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California's New 20% Underpayment Penalty

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On October 1, 2008, California enacted SBX1 28, which imposes a new penalty of 20% on understatements of corporate taxes in excess of $1 million for tax years beginning on or after January 1, 2003 that remain open under the statute of limitations. The new penalty is imposed in addition to all existing penalties. California taxpayers seeking to avoid the new penalty have until May 31, 2009 to file amended returns for tax years beginning before January 1, 2008. The basics of the new penalty are outlined here.[1]

- An "understatement of tax" is defined as the amount by which the tax imposed by Part 11 exceeds the amount of tax shown on an original return or on an amended return filed on or before the due date of the return for the taxable year
    - Amended returns filed by May 31, 2009, for tax years beginning before January 1, 2008, will be treated as reflecting amounts of tax shown on an original return for this purpose
- The $1 million threshold applies to the aggregate amount of tax liability for all taxpayers required or authorized to be included in a combined report
    - Relief from the new penalty is available only if:
    - The Franchise Tax Board failed to properly compute the penalty
    - 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 year in which the change is operative
        - A "change in law" is defined as a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel issued pursuant to Government Code § 11340.9, or published federal or California court decision
        - The Franchise Tax Board is instructed to implement this provision in a reasonable manner
    - The taxpayer reasonably relied upon a written chief counsel ruling issued pursuant to Revenue and Taxation Code § 21012(a)(1)
- The Franchise Tax Board does not have authority to waive the penalty based upon traditional grounds such as reasonable cause, substantial authority or adequate disclosure
- Taxpayers wishing to avoid the new penalty for tax years beginning on or after January 1, 2003 and before January 1, 2008 should amend their current returns and pay any additional tax due by May 31, 2009 and thereafter submit a timely claim for refund
- Taxpayers wishing to avoid the new penalty for tax years beginning after January 1, 2008 should err on the side of overpayment by filing a conservative original return and paying the tax, followed by an amended return claiming a timely refund

Footnotes

[1] For more information regarding the new penalty and other major income tax provisions of the 2008 budget bills, please see "The Income Tax Provisions of California's Fiscal 2009 Budget Act," by Eric J. Coffill and David A. Ziring, which was published in the October 28, 2008 edition of State Tax Notes. 2008 STT 209-12 (Oct. 28, 2008).