

**MAP 11
PENALTIES**

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11.1 INTRODUCTION

The California Revenue and Taxation Code (R&TC) contains numerous provisions for the assessment of penalties in various situations where taxpayers have failed to comply with the law. There are several types of penalties that we may impose based on a taxpayer's tax liability. Familiarize yourself with the penalty sections of the law and apply the penalties uniformly. It is our practice to consider the imposition of any penalty in each case where the penalty is applicable.

Some penalties are automatically imposed by our software systems, and the auditor develops others as appropriate during the audit.

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Penalties determined at the audit level include:

- Accuracy Related Penalty (See MAP 11.3 Accuracy Related Penalty).
- Failure to Furnish Information Penalty (See MAP 11.4 Failure to Furnish Information Penalty).
- Fraud Penalty (See MAP 11.5 Fraud Penalty).
- Tax Shelter Penalties (See MAP 11.6 Tax Shelter Penalties).

Any penalty that is considered by the auditor must be documented in the work papers by creating an issue folder for each penalty. Include reasons why the penalty is or is not assessed (including whether or not various defenses to the penalty apply). All notices that contain a penalty must include the name of the penalty, R&TC section that authorizes the penalty, and a description of the computation of the penalty (R&TC Section 19187(a)). In addition, supervisor approval of the penalty needs to be documented in the case. (See MAP 11.2 Supervisor Approval of Penalties).

Automatic penalties (imposed by the system, auditor does not need to make the determination of whether or not they apply) include:

- Amnesty Penalty
- Failure to File Annual Statement (SOS Penalty)
- Failure to File Return/Delinquency Penalty
- Underpayment of Estimated Tax.
- Underpayment Penalty

Do not create issue folders for automatic penalties, unless the taxpayer or the auditor raises the issue of waiving the penalty. In those cases, document the defenses raised, and whether or not we are waiving the penalty.

The Large Corporate Understatement Penalty is imposed when the liability becomes final and will generally be imposed by BES.

- Large Corporate Understatement Penalty

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**11.2 SUPERVISOR
APPROVAL OF
PENALTIES**

In accordance with R&TC Section 19187, supervisors must approve imposition of any accuracy related penalty, failure to furnish information penalty, fraud penalty, or tax shelter penalties on all notices. Documentation of their approval must be in the case file.

In the case of the fraud penalty, auditors should contact Technical Resource Section before beginning to develop the fraud penalty.

Supervisor's approval is not necessary in the following circumstances:

- Any penalty calculated through electronic means, including Automated Audits.
- Any penalty assessed as a result of a Revenue Agent Report (except for fraud).

In the absence of the immediate supervisor, another designated supervisor of higher authority may also approve the penalty.

The supervisor reviewing the case must do one of the following:

- Make an entry in the PASS Event log approving the case.
- Sign the Audit Report, FTB 6430, or the Narrative Report.

Because of the express language of the law, a lead or another auditor who is acting in a review capacity will not meet this requirement.

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11.3 ACCURACY RELATED PENALTY	<p>The Accuracy Related Penalty is found in R&TC Section 19164. This penalty is generally determined in accordance with IRC Section 6662.</p> <p>Details regarding the Penalty, when to impose it, and defenses to its imposition are found at Accuracy Related Penalty website.</p> <p style="text-align: right;">Rev. 7/17</p>
11.4 FAILURE TO FURNISH INFORMATION PENALTY	<p>R&TC Section 19133 states that if any taxpayer fails or refuses to furnish any information requested in writing, through a formal demand, FTB may add a penalty of 25 percent of the additional tax.</p> <p>Before making a formal demand, examine the relevance of the request:</p> <ul style="list-style-type: none">• Is the request reasonable?• Has a reasonable amount of time to gather the requested information been allowed?• Has the information already been provided, but in some alternative format?• Are other alternatives available?• Is the requested information relevant to the issue under examination?• Has the auditor made an attempt to obtain the requested information/documentation through alternative internal or external resources? <p>If a formal demand is necessary, it must be in writing and include:</p> <ul style="list-style-type: none">• The specific information requested.• The need for the specific information.

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- A due date with at least 30 days from the mail date of the formal demand letter.
- Citation to the Failure to Furnish Information (FTF) Penalty under R&TC Section 19133, or the following language regarding the imposition of the FTF Information Penalty:

This is a formal legal demand for the information. If you fail to provide the information requested within 30 days of the date of this demand for information, we may impose a 25 percent penalty of the additional tax for failure to provide the information, regardless of prior payments or deposits, unless the failure is due to reasonable cause. See Revenue and Taxation Code Section 19133. If you need additional time to respond, please call (telephone number) as soon as possible.

- The prior requests (date of initial request, extensions, and any subsequent request(s)).
- Reiteration of the taxpayer's or representative's failure to provide information relevant to previous request(s) for information. Be specific as to how the information provided by the taxpayer or representative did not address the request(s).

The (FTF) Information Penalty should be assessed in cases where a formal demand is refused or ignored. The FTF Information Penalty should not be assessed when the failure to provide the requested information is due to reasonable cause. See MAP 11.4.1 Waiver of Failure to Furnish Information Penalty. Always obtain supervisor approval and guidance from TRS when determining applicability of the FTF Information Penalty.

Make sure to document all prior requests for information in PASS or retain copies of the prior requests for information. If the audit requests are not documented or the appropriate request and demand for information have not been made, any recommendations to assess the penalty based on a lack of taxpayer cooperation or refusal to furnish information will not be accepted.

Extensions of Time & the FTF Information Penalty

All formal demand letters must have at least a 30-day due date before the FTF Information Penalty can be assessed. The FTF Information Penalty **cannot** be assessed when an extension of time to respond has been granted by the auditor **AFTER** the formal demand letter has been sent. Any extension of time granted to

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respond to the information request(s) in a formal demand letter will nullify the legality of the demand letter as the "formal demand".

In order to assess the FTF Information Penalty where an extension has been granted subsequent to a formal demand, the auditor must send another formal demand letter. This subsequent formal demand letter must include all the required language as discussed above, including another 30-day due date from the mail date of the subsequent formal demand letter.

FTF Information Penalty Calculation

This penalty is only assessed on the issue for which information and/or documentation was not provided as requested. In other words, if several issues are under examination and the taxpayer or representative fails or refuses to provide information and/or documentation on one issue, the auditor must calculate the penalty only on the deficiency attributable to that issue.

R&TC Section 19133 does not provide clear guidance for computing the deficiency attributable to a particular issue(s) when there are other issue(s) to which the penalty does not apply. Like the accuracy-related penalty, the FTF Information penalty applies only to the portion of the underpayment that is attributable to certain conditions (such as negligence). The ordering rules provided in Treasury Regulation section 1.6664-3 are a reasonable methodology to apply for this purpose.

Example A

John claimed a \$150,000 bad debt deductions on his Schedule C for taxable year 2005. He also deducted \$575,000 as other expenses on Schedule C. He reported (\$250,000) taxable income (loss) for 2005.

John failed or refused to provide any information/documentation to substantiate the \$150,000 bad debt. However, he provided documentation, which showed \$200,000 in personal expenses was deducted as other expenses. Revised taxable income is \$100,000 and revised tax is \$7,269. After considering tax previously assessed of \$0, the total deficiency is \$7,269.

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Failure to Furnish Information Penalty Calculation:

Step 1.

Taxable income (loss) as reported	(\$250,000)
Adjustment – Other expenses	<u>200,000</u>
"Adjusted" TI	<u>(\$50,000)</u>
Tax on "Adjusted" TI	0
Portion of deficiency with no penalty	0

Step 2.

Total deficiency	\$7,269
Tax on "Adjusted" TI from Step 1.	<u>0</u>
Portion of deficiency with FTF penalty	<u>\$7,269</u>
FTF Penalty (25%)	<u>\$1,817</u>

The FTF Information Penalty of \$1,817 is based on the deficiency computed to be attributable to the disallowance of the bad debt.

Example B

Same facts as above except John reported taxable income of \$250,000 for 2005. Revised taxable income is \$600,000 and revised tax is \$53,769. After considering tax previously assessed of \$21,219, the total deficiency is \$32,550.

Failure to Furnish Information Penalty Calculation:

Step 1.

Taxable income (loss) as reported	\$250,000
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	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Adjustment – Other expenses</td> <td style="text-align: right;"><u>200,000</u></td> </tr> <tr> <td>"Adjusted" TI</td> <td style="text-align: right;"><u>\$450,000</u></td> </tr> <tr> <td>Tax on "Adjusted" TI</td> <td style="text-align: right;">\$39,819</td> </tr> <tr> <td>Tax previously assessed</td> <td style="text-align: right;"><u>21,219</u></td> </tr> <tr> <td>Portion of deficiency with no penalty</td> <td style="text-align: right;"><u>\$18,600</u></td> </tr> <tr> <td colspan="2">Step 2.</td> </tr> <tr> <td>Total deficiency</td> <td style="text-align: right;">\$53,769</td> </tr> <tr> <td>Tax on "Adjusted" TI from Step 1.</td> <td style="text-align: right;"><u>18,600</u></td> </tr> <tr> <td>Portion of deficiency with FTF penalty</td> <td style="text-align: right;"><u>\$34,169</u></td> </tr> <tr> <td>FTF Penalty (25%)</td> <td style="text-align: right;"><u>\$9,292</u></td> </tr> </table> <p>The FTF Information Penalty of \$9,292 is based on the deficiency computed to be attributable to the disallowance of the bad debt.</p> <p>The immediate supervisor's approval is required anytime a FTF Information Penalty is assessed. (See MAP 11.2 Supervisor Approval of Penalties) For significant or large audits, the supervisor may want to keep the program manager informed. The auditor needs to prepare the Audit Issue Section (6870B) in PASS when the FTF Information Penalty is assessed.</p> <p>For additional information regarding the FTF Information Penalty, refer to MAP 6.7.1 Failure to Furnish Information Penalty.</p> <p style="text-align: right;">Rev. 7/17</p>	Adjustment – Other expenses	<u>200,000</u>	"Adjusted" TI	<u>\$450,000</u>	Tax on "Adjusted" TI	\$39,819	Tax previously assessed	<u>21,219</u>	Portion of deficiency with no penalty	<u>\$18,600</u>	Step 2.		Total deficiency	\$53,769	Tax on "Adjusted" TI from Step 1.	<u>18,600</u>	Portion of deficiency with FTF penalty	<u>\$34,169</u>	FTF Penalty (25%)	<u>\$9,292</u>
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<p>11.4.1 Waiver of Failure to Furnish Information Penalty</p>	<p>This penalty can be waived if the taxpayer submits a written statement listing the facts that support reasonable cause for failing to provide information upon notice and demand. In order to waive the penalty, the taxpayer or representative must show that the failure is due to reasonable cause and not willful neglect. If the failure to provide information/documentation is due to reasonable cause then the</p>																				

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penalty should **not** be assessed. Reasonable cause requires the taxpayer to exercise ordinary business care and prudence. If a taxpayer has exercised such ordinary care and prudence and is nevertheless unable to provide the information, then the failure is due to reasonable cause. One example of reasonable cause could be if the taxpayer timely responds in writing that they have reviewed their records, and they do not have the documents/information requested.

The following items are intended as a guide for purposes of uniform treatment and clarification. Auditors must use their judgment in borderline and exceptional cases and, if necessary, should refer the matter to their supervisor or other designated reviewer. Reasonable cause determination must be made on a case-by-case basis considering the totality of the circumstances.

Generally Acceptable Reasons:

- Unforeseeable destruction or impounding of records so that a return cannot be prepared and filed.
- Taxpayer proves that the demand notice was not mailed to the Last Known Address.

Similar circumstances that warrant waiving penalties may be considered in this category. However, undue delay after a taxpayer has been contacted may not be considered as reasonable cause.

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11.5 FRAUD PENALTY

An auditor is required to obtain supervisor's approval for all fraud penalties. The auditor should contact Technical Resource Section before beginning to develop the fraud penalty. See MAP 11.2 Supervisor Approval of Penalties.

R&TC Section 19164 provides for the imposition of a fraud penalty. This penalty is determined in accordance with IRC Section 6663.

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IRC Section 6663 provides for the imposition of a fraud penalty if any part of any underpayment of tax is due to fraud. The penalty is equal to 75 percent of the portion of the underpayment that is attributable to fraud.

The courts have defined fraud as the intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owed (*Akland, et al. v. Commissioner* (9th Cir. 1985) 767 F.2d 618). Negligence or ignorance of the law does not constitute fraud.

We may impose the fraud penalty where the taxpayer:

1. Knew the contents of the return when he or she signed it.
2. Knew the return to be false.
3. Made the return with the fraudulent intent to evade tax.

You should examine the taxpayer's entire course of conduct to establish intent. FTB has the burden of proof when applying the fraud penalty. Unlike criminal fraud, civil fraud need not be proved beyond a reasonable doubt. Rather, FTB must prove fraud by clear and convincing evidence, which has been defined as explicit and unequivocal, and leaving no substantial doubt. The sophistication, education and intelligence of the taxpayer are relevant to determining fraudulent intent. Because fraudulent intent is rarely established by direct evidence, the courts have developed a list of nonexclusive circumstantial factors from which intent may be inferred. Although no one factor is necessarily sufficient to establish fraud, a combination of factors is persuasive evidence. These indications (**badges**) of fraud include but are not limited to:

- Understatement of income
- Inadequate records
- Failure to file tax returns
- Implausible or inconsistent explanations of behavior

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- Concealing assets
- Failure to cooperate with tax authorities

The fraud penalty will not be imposed for any portion of an underpayment if it is shown that the taxpayer actually and reasonably relied on the improper advice of a tax professional for that portion. However, the taxpayer must show that complete and accurate information was provided to the professional. A taxpayer cannot escape the penalty by delegating preparation of the return to someone else.

If the penalty is assessed, the audit file must contain:

- The documentation obtained to determine fraud was committed
- A working paper section discussing:
 1. The badges of fraud
 2. A summary of how the documentation relates to the badges of fraud
 3. How the taxpayer meets the badges of fraud upon which the penalty is based
 4. A reconstruction of the income that was excluded due to the fraudulent act
 5. The taxpayer's statement as to why the taxpayer feels that the penalty does not apply (if applicable) and why the penalty should apply

For assessments based upon Revenue Agent Reports (RAR), if the IRS has assessed the fraud penalty, we will not automatically assess the penalty. This is because the

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	<p>presumption of correctness is not present. FTB must independently prove fraud in order to assess the penalty.</p> <p style="text-align: right;">Rev. 7/17</p>
11.6 TAX SHELTER PENALTIES	<p>Various penalties are imposed on participants and promoters of abusive tax shelters and transactions.</p> <p>Tax shelter penalties include:</p> <ul style="list-style-type: none">• Interest-based• Noneconomic Substance Transaction Understatement• Accuracy Related Penalty (Special rules for tax shelters)• Reportable Transaction Understatement• Failure to Disclose Reportable and Listed Transaction• Frivolous Return• Frivolous Submissions• Failure to Maintain Investor List• Failure to Register• Preparer Penalty• Promoter Penalty <p>Details on these penalties and procedures to impose them are found at:</p> <p>Audit Procedures - Tax Shelter Penalties</p> <p style="text-align: right;">Rev. 7/17</p>
11.7 AMNESTY PENALTY	<p>An amnesty penalty under R&TC Section 19777.5 may apply to 2002 and prior tax years. It is imposed for tax years for which a taxpayer had the opportunity to participate in the amnesty program, didn't do so, and there was an unpaid amount</p>

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due on March 31, 2005 (50% Interest Based penalty). The penalty is also imposed where FTB mails an NPA or a notice of tax due or where a taxpayer self-assesses additional tax for an amnesty eligible tax year after the end of the amnesty period (post-amnesty penalty). A description of the Amnesty Penalty is in the FTB Public website.

Answers to frequently asked questions regarding the amnesty penalty are found at California Tax Amnesty FAQ.

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**11.8 FAILURE TO FILE
ANNUAL STATEMENT
(SOS PENALTY)**

Corporations are required to file an annual Statement of Information (Form SI-100) with the Secretary of State. See R&TC Section 19141.

If the corporation fails to file an annual statement, the following actions are taken:

- The Secretary of State (SOS) notifies the corporation of the possibility of suspension if a statement is not filed within 60 days.
- SOS suspends the corporation if the corporation does not comply within the 60 days.
- SOS notifies the FTB that the corporation is suspended.
- FTB assesses the penalty against the corporation and sends the billing.
- The penalty amounts are \$250 for general, and foreign corporations, and \$50 for domestic nonprofit corporations.
- Interest is not charged on the penalty.

As a condition of reinstatement, a suspended corporation must furnish proof that the Statement of Information was filed with the SOS. The FTB is only the collection agency for this penalty. It does not have the authority to cancel or waive the penalty unless notified to do so by the SOS.

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	<p>Questions regarding the assessment should be directed to the Office of Secretary of State, telephone number 916.657.3537.</p> <p>Taxpayers may access the Secretary of State via Internet at Secretary of State.</p> <p style="text-align: right;">Rev. 7/17</p>
<p>11.9 FAILURE TO FILE RETURN/DELINQUENCY PENALTY</p>	<p>R&TC Section 19133 provides that if any taxpayer fails or refuses to file a return upon notice and demand by FTB, unless the failure is due to reasonable cause and not willful neglect, the FTB may add a penalty of 25 percent of the amount of tax assessed. Different rules apply for PIT taxpayers. See CCR Section 19133.</p> <p>R&TC Section 19131 imposes a delinquent penalty on any taxpayer that fails to file a return on or before the due date or extended due date. The penalty is assessed on the net amount of the tax due on the return.</p> <p>For partnerships, R&TC Section 19172 imposes an additional delinquent penalty, also known as the per partner/member penalty, for failure to file a return by the original or extended due date. The penalty is calculated based on the number of partners or members.</p> <p>For S corporations, R&TC Section 19172.5 imposes an additional delinquent penalty, also known as the per shareholder penalty, on S corporations for failure to file a return by the original or extended due date. The penalty is calculated based on the number of shareholders.</p> <p>Normally, these penalties are automatically assessed by the system. However, the auditor may have to assess them manually in circumstances such as when the taxpayer has not filed a return for that year.</p> <p>First time non-filers will receive a Request to File letter (use PASS template FTB 4919 Demand To File PIT Rtn). If there is no response after 30 days, we issue a Notice that includes tax and late filing penalties. A repeat non-filer will receive a Demand to File letter. (See CCR Section 19133.) If there is no response after 30 days, we issue a Notice that includes tax, Failure to File Return penalty, Delinquency penalty, and a filing enforcement fee.</p> <p>A repeat non-filer is defined as anyone who, within the past four years, was assessed a non-filer Notice of Proposed Assessment. See CCR Section 19133(d), Example 2.</p>

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Amount of Penalty

R&TC Section 19172 – The penalty is assessed at the partnership level, for \$10 per partner to a maximum of five months for returns originally due on 2010 and prior. For returns with due dates as of January 1, 2011 and later, the penalty increased to \$18 per partner to a maximum of 12 months per partner.

R&TC Section 19172.5 – Same calculation as R&TC Section 19172 except it applies to S corporations.

R&TC Section 19131 - The penalty is assessed at the rate of 5 percent of the tax for each month, or a fraction of a month, elapsing between the due date of the return (determined without regard to any extension of time for filing) and the date on which filed, but the total penalty shall not exceed 25 percent of the tax.

In the case of a commencing corporation, the penalty shall apply to all tax accruable on the due date of the return.

If the taxpayer is an individual or fiduciary, and fails to file a return within 60 days without regard to extensions, the penalty is the lesser of the following:

- One-hundred thirty-five dollars (\$135), or
- One hundred percent (100 percent) of the tax required on the return.

The delinquent penalty may be increased or decreased based on the adjustments to the tax after the original return is filed.

Waiver

These penalties can be waived if the taxpayer submits a written statement listing the facts which support reasonable cause and no willful neglect for failing to file the return by the original due date. (See MAP 11.9.1 Waiver of Failure to File Return/Delinquency Penalty)

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	<p>Exception</p> <p>If the sum of the penalties assessed under R&TC Sections 19131 and 19133 are greater than the Underpayment Penalty (R&TC Section 19132), then the Underpayment Penalty should not be assessed. See R&TC Section 19132(b) and MAP 11.11 Underpayment Penalty.</p> <p>R&TC Section 19172 applies to partnerships/LLCs only. It does not apply to LLCs owned by a single member (SMLLCs).</p> <p style="text-align: right;">Rev. 7/17</p>
<p>11.9.1 Waiver of Failure to File Return/Delinquency Penalty</p>	<p>The delinquency penalty is assessed unless there is reasonable cause and no willful neglect. Reasonable cause requires the taxpayer to exercise ordinary business care and prudence. If a taxpayer has exercised such ordinary care and prudence, and is nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause. Forgetting to file or assuming someone else will file is not reasonable cause.</p> <p>The following acceptable/unacceptable reasons are a guideline for purposes of uniform treatment and clarification. Auditors will continue to use their judgment in borderline and exceptional cases and, if necessary, should refer the matter to their supervisor or other designated reviewer.</p> <p>Generally, information submitted by the taxpayer for reasonable cause will be acceptable in letter form; but, in cases of doubt or where evidence of mailing is required, an affidavit should be requested setting forth reasons for late filing. Reasonable cause determination must be made on a case-by-case basis considering the totality of the circumstances.</p> <p>Generally Acceptable Reasons</p> <ul style="list-style-type: none">• Taxpayer shows death, or severe illness of the taxpayer, officer, or qualified representative or employee responsible for submitting or completing the return and no other person was able to file on their behalf

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- Taxpayer alleges timely filing by mail and provides a copy of a USPS certified mail receipt.
- Taxpayer was in a Governor-declared disaster zone and filed within the applicable extended disaster relief time period.

Generally Unacceptable Reasons

- Confusion as to the state income tax filing due dates.
- Belief that a return was not required because of inactivity or operation at a loss.
- Payment of the tax by the due date but failure to file a return.

NOTE: The R&TC Section 19131 Delinquent Filing Penalty will not be imposed if there is no tax due. However, R&TC Section 19172 or 19172.5 per partner/member/shareholder Late Filing Penalty will be imposed even when there is no tax due because the penalty is calculated based on the number of partners/members/shareholders.

- Belief that the corporation was exempt or dissolved.
- Failure to receive forms because of change of address or otherwise.
- Change of fiscal year caused filing of delinquent return.
- Confusion as to the correct incorporation date.
- Lack of funds to pay the tax.

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**11.10 UNDERPAYMENT
OF ESTIMATED TAX**

A penalty is imposed on the underpayment of tax if an installment is not paid in the correct amount, or in a timely manner (R&TC Section 19136 (PIT) and R&TC Section 19142 (corp)). The penalty is computed on the underpayment of estimated

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	<p>tax from the date of the installment to the earlier of the date of payment, or the original due date of the return.</p> <p>Generally, the underpayment of estimated tax is the difference between the amount due for each installment of the estimated tax and the amount actually paid or credited on or before the due date of that installment.</p> <p>In the case of any underpayment of estimated tax, an addition to tax is imposed based on the interest rate, for the amount of underpayment, for the period of the underpayment.</p> <p>An auditor rarely assesses this penalty, as it is normally automatically assessed, when applicable.</p> <p style="text-align: right;">Rev. 7/17</p>
11.11 UNDERPAYMENT PENALTY	<p>The underpayment (also known as the late payment) penalty is assessed if a taxpayer fails to pay the amount of the tax due by the original return due date (R&TC Section 19132). The automatic extension of time to file a return is not an extension of time to pay the tax due.</p> <p>A penalty will not be imposed based on a presumption of reasonable cause if all of the following requirements are met:</p> <ul style="list-style-type: none">• Taxpayer files the return after the original return due date and on or before the extended due date.• At least 90 percent of the total tax liability is paid by the original due date of the return.<ul style="list-style-type: none">○ If a corporation only owes the minimum franchise tax, this exception does not apply.• If the return is for tax year 2005 or earlier, the remaining ten percent must be paid on or before the extended due date.• Any additional tax assessed due to the correction of a mathematical error on the return is paid within 15 days of the date on the notice.

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	<p>The penalty is computed as five percent of the unpaid tax due on the original return due date, plus .05 percent per month of the remaining tax, not to exceed 40 months during which the remaining tax is greater than zero. The aggregate amount of penalty imposed by this subdivision shall not exceed 25 percent of the total unpaid tax.</p> <p>Once the underpayment penalty is assessed, it may be decreased in conjunction with any decrease in the assessed tax, but it may not be increased.</p> <p>An auditor rarely assesses this penalty, as it would normally be assessed automatically, when appropriate. An auditor may encounter the issue on a claim for refund.</p> <p style="text-align: right;">Rev. 7/17</p>
<p>11.12 LARGE CORPORATE UNDERSTATEMENT PENALTY</p>	<p>R&TC Section 19138 authorizes the large corporate understatement penalty (LCUP), which is 20% of the understatement. The understatement is measured by the difference between the correct amount of tax and the tax reported on the original return or on an amended return filed on or before the extended due date.</p> <p>Thresholds will vary according to tax year:</p> <ul style="list-style-type: none">• For taxable years beginning on or after 1/1/2003 and before 1/1/2010, the understatement must exceed \$1 million.• For taxable years beginning on or after 1/1/2010, the understatement must exceed the greater of:<ul style="list-style-type: none">○ \$1 million, or○ 20% of the tax shown on the original return, or shown on an amended return filed on or before the extended due date. <p>For taxpayers required or authorized to be included in a combined report, the threshold applies to the <u>aggregate</u> amount of tax liability of the group.</p>

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For taxable years beginning on or after January 1, 2015, the amount of additional tax shown on the first amended return reflecting a proper election under IRC Section 338 (relating to certain stock purchases treated as asset acquisitions), is treated as if included in the amount of tax shown on an original return for measuring both the understatement as well as the 20 percent threshold.

The LCUP is assessed when a deficiency becomes final and cannot be protested. A refund or credit for any amounts paid to satisfy the LCUP may be allowed only on the grounds that the amount of the penalty was not properly computed by the FTB. There is no reasonable cause exception; however, the penalty will not be imposed if the understatement is attributable to either of the following:

- A change in law that occurs after the earlier of the date the taxpayer files the return or the extended due date of the return, for the year the change is operative.
- Reasonable reliance on a formal FTB Chief Counsel Ruling.
- A change to the taxpayer's federal accounting method pursuant to IRC Section 446 (relating to general rule of methods of accounting), only to the extent the original due date of the return is before the date of consent to that change. (This exception applies to taxable years beginning on or after January 1, 2015.)
- The imposition of an alternative apportionment or allocation method by the Franchise Tax Board under the authority of R&TC Section 25137. (This exception applies to understatements for any taxable year for which the statute of limitations on assessments had not expired as of September 30, 2015.)

Those subject to this penalty include: Banks, corporations, and any other entity (e.g., S Corporations, partnerships or limited liability companies that elected to be treated as corporations) subject to tax under Part 11 of the R&TC.

EPAL paragraph 53992 should be included on NPAs that meet the LCUP thresholds.

When an amended for more return meeting the LCUP thresholds is received and the case is under audit, the auditor must:

- Contact the taxpayer to provide information regarding the issuance of the LCUP Letter
- Issue LCUP Letter*

*If no response is received within 30 days after the issuance of the letter, contact the taxpayer and request a response. If taxpayer chooses not to respond, contact

**MAP 11
PENALTIES**

TRS for further guidance. Do not initiate billing of the LCUP unless the taxpayer affirmatively requests us to do so.

LCUP Letter Templates

LCUP Procedures Chart

For more information on this penalty, see the Large Corporate Understatement Penalty website.

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