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Requested Date: May 14, 2004
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SUBJECT: Assessment Procedures – Entities Filing Tax Exempt Returns

QUESTION PRESENTED

If any entity that has not established that it qualifies for tax exempt status files an exempt organization return, does FTB have the authority to issue a summary assessment¹ based on a math error under Revenue and Taxation Code section 19051, instead of a statutory notice of proposed deficiency under Revenue and Taxation Code section 19033?

CONCLUSION

The FTB does not have the authority to issue a summary assessment under Revenue and Taxation Code section 19051, because the error in filing an exempt organization return is not discernable from the face of the return and the assessment of tax is disputable.

ANALYSIS AND DISCUSSION

Under Revenue and Taxation Code section 23701, organizations are exempt from taxation if (a) an application for exemption is submitted to FTB, (b) a filing fee of \$25.00 is paid with each application for exemption, and (c) FTB issues a determination exempting the organization from tax.

¹ For purposes of this memorandum, the term "summary assessment" refers to an assessment resulting from a mathematical error on a tax return, pursuant to Revenue and Taxation Code section 19051, notice of which is typically made on a Return Information Notice. The "summary assessment" procedures do not provide the taxpayer with protest or appeal rights; unlike the normal deficiency assessment procedures.

This request for a TAM stems from an increasing number of entities that have filed exempt organization returns and reported no tax liability, despite their failure to follow the procedures under Revenue and Taxation Code section 23701 and obtain a determination of tax exempt status. *****

The Exempt Organization Unit reviews FTB's records to determine if the entity filing the exempt organization return is a private foundation or if the entity followed the procedures set forth under Revenue and Taxation Code section 23701 to obtain a tax exempt status. If the entity is not a private foundation and has not followed the procedures set forth under Revenue and Taxation Code section 23701, the Exempt Organization Unit sends a letter to the entity advising it that the entity has not obtained a tax exempt status and that it should file a corporate return (Form 100) or a tax return for trusts (Form 541) and pay the appropriate tax. The letter further advises that, in the alternative, if the entity still believes that it is an organization exempt from tax, it should file a Form 3500 to apply for tax exempt status. If no response to the initial letter is received, a follow up letter, similar to the initial letter, is sent. The follow up letter also advises that if no response is received, a Notice of Proposed Assessment (NPA) will be issued which will include a failure to furnish information penalty. Thereafter, an NPA is issued to entities that have not filed a corporate or trust tax return or have not shown that they qualify as a tax exempt organization. The NPA will assess tax, which is based on the net income shown on the exempt organization return, in addition to the appropriate penalties and interest.

Upon issuance of the NPA, the taxpayer obtains protest and appeal rights set forth under Revenue and Taxation Code sections 19041 and 19045, respectively. Those sections provide the taxpayer with rights to dispute the deficiency without first requiring payment of the deficiency.

Revenue and Taxation Code section 19051 provides for a summary assessment procedure under specific circumstances where the taxpayer has no right of protest, and no right of appeal, unless the taxpayer pays the assessment and files a claim for refund which is denied. Revenue and Taxation Code section 19051 states in pertinent part:

Any amount of tax in excess of that disclosed by the return, due to a mathematical error, notice of which has been mailed to the taxpayer, is not a deficiency assessment. The taxpayer has no right of protest or appeal based on that notice . . ."

The Exempt Organization Unit proposes a less complex and more efficient procedure, whereby a summary assessment under Revenue and Taxation Code section 19051, instead of an NPA, is issued to the entity. Under the proposed summary assessment procedures, the Exempt Organization Unit would continue to issue the letter(s) requesting the appropriate tax return or the filing of an application for tax exempt status. Thereafter, if the entity has not filed a corporate or trust tax return or has not shown that it qualifies for tax exempt status, a "math error correction" notice would be issued under Revenue and Taxation Code section 19051. The math error correction notice would show a (summary) assessment of tax which is based on the net income shown on the exempt organization return, in addition to the appropriate penalties² and interest. However, as set forth under Revenue and Taxation Code section 19051, the entity would have no right of protest or appeal based on the "math error correction" notice.

² It should be noted that Revenue and Taxation Code sections 19133 and 19087 provide that the failure to furnish information penalty be assessed on an NPA. Under those code sections, FTB would not have the authority to impose a failure to furnish information penalty pursuant to the summary assessment procedures under Revenue and Taxation Code section 19051. Accordingly, if the procedures proposed by the Exempt Organization Unit were adopted, the failure to furnish information penalty could not be imposed on the summary assessment notice (Return Information Notice).

The Exempt Organization Unit states that the NPA process is significantly more costly in terms of personnel, processing and delays in collection of taxes, than the process of resolving these cases under the summary assessment procedures.

The primary question to be resolved by this memorandum is whether an assessment of tax that results from an entity's failure to establish tax exempt status is an "amount of tax in excess of that disclosed by the return, due to a mathematical error," as set forth under Revenue and Taxation Code section 19051. If the assessment of tax can be described as an assessment of tax "due to a mathematical error," FTB would be legally permitted to issue the summary assessment notice under Revenue and Taxation Code section 19051.

In answering that question, it is necessary to define "mathematical error." Research provides limited guidance as to the definition of a mathematical error. However, the IRS has published General Counsel Memorandums 35467 (errors in transposing or failing to transpose amounts from a separate schedule or page of a Form 1040) and 34508 (unallowable items on tax returns) which provide a definition of "mathematical error" for purposes of Internal Revenue Code section 6213(b)(1). General Counsel Memorandums 35467 and 34508 were published prior to the 1976 amendments of Internal Revenue Code section 6213, and therefore, the memorandums are particularly useful in defining a "mathematical error" for purposes of Revenue and Taxation Code section 19051.³

Each of the General Counsel Memorandums relied on case law⁴ which provides guidance in defining the term "mathematical error." Each of those General Counsel Memorandums applied Internal Revenue Code section 6213 very conservatively to the specific circumstances in the requests for legal advice. The memorandums state, "We should be very careful in extending the definition of a mathematical error from that described in the court decisions . . . , since the affect thereof would be a circumvention of the specifically prescribed deficiency procedures."

That same cautious approach to applying Revenue and Taxation Code section 19051 should also be followed here. It is very important that FTB does not usurp the taxpayer's right to protest and appeal assessments unless statutory law specifically provides for an exception to the taxpayer's right to protest or appeal an assessment. Revenue and Taxation Code section 19051 provides

³ The 1976 amendments to Internal Revenue Code section 6213 added clerical errors as a basis for the summary assessment notice (IRC 6213(b)(1)) and specific definitions (examples) of mathematical and clerical errors (IRC 6213(g)(2)). Prior to the 1976 amendments, Internal Revenue Code section 6213(b)(1) provided, "If the taxpayer is notified that, on account of a mathematical error appearing on the return, an amount of tax in excess of that shown upon the return is due, and that an assessment of the tax has been or will be made on the basis of what should have been the correct amount of tax but for the mathematical error, such notice shall not be considered as a notice of deficiency for the purposes of subsection (a)" Internal Revenue Code section 6213(b)(1), prior to the 1976 amendments, is substantially similar to the current Revenue and Taxation Code section 19051. Neither the pre-1976 version of Internal Revenue Code section 6213 nor Revenue and Taxation Code section 19051 provide for a summary assessment based on clerical errors or provide a definition of mathematical errors. Furthermore, the current version of Internal Revenue Code section 6213, which provides for a summary assessment based on clerical errors and a definition of clerical and math errors, does not specifically provide for summary assessment procedures under the circumstances contemplated by this memorandum. General Counsel Memorandums 35467 and 34508, which focus on IRC section 6213(b) prior to the 1976 amendments, are particularly useful in defining a mathematical error for purposes of Revenue and Taxation Code section 19051.

⁴ *Repetti v. Jamison* (N.D. Cal. 1955) 131 F. Supp. 626, aff'd. (9th Cir. 1956) 239 F.2d 901; *Farley v. Scanlon* (E.D. N.Y. 1964) 13 AFTR 2d 932.

FTB with the authority to except an assessment from the normal deficiency procedures; however, under that section, the assessment must be based upon a "mathematical error." Denying a taxpayer the right to protest or appeal an assessment without statutory authority would be in direct conflict with the fundamental legal right of "due process." Moreover, if an assessment is deemed invalid because FTB did not provide the taxpayer with the right of due process, it is conceivable that the statute of limitations for issuing a normal deficiency notice (NPA) would have expired, barring FTB from ever assessing the appropriate amount of tax. Therefore, it is imperative that the FTB does not extend its authority to issue a summary assessment beyond the "mathematical error" exception provided for by statute.

In the General Counsel Memorandums, the IRS defined a "mathematical error appearing on the return," as used in Internal Revenue Code section 6213(b)(1), as an error appearing of the face of the return where there can be no real dispute. The General Counsel Memorandums and the cases cited therein provide a reasonable definition of a mathematical error for purposes of Revenue and Taxation Code section 19051. Therefore, the definition of a "mathematical error" for purposes of Revenue and Taxation Code section 19051 is an "error appearing of the face of the return where there can be no real dispute." Based on the analysis below, the type of error considered in this memorandum cannot be defined as a mathematical error.

Error Appearing On The Face Of The Return

During the processing of an exempt organization tax return, the Exempt Organization Unit cannot ascertain, from the face of the return, whether the entity purporting to be exempt from taxation has followed the proper procedures to obtain a tax exempt status, under Revenue and Taxation Code section 23701. In order to identify that an entity purporting to be exempt from taxation has not followed the procedures set forth under Revenue and Taxation Code section 23701, the Exempt Organization Unit must review its computer records. Therefore, the error in failing to obtain a tax exempt status is not apparent "on the face of the return."

No Real Dispute

As indicated above, under Revenue and Taxation Code section 23701, organizations are exempt from taxation if (a) an application for exemption is submitted to FTB, (b) a filing fee of \$25.00 is paid with each application for exemption, and (c) FTB issues a determination exempting the organization from tax.

Under the Exempt Organization Unit's proposed procedures, an entity that has not shown that it qualifies as a tax exempt organization would receive a math error correction notice, assessing tax which is based on the net income shown on the exempt organization return.

Revenue and Taxation Code section 23701 further states, "This section shall not prevent a determination from having retroactive effect . . ." Regulation 23701(b)(1)(B)(2)(4) also provides that "exempt status may be granted for years prior to approval of the exemption application but only to the extent the organization establishes it satisfied the exemption requirement during each of such prior years."

Therefore, an entity purporting to be exempt from taxation that has been assessed a tax because it has not shown that it qualifies as a tax exempt organization may dispute the assessment of tax by establishing that it met the exemption requirements for the year(s) in question. If the exemption requirements were established for the tax year in question, the tax exempt status could be applied retroactively and the assessment of tax for the tax year in question would be abated.

As such, a tax assessed because of an entity's failure to establish that it has qualified as an exempt organization is clearly an assessment which can be disputed.

Based on the above, an error attributable to an entity that files an exempt organization return which has failed to establish that it qualifies as an exempt organization cannot be defined as a "mathematical error" for purposes of Revenue and Taxation Code section 19051.

Other Considerations

Under the circumstances contemplated by this memorandum, the IRS has procedures in place which are substantially similar to the procedures currently followed by FTB. The IRS reviews its computer records to determine whether the entity filing the exempt organization return has obtained a tax exempt status. If there is no record of the tax exempt status, the IRS will send correspondence requesting verification of its tax exempt status, request that the entity file an application, or request that the entity file a corporate or partnership return. If no response to that letter is provided within nine months, a second letter is issued wherein the IRS requests that the entity file a corporate or partnership return. If the entity fails to respond to the letters or does not provide sufficient evidence that it qualifies as an exempt organization, the matter is sent to its Compliance Unit. The IRS's Compliance Unit then has the discretion to perform an audit and issue a statutory notice of deficiency. Therefore, the IRS does not issue a summary assessment, under Internal Revenue Code section 6213(b)(1), to entities that have failed to show they qualify as an exempt organization.

Finally, in other non-math error situations, the Legislature has had to provide FTB with separate statutory authority to issue a summary assessment in the same manner as provided for by Revenue and Taxation Code section 19051. For example, Revenue and Taxation Code section 19054 provides FTB with the authority to issue summary assessments, in the same manner as prescribed by Revenue and Taxation Code section 19051, where there is an overstatement of a withholding credit or estimated tax payment. (See also Revenue and Taxation Code sections 19043.5 and 17053.8.) As evidenced by these statutes, the Legislature has provided a specific summary remedy for errors, other than mathematical errors, where the errors did not justify the expense of an audit or the normal deficiency procedures under Revenue and Taxation Code sections 19041 and 19045. As such, FTB should be very cautious in utilizing summary assessment procedures unless statutory authority exists which specifically sets forth the circumstances under which the summary assessment may be made.

Therefore, the FTB does not have the authority to issue a summary assessment under Revenue and Taxation Code section 19051 based on the circumstances contemplated here, because the error in filing an exempt organization return cannot be defined as a "math error." There would need to be a specific statute that authorizes a summary assessment under these circumstances.

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