



State of California
Franchise Tax Board
Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720

chair **John Chiang** | member **Betty T. Yee** | member **Michael C. Genest**

03.27.09

FTB NOTICE 2009-03

**Subject: Large Corporate Understatement Penalty –
Payments and Amended Returns for the 2003-2007 Taxable Years**

Purpose

The purpose of this notice is to set forth guidance on procedural issues relating to the payment of tax and filing of amended returns under California Revenue and Taxation Code (R&TC) section 19138, subdivision (b).

Background

R&TC section 19138 was recently added by SBX1 28 (Stats. 2008, 1st Ex. Sess. 2007-2008, Ch. 1) and is effective December 19, 2008, and operative for taxable years beginning on or after January 1, 2003, for which the statute of limitations on assessment had not expired as of December 19, 2008.

The penalty applies to taxpayers subject to tax under Part 11 of the R&TC, primarily corporations, where the taxpayer has an understatement of tax in excess of \$1 million. The penalty is 20% of the entire amount of the understatement, which is measured by the difference between the correct tax liability and the tax reported on the original return or an amended return filed on or before the extended due date.

The penalty will not be imposed to the extent the understatement of tax is attributable to a change in law that is enacted, promulgated, issued, or becomes final after the earlier of the date the taxpayer files the return or the extended due date of the return for the taxable year for which the change is operative. In addition, the penalty will not be imposed to the extent that the understatement of tax is attributable to the taxpayer's reasonable reliance on a legal ruling by the Chief Counsel of the Franchise Tax Board (FTB). The penalty is payable upon notice and demand, and claims for refund of amounts paid in satisfaction of the penalty may be allowed only if the penalty was computed incorrectly.

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 this penalty. This action will increase the taxpayer's self-assessed tax base against which the understatement of tax is measured to reduce the likelihood of receiving this penalty for those years.

Applicable Law

R&TC section 19138, subdivision (b), provides that the penalty is an amount equal to 20% of any understatement of tax. The term "understatement of tax" is defined as the amount of tax imposed under the Corporation Tax Law (Part 11 of the R&TC) that is in excess of the tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return.

R&TC section 19138, subdivision (b), further provides, for taxable years beginning before January 1, 2008, that taxpayers may treat tax paid on or before May 31, 2009 and shown on an amended return filed on or before May 31, 2009, as the amount of tax shown on an original return for purposes of determining the understatement of tax.

R&TC section 18601, subdivision (a), provides that corporate taxpayers must submit "a return in a form prescribed by [FTB], specifying for the taxable year, all the facts as [FTB] may by rule, or otherwise, require in order to carry out this part."

R&TC section 18621 provides that any return, declaration, statement, or other document required to be made under any provision of Parts 10, 10.2, or 11 of the R&TC shall contain, or be verified by, a written declaration that is it made under penalties of perjury. Those returns and documents must be in the form prescribed by FTB.

In *United States v. Porth* (10th Cir. 1970) 426 F.2d 519, the court determined that in order to be a return, the document must contain information relating to the taxpayer's income from which the tax can be computed.

In *Florsheim Brothers Drygoods Co., Ltd. v. United States* (1930) 280 U.S. 453, 462, the Supreme Court stated that a purported return "must honestly and reasonably be intended" to contain "a specific statement of the items of income, deductions, and credits" to be a valid return.

The Ninth Circuit in *United States v. Hatton* (9th Cir. 2000) 220 F.3d 1057, 1060 and 1061, stated that:

Although the I.R.C. does not provide a statutory definition of 'return,' the Tax Court developed a widely-accepted interpretation of that term in *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). In order for a document to qualify as a return: '(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.' *Hindenlang*, 164 F.3d at 1033 (citing definition of 'return' in *Beard*); *Beard*, 82 T.C. at 767. The *Beard* definition was derived from two Supreme Court cases, *Germantown Trust Co. v. Commissioner*, 309 U.S. 304, 84 L. Ed. 770, 60 S. Ct. 566 (1940) and *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 79 L. Ed. 264, 55 S. Ct. 127 (1934), and provides a sound approach under both the Bankruptcy Code and the I.R.C. Furthermore, the *Beard* definition is consistent with the purpose of a return, which is not only to get tax information in some form, but 'to get it with such uniformity, completeness, and arrangement that the physical task of handling

and verifying returns may be readily accomplished. *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 223, 88 L. Ed. 684, 64 S. Ct. 511 (1944).

R&TC section 19322 provides that every claim for refund must be in writing, must be signed by the taxpayer or the taxpayer's representative, and must state the specific grounds upon which it is based. Cal. Code Regs. tit. 18, section 19322, subsection (a), states that the claim must set forth in detail each ground upon which a refund or credit is claimed and provide sufficient facts to apprise the FTB of the exact basis of the claim. A document that does not meet these requirements is not a valid claim. (*Shiseido Cosmetics (America) Ltd. v. Franchise Tax Board* (1991) 235 Cal.App. 3d 478.)

Cal. Code Regs. tit. 18, section 19322, subsection (b), further states that taxpayers may not on their own initiative offset an overpayment for one year against taxes due for another year. The full amount of tax for each year must be paid notwithstanding an overpayment may have been made, unless the taxpayer has filed a claim for refund of the overpayment and has been notified that the overpayment has been credited to the tax due.

Under R&TC section 19041.5, the provisions of Internal Revenue Code (IRC) section 6603, involving the treatment of designated and undesignated remittances, are incorporated by reference, except as otherwise provided. R&TC section 19041.5, subdivision (a), specifically provides that a tax deposit payment will not be treated as a payment of tax for purposes of the running of the statute of limitations, converting an administrative protest or appeal to a refund action, or filing suit for refund until a written designation is provided or a tax liability becomes final. FTB Notice 2005-6 explained that FTB will generally follow corresponding federal interpretations and procedures relating to tax deposits.

Payment and Amended Return Requirements

R&TC section 19138, subdivision (b), allows, for taxable years beginning before January 1, 2008, taxpayers to treat tax paid on or before May 31, 2009 and shown on an amended return filed on or before May 31, 2009, as the amount of tax shown on an original return for purposes of determining the understatement of tax. The filing of such an amended return to self-assess and pay the additional tax will reduce a taxpayer's exposure to the penalty by increasing the base against which an understatement of tax is measured for purposes of computing both the \$1 million threshold and the 20% penalty amount.

Payment Requirement

To obtain the benefit provided under R&TC section 19138, subdivision (b), a taxpayer must pay the tax shown on an amended return on or before May 31, 2009. Under R&TC section 19041.5, a tax deposit is not a sufficient payment for this purpose unless the taxpayer designates in writing that the deposit is a payment of tax or the tax liability becomes final. FTB 3581, Tax Deposit Refund and Transfer Request, should be used for this purpose. In addition, a claim for refund or proposed overpayment pending on another tax year cannot be applied to satisfy the payment requirement of RT&C section 19138, subdivision (b), unless the claim is allowed or the overpayment becomes final on or before May 31, 2009. (*In the Matter of the Appeal of General Telephone Company of California*, 78-SBE-076, Sept. 27, 1978.)

Amended Return Requirement

An amended return filed pursuant to R&TC section 19138, subdivision (b), must be in the form and manner as prescribed by FTB under the general provisions of R&TC section 18621. In addition, as described in the cases cited above, a return must be sufficiently detailed that it can be determined what item of income, deduction, or credit is being adjusted.

Because the computation of the large corporate understatement penalty is generally similar to the accuracy-related penalty, the provisions of IRC sections 6662 and 6664 and underlying regulations with respect to the requirements for filing an amended return are instructive here. For purposes of computing the underpayment subject to the 20% accuracy-related penalty under IRC section 6662, subsection (a), the amount of tax shown by the taxpayer on their original return includes any additional tax shown on a "qualified amended return," unless the additional tax relates to a fraudulent position on the original return. (Treas. Reg. § 1.6664-2(c) (2008).) A qualified amended return for this purpose is defined as an amended return that is filed before the earliest of certain prescribed dates (most commonly the date the taxpayer is first contacted by the IRS about any audit with respect to the return) and includes an amended return that does not report any additional tax liability, but is filed to make a disclosure for purposes of avoiding the negligence or substantial understatement penalty. The rationale for requiring such disclosure in a qualified amended return to avoid the negligence or substantial understatement penalty can likewise be applied to an amended return filed under R&TC section 19138, subdivision (b), to increase the self-assessed tax base and therefore limit exposure to the large corporate understatement penalty.

Therefore, to be valid and effective to increase the penalty base as provided under R&TC section 19138, subdivision (b), an amended return must represent an honest and reasonable attempt to satisfy the requirements of the tax law. Such amended returns must be complete and must be signed under penalty of perjury. Such amended returns (and any subsequently filed claims for refund) must contain sufficient detail to identify the adjustments resulting in the revised tax shown on the amended return. (See R&TC section 19322, underlying regulations, and related case law set forth above relating to valid claims for refund.) Taxpayers will be notified and given a reasonable time period to perfect any amended returns that lack such detail. If not so perfected, the amended returns will not satisfy the amended return requirement under R&TC section 19138, subdivision (b).

Taxpayers subject to an ongoing or anticipated state or federal examination for one or more of the 2003 – 2007 taxable years may wish to file an amended return self-assessing additional tax related to such examinations to reduce their exposure to the penalty. If the taxpayer has not received a notice of proposed assessment (NPA) relating to an ongoing or anticipated audit, the taxpayer should consider filing an amended return that reflects anticipated adjustments to increase its self-assessed tax base.

An amended return is required to satisfy the express terms of R&TC section 19138, subdivision (b). However, in order to reduce the compliance burden on taxpayers under specified circumstances, FTB will permit taxpayers to make an affirmative election

(hereinafter "the Election") in lieu of filing an amended return (i.e., Form 100X) to treat the tax shown on a final or proposed assessment as the tax shown on an amended return. [FTB 650](#), Election in Lieu of Filing an Amended Return, should be used for this purpose. These specified circumstances and the effect of the Election are as follows:

- Pending NPA. For any NPA issued on or before May 31, 2009, for a 2003 – 2007 taxable year where the period to protest the NPA expires after May 31, 2009, and the NPA is fully paid on or before May 31, 2009, FTB will treat the total tax shown on the NPA as a self-assessment of tax shown on an amended return filed on or before May 31, 2009. If the taxpayer wishes to dispute the adjustments shown on the NPA, FTB will concurrently treat the Election as a claim for refund based on grounds provided with the Election.
- Disputed Assessment. For any NPA (or as revised or affirmed by a Notice of Action (NOA)) issued on or before May 31, 2009, for a 2003 – 2007 taxable year that is not final (i.e., it remains under protest, appeal, litigation, or settlement) and the NPA is fully paid on or before May 31, 2009, FTB will treat the total tax shown on the NPA or NOA, as applicable, as a self-assessment of tax shown on an amended return filed on or before May 31, 2009.
- Final assessment. For any NPA or NOA issued, or closing agreement or settlement agreement fully executed prior to May 31, 2009, for a 2003 – 2007 taxable year that is final (i.e., not under protest, appeal, settlement, litigation, or any other administrative or judicial dispute resolution process) and fully paid on or before May 31, 2009, FTB will treat the total tax shown on that notice or agreement as a self-assessment of tax shown on an amended return filed on or before May 31, 2009.

The Election to treat the amount of tax shown on the NPA, NOA, closing agreement, or settlement agreement, as applicable, that is paid on or before May 31, 2009, as a self-assessment of tax shown on an amended return filed on or before May 31, 2009, can be made only for the entire amount shown on the notice or agreement. Thus, a taxpayer may not make the Election for only a portion of the adjustments reflected in the notice or agreement or to make any additional adjustments not reflected in the notice or agreement. If a taxpayer wishes to treat only a portion of the notice or agreement as a self-assessment of tax for purposes of R&TC section 19138, subdivision (b), then the taxpayer must file an amended return reflecting such adjustments on or before May 31, 2009.

Claims for Refund Subsequent to Self-Assessed Amended Returns

After filing an amended return self-assessing additional tax to satisfy R&TC section 19138, subdivision (b), taxpayers may file a claim for refund of such amounts. As described above, the claim for refund must contain all elements, including sufficient detail, required for a valid claim for refund pursuant to R&TC section 19322, underlying regulations, and related case-law as described above.

It should be noted here that claims for refund (whether already acted upon by FTB or still pending) filed after the extended due date of the tax return, but on or before May 31, 2009, for pre-2008 taxable years, will not be treated by FTB as reducing the original return (or

amended return filed by the extended due date) self-assessed tax base for measuring the understatement of tax. This treatment is consistent with the general rule in R&TC section 19138, subdivision (b), that defines the term "understatement of tax" as the amount by which the tax imposed by Part 11 exceeds the amount of tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return for the taxable year.

Summary of Possible Actions to Reduce Exposure to the Penalty for the 2003–2007 Tax Years

No NPA: No NPA for the taxable year has been issued on or before May 31, 2009, regardless of whether there is an ongoing or anticipated examination (either by FTB or the IRS).

- File an amended return self-assessing the correct amount of additional tax on or before May 31, 2009,

AND

- Pay the amount of tax shown on the amended return on or before May 31, 2009.

Pending NPA: An NPA has been issued on or before May 31, 2009, where the period to protest the NPA expires after May 31, 2009.

- File an amended return self-assessing additional tax on or before May 31, 2009, or
- Make the Election on or before May 31, 2009,

AND

- Pay the amount of tax shown on the amended return or the amount treated as the tax shown on an amended return on or before May 31, 2009.

Disputed Assessment: An NPA (or as revised or affirmed by an NOA) has been issued on or before May 31, 2009, that is in protest, appeal, litigation, or settlement on or before May 31, 2009.

- File an amended return self-assessing additional tax on or before May 31, 2009, or
- Make the Election on or before May 31, 2009,

AND

- Pay the amount of tax shown on the amended return or the amount treated as the tax shown on an amended return on or before May 31, 2009.

Final Assessment: An NPA or NOA has been issued or a closing agreement or settlement agreement has been fully executed on or before May 31, 2009, that is final on or before May 31, 2009.

- File an amended return showing previously adjusted and final amounts in Column A, making no changes in Column B, and showing those same amounts in Column C, on or before May 31, 2009, or
- Make the Election on or before May 31, 2009,

AND

- Pay the amount of tax shown on the amended return or the amount treated as the tax shown on an amended return on or before May 31, 2009.

Consistent with normal practices, information submitted to FTB may be shared with other agencies and the IRS under existing exchange agreements.

FTB has published frequently asked questions (FAQs) on its website to provide additional information and procedural guidance relating to the penalty, including payment of tax and filing of amended returns for the 2003 – 2007 tax years.

The principal author of this notice is Anne Mazur of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Ms. Mazur at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.