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March 12, 2009

BY ELECTRONIC MAIL

Colleen Berwick, Regulations Coordinator  
Franchise Tax Board, Legal Department  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720

Re: California RTC Section 19138—Franchise Tax Board FAQs

Dear Ms. Berwick:

This letter is submitted on behalf of Pillsbury Winthrop Shaw Pittman LLP regarding the second set of frequently asked questions (“FAQs”) drafted and released on February 23, 2009 by the Franchise Tax Board (“FTB”) pertaining to California’s new corporate understatement penalty under Revenue and Taxation Code section 19138 (the “Penalty”).<sup>1</sup>

We believe that the Penalty is invalid and violative of the United States and California Constitutions and thus cannot be enforced. Without conceding the constitutionality or validity of the Penalty, we disagree with the FTB’s approach taken in the draft FAQs regarding the filing of amended returns under the “cure provision” of Section 19138(b). The FTB’s approach is unduly restrictive and violates the plain language and legislative purpose of Section 19138.

1. FTB’s approach is patently unreasonable.

Section 19138(b) provides that for the taxable years 2003 through 2007, taxpayers potentially may reduce or eliminate the Penalty by paying the amount of tax shown on an amended return by May 31, 2009. Section 19138(f)(3) expressly provides that the FTB shall implement the Penalty provisions “in a reasonable manner.”

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<sup>1</sup> Unless otherwise indicated, all statutory references are to the Revenue and Taxation Code.

The FTB's approach regarding the filing of amended returns under the cure provision is unduly burdensome to taxpayers and thus patently unreasonable. For example, the FTB states in response to Question 23 of its draft FAQs that the amended return must include "a detailed explanation of any adjustment to taxable income or loss, or credit items, and . . . supporting documentation. An amended return that does not satisfy this standard for completeness will not be treated as an amended return under R&TC section 19138(b)." The FTB's extremely narrow interpretation of what constitutes an "amended return" for purposes of Section 19138(b) is baseless.

First, the FTB's proposed requirement that the amended return include a detailed explanation with supporting documentation is not required under Section 19138 and, indeed, is more stringent than the current requirements for filing an amended return in general.<sup>2</sup>

Second, the FTB's proposal is impracticable and unworkable. In the case of federal RAR adjustments that are currently unknown, for example, it is not possible for taxpayers to comply with the FTB's proposed requirement that a detailed explanation with supporting documentation be provided with the amended return.<sup>3</sup>

Third, the FTB itself has proposed to dispense with the amended return requirement in administering the cure provision in certain situations. In its draft FAQs, the FTB states that it will not require the filing of a formal amended return and instead will accept an election form "to be released soon by FTB," where the taxpayer agrees with certain assessments or disagrees with certain proposed assessments in their entirety.<sup>4</sup>

The FTB should take a similar, less rigid approach to enable, if not encourage, taxpayers—whatever their situation—to avail themselves of the cure provision under Section 19138(b) for the 2003-2007 years. The proposed amended return requirements that are currently set forth in the draft FAQs are unworkable and serve to deter taxpayers from taking advantage of the cure provision. As such, the FTB has failed to comply with the Legislature's mandate that the Penalty provisions be administered in a reasonable manner.

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<sup>2</sup> See, e.g., FTB Form 100X, Amended Corporation Franchise or Income Tax Return, and Instructions for Form 100X.

<sup>3</sup> This and other problems with imposing rigid amended return requirements were fully expressed at the FTB's interested parties meeting held on December 5, 2008.

<sup>4</sup> See responses to Questions 33 through 35 and 37 of the draft FAQs.

2. FTB's approach is at odds with legislative intent.

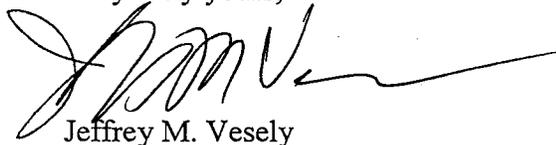
The FTB's approach is also at odds with the Legislature's intent. In 2008, the Legislature passed Senate Bill No. 28X ("SBX1 28"), which enacted Section 19138. The Legislature estimated that Section 19138 would increase the State's net revenue as follows: \$1.4 billion (2008), \$75 million (2009) and \$45 million (2010).<sup>5</sup> However, the FTB's imposition of stringent amended return requirements discourages taxpayers from making payments under the cure provision and thus is at odds with the Legislature's purpose in enacting Section 19138.

3. FTB should accept tax deposits for understatement purposes.

Instead of adopting the rigid approach as reflected in the draft FAQs, the FTB should administer the cure provision by treating the amounts paid under such provision as tax deposits and providing a simple form that taxpayers can submit with their payment in lieu of a formal amended return. This is a practicable and reasonable approach that comports with the statutory language and purpose of Section 19138, and is similar to the approach that the FTB has adopted previously in administering California's recent tax amnesty program.

In sum, the FTB's approach regarding the filing of amended returns under Section 19138(b), as reflected in the FAQs, is unduly restrictive and is inconsistent with the plain language and legislative purpose of Section 19138.

Very truly yours,



Jeffrey M. Vesely

cc: Kerne H. O. Matsubara  
Annie H. Huang  
Michael J. Cataldo

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<sup>5</sup> See Senate Bill Analysis of SBX1 28 and Assembly Bill Analysis of SBX1 28.



March 12, 2009

Ting Lee  
Legal Division  
Franchise Tax Board  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720

RE: Comments on Franchise Tax Board's Draft Second Set of FAQs  
Revenue and Taxation Code Section 19138

Dear Mr. Lee:

The Securities Industry and Financial Markets Association (SIFMA)<sup>1</sup> appreciates the opportunity to comment on the FTB's draft second round of FAQs concerning the implementation of Section 19138 of the California Revenue and Taxation Code, commonly known as the 20% understatement penalty.

SIFMA is certainly not the first entity to note the harshness of a 20% strict liability provision for underpayment of taxes. It is hard to believe that corporations will be forced to pay this additional amount regardless of whether they acted in good faith, had reasonable cause to believe that the tax being declared was appropriate, or had a strong legal basis for their position. While SIFMA understands that the FTB does not have the authority to change the law, it does have the authority and, in fact, is expressly directed to "implement this subdivision in a reasonable manner."<sup>2</sup> SIFMA strongly encourages the FTB to be as reasonable as possible in this implementation phase.

SIFMA's principal concern with the latest FAQs is the very strict protocol applied to taxpayers wishing to make a valid amendment and/or general tax deposit as a means of containing exposure to Section 19138 liability. Taxpayers must file amended returns, "including providing a detailed explanation of any adjustment to taxable income or loss, or credit items, and providing supporting documentation."<sup>3</sup> A general tax deposit is expressly insufficient under the FAQs. Indeed, the FTB states, "A blank amended return without an

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<sup>1</sup> The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

<sup>2</sup> Rev. & Tax Code Section 19138(f)(3).

<sup>3</sup> Large Corporate Understatement Penalty FAQs (2)," Response 23.

explanation of the adjustments or an amended return using an explanation similar to “protective adjustment to avoid R&TC section 19138 penalty” will not satisfy the requirements under R&TC section 19138(b).<sup>4</sup>”

Requiring a detailed explanation of adjustments presupposes a level of accuracy and knowledge that simply doesn’t exist. To avoid liability under Section 19138, taxpayers must, as a practical matter, identify in advance every conceivable area of potential disagreement on both their federal and state filings. They then must make the case for the opposing position by providing supporting documentation for that claim.

A taxpayer who goes to this length even then might not be fully protected. For example, the taxpayer could believe its position is reasonable but ultimately not prevail with the auditors. It could likewise make an honest mistake that is not identified until audit. Moreover, some disagreements might be timing related, resulting in a taxpayer overpaying for one year and underpaying for another. A taxpayer could also end up in the unenviable position of identifying an audit issue but not sufficiently documenting it; it could then face Section 19138 liability notwithstanding its good faith effort to comply with the statutory requirements.

Taxpayers attempting to avoid liability under Section 19138 will have trouble accurately identifying areas of potential disagreement and providing detailed explanations of adjustments for additional reasons. The IRS and the FTB are constantly developing new audit theories and informal policies, many of which are not formally announced and therefore are known only to the IRS and the FTB. Moreover, unforeseen events can result in unanticipated tax deficiencies. For example, FTB Notice 2006-4 withdrew Legal Ruling 376 after the California Court of Appeals determined that California Revenue & Taxation Code section 24402 was unconstitutional.<sup>5</sup>

Furthermore, in some instances, there are no clear cut rules, and audit issues are explicitly to be determined on a case by case basis. After the *Microsoft* decision,<sup>6</sup> the FTB issued FTB Notice 2006-3 stating, “The determination on whether such receipts should be excluded from the sales factor and whether that exclusion is necessary to provide a fair reflection of a taxpayer’s activities in California will remain subject to possible audit and adjustment, and may be adjusted on a case by case basis.” More recently, the State Board of Equalization reached a decision in *Appeal of Home Depot U.S.A., Inc.*<sup>7</sup> that stands in stark contrast to the decision in *Microsoft*, reinforcing the fact that such matters may be adjusted on a case by case basis. It is impossible for the taxpayer to accurately plan for and predict these outcomes.

Finally, having taxpayers file an amended return to protect against Section 19138 liability and then immediately file a claim for refund makes little sense. On or before May 31, the

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<sup>4</sup> “Large Corporate Understatement Penalty FAQs (2),” Response 24.

<sup>5</sup> See *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976; review denied, 2003 Cal. Lexis 6615; cert. denied 540 U.S. 1178 (2004).

<sup>6</sup> *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750

<sup>7</sup> *Appeal of Home Depot U.S.A., Inc.*, State Bd. of Equalization, Case No. 298683 (Dec. 16, 2008).

FTB will be facing at least three submissions from larger taxpayers for each of the last six taxable years. This is burdensome and wasteful for both the taxpayer and the FTB.

SIFMA believes that the fairest, most reasonable solution is to permit taxpayers to make tax deposits or lump sum payments as collateral against possible adjustments of liability. In terms of executing a tax deposit or lump sum payment, SIFMA supports the idea put forth by Cal-Tax and others in their December 19, 2008 FTB letter that the Board “place a separate line on original and amended tax returns wherein taxpayers can state an amount in excess of what they believe they owe without overstating actual tax liability.”

SIFMA appreciates the opportunity to provide comments on the FTB’s second round of FAQs. Please do not hesitate to contact me at 212-313-1311 should you have any comments or questions.

Sincerely,

A handwritten signature in black ink that reads "Kim Chamberlain". The signature is written in a cursive, flowing style.

Kim Chamberlain  
Managing Director & Counsel  
State Government Affairs

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March 12, 2009 -

Colleen Berwick (MS A260)  
Regulations Coordinator  
California Franchise Tax Board  
Post Office Box 1720  
Rancho Cordova, California 95741-1720**Via E-Mail**  
[colleen.berwick@ftb.ca.gov]

RE: Large Corporation Understatement Second Round Penalty FAQ (2)

Dear Ms. Berwick:

Thank you for sending me an advanced copy of the draft "Large Corporation Understatement Penalty FAQ (2)".

I will limit my comments to the approach taken in the answer to question 24. At the December meeting FTB representatives asserted that the legislative purpose behind new Section 19138 of the Rev. & Tax. Code was to require more accurate returns. On being queried, staff members from the Assembly Rev. & Tax. Committee said they could not comment on the legislative purpose as it had not gone through the Assembly Rev. & Tax. Committee. Rather, the bill went through the Finance Committee which is responsible for budgetary matters. Several members of the audience suggested that the new section was enacted for the purpose of raising revenue rather than penalizing taxpayers to incentivize them to file more accurate returns.

One of the comments made by Franchise Tax Board representatives was to the effect that the law was rather strict in what qualified as a valid return. We have reviewed considerable case law, both at the state and federal levels, as to cases holding that purported returns were not in fact valid returns. Overwhelming, these cases involved tax protesters and/or tax shelters and not efforts by responsible taxpayers to satisfy their filing and payment obligations. If it would be helpful to the Franchise Tax Board in analyzing this question to see research on this topic, we would be pleased to provide such analysis. On the other hand, if the Franchise Tax Board intends to issue the response to Question 24 as is without regard to the case law on what qualifies as a valid return, then we do not believe there would be any point in furnishing such analysis.

As we indicated at the December hearing, often it is impossible for taxpayers to know with precision what their final tax liability will be determined to be. In many cases, resolution of tax liability is a process resulting from give-and-take compromise between the tax authorities and the taxpayer attempting to reconcile often complex and sometimes confusing facts to often ambiguous provisions of the law. If tax liabilities could be determined with mathematical precision or computer analysis, there would hardly be the need for highly

skilled tax professionals in tax agencies such as the Franchise Tax Board or the Internal Revenue Service or, indeed, in the private tax bar and accounting firms. Rather, in many cases, a taxpayer's actual tax liability is not known until the results of the give-and-take of compromise and negotiations are completed.

The new Section 19138 does not have any scalability element and consequently for a large taxpayer even misjudging its final tax liability by a few percentage points could result in penalties. Taxpayers should be able to avoid such penalties through reasonable means such as making a protective payment in the event that there are adjustments by the IRS.

If we can provide further information or analysis, please let us know. Thank you for your consideration.

Very truly yours,



J. Pat Powers

JPP/kb

Colleen,

Thank you for asking for my opinion on the FTB's second set of FAQs.

The FTB seems to be interpreting the law as not permitting deposits and insisting on detailed amended returns. Is that the case? Also, if the amended return is not "detailed" enough, will the FTB reject it later and subject the taxpayer to a penalty? Also, how does a taxpayer provide detail when it is unaware of the audit issues? You should have an FAQ to address this problem.

You should also have an FAQ that addresses timing issues. For example, let's say a company with a 50% factor claims a worthless stock deduction of \$30M in year X1. The IRS completes an audit four years later, agreeing that the stock loss is valid but it should be claimed in year X2, not in year X1. The taxpayer agrees with the IRS and really only owes interest for claiming the deduction in the wrong year. The company then files an amended California return to report the RAR adjustment after May 31, 2009, and it looks like this:

	Year X1	Year X2
Taxable Income	\$200,000,000	\$200,000,000
RAR Adjustment	\$30,000,000	<\$30,000,000>
Adjusted Taxable Income	\$230,000,000	\$170,000,000
Apportionment %	50.0000%	50.0000%
California Taxable Income	\$115,000,000	\$85,000,000
Tax Rate	8.84%	8.84%
Tax, As Revised	\$10,166,000	\$7,514,000
Tax, As Reported	\$8,840,000	\$8,840,000
Tax/<Refund> Due	\$1,326,000	<\$1,326,000>
<b>California 20% Penalty</b>	<b>\$265,200</b>	<b>0</b>

This illustrates an unwarranted, unfair and unjust penalty. Nonetheless, the FTB would impose the penalty.

Sincerely,

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March 12, 2009

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**SUBJECT: Supplementary Comments Regarding the Franchise Tax Board's Implementation of Revenue & Taxation Code Section 19138(b) (20 Percent Understatement Penalty), Draft Frequently Asked Questions**

Dear Mr. Lee:

These comments supplement and do not replace the December 19, 2008 comments provided by the undersigned. These comments address industry concerns about the draft Frequently Asked Questions ("FAQs") issued by the Franchise Tax Board concerning Section 19138(b) of the California Revenue and Taxation Code. We appreciate the opportunity to provide input.

Our concerns are as follows:

- **We strongly urge elimination of a substantiation requirement in the draft FAQs.** The draft FAQs state that an amended return will not be accepted without a detailed explanation and supporting documentation of any adjustments. We believe this is not consistent with the goal of SBX1 28 in establishing Section 19138(b).

The purpose of allowing taxpayers to file by May 31, 2009 amended returns for tax years 2003-2007 was to afford them the opportunity to mitigate liability under Section 19138. However, the strict requirements that the FTB has read into the amended return requirement, as reflected in the draft FAQs, undermine taxpayers' ability to take advantage of the mitigation provision. As a practical matter, many taxpayers simply will not have the specific information you are suggesting would be required. To render that provision meaningful, the FTB should allow taxpayers to file more streamlined amended returns and to make payments reflected on those returns. The FTB can modify the existing amended return form to permit taxpayers to estimate future adjustments (rather than provide detail descriptions) that might result in additional tax liabilities. This approach would be consistent with, and promote, the Legislature's intent behind the mitigation provision.

In any event, the notion that a valid amended return requires substantiating documentation is not supported by the governing authorities. As the instructions to filing Form 100X, Amended Corporation Franchise or Income Tax Return-state, a taxpayer is only required to provide an explanation of the adjustment being reported. Thus, the FTB should eliminate any reference to a substantiation requirement in the FAQs.

Additionally, we reiterate our prior suggestion that FTB place a separate line on original and amended tax returns wherein taxpayers can state an amount in excess of what they believe they owe without overstating actual tax liability.

- **Clarifications are still needed regarding what FTB will interpret to be “changes of law.”** The FAQs repeat Section 19138’s “change in law” exception to the penalty, and state that any FTB ruling other than Chief Counsel rulings cannot serve as a basis for avoiding the penalty. Guidance is still needed with respect to federal policy changes, rulings, regulatory, and statutory changes, as well as what FTB considers to be changes of law applicable to tax years 2003-2007.

Thank you for your consideration of these comments. We welcome the opportunity to answer any questions or concerns pertaining to these comments.

Respectfully submitted,

California Chamber of Commerce  
California Bankers Association  
California Manufacturers and Technology Association  
TechAmerica

cc: Geoffrey Way, Chief Counsel  
geoff.way@ftb.ca.gov