



The 20 Percent Understatement Penalty Bad for Business, Worse for the Economy

Background

The 20 percent understatement penalty was enacted into law by SB X1 28 as part of the 2008-09 budget deal. Originally, the budget deal included a provision to increase Personal Income Tax withholding, and the Governor threatened to veto that legislation. In response to the Governor's concerns, the Legislature passed SB X1 28, described inaccurately to lawmakers and to the press as a bill to double existing penalties for tax scofflaws.ⁱ

Major Provisions of SB X1 28

- **New Strict Liability Penalty.** Creates a new, 20 percent strict-liability penalty in addition to all existing penalties.
- **Retroactive.** Took effect December 22, 2008, but applies to tax years beginning January 1, 2003.
- **Application.** Applies to understatements of corporate tax liability in excess of \$1 million.
- **Exceptions.** Subsequent change of law results in underpayment; Taxpayer reliance on written advice of FTB Chief Counsel; and expiration of the statute of limitations.
- **Amnesty Program.** Creates a temporary amnesty program that allows taxpayers to amend returns from 2003-2007 and pay all outstanding tax liabilities by May 31, 2009 to avoid the penalty.
- **Permanent Penalty.** Provides that the 20 percent understatement penalty is permanent.

Unintended Consequences of SB X1 28

- **Unfair Application.** The strict-liability aspect of this penalty makes it applicable to compliant taxpayers and tax cheats alike, with no distinction between the two.ⁱⁱ
- **Diverts Money Away From Capital Investment and Job Creation.** The only way for taxpayers to guard against the 20 percent understatement penalty is to overpay their tax liability every year by millions of dollars – money that instead could be invested into the economy and jobs. Such investment would improve the state's revenue collections in the long term.
- **Impossible Standard.** While the \$1 million threshold for application of the penalty may seem like a large amount of tax understatement, for a taxpayer with a multimillion-dollar tax liability, avoiding the penalty without substantial overpayment is impossible. Ironically, the more taxes a taxpayer pays to the state, the more likely the taxpayer is to be hit with the penalty.ⁱⁱⁱ
- **Catch-22 for Taxpayers.** Because taxpayers must greatly overstate their tax liability to avoid imposition of the 20 percent understatement penalty, taxpayers are caught between avoiding the penalty and filing a return they know to be false. Deliberately overstating tax liability is a violation of law, and taxpayers sign the returns, certifying that they are true and correct under penalty of perjury.

- **Administrative Burden for Taxpayers.** The understatement penalty could result in taxpayers filing returns two or three times. These taxpayers may file an original return with inflated income, and then one or more amended returns to claim refunds to adjust the numbers on the original return to reach accurate tax liability.
- **Substantially Worsens Business Climate and California's Economy.** The 20 percent understatement penalty targets the state's largest job creators and investors by forcing them to take money out of their workforce and capital investment and loan it to the state pending resolution of their refund claims. This is the absolute worst thing for the state to do at a time when it must bolster the economy to create California jobs and attract and increase capital investment.

Solution

Repeal the 20 percent understatement penalty and consider other, more equitable options that do not encourage inaccurate reporting or discourage capital investment in California.

ⁱ The Franchise Tax Board currently has numerous penalties at its disposal to address concerns associated with inaccurate reporting of tax liability. They are:

- **Underpayment of Tax – Rev. & Tax. Code Section 19132.** If a corporation fails to pay the amount of tax owed by the original return due date, an underpayment penalty not to exceed 25 percent of the total unpaid tax is assessed, with some exceptions.
- **Underpayment of Estimated Tax – Rev. & Tax. Code Section 19142.** An interest is imposed on an underpayment of tax if an installment is not paid in the correct amount or is not paid in a timely manner.
- **Accuracy-Related Penalty – Rev. & Tax. Code Section 19164.** A penalty of 20 percent of the underpayment may be imposed on the portion of the underpayment of tax that should be shown on the return, if the taxpayer was negligent or made a substantial understatement of income tax. The penalty increases to 40 percent for years prior to 2003 in which amnesty could have been requested.
- **NEST (Noneconomic Substance Transaction) Penalty – Rev. & Tax. Code Section 19774.** Imposes a state-only penalty of 20 percent of the underpayment for understatements of tax resulting from noneconomic substance transactions. A noneconomic substance transaction is one that lacks economic benefit or which has no bona fide, non-tax California business purpose. The penalty increases to 40 percent for transactions that are not adequately disclosed.

ⁱⁱ **Example:** ABC Corporation has taken a position on its annual tax return that is consistent with the Franchise Tax Board's long-held interpretation of the California Revenue and Taxation Code with respect to that issue. The Franchise Tax Board decides to issue a policy notice that modifies its long-held view. This modification results in an understatement on ABC Corporation's return. There is no change in law, so the taxpayer would be subject to the 20 percent understatement penalty (provided the taxpayer meets the \$1 million threshold), even though it did nothing wrong.

- **Example:** ABC Corporation has taken a position on its annual tax return that is consistent with the long-held IRS interpretation of the Internal Revenue Code with respect to that position. The IRS issues a policy notice that modifies its long-held view. This modification results in an understatement on ABC Corporation's federal return based on the federal policy change. The federal understatement necessitates an adjustment on the California return, which now contains an understatement. There is no change in law, so the taxpayer would be subject to the 20 percent understatement penalty, even though it filed a return that complied with all state laws in effect at the time of filing.
- **Example:** ABC Corporation has just undergone an audit wherein an item of income has been moved from tax year 2006 to tax year 2007. This results in an overpayment in 2006 and an underpayment in 2007 in excess of \$1 million. The 2007 underpayment triggers the 20 percent understatement penalty.

ⁱⁱⁱ **Example:** ABC Corporation is a multinational corporation with billions of dollars in tax liability worldwide. Its California tax liability is approximately \$100,000,000. For ABC Corporation to state tax liability within \$1 million would require 99 percent accuracy.