



FENWICK & WEST LLP

## Tax Alert

February 10, 2005

Ron Schrotenboer

650.335.7207

Bill Colgin

650.335.7944

Michelle Andrighetto

650.335.7996

### **New, Severe California Penalties for Taxable Years Before January 1, 2003**

Could your company owe income or sales and use taxes in California for tax years beginning prior to January 1, 2003? If you have such an amount due on *or after* March 31, 2005, California plans to impose a new penalty measured by a surcharge of 50% of the interest on the tax due. California also plans to increase the accuracy related penalty from 20% to 40% under certain circumstances for pre-January 1, 2003 periods. Moreover, the statute of limitations for pre-2003 periods for sales/use tax that were open on August 6, 2004, has been extended to 10 years. All of this is part of California's "amnesty" program that began February 1, 2005. Unfortunately, taxpayers with legitimate tax disputes could get caught in the new penalty regime.

Although the amnesty program was designed as a vehicle for taxpayers to "come clean" with any outstanding franchise, personal income, or sales and use tax liability for pre-2003 tax periods, the new penalty regime — effective after amnesty ends on March 31, 2005 — applies equally to taxpayers whether or not they believe they have amounts due in pre-2003 periods and whether or not they believe they are eligible for amnesty. That is, the new penalty regime will apply to a taxpayer that, in good faith, does not believe he has anything to report under the amnesty program, but is later assessed a deficiency for pre-2003 periods. Therefore, any taxpayer with a potential deficiency in a pre-2003 taxable year should consider ways to minimize new penalty exposure. Consider the following examples:

- A taxpayer under Federal audit for 2001 (with no California audit) could sign a closing agreement with agreed income tax items on April 20, 2005. The taxpayer would notify California of the increased income. California could impose both the 50% interest penalty surcharge and a 40% accuracy-related penalty, in addition to normal interest and any other penalties.

Avoiding these new penalties may require payment of the anticipated liability prior to March 31, 2005. A refund claim might then be used to protect against any overpayment.

- A taxpayer with a pending California audit or protest could be penalized with the 50% interest surcharge on any amount determined by the FTB for pre-2003 periods.
- A taxpayer is audited for sales/use tax in 2005 for pre-2003 tax periods. The 50% interest penalty surcharge will be automatically applied for any sales/use tax due for pre-2003 periods.

Each situation is different, of course. The bottom line is that taxpayers with fully legitimate tax disputes can fall within the new harsh penalty regimes. Strategic alternatives must be explored immediately. The deadline for taking action to avoid the imposition of penalties is March 31, 2005.

### **How The Amnesty Program Ostensibly Works**

In August of 2004, the State of California enacted the tax amnesty and penalty legislation for tax periods beginning before January 1, 2003. The new tax amnesty program is scheduled to run from February 1, 2005 through March 31, 2005 and covers California corporate franchise, personal income, and sales and use taxes for pre-2003 tax periods. Eligible taxpayers who participate in the amnesty program will not be subject to penalties or criminal prosecution for the nonreporting, nonpayment, or underreporting of any applicable taxes. Taxpayers who are eligible to participate in the program, but fail to do so, could be subject to a 40% accuracy-related penalty (increased from 20%) and sales tax penalties are doubled, plus there is an automatic 50% penalty surcharge on unpaid interest. Amounts paid through the income tax amnesty program are NON-REFUNDABLE, which eliminates a strategy of protective participation in the program. However, refunds can be requested for amounts paid under the sales tax amnesty.

### **The 50% Interest Surcharge**

Section 19777.5(a) of the Revenue and Taxation Code imposes an entirely new interest penalty for income taxes. Section 7074 imposes a new interest penalty for sales/use tax. For amounts due and payable on or after March 31, 2005, §§19777.5(a) and 7074 impose a penalty equal to 50% of any unpaid interest for years in which the taxpayer could have requested amnesty (*i.e.*, years before 2003). The penalty applies to the interest for the period beginning on the last date prescribed by law for the payment of the tax through March 31, 2005 (the last day of the amnesty program). Unlike the increased accuracy-related penalty discussed below, there does not appear to be an exception for understatements that are the subject of an audit, protest, appeal, settlement, or litigation at the start of the amnesty program. That is, the interest penalty surcharge is automatic if there is any tax owed after March 31, 2005 for pre-2003 periods.

Although this surcharge is calculated on the basis of interest due, it is characterized as a “penalty.” Therefore, it would not be characterized as deductible interest for income tax purposes.

### **The 40% Accuracy-Related Penalty**

Although the new law eliminates the accuracy-related penalty for taxpayers that participate in the amnesty, it increases that penalty for those that do not. Specifically, in the case of a proposed deficiency assessment issued after March 31, 2005, for any taxable year beginning prior to January 1, 2003, the accuracy-related penalty of §19164 will increase from 20% to 40%. Unlike the automatic interest penalty surcharge, the increased accuracy penalty only applies when the basic requirements of §19164 are satisfied (*e.g.*, negligence, lack of substantial authority).

The increased penalty does not apply to understatements related to tax shelter items. The increased penalty also does not apply to any income tax understatement that is the subject of an audit, protest, appeal, settlement, or litigation as of February 1, 2005 (the start of the amnesty period). The increased penalty, however, will apply for sales tax due for pre-2003 periods, even if those periods are currently under audit.

### **Who is Eligible to Participate in Amnesty?**

California individual and business taxpayers are eligible for amnesty for taxable years beginning before January 1, 2003, if they did any of the following:

- 1) Did not file the required California tax returns;
- 2) Underreported income on a previously filed tax return;
- 3) Claimed excessive deductions; or
- 4) Did not pay previously assessed taxes, interest, penalties, or fees.

Taxpayers that are currently under criminal investigation or prosecution on tax-related matters are not permitted to request amnesty. In addition, “abusive tax shelter transactions” that were eligible for relief under California’s Voluntary Compliance Initiative or the 2003 IRS Offshore Voluntary Compliance Initiative are not eligible for amnesty. However, a taxpayer that participated in an “abusive tax shelter transaction” will be eligible for amnesty for non-abusive tax shelter items.

### **How Does One Request Amnesty?**

To participate in the program, a taxpayer must:

- 1) file an amnesty application during the program period (*i.e.*, between 2/1/05 and 3/31/05);
- 2) file any missing or amended income tax returns by 5/31/05; and
- 3) pay in full any outstanding tax liabilities and interest for all periods for which amnesty is requested by 5/31/05, or set up an installment agreement that will fully pay the amnesty years liability by June 30, 2006.

More information on how to participate in the program is available on these websites — [FTB Franchise and Income Tax Amnesty Website](#) — [SBE Sales and Use Tax Amnesty Website](#).

### **Considerations for Participating in Amnesty**

Taxpayers should review all pre-2003 open years. For California income and franchise tax, a year should be considered open if a federal extension of the statute of limitations is executed and outstanding for that year.

If a pre-2003 year item is obviously incorrect, amnesty should be considered. For example, if a federal audit is in

process and adjustments have been agreed to for federal purposes for some items, the equivalent California franchise tax adjustment may be appropriate for amnesty. Because the change has been agreed to for federal purposes, giving up the ability to claim a California refund on the item is not likely to be important.

If a pre-2003 year franchise tax item may be found ultimately to be incorrect, paying the tax and interest outside of amnesty prior to March 31, 2005, and filing a claim for refund should be considered. Penalties (if applicable) are not waived, but the ability to contest the issue is not given up. By paying before March 31, 2005, there is no amount due on which the penalty interest surcharge applies.

As one can see, there is no easy solution that can apply to all taxpayer circumstances.

Various groups are working to have changes made to the Amnesty Statute to eliminate the automatic penalties. However, there is no certainty what, if any, changes will be enacted prior to March 31, 2005.

Please contact:

Ron Schrottenboer,  
[rschrottenboer@fenwick.com](mailto:rschrottenboer@fenwick.com), 650-335-7207

Bill Colgin,  
[wcolgin@fenwick.com](mailto:wcolgin@fenwick.com), 650-335-79444

Michelle Andrighetto  
[mandrighetto@fenwick.com](mailto:mandrighetto@fenwick.com), 650-335-7996

© 2005 Fenwick & West LLP. All Rights Reserved.

THIS UPDATE IS INTENDED BY FENWICK & WEST LLP TO SUMMARIZE RECENT DEVELOPMENTS IN THE LAW. IT IS NOT INTENDED, AND SHOULD NOT BE REGARDED, AS LEGAL ADVICE. READERS WHO HAVE PARTICULAR QUESTIONS ABOUT THESE ISSUES SHOULD SEEK ADVICE OF COUNSEL.