R&TC section 19058. Under current California law the six-year SOL is inapplicable when there is an omission of gross income in excess of 25 percent of the amount of gross income stated in the return as a result of the overstatement of unrecovered costs or basis.

Effective/Operative Date of Solution

If enacted in the 2020 legislative session, this proposal would be effective January 1, 2021, and specifically operative for returns filed after the effective date of this proposal and returns filed on or before the effective date of this proposal if the SOL has not expired as of the effective date.

Justification

Overstatements of unrecovered cost or basis lack the third-party reporting requirements that apply to items of income and can only be discovered during review of taxpayer records. Including understatement of unrecovered costs or basis as a situation that could trigger the six-year SOL for specified omissions from gross income would realign California law with federal law, and could reduce the tax gap by allowing additional time for review of documents when an understatement is indicated.

Implementation

Implementing this proposal would require some changes to existing forms and instructions and information systems, which could be accomplished during the normal annual update.

Fiscal Impact

This proposal would not significantly impact the department’s costs.

Economic Impact

Revenue Estimate

Overstatement of Unrecovered Cost or Basis as Trigger for Six-Year SOL.
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Revenue Discussion

This estimate is based on a proration of the JCT estimate for clarifying the six-year SOL in the case of overstatement of basis. In July 2015, the JCT estimated the federal revenue impact of the limitation to be a gain of $110 million in federal fiscal year 2019-20. Based on data from the IRS’s Statistics of Income, it is estimated that 17 percent of nationally reported capital gains income was from California, and that the state tax rate on this income is 59 percent of the federal tax rate. This suggests a revenue impact to California of approximately $11 million. It is further assumed that taxpayer behavioral response to the federal law change would reduce the revenue impact by 70 percent. Thus, the revenue gain to California is estimated to be $3 million in tax year 2020.

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Policy Considerations

State law was aligned with federal law for purposes of triggering the six-year SOL prior to the federal law change in 2015. This proposal would return state law into alignment with federal law.

Other Agency/Industry Impacted

The Office of Tax Appeals could be affected if there is a change in the volume of appeals.

Other States

The states surveyed include Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Research of the other states surveyed found no law similar to this proposal's extended SOL.

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Franchise Tax Board's Proposed Amendments for LP B

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Subject: Modify The Six-Year Statute of Limitations for Understatement of Gross Income in Excess of 25 percent of Gross Income

Amendment 1

Section 19058 of the Revenue and Taxation Code is amended to read:

19058 (a) If the taxpayer omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return, a notice of a proposed deficiency assessment may be mailed to the taxpayer within six years after the return was filed. Additionally, in the case of a corporation, a proceeding in court for the collection of the tax may be commenced without assessment at any time within six years after the return was filed.
(b) For purposes of this section ~~both of the following shall apply~~:
(1)In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if the amounts are required to be shown on the return) prior to diminution by the cost of the sales or service.
(2) An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income.
~~(2)~~(3)In determining the amount omitted from gross income (other than in the case of an overstatement of unrecovered cost or other basis), there shall not be taken into account any amount which is omitted from gross income stated in the return if the amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Franchise Tax Board of the nature and amount of the item.
(c) The amendments made to this section by the act adding this subdivision shall apply to the following:
(1)Returns filed after the effective date of this act.

(2)Returns filed on or before the effective date of this act if the period specified in Section 19057, determined without regard to the amendments made by this act, for the assessment of taxes with respect to that return has not expired as of the effective date.