



September 22, 2008

The Honorable Arnold Schwarzenegger
State Capitol, 1st Floor
Sacramento, CA 95834

RE: Line Item Veto of Section 5, SBX1 28

Dear Governor Schwarzenegger:

The Securities Industry and Financial Markets Association (SIFMA)¹ is writing to express its strong opposition to Section 5 of the budget package, SBX1 28. This provision emerged late last week without appropriate vetting and has dramatic negative consequences for entities doing business in the state.

Section 5 “imposes a new penalty for an understatement of tax for any open taxable year beginning on or after January 1, 2003.” Any understatement of tax of more than one million dollars will be subject to a 20% penalty. The most problematic portion of this penalty is that it is, according to the analysis, “a strict liability penalty.” Corporations must pay the penalty regardless of whether the entities acted in good faith, had reasonable cause to believe that the tax being declared was appropriate, or there was substantial legal authority supporting the taxpayers’ position.

There are many reasons why a taxpayer could have underpaid that are not reflective of bad behavior but will nonetheless trigger this draconian penalty. For example:

- Changes to federal taxable income by the IRS, where there is simply a straightforward disagreement on the treatment of an item, could result in a state penalty, even if the issues are settled at the federal level without penalty.
- While changes in federal statutes and regulations seem to qualify as changes in law, any other changes in federal law do not seem to be covered, including even IRS Revenue Rulings and Revenue Procedures. Thus, reliance upon these rulings and procedures could still result in the payment of state penalties.

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

- Some changes in IRS or FTB audits and/or legal positions that don't fit within the letter of the statutory carve-out would trigger penalties.

Moreover, Section 5 makes no allowances for overpayments in other years. For example, a taxpayer, acting in good faith, could have underpaid one year and overpaid the next. If the IRS or FTB asserts an adjustment that is timing in nature, simply shifting income one year earlier or later would result in the taxpayer being hit with a penalty for the year it has underpaid with no offsetting "credit" for the year it has overpaid.

Taxpayers that want to avoid paying an exorbitant penalty for reasonable interpretations will be forced to intentionally overpay their taxes. While the protective overpayments may ultimately be returned once the year has been audited and issues resolved, this comes with a substantial cost to the taxpayers. To manage these costs, some taxpayers may choose to reduce their employment and capital investment in the state.

We strongly encourage you to strike Section 5 from the bill.

Sincerely,

A handwritten signature in black ink that reads "Kim Chamberlain". The signature is written in a cursive, flowing style.

Kim Chamberlain

Cc: Assembly Speaker Karen Bass
Senate President Don Perata