

## California Imposes New 20 Percent Understatement Penalty on Corporate Taxpayers

**Kerne H. O. Matsubara**

On October 1, 2008, Governor Schwarzenegger signed into law Senate Bill No. 28X (“SB 28X”) imposing a new 20 percent understatement penalty (the “Penalty”) under newly added Section 19138 of the California Revenue and Taxation Code. The Penalty applies to corporate taxpayers with an understatement of tax in excess of \$1 million for any taxable year beginning on or after January 1, 2003 for which the statute of limitations on assessment has not expired. A taxpayer can reduce or avoid the Penalty by filing an amended return and paying the tax shown on that return by May 31, 2009.

### Understatement of Tax

For purposes of the Penalty, an “understatement of tax” is defined as the amount by which the California corporation franchise and income tax exceeds the amount of tax shown on an original return or an amended return filed on or before the due date of the return, including extensions, for the taxable year. The amount of the Penalty is equal to 20 percent of the understatement and is in addition to any other penalties. Since the Penalty is based on an understatement, rather than underpayment, of tax for a taxable year, any offsets, credits or overpayments of tax from prior or subsequent taxable years would not appear to reduce or eliminate the Penalty for such year. For combined report filers, the \$1 million understatement threshold applies to the aggregate amount of the understatement for all taxpayers included in the combined report.

### Limited Exceptions

The Senate’s analysis of SB 28X describes the Penalty as “a strict liability penalty, where no reasonable cause exception exists, and contains no allowance for a taxpayer relying on substantial authority.” Revenue and Taxation Code Section 19138 sets forth limited exceptions to the Penalty, as follows:

- **Change in law.** The Penalty does not apply to any understatement that is attributable to a change in law that occurs after the earlier of (i) the date the taxpayer files the return or (ii) the extended due date for the return for the taxable year for which the change is operative. A “change of law” includes a statutory change or an interpretation of law by regulation, rule or court decision.
- **FTB Chief Counsel Ruling.** The Penalty will not be imposed to the extent that a taxpayer’s understatement is attributable to the taxpayer’s reasonable reliance on written advice of the Franchise Tax Board (“FTB”) in the form of a legal ruling by the Chief Counsel.
- **Correction by Amended Return by May 31, 2009.** For purposes of the Penalty, an understatement does not include amounts shown on an amended return filed on or before May 31, 2009 for which the tax is paid by such date. Thus, a taxpayer can reduce or avoid the Penalty by filing an amended return and paying the tax shown on that return by May 31, 2009.

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### Narrow Grounds for Claiming a Refund of the Penalty

Similar to the amnesty penalty procedures under Revenue and Taxation Code Section 19777.5, a claim for refund of the Penalty can be filed only on the basis that the amount of the Penalty was not properly computed by the FTB. In addition, the FTB’s normal protest and collection procedures do not apply to the assessment and collection of the Penalty.

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*Kerne H. O. Matsubara is a tax partner in the San Francisco office of Pillsbury Winthrop Shaw Pittman LLP. This article can also be found as part of the Pillsbury Winthrop Shaw Pittman LLP Tax Page.*

### FTB Guidance Forthcoming

Revenue and Taxation Code Section 19138, which instructs the FTB to implement the Penalty provisions in a “reasonable manner,” leaves many questions unanswered. For example, if the taxpayer and FTB agree that additional tax is owing, is the taxpayer required to file an amended return to pay the undisputed tax? If a taxpayer files an amended return and pays the tax by May 31, 2009 to avoid the Penalty but not to concede the

tax, how should the taxpayer claim a refund of the tax? Must the taxpayer wait until after May 31, 2009 to file an amended return claiming the refund? How should tax payments be made? Will the application of overpayments from other taxable years be allowed? We understand that the FTB currently is drafting guidance to taxpayers regarding the Penalty in the form of “Frequently Asked Questions” that will be posted on the FTB’s website in the coming weeks.

## Bundled or Embedded Applicational Software Is Not Subject to Personal Property Taxation

Richard E. Nielsen

California’s Fourth District Court of Appeal, reversing the trial court and Orange County Assessment Appeals Board (“Appeals Board”), recently held that applicational software is not subject to property taxation even if it comes “bundled” with the computer hardware. At issue were the Pyxis MedStation 2000 systems, leased to hospitals by Cardinal Health 301, Inc. for a single price (“bundled”). The system is a series of stand-up medicine storage cabinets, each called a “MedStation,” with a built-in computer that serves as a medicine tracking system and is programmed with patient and medication information. Pillsbury obtained a total reversal of an earlier unfavorable tax ruling, handling the matter from the administrative appeal hearing, through court trial and before the court of appeal.

Cardinal Health contended that a portion of the bundled lease price was allocable to applicational software, which was not subject to property tax. The company presented information to the Orange County Assessor and the Appeals Board that would have allowed the Assessor to segregate the value of the firm’s nontaxable proprietary application software from the otherwise taxable MedStation units. The Appeals Board noted that Cardinal Health’s software “is not sold or leased separately from the MedStation equipment, and is not priced separately for sale or lease, and does not have any use outside of the MedStation itself. The software is therefore ‘embedded’ or ‘bundled’ in the various MedStation units.” The Appeals Board then noted that the Assessor had “used the cost of the MedStation units as a basis for valuing each unit, with no deduction or

offset for the software embedded in the equipment.” The Appeals Board made its decision assuming that such information was irrelevant. It was strictly on the basis of the “bundling” or “embedding” of the software that the Appeals Board upheld the Assessor’s approach.

Cardinal Health filed a suit for refund of property taxes in the Superior Court. The case was tried on stipulated facts—basically, the administrative record before the Appeals Board. Like the Board, the trial court considered the fact of bundling (or “embedding”) dispositive.

In reversing the trial court, the court of appeal conducted a thorough and lengthy analysis of the relevant statutory and regulatory provisions. The court noted that sections 995 and 995.2 of the Revenue and Taxation Code provide that “application” software, as distinct from “basic operational” software, is not to be valued for purposes of property taxation. Further, the State Board of Equalization has clearly provided, in section 152 of title 18 of the California Code of Regulations—often referred to as “Rule 152”—that taxpayers may demonstrate that a portion of the value of a computer represents nontaxable application software despite the fact that application

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*Richard E. Nielsen is counsel in the San Francisco office of Pillsbury Winthrop Shaw Pittman LLP. This article can also be found as part of the Pillsbury Winthrop Shaw Pittman LLP Tax Page.*

software came “bundled” inside the computer when the customer bought or leased it.

The court of appeal rejected the Assessor’s contention adopted by the Appeals Board and trial court that bundling rendered the application software subject to property taxation. The court of appeal also reviewed in detail the lone appellate decision, *Hahn v. State Board of Equalization*, 73 Cal. App. 4<sup>th</sup> 985 (1999), which the

Assessor, Appeals Board and trial court, misconstrued. The court of appeal reversed the trial court judgment and remanded for further proceedings on the issues of the valuation of the non-BIOS software in the Medstations that is not to be included in each station’s taxable value.

The case is *Cardinal Health 301, Inc. v. County of Orange*, \_\_\_ Cal. App. 4<sup>th</sup> \_\_\_, 2008 WL 4405337 (September 30, 2008).

#### Important Notice to Readers

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