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Technical Advice Memorandum: 2007-02

Requested By: Jann Fine, Marion Boone, BETS  
 Requested Date: 03/20/2007  
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SUBJECT: Automated processing rules for look-back transactions

**QUESTION(S) PRESENTED**

With the implementation of automated processing rules for look-back tax interest in BETS, should BETS post the look-back interest in the following manner:

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- \*\*\*\*\*  
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**Example 1:** Form 100 for calendar year ending 12/31/2006 is filed on 03/15/2007. The self-assessed tax is \$1,000 and FTB 3834 claiming a look-back tax interest allowed of \$100 is attached to the return.

Tax shown on return	\$1,000.00
Timely payments & credits	- 0.00
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Tax balance due	\$1,000.00
Look-back tax interest credit	- \$100.00
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Penalty base	\$900.00
Interest due base	\$900.00

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**Example 2:** Form 100 for calendar year ending 12/31/2006 is filed on 03/15/2007. The self-assessed tax is \$1,000 and FTB 3834 claiming a look-back tax interest due of \$200 is attached to the return.

Tax shown on return	\$1,000.00
Timely payments & credits	- 0.00
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Tax balance due	\$1,000.00
Look-back tax interest due	\$200.00
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Penalty base	\$1,000.00
Interest due base	\$1,200.00

## **CONCLUSION**

Your recommended methodology complies with the federal regulation, with the exception that when there is a debit balance of look-back interest (your example 2), the look-back interest due should be included in the base for penalty calculation purposes, with the exception of the underpayment of estimated tax penalty. (Revenue and Taxation Code section 19142.)

## **ANALYSIS AND DISCUSSION**

Revenue and Taxation Code (RTC) Section 17564 conforms to Internal Revenue Code (IRC) section 460 by reference in the treatment of long term contracts for state income tax purposes. RTC section 17024.5(d) and RTC section 23051.5(d) provide that when applying the IRC for California purposes federal regulations (temporary or final) issued by "the secretary" shall be applicable as California regulations to the extent they do not conflict with the RTC or regulations issued by the Franchise Tax Board (FTB). Since the FTB has not issued any regulations related to RTC section 17564, it should look to federal regulations for guidance on how the IRS applies IRC section 460.

Treas. Reg. § 1.460-6(f)(2) provides for the treatment of the look-back interest as follows:

Treatment of interest on return -- (i) General rule. The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, an underpayment penalty under section 6651, and the taxpayer also is liable for

underpayment interest under section 6601. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for subtitle F purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability or a tax refund. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

Your recommended methodology complies with the federal regulation, with the exception that when there is a debit balance of look-back interest (your example 2), the look-back interest due should be used to increase the base for penalty calculation purposes, with the exception of the underpayment of estimated tax penalty. (Revenue and Taxation Code section 19142.)

Other than this modification I agree that the automated process you recommend will correctly handle the treatment of look-back interest.

Tax Counsel