



March 12, 2009

Ting Lee
Legal Division
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720

RE: Comments on Franchise Tax Board's Draft Second Set of FAQs
Revenue and Taxation Code Section 19138

Dear Mr. Lee:

The Securities Industry and Financial Markets Association (SIFMA)¹ appreciates the opportunity to comment on the FTB's draft second round of FAQs concerning the implementation of Section 19138 of the California Revenue and Taxation Code, commonly known as the 20% understatement penalty.

SIFMA is certainly not the first entity to note the harshness of a 20% strict liability provision for underpayment of taxes. It is hard to believe that corporations will be forced to pay this additional amount regardless of whether they acted in good faith, had reasonable cause to believe that the tax being declared was appropriate, or had a strong legal basis for their position. While SIFMA understands that the FTB does not have the authority to change the law, it does have the authority and, in fact, is expressly directed to "implement this subdivision in a reasonable manner."² SIFMA strongly encourages the FTB to be as reasonable as possible in this implementation phase.

SIFMA's principal concern with the latest FAQs is the very strict protocol applied to taxpayers wishing to make a valid amendment and/or general tax deposit as a means of containing exposure to Section 19138 liability. Taxpayers must file amended returns, "including providing a detailed explanation of any adjustment to taxable income or loss, or credit items, and providing supporting documentation."³ A general tax deposit is expressly insufficient under the FAQs. Indeed, the FTB states, "A blank amended return without an

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 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.

² Rev. & Tax Code Section 19138(f)(3).

³ Large Corporate Understatement Penalty FAQs (2)," Response 23.

explanation of the adjustments or an amended return using an explanation similar to “protective adjustment to avoid R&TC section 19138 penalty” will not satisfy the requirements under R&TC section 19138(b).⁴”

Requiring a detailed explanation of adjustments presupposes a level of accuracy and knowledge that simply doesn’t exist. To avoid liability under Section 19138, taxpayers must, as a practical matter, identify in advance every conceivable area of potential disagreement on both their federal and state filings. They then must make the case for the opposing position by providing supporting documentation for that claim.

A taxpayer who goes to this length even then might not be fully protected. For example, the taxpayer could believe its position is reasonable but ultimately not prevail with the auditors. It could likewise make an honest mistake that is not identified until audit. Moreover, some disagreements might be timing related, resulting in a taxpayer overpaying for one year and underpaying for another. A taxpayer could also end up in the unenviable position of identifying an audit issue but not sufficiently documenting it; it could then face Section 19138 liability notwithstanding its good faith effort to comply with the statutory requirements.

Taxpayers attempting to avoid liability under Section 19138 will have trouble accurately identifying areas of potential disagreement and providing detailed explanations of adjustments for additional reasons. The IRS and the FTB are constantly developing new audit theories and informal policies, many of which are not formally announced and therefore are known only to the IRS and the FTB. Moreover, unforeseen events can result in unanticipated tax deficiencies. For example, FTB Notice 2006-4 withdrew Legal Ruling 376 after the California Court of Appeals determined that California Revenue & Taxation Code section 24402 was unconstitutional.⁵

Furthermore, in some instances, there are no clear cut rules, and audit issues are explicitly to be determined on a case by case basis. After the *Microsoft* decision,⁶ the FTB issued FTB Notice 2006-3 stating, “The determination on whether such receipts should be excluded from the sales factor and whether that exclusion is necessary to provide a fair reflection of a taxpayer’s activities in California will remain subject to possible audit and adjustment, and may be adjusted on a case by case basis.” More recently, the State Board of Equalization reached a decision in *Appeal of Home Depot U.S.A., Inc.*⁷ that stands in stark contrast to the decision in *Microsoft*, reinforcing the fact that such matters may be adjusted on a case by case basis. It is impossible for the taxpayer to accurately plan for and predict these outcomes.

Finally, having taxpayers file an amended return to protect against Section 19138 liability and then immediately file a claim for refund makes little sense. On or before May 31, the

⁴ “Large Corporate Understatement Penalty FAQs (2),” Response 24.

⁵ See *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976; review denied, 2003 Cal. Lexis 6615; cert. denied 540 U.S. 1178 (2004).

⁶ *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750

⁷ *Appeal of Home Depot U.S.A., Inc.*, State Bd. of Equalization, Case No. 298683 (Dec. 16, 2008).

FTB will be facing at least three submissions from larger taxpayers for each of the last six taxable years. This is burdensome and wasteful for both the taxpayer and the FTB.

SIFMA believes that the fairest, most reasonable solution is to permit taxpayers to make tax deposits or lump sum payments as collateral against possible adjustments of liability. In terms of executing a tax deposit or lump sum payment, SIFMA supports the idea put forth by Cal-Tax and others in their December 19, 2008 FTB letter that the Board “place a separate line on original and amended tax returns wherein taxpayers can state an amount in excess of what they believe they owe without overstating actual tax liability.”

SIFMA appreciates the opportunity to provide comments on the FTB’s second round of FAQs. Please do not hesitate to contact me at 212-313-1311 should you have any comments or questions.

Sincerely,

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

Kim Chamberlain
Managing Director & Counsel
State Government Affairs