

Understanding the Types of Penalties that States May Impose, Potential Relief and Constitutional Considerations

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I. Introduction

The wide array of penalties that a state may impose on a taxpayer is daunting and growing by the day. States are becoming more and more aggressive in imposing penalties. Alarming, there is a huge increase in strict liability penalties—*i.e.*, penalties being imposed without any showing of bad behavior by the taxpayer.

This outline will discuss some of the types of penalties which a state may impose on a corporation in an income/franchise tax audit, the exceptions and safe harbors thereto and the constitutional limitations which may apply.

While the focus will be on California, the discussion is directly relevant to all states.

II. California Case Study

A. Audit Standards

1. In its Manual of Audit Procedures (“MAP”) Section 1.8, the Franchise Tax Board (“FTB”) advises its auditors to use the following standard in completing audits, called LOTS:
 - LEGALITY – Ensure audit activities and conclusions agree with established laws and legal interpretations.
 - OBJECTIVITY – Examine all relevant, available facts fairly and without bias.
 - TIMELINESS – Conduct and complete audits with a minimum of inconvenience to taxpayers.
 - SUPPORTABILITY – Adequately support recommendations with facts and law.

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To consistently meet our audit standards, you are expected to correctly apply and administer the tax laws in a reasonable, practical, fair, and impartial manner. Conduct audits within the bounds of the law, with sound administration, minimal delay, courtesy, and respect to taxpayers. Also, conduct audits in a manner that is the least burdensome, costly, or intrusive to taxpayers.

2. The FTB cautions its auditors that: “Need to know is the need to see information in order to perform official responsibilities. Always question the need to know if an information request is unusual.” (MAP § 2.2.)
3. “The purpose of the audit is to efficiently determine the correct amount of tax based on an analysis of relevant tax statutes and regulations and case law as applied to the facts of the audit.” (FTB Audit Regulation 19032(a)(1).)
4. In an audit, the FTB staff has the duty to:

“(A) apply and administer the law in a reasonable, practical manner consistent with applicable federal and California law and the Statement of Principles of Tax Administration, which is incorporated by reference. (See Statement of Principles of Tax Administration, at [<http://www.ftb.ca.gov/aboutFTB/MisPrin.shtml>] ...),

“(B) take into account the materiality of an issue being audited as defined in subsection (a)(7) of this regulation,

“(C) make relevant and reasonable information requests for the issues under examination as provided for in Revenue and Taxation Code section 19504:

“(1) The auditor shall explain the relevance or reasonableness of the request when asked to do so,

“(2) Requests for information are relevant if the requested information is

germane to or applicable to the audit issues, and

“(3) The auditor and the taxpayer or the taxpayer’s representative should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the issue under audit.

“(D) timely analyze information received or responses submitted and to request additional relevant information or inform the taxpayer of the potential audit determination.

“(E) apply the relevant statutes and regulations in a consistent manner regardless of whether the determination of the correct amount of tax results in a proposed assessment or proposed overpayment.” (Regulation 19032(a)(4).)

5. The Mission of the FTB is described as follows:

“The purpose of the Franchise Tax Board is to collect the proper amount of tax revenue, and operate other programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.”

6. The FTB’s Statement of Principles of Tax Administration:

“The primary function of the Franchise Tax Board is to administer the Revenue and Taxation Code. Tax policy for raising revenue is determined by elected officials.

“With this in mind, it is the duty of the Franchise Tax Board to carry out that policy by correctly applying the laws enacted by the Legislature; to determine the reasonable meaning of various code provisions in light of the legislative purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

“At the heart of administration is interpretation of the Code. It is the responsibility of each

person in the Franchise Tax Board, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ‘protecting the revenue.’ The revenue is properly protected only when the true meaning of the statute is ascertained and applied.

“The Franchise Tax Board also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised when they have merit, never arbitrarily or for trading purposes. At the same time, employees should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Franchise Tax Board position.

“Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.”

7. The FTB instructs its auditors that “quality customer service” is required:

“We emphasize customer service while ensuring compliance. To ensure quality customer service, the Audit Division stresses the following goals:

- **Value Customer Service** – Be aware of customer service and its application during activities.
- **Be Efficient** – Audit tax year(s) that are more current, shorten audit time, and produce quality audits.
- **Follow up and Meet Deadlines** – Always respond timely to letters, phone calls, *etc.*
- **Minimize Intrusiveness** – Use all available resources to minimize information requests. Be flexible by accepting alternative documents when possible. Apply the law consistently and clearly. Emphasize education and compliance to measure benefits and efficiencies.

- **Value and Apply Professionalism in the Workplace** – Value communication. Respect individuality and ideas. Provide equal opportunities to staff. Continue developing and training staff.

“It is critical to establish a positive relationship with the taxpayer or representative to ensure completion of the audit effectively and on time. To encourage positive working relationships, use the audit standards of Legality, Objectivity, Timeliness, and Supportability (see MAP *Audit Standards*).

“When interacting with the taxpayer and/or representative, ensure that:

- The taxpayer understands the audit’s purpose and our legitimate need for the information requested. Discuss alternative information sources that could be used to satisfy the request.
 - You evaluate the audit data and determine the results in a timely, fair, and impartial manner.
 - You ensure that the audit progresses with a minimum of inconvenience to the taxpayer. This includes obtaining information from third party sources in order to minimize the inconvenience (see MAP *Third Party Contacts*). Auditors should always keep in mind the other available sources of information, which could make an Information/Document Request (IDR) unnecessary.
 - Both the facts and the law support the final audit recommendations.
 - You communicate the results of the audit in writing to the taxpayer, and provide the taxpayer with the opportunity to rebut any findings.” (MAP § 1.1.)
8. California Revenue and Taxation Code (“RTC”) Section 19504.7 sets forth guidelines with respect to the contacts that the FTB may have with third parties in connection with an audit. It provides:

“(a) An officer or employee of the Franchise Tax Board may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of the taxpayer

without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made. The notice shall explain that a request may be made as provided in subdivision (b). A notice shall be valid for any third-party contacts made during the 12 months following the date of the notice. For any third-party contacts made after the expiration of the 12 months, an additional preliminary notice must be provided. This subdivision shall not apply if mail to the same address is returned undeliverable with no forwarding address. The notice shall not be required if the unpaid tax for which notice would otherwise be required under this paragraph is consolidated for collection purposes with a preexisting unpaid tax for which notice has been given under this paragraph with respect to that described preexisting unpaid tax of the person.

“(b) The Franchise Tax Board shall provide, upon request from the taxpayer, a record of persons contacted during that 12-month period by the Franchise Tax Board with respect to the determination or collection of the tax liability of the taxpayer. The taxpayer’s request shall be made no later than 60 days after the 12-month period has expired.

“(c) This section shall not apply:

“(1) To any contact which the taxpayer has authorized.

“(2) If the Franchise Tax Board determines for good cause shown that the notice would jeopardize collection of any tax or the notice may involved reprisal against any person.

“(3) With respect to any pending criminal investigation.

“(d) This section shall be operative for contacts made after 180 days after the effective date of the act adding this section.”

III. Principal Types of Penalties Confronted during Audit

A. Failure to Furnish Information

1. RTC § 19133 provides:

“If any taxpayer fails or refuses to furnish any information requested in writing by the

- Franchise Tax Board or fails or refuses to make and file a return required by this part upon notice and demand by the Franchise Tax Board, then, unless the failure is due to reasonable cause and not willful neglect, the Franchise Tax Board may add a penalty of 25 percent of the amount of tax determined pursuant to Section 19087 or of any deficiency tax assessed by the Franchise Tax Board concerning the assessment of which the information or return was required.”
2. The penalty is limited. It is based on the tax amount for which information was requested.
 3. The penalty is not to be imposed if the failure to furnish information is due to reasonable cause and not willful neglect.
 - a. Reasonable cause has been defined as the “exercise of ordinary business case and prudence.” *United States v. Boyle*, 469 U.S. 241, 250 (1985).
 - b. Reasonable cause may be shown where the requested records and data were not available or were too costly to obtain. *Appeal of BSR USA Ltd.*, 96-SBE-009.
 - c. “If the requested information is not required to be collected or maintained by any U.S. or California record keeping requirement, then there may be reasonable cause for failing to provide the information if the taxpayer can demonstrate that the data does not exist, has been discarded in the normal course of business, or is otherwise not available due to circumstances beyond the control of the entity who had possessed the information.” (FTB Multistate Audit Technique Manual (“MATM”) Section 3535.)
 - d. If the requested information is under the control of an uncooperative foreign parent corporation, a reasonable cause exception may exist. See MATM § 3535.
 - e. Where the FTB changes its position from a prior year’s audit, reasonable cause for failure to furnish information may exist.
 - (i) Auditors are instructed that the interpretation of a taxpayer’s unitary facts should be applied consistently from year to year. A change in position from the prior audit is not a decision that should be taken lightly. (MATM § 3590.)
 4. The failure to furnish penalty only arises after a notice and demand. There are a number of steps that must be taken before a formal demand is made.
 - a. A formal notice and demand to furnish information may be issued upon the taxpayer’s failure to comply with an initial request and second request for any item of information (Regulation 19032(b)(5)(C)3.)
 - b. Before issuing a formal notice and demand, the auditor is instructed to exercise discretion in a reasonable manner that is appropriate under the relevant circumstances related to that particular audit. (Regulation 19032(b)(5)(C)2.)
 - c. In MAP § 11.4, the FTB instructs its auditors as follows:

“Before making a formal demand, examine the relevance of the request. Ask yourself:

 - Is the request reasonable?
 - Have I allowed a reasonable amount of time to gather the requested information:
 - 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?
 - Is the failure to provide the requested information due to reasonable cause? See *MAP Waiver of Failure to Furnish Information Penalty.*”
 5. Fishing expeditions are not allowed.
 - a. RTC § 19504 provides that the FTB “shall have the power to require by demand, that an entity of any kind ... provide information or make available for examination or copying at a specified time and place, or both, any book, paper, or other data which may be relevant to [the purpose of ascertaining the correctness of any return].”
 - b. In *Franchise Tax Board v. Firestone Tire & Rubber Co.*, 87 Cal. App. 3d 878 (1978), a California Court of Appeal confirmed the broad statutory authority granted to the FTB and held that a prohibitory injunction would be issued restraining Firestone from interfering with the FTB’s exercise of its power. *Id.* at 885. The FTB had demanded that Firestone “(1) make available to it for audit examination and investigation all of Firestone’s books, records and documents pertaining to its business operations and those of its subsidiaries during the income years November 1, 1963, through October 31, 1974, and (2) make available to it for examination Firestone’s employees who

have any knowledge of such operations.” Despite the seemingly broad language of the FTB’s request, it should be noted that Firestone never objected on the basis of relevancy or specificity, so the Court had no occasion to specifically address those points.

- c. In *Western Oil and Gas Association v. State Board of Equalization*, 44 Cal. 3^d 208 (1987), the California State Board of Equalization (“SBE”) demanded information from oil companies about their lands and rights of way for purposes of property tax assessment. Western Oil and Gas Association and seven oil companies objected to the information request, but the Court agreed with the SBE that the information was relevant and denied the taxpayers’ appeal. However, in discussing the SBE’s authority to demand taxpayer information, the Court stated that the SBE may compel the disclosure of information only in situations where: (1) its inquiry is authorized; (2) the requests are specific; and (3) the information sought is reasonably relevant to the inquiry. *Id.* at 214.
- d. Two years later in *Union Pacific R.R. Co. v. State Board of Equalization*, 49 Cal. 3^d 138 (1989), the California Supreme Court again had the occasion to consider the ability of the SBE to compel disclosure of certain taxpayer information. In this case, the SBE issued a subpoena seeking Union Pacific’s confidential strategic plan of future acquisitions. The Court held that the SBE was not entitled to Union Pacific’s plan because it was not reasonably relevant to the SBE’s assessment of Union Pacific’s existing property.

The Court stated that it is within the jurisdiction of courts to determine whether “the Board’s inquiry offends the prohibition against unreasonable searches and seizures or violates the right of privacy or privilege against self-incrimination.” *Id.* at 146. The Court then reiterated the three requirements set forth in *Western Oil & Gas* regarding the SBE’s compulsion of the disclosure of taxpayer information. The Court also explained that the “reasonable relevance” requirement is necessary because it is “a requirement that is historically rooted in the Fourth Amendment guaranties against unreasonable searches and seizures.” *Id.* at 147.

- e. In a non-tax case, *Lawyers Title Insurance Corporation v. United States Fidelity & Guaranty Company*, 122 F.R.D. 567 (1988), the plaintiff sought information about the computer system defendant used to store, organize and retrieve data about claims. The plaintiff justified this “broadly framed and intrusive request” on the

ground that it needed the information “in order to facilitate the production of the relevant matter.” *Id.* at 570. The Court disagreed with the plaintiff and held that “[t]he mere possibility that a party might not produce all relevant, unprotected documents, is not sufficient basis for ordering such a party to disclose its entire computerized system of information management. Nor should the possibility that a lawyer could better frame his discovery requests serve as a sufficient predicate for ordering disclosure of proprietary information about a computer system.” *Id.* While this decision did not involve a taxing agency’s request for information, the Court’s analysis and conclusions are consistent with the standards set forth in *Western Oil & Gas* and *Union Pacific*.

- f. In *Pacific-Union Club v. The Superior Court of San Francisco County*, 232 Cal. App. 3^d 60 (1991), the Court denied the FTB’s demand for Pacific-Union Club’s membership list in order to determine whether its members improperly deducted dues paid to a club with discriminatory practices. The Court rejected the FTB’s request and held that “[w]hile mass audits would be the most convenient means of determining whether a club member violated the regulation, the administrative convenience of the state cannot vitiate a constitutional right of privacy.” *Id.* at 79.
- g. In addition to the state authorities discussed above, federal authorities also require that the request be specific and reasonably relevant. In *United States v. Morton Salt Co.*, 338 U.S. 632 (1950), the U.S. Supreme Court noted that there are times when “a governmental investigation into corporate matters may be of such a sweeping nature and so unrelated to the matter properly under inquiry as to exceed the investigatory power.” *Id.* at 652. However, the Court held that the inquiry is permitted “if the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant.” *Id.* The gist of the protection is in the requirement, expressed in terms, that the disclosure sought shall not be unreasonable. *Id.* at 652-653 (quoting *Oklahoma Press Publishing Co. v. Walling*, 327 U.S. 186, 208).
- h. Federal courts have specifically denied discovery requests that they believe are fishing expeditions. See, e.g., *Fennell v. First Step Designs, Ltd.*, 83 F.3^d 526 (1st Cir. 1996) (an order denying electronic discovery affirmed where that discovery would be a “fishing expedition.”)
- i. Any claim that access to the requested information would be more convenient for the taxing authority in conducting its audit would not withstand

judicial scrutiny as the term “relevant” connotes and encompasses more than “convenience.” *United States v. Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973).

B. Failure to File Return

1. RTC § 19131 provides:

“(a) If any taxpayer fails to make and file a return required by this part on or before the due date of the return or the due date as extended by the Franchise Tax Board, then, unless it is shown that the failure is due to reasonable cause and not due to willful neglect, 5 percent of the tax shall be added to the tax for each month or fraction thereof 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 may not exceed 25 percent of the tax.”

- a. Penalty is not to be assessed if an underpayment penalty is being assessed which results in a larger penalty. (MAP § 11.9.)
2. The penalty shall not be imposed if the failure to file the return is due to reasonable cause and not willful neglect.
 - a. “If a taxpayer relies on **improper advice** of an accountant or tax attorney as to a **matter of tax law**, such as whether the taxpayer has a tax liability, failing to file a return in reliance on this advice may be considered reasonable cause if certain conditions are met. (*Rohrbaugh v. United States* (7th Cir. 1979) 611 F.2d 211, as cited in *United States v. Boyle* (1985) 469 U.S. 241, 83 L.Ed. 2d 622.) These conditions include: (1) the person relied on by the taxpayer is a tax professional with competency in the subject tax law, and (2) the tax professional’s advice is based on the taxpayer’s full disclosure of the relevant facts and documents.” (FTB Law Summary-Reasonable Cause (6/27/06).)
 - b. Taxpayer may submit a letter or affidavit under oath explaining reasons for not filing.
3. Common issue which arises in California is whether a particular member of a combined reporting group has nexus with California (under either Public Law 86-272 or the U. S. Constitution) and thus is required to file a return.
 - a. California applies a second level of apportionment (intrastate apportionment) to determine the individual tax liabilities of the taxpayer members of the combined reporting group.

- b. If a member of the combined reporting group has no nexus in California, its income is included in the income of the unitary group and its property, payroll and sales are included in the denominators of the apportionment formula. However, its California property, payroll and sales are not included in the numerators of the apportionment formula.

(i) Query, has it filed a California return?

(ii) If there is a failure to file, is there reasonable cause for not doing so?

C. Failure To Pay Tax

1. RTC § 19132 provides:

“(a)(1) Unless it is shown that the failure is due to reasonable cause and not due to willful neglect, a penalty computed in accordance with paragraph (2) is hereby imposed in the case of failure to pay any of the following:

“(A) The amount shown as tax on any return on or before the date prescribed for payment of that tax determined with regard to any extension of time for payment.

“(B) Any amount in respect of any tax required to be shown on a return which is not so shown including an assessment made pursuant to Section 19051 within 15 days of the date of the notice and demand therefore ...

“(2) The penalty imposed under paragraph (1) shall consist of both of the following:

“(A) Five percent of the total tax unpaid as defined in subdivision (c).

“(B) An amount computed at the rate of 0.5 percent per month of the ‘remaining tax’ as defined in subdivision (d) for each additional month or fraction thereof not to exceed 40 months during which the ‘remaining tax’ is greater than zero.

“(3) The aggregate amount of penalty imposed by this subdivision shall not exceed 25 percent of the total unpaid tax and shall be due and payable upon notice and demand by the Franchise Tax Board

“(b) The penalty prescribed by subdivision (a) shall not be assessed if, for the same taxable year, the sum of any penalties imposed under Section 19131 relating to failure to file return and Section 19133 relating to failure to file return after demand is equal to or greater than the subdivision (a) penalty. In the event the penalty imposed under subdivision (a) is greater than the sum of any penalties imposed under Sections 19131 and 19133, the penalty imposed under subdivision (a) shall be the amount which exceeds the sum of any penalties imposed under Sections 19131 and 19133.”

2. The penalty is not to be imposed if the failure to pay the tax is due to reasonable cause and not willful neglect.

a. “Complexity of the tax law which leads to a delay in computing tax liability, and therefore a delay in paying the tax shown on the return by the due date, is not reasonable cause. (*Appeal of Philip C. and Anne Berolzheimer*, 86-SBE-172, November 19, 1986; *Appeal of Roger W. Sleight*, 83-SBE-244, October 26, 1983.)

“However, if a taxpayer relies on improper substantive advice of an accountant or tax attorney as to a matter of tax law, such as whether the taxpayer has a tax liability, failing to pay the tax shown on the return by the due date **may** be considered reasonable cause if certain conditions are met. (*United States v. Boyle* (1985) 469 U.S. 241, 83 L.Ed. 2^d 622.) These conditions include: (1) the person reasonably relied on by the taxpayer is a tax professional with competency in the subject tax law, and (2) the tax professional’s advice is based on the taxpayer’s full disclosure of the relevant facts and documents.” (FTB Law Summary-Late Payment of Tax Penalty (6/27/06).)

b. “Federal Regulations related to the federal failure to pay tax penalty (Internal Revenue Code section 6651) are instructive. ‘A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship ... if he paid on the due date.’ (Treas. Reg. section 301.6651-1(c)(1).) An ‘undue hardship’ is defined in the federal regulations as, ‘... more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer ... If a market exists,

the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.’ (Treas. Reg. section 1.6161-1(b).)” (FTB Law Summary-Late Payment of Tax Penalty (6/27/06).)

c. “The underpayment penalty will not be assessed if ALL of the following requirements are met:

- An extension of time to file has been granted.
- At least 90 percent of the tax due is timely paid by the original return due date.
- The remainder of the tax due is paid by the extended due date.” (MAP § 11.11.)

D. Accuracy Related Penalty (“ARP”)

1. RTC § 19164 provides:

“(a)(1)(A) An accuracy-related penalty shall be imposed under this part and shall be determined in accordance with Section 6662 of the Internal Revenue Code, relating to imposition of accuracy-related penalty on underpayments, except as otherwise provided.”

- a. California follows IRC § 6662.
- b. 20 percent penalty may be imposed on any portion of an underpayment of tax that should be shown on the return.
- c. Underpayment of tax may be attributable to one or more of the following:
 - (i) Negligence or disregard of rules or regulations.
 - (ii) Substantial understatement of income tax.
 - (A) Amount of understatement of tax exceeds the lesser of
 - (1) 10% of tax required to be shown on return; or
 - (2) \$5,000,000.
 - (iii) Substantial valuation misstatement
 - d. 40 percent penalty may be imposed for gross valuation misstatements.
 - e. Penalty is doubled to 40 percent for amnesty eligible years.
 - (i) Only for tax years before 2003.
 - (ii) Notices of proposed assessment must be issued after March 31, 2005.

- (iii) Understatement of tax caused by one of the following:
 - (A) Negligence or disregard of rules and regulations.
 - (B) Substantial understatement of income tax.
 - (C) Substantial valuation misstatement.
 - (iv) The increased penalty does not apply to understatements related to tax shelter items.
 - (v) The increased penalty does not apply to any understatement that is the subject of a pending audit, protest, appeal, settlement or litigation as of the start of the amnesty period (February 1, 2005).
2. The ARP may be avoided if good faith and reasonable cause exists, there is substantial authority for the taxpayer's treatment of an item in the return or an adequate disclosure of such treatment on the return.
 - a. A taxpayer may file an amended return for the purpose of disclosing treatment of an item on its return, but the taxpayer must have filed the amended return before being contacted by the FTB concerning examination of the taxpayer's original return (FTB Notice 92-12; FTB Notice 92-9).
 - b. Taxpayers subject to IRS Coordinated Examination Program ("CEP") can make disclosure by written statement after the examination has begun (FTB Notice 92-9; FTB Notice 92-12).
 - c. Treasury Regulation 1.6664-4 provides guidance on what constitutes reasonable cause and good faith and whether those standards are met (FTB Tax News, September 2009).
 3. Existing FTB Regulation 19164 provides an exception to the accuracy related penalty for understatements of tax which are attributable to the taxpayer's good faith determination, whether based on the facts or unresolved legal issues, of either (i) the contours of the taxpayer's unitary business(es) or (ii) business vs. nonbusiness income items.
 4. FTB Notice 2004-5
 - a. On August 6, 2004, the FTB announced that accuracy related penalties may be asserted against taxpayers who file original California franchise tax returns inconsistent with the standard allocation and apportionment provisions of RTC §§ 25120-25136 and who have not obtained prior approval from the FTB.
 - (i) Applicable to returns with a due date, determined without extensions, after October 14, 2004.
 - (ii) For returns with a due date before October 15, 2004, a statement attached to the return that adequately disclosed that the taxpayer's return was inconsistent with the standard allocation and apportionment rules, or that the taxpayer had relied on RTC § 25137 will be considered adequate disclosure.
 5. FTB Notice 2006-3
 - a. The FTB announced that, for purposes of applying FTB Notice 2004-5 (see above), a taxpayer that excludes from the sales factor the amount realized on the redemption of marketable securities as part of its treasury function, and includes only the interest income and net gains from such securities, will not be subject to the accuracy related penalty under RTC § 19164.
 - b. The FTB based its position on the California Supreme Court's August 17, 2006 decision in *Microsoft v. FTB*, 39 Cal. 4th 750 (2006) and *Appeal of Pacific Telephone & Telegraph*, 78-SBE-028 (May 4, 1978).
- E. Estimated Tax Penalty
1. RTC § 19142 provides:
 - (a) Except as provided in Sections 19147 and 19148 and subdivision (b), in the case of any underpayment of tax imposed under Part 11 (commencing with Section 23001) there shall be added to the tax for the taxable year an amount determined at the rate established under Section 19521 on the amount of the underpayment for the period of the underpayment ...
 2. No reasonable cause exception exists.
 - a. See however, *Toys "R" Us v. FTB*, Sacramento Superior Court No. 99AS03572 (October 18, 2000) in which a trial court abated an estimated tax penalty based on a finding the taxpayer exercised ordinary business care and prudence.
 3. In California, estimated tax penalty issues arise in the context of a combined report and intrastate apportionment.
 - a. Query, if the contours of a unitary business are adjusted on audit such that an individual taxpayer

member has underpaid its estimated tax, should the penalty arise?

F. Amnesty Penalty

1. In 2004, California enacted SB 1100 which created an FTB amnesty program for corporate and personal income taxes and imposed a 50-percent interest penalty for taxpayers who failed to participate in the amnesty program. (RTC § 19777.5)

- a. For amounts due and payable on or after March 31, 2005 (the last date of the amnesty program), taxpayers are liable for a penalty equal to 50 percent of the applicable interest on the tax amount due.
- b. The amnesty penalty is in addition to any other penalty imposed.
- c. The amnesty penalty cannot be protested or appealed. Taxpayers may file a claim for refund of the penalty paid, but only on the grounds that the FTB did not properly compute the penalty.
- d. This is a strict liability penalty. No reasonable cause exception exists.

2. *General Electric Company v. Franchise Tax Board*, San Francisco Superior Court No. 449157

- a. The taxpayer challenged the validity of the amnesty penalty under RTC § 19777.5 in a declaratory relief action.
- b. It was the taxpayer's position that the amnesty penalty is invalid for a number of reasons and sought a declaration from the Court to that effect.
 - (i) The taxpayer alleged that the amnesty penalty is unconstitutional under the Due Process Clause due to the absence of a plain, speedy and efficient remedy to challenge the merits of the penalty on any and all grounds, either in court or administratively.
 - (ii) The taxpayer alleged that the amnesty penalty is unconstitutional under the Due Process Clause due to its retroactive nature.
 - (iii) The taxpayer alleged that the FTB's interpretation of "due and payable" in RTC § 19777.5 is at odds with RTC § 19049. The taxpayer requested a declaration from the Court, consistent with RTC § 19049, that no amnesty penalty will arise if the taxpayer pays the amount of the assessment on or before it

receives a notice and demand for payment or within 15 days thereafter.

- c. The FTB filed a demurrer to the complaint on the ground that the action was not ripe. The Court sustained the demurrer with leave to amend. On May 10, 2006, the taxpayer filed an amended complaint, to which the FTB filed another demurrer on ripeness grounds. The Court sustained the FTB's demurrer.
- d. On September 15, 2006, the taxpayer filed a notice of appeal. On July 13, 2007, after briefs were filed and while the case was awaiting oral argument, the case settled and the appeal was dismissed.

3. Other cases involving the amnesty penalty

- a. *River Garden Retirement Home v. FTB*, San Francisco Superior Court No. CGC 03467783. On September 24, 2008, the trial court granted the FTB's motion for summary judgment on the amnesty penalty issue. The Court held that even if the plaintiff's interpretation of "due and payable" was correct, payment was not made within 15 days of notice and demand. Case is on appeal.
- b. *Mercury General Corporation v. FTB*. Plaintiff raised the issue whether the amnesty penalty violates the Due Process Clause and statutory interpretation principles regarding the term "due and payable." Since the trial court entered judgment in favor of the plaintiff on the underlying substantive tax issue, the Court did not reach the amnesty penalty issue.
- c. Pending cases in California superior court challenging the validity of the amnesty penalty include *Microsoft Corporation v. FTB*, *Butler v. FTB*, *Gribble et al. v. FTB*, and *Shaw v. FTB*.

G. 20 Percent Understatement Penalty under RTC § 19138

1. In 2009, California imposed a new penalty on corporate taxpayers equal to 20 percent of the understatement of tax if the understatement exceeds \$1 million.
 - a. "Understatement of Tax" – Amount of tax that exceeds the amount of tax shown on an original or amended return filed on or before the original or extended due date of the return for the taxable year.
 - b. In the case of taxpayers filing a combined report, the \$1 million threshold applies to the aggregate

amount of the understatement for all entities in the combined report.

- c. Tax deposits cannot “cure” the understatement.
- 2. The penalty is in addition to any other penalties and applies to taxable years beginning on or after January 1, 2003 for which the statute of limitations on assessment has not expired.
- 3. The penalty will not apply to understatements in the following situations:
 - a. There is a change of law that causes the understatement, where the law change occurs after the date the taxpayer filed the return (or the extended due date for the return, whichever is earlier) for the taxable year for which the change is operative; or
 - b. The understatement is attributable to the taxpayer’s reasonable reliance on a legal ruling by the FTB Chief Counsel.
- 4. RTC § 19138 does not expressly provide for any “reasonable cause” exception and limits the grounds for refund or credit of any penalty paid to computational errors.
 - a. It is a strict liability penalty.
- 5. The California Taxpayers’ Association (Cal-Tax) filed a lawsuit against the FTB in February 2009 to enjoin the enforcement of the penalty. On May 21, 2009, the trial court rejected the challenge to the penalty. Cal-Tax has filed an appeal.
 - a. Similar to the amnesty penalty, the validity of the 20 percent understatement penalty is questionable under the Due Process Clause because of its retroactive application and the absence of a plain, speedy and efficient remedy to challenge the merits of the penalty on any and all grounds, either administratively or in court.

H. Tax Shelter Penalties

- 1. In 2003, California enacted tax shelter legislation that provided for various penalties in connection with the use of tax shelters, including enhanced penalties for noneconomic substance transaction understatements (up to 40 percent) and reportable transaction understatements (up to 30 percent). (AB 614 and AB 1601)

- 2. The 2003 legislation also provided for penalties aimed at tax shelter promoters, advisors and return preparers.
- 3. California enacted subsequent legislation (AB 115) effective beginning in 2005 that conformed to much of the federal tax shelter legislation enacted under the 2004 American Jobs Creation Act, including tax shelter penalties.

IV. Miscellaneous Issues

A. Burden of Proof

- 1. Except for the fraud penalty, the taxpayer has the burden of proving the determination that a penalty should be imposed is erroneous or unjustified.
- 2. In determining whether the reasonable cause exception applies, it is a fact and circumstance analysis. Each case stands on its own.

B. How Are Penalties Imposed?

- 1. RTC § 19036 provides:

“Notwithstanding any provision to the contrary, any ... penalty ... may be assessed and collected in the same manner as if it were a deficiency.”
- 2. Some penalties are included in Notices of Proposed Assessment. As such, they can be contested by filing an administrative protest and appeal, without making payment.
- 3. Other penalties may be imposed following a notice and demand. In this situation, no protest rights exist. A taxpayer can only challenge these by paying the penalty and filing a claim for refund.

C. Interest on Penalties.

- 1. On penalties that are due and payable on notice and demand, rather than on deficiencies, interest is imposed from the date of the notice and demand to the date of payment. (RTC § 19106.)
- 2. On penalties that are assessed as deficiencies, interest is generally imposed from the date of the Notice of Proposed Assessment to the date of payment. (RTC § 19106.)

- a. An exception exists for failure to file a return, failure to pay tax and accuracy related penalties where interest is imposed from the date the return was required to be filed to the date of payment.
- D. Stacking of Penalties
- 1. In certain circumstances, multiple penalties can be imposed.
 - a. See, e.g., RTC § 19138(c). 20 percent understatement penalty is in addition to any other penalty.
- E. Estoppel
- 1. The modern doctrine of equitable estoppel is a descendant of the ancient equity doctrine that “if a representation be made to another who deals upon the faith of it, the former must make the representation good if he knew or bound to know it to be false” *Lentz v. McMahan*, 49 Cal. 3^d 393 (1989).
 - 2. Equitable estoppel may be applied against the government where justice and right require it. *Id.* at 399.
 - 3. Four elements are required for the doctrine of equitable estoppel to be applied.
 - a. The party to be estopped must be apprised of the facts.
 - b. The party to be estopped must intend that its conduct shall be acted upon, or must so act that the party asserting the estoppel had a right to believe it was so intended.
 - c. The party asserting estoppel must be ignorant of the true state of the facts.
 - d. The party asserting estoppel must rely upon the conduct to its injury. *Id.*
 - 4. In general, penalties can be waived to the extent the taxpayer can demonstrate that it reasonably relied upon actions taken by the taxing authority to its detriment. See, e.g., *Market Street Railway Co. v. SBE*, 137 Cal. App. 2^d 87 (1955).
 - 5. RTC § 21012(a)(1) provides that taxes, interest and penalties may be relieved if a person’s failure to make a timely return or a payment was due to the person’s reasonable reliance on the written advice of a legal ruling by the chief counsel of the FTB, provided the conditions in RTC § 21012(b) are satisfied. (FTB Notices 89-277, 2009-8 and 2009-9.)
 - 6. RTC § 21012(a)(2) provides that interest and penalties may be waived if a person’s failure to make a timely return or payment was due to reliance on written advice other than a chief counsel ruling. (FTB Notices 89-277, 2009-8 and 2009-9.)
 - 7. Query, what is the effect of a prior audit?

Important Notice to Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.