

# State tax attribute utilization in a recessionary economy

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While the significance of federal tax attributes often outweighs that of state tax attributes, companies struggling to maintain cash flow and preserve cash-on-hand cannot ignore the state tax issues associated with the tax attributes in play.



# Introduction

To say that in the last year the U.S. has experienced a downturn in the economy would be an understatement. Significant decreases in housing values and stock prices have led to a comparable decrease in consumer spending. When coupled with the impact of the increased number of layoffs within the American workforce, many sectors of the economy will struggle to be profitable, including financial institutions, retailers, and consumer and industrial products companies. The declining U.S. economy has rapidly changed the character of transactions undertaken by corporate groups. An environment that had been dominated by significant merger and acquisition (M&A) activity has been transformed into an atmosphere in which there are, or are likely to be, a large number of reorganizations or liquidations driven, in part, by the bankruptcy process. This, in turn, has led to an increased focus by corporations on monetizing certain tax attributes under the Internal Revenue Code (IRC), such as net operating losses (NOLs), capital losses, stock basis, and uncollectible debts and receivables. Companies struggling in this economically challenging environment will need to examine tax issues involving large dollar amounts and significant technical risk.

In the context of this economy, the determination and utilization of tax attributes will take on increased importance in the tax planning process. As such, companies will need to analyze and address the following questions:

- What is the tax basis of a stock or security that may now be worthless?
- What losses can be carried back?
- For companies undergoing an ownership change as a result of acquisition, disposition, or bankruptcy, what attributes survive and to what extent can they be utilized?

While, in the federal context, these questions can be complex to answer, the state income tax consequences raise an added level of uncertainty, which increases when unitary concepts, state group reporting rules, and apportionment implications are added to the analysis. The following discussion explores the key federal tax issues that companies in this economy will need to analyze, and then explains how various states adopt, decouple from, and/or interpret the general federal tax concepts that govern these issues.

# Key federal tax attributes at issue

A recessionary economy is likely to affect corporations well after the economy recovers. For example, many corporations may be forced to make significant changes during the downturn that may result in ownership changes that may, in turn, impact the use of federal tax attributes in future years. Attributes that potentially may be impacted include NOLs, capital losses, and stock basis. Built-in losses also may be adversely affected following an ownership change. Finally, as the value of a corporation's assets declines, questions come into play regarding whether the stock of a subsidiary becomes worthless or debt becomes uncollectible, and if so, whether a deduction may be available for these items.

## Net operating losses

The IRC provides for the computation of NOLs when deductions exceed income in a given tax year.<sup>1</sup> In general, under federal rules, NOLs generated in a given year can be carried either forward or back, subject to certain statutory limitations.<sup>2</sup>

## Capital losses

For corporate income tax purposes, a "net capital loss" means the excess of all losses from sales or exchanges of capital assets over the sum of gains from sales or exchanges of capital assets during the tax year.<sup>3</sup> In general, under the IRC, a net capital loss can be carried back three years and forward five.<sup>4</sup>

## Stock basis

Generally, when an entity, or a group of entities, is acquired by purchase (or, in some cases, acquisitive reorganizations), the basis of the acquired stock equals its cost (or the cost of the consideration used in an acquisitive reorganization).<sup>5</sup> In general, if a security such as stock becomes worthless during a tax year, the event is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset.<sup>6</sup> Securities in a domestic affiliated corporation, however, are not treated as capital assets.<sup>7</sup> Therefore, losses on such domestic entities are often treated as ordinary losses.

## Notes and other receivables

The IRC allows a deduction for debts that become worthless during a tax year.<sup>8</sup> Whether a debt has become worthless is a factual matter generally centering on whether the debt is, in fact, collectible.<sup>9</sup> In general, the basis of a debt instrument is the cost of such property.<sup>10</sup>

## Tax attributes and financial reporting

The ability of a taxpayer to use NOLs or capital losses, or the availability of deductions for worthless stock or bad debts, all can impact the taxpayer's calculation of the tax provision. Specifically, Financial Accounting Standards Board Statement No. 109, Accounting for Income Taxes (SFAS 109), requires separate calculations of a current deferred tax expense for each taxpaying component of an enterprise in each tax jurisdiction (federal, state, local, and foreign).<sup>11</sup> Therefore, to accurately compute financial statement tax expense in each tax jurisdiction, an enterprise should separately identify changes in deferred tax assets and liabilities for each jurisdiction in which it operates.<sup>12</sup>

A deferred tax asset is recognized for operating losses, and is measured using the enacted tax rate in the jurisdiction for the tax year in which the benefit is expected to be realized. Management's expectations regarding how, when, or to what extent NOL carryforwards or carrybacks will be used potentially will impact both the measurement of deferred tax assets and tax expense.

Further, in determining whether tax attributes such as tax losses can be recognized for financial statement purposes, a taxpayer must determine, on a "more likely than not" basis, that the tax position will be sustained.<sup>13</sup>

# Overview of federal tax attribute limitation rules

Tax attributes are the tax characteristics of a given taxpayer. A taxpayer's tax attributes can include its accounting method, its earnings and profits, NOLs, capital losses, tax credits, and its basis in certain assets.<sup>14</sup> Under federal tax law, however, there are limitations on the use of such attributes in certain circumstances. The following discussion addresses some of those limitations.

## Federal NOL and capital loss carryforward and carryback rules

For large corporate taxpayers, a federal NOL can be carried back two tax years and forward 20.<sup>15</sup> A taxpayer may elect to relinquish the entire carryback period for an NOL pertaining to any tax year. Once made, however, such an election is irrevocable for that tax year.<sup>16</sup>

As noted above, corporate taxpayers generally may carry capital losses back three years and forward five.<sup>17</sup> A capital loss may be carried back only to the extent: (1) such loss is not attributable to a foreign expropriation capital loss; and (2) the carryback of such loss does not increase or produce an NOL (as defined in IRC Section 172(c)) for the tax year to which it is carried back.<sup>18</sup>

## IRC Section 382 limitation rules

IRC Section 382 applies loss reduction rules when there is an ownership change in an acquired corporation. The key to the application of Section 382 is: what constitutes an ownership change in a "loss corporation." An ownership change is deemed to occur if, immediately after any owner shift involving a 5 percent shareholder or any "equity structure shift," (1) the percentage of the stock of the loss corporation owned by one or more 5 percent shareholders has increased by more than 50 percentage points over (2) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.<sup>19</sup> For this purpose, the testing period is the three-year period ending on the day the 5 percent-shareholder owner shift or "equity structure shift" occurs.<sup>20</sup> Generally, (1) a 5 percent-shareholder owner shift is a change in the respective ownership of the corporation's stock that affects the percentage of stock owned by any person who is a 5 percent shareholder before or after such change, and (2) an "equity structure shift" is a reorganization within the meaning of IRC Section 368.<sup>21</sup>

If an ownership change has occurred, IRC Section 382 limits the amount of a new loss corporation's<sup>22</sup> income for a post-change year that can be offset by pre-change losses (often called the Section 382 "limitation amount"). Specifically, the limitation amount is the product of (1) the fair market value of the old loss corporation at the time of the ownership change and (2) the federal long-term tax-exempt rate.<sup>23</sup>

### Built-in gain and built-in loss rules

When, for purposes of IRC Section 382, an ownership change has occurred, preacquisition losses generally may not offset built-in gains recognized on the sale or other disposition of an asset during the five-year period after the ownership change.<sup>24</sup>

A "net unrealized built-in gain" (NUBIG) is the amount by which, at the time of the ownership change, the fair market value of the assets of the corporation experiencing the ownership change exceeds the aggregate adjusted tax basis of those assets.<sup>25</sup> Conversely, a "net unrealized built-in loss" (NUBIL) exists when, at the time of the ownership change, the fair market value of the assets of the corporation experiencing an ownership change is less than the aggregate adjusted tax basis of those assets.<sup>26</sup> These rules, by their terms, require that a determination of the "fair market value" of certain assets be made at the date of the "ownership change" transaction.

### Determining the tax basis of worthless stock

In general, in order to obtain a deduction under IRC Section 165(g) for a worthless security, the taxpayer has the burden of showing that the security: (1) had a tax basis; (2) was not worthless prior to the year in which loss is claimed; and (3) was worthless in the year claimed. IRC Section 165(b) provides: "For purposes of [claiming a loss under] subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property."

Accordingly, the loss deductible under IRC Section 165(g) is limited to the taxpayer's basis in the security. The burden is on the taxpayer to establish the basis. If the taxpayer fails to meet that burden, the basis is deemed to be zero (or such other amount asserted by the IRS) and the deduction is denied (or limited).<sup>27</sup>

### Determining the security's date of worthlessness

Further, the deduction for a worthless security is available only in the year the worthlessness occurs. Thus, the taxpayer must also establish that the stock did not become worthless in a prior year and that it had some value at the beginning of the year in which the deduction is claimed.<sup>28</sup>

In *Avery v. C.I.R.*,<sup>29</sup> the federal Court of Appeals for the Fifth Circuit justified this requirement, stating: "A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their worthlessness. To do so would enable him to withhold deductions in his less prosperous years, when they would have little effect in reducing his

taxes, and then to apply the accumulation at another time to the detriment of the fisc. This would defeat the intent and purpose of the law.”

If the taxpayer fails to carry the burden of proof, the security is presumed worthless in a prior year, and the deduction for the year claimed will be lost. Further, the statute of limitations might have already run on the prior year, thus negating any chance for an IRC Section 165(g) deduction in that prior year.<sup>30</sup>

### Determining the basis of debt

As noted above, the IRC allows a deduction for any debt that becomes worthless during a tax year.<sup>31</sup> Whether a debt has become worthless is a factual matter generally centering on whether the debt is, in fact, collectible.<sup>32</sup> Neither the IRS nor the courts, however, have defined “worthlessness.” Instead, case law has demonstrated that taxpayers must base their claims on the existence of factual evidence established at the time the deduction is claimed.

### Determining the debt's date of worthlessness

Generically, “worthlessness” may be defined as a lack of current value.<sup>33</sup> Therefore, in claiming a bad debt deduction, one must investigate whether there is evidence that a debt is worthless, and if so, the period in which the debt became worthless.

In determining whether a debt is worthless, Treasury Regulations provide that all the pertinent evidence must be considered including:

- The financial condition of the debtor.
- The value of the collateral securing the debt.
- The probable effectiveness of legal action to enforce collection.<sup>34</sup>

Courts have ruled that worthlessness is determined by an objective standard<sup>35</sup> and have identified several other factors that can indicate worthlessness.<sup>36</sup>

### Cancellation of indebtedness income

The corollary to the write-off of a bad debt is the potential inclusion of income by the creditor.<sup>37</sup> This is typically referred to as cancellation of indebtedness (COD) income. When debt restructurings occur, or alternatively, when related parties cancel intercompany notes, issues surrounding potential income inclusion often come into play. For federal purposes, the general rule is inclusion of such COD income in federal taxable income<sup>38</sup> unless, within a related party group, federal consolidated rules are implicated.<sup>39</sup>

### Insolvency exclusion

For federal purposes, gross income does not include any amount that would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge

occurs when the taxpayer is “insolvent.”<sup>40</sup> In this context, “insolvent” means the excess of liabilities over the fair market value of assets.<sup>41</sup>

If a taxpayer is allowed to exclude discharge of indebtedness income from gross income under IRC Section 108(a)(1)(A), (B), or (C), the amount excluded is applied to reduce, in the following order, the following tax attributes of the taxpayer:

- 1 **NOLs:** Any NOL for the tax year of the discharge, and any NOL carryover to that year.
- 2 **General business credit:** Any carryover to or from the tax year of the discharge for purposes of determining the credit allowable under IRC Section 38.
- 3 **Minimum tax credits:** The amount of the alternative minimum tax credit available under IRC Section 53(b) as of the beginning of the tax year immediately following the tax year of the discharge.
- 4 **Capital loss carryovers:** Any net capital loss for the tax year of the discharge, and any capital loss carryover to such year under IRC Section 1212.
- 5 **Basis of property:** Basis reduction of the taxpayer’s property pursuant to IRC Section 1017.
- 6 **Passive activity loss and credit carryovers:** Any passive activity loss or credit carryover of the taxpayer under IRC Section 469(b) from the tax year of the discharge.
- 7 **Foreign tax credit carryovers:** Any carryover to or from the tax year of the discharge for purposes of determining the credit allowable under IRC Section 27.<sup>42</sup>

In addition, this attribute reduction scheme is subject to an election that a taxpayer can make to reduce, first, the basis of depreciable assets.<sup>43</sup> Accordingly, decisions regarding the election require a careful analysis of which attribute reduction order is most beneficial to the taxpayer. (IRC Section 108(i) (added by the American Recovery and Reinvestment Act of 2009; P.L. 111-5, 2/17/09; the “Recovery Act”) permits cancellation of debt income that would otherwise be recognized during 2009 and 2010 to be deferred. This new provision allows such deferred income to be recognized over five years beginning in 2014. Many states likely will decouple from IRC Section 108(i) largely as a revenue raising measure.)

#### Deductions for interest accrued between related parties

One significant reason for the federal tax law allowing a bad debt deduction is to provide tax relief to taxpayers who have reported as income items that they have failed to receive or collect.<sup>44</sup> Accordingly, as a general premise, a taxpayer that has not included an accrued receivable in income has no income tax basis in the receivable (assuming the receivable was not purchased).

## State income tax attribute limitation rules

The determination of federal tax attributes, and the application of the related complicated limitation provisions, can be particularly challenging for taxpayers. When these rules are translated into the state income tax context, more complication and uncertainty result. State NOL and capital loss rules are particularly distinct from the federal rules, and many states are not clear with respect to the effect of the IRC Section 382 limitation. Further, special basis problems can develop, particularly in the area of determining a parent's basis in its subsidiary's stock, and in dealing with the consequences that may arise from cancellation of indebtedness income.

### State NOL carryback/forward rules and moratoriums

State NOL carryback and carryforward rules differ from the federal two-year carryback and 20-year carryforward. In general, most states do not allow NOL carrybacks.<sup>45</sup> A few states allow a two-year NOL carryback<sup>46</sup> and three others provide for a three-year carryback.<sup>47</sup> While many states that impose a corporate income tax adopt the federal 20-year carryforward period, a significant number of states decouple and, instead, either provide shorter carryforward periods or do not allow carryforwards at all.<sup>48</sup>

### Examples of state NOL moratoriums

Historically, as a revenue conservation measure, states have often imposed moratoriums on the use of NOL deductions. For example, California suspended the use of NOL deductions in tax years beginning after 2001 and before 2004, and again in tax years beginning after 2007 and before 2010.<sup>49</sup> In New Jersey, for privilege periods beginning in 2002 and 2003, taxpayers were not allowed to deduct NOLs. Further, the corporation business tax application of NOLs was limited to 50 percent of taxable income for tax years 2004 and 2005.<sup>50</sup>

### Unique state capital loss issues

The use of capital losses for state income tax purposes can vary significantly from the federal rules. When recognizing and deducting capital losses for state income tax purposes, the following issues commonly come into play: (1) whether the use of a capital loss for federal income tax purposes can be included in the computation of the tax base for state income tax purposes; (2) the determination of the amount of the loss (the asset giving rise to the capital loss can have different bases for state and federal purposes); (3) decoupling from the federal capital loss netting rules; (4) differing carryforward and

carryback periods; (5) group reporting/use issues; and (6) for apportionment purposes, unique rules for the sourcing of the loss (including the determination of whether the capital loss constitutes business or nonbusiness income).<sup>51</sup>

As an illustration of some of these rules, consider that in determining taxable income for Florida purposes, a subtraction is allowed for a capital loss claimed in computing federal taxable income.<sup>52</sup> In Utah, capital losses must be adjusted for any difference between an asset's bases for federal and state purposes.<sup>53</sup> Arkansas generally adopts the federal capital gain and loss provisions but the statute expressly provides that they do not apply to C corporations.<sup>54</sup> Minnesota provides a modified deduction for capital losses claimed under the federal rules.<sup>55</sup> Hawaii generally limits the carryforward of capital losses to five years.<sup>56</sup> Tennessee and Montana decouple from the federal rules in that, in computing income for state purposes, they require capital losses to be deducted in the year incurred, rather than carried back or forward.<sup>57</sup> Idaho requires a corporation to add back federal deductions for capital losses if the loss was incurred during a tax year in which the corporation did not transact business in the state (or the taxpayer was not part of a unitary group with at least one Idaho-taxable member in that year).<sup>58</sup>

In addition, states have apportionment rules that may affect the use of capital losses. For example, Arkansas allocates capital losses from the sale of tangible personal property based on the location of the asset at the date of sale or the taxpayer's state of commercial domicile.<sup>59</sup>

While the above rules are by no means an exhaustive list of all the state nuances applicable to capital losses, these examples provide an indication of the variety of state treatments that may come into play when considering the effects of capital losses.

### State attribute limitations based on IRC Section 382

In addition to the nonconformity between federal and state NOL provisions, states do not uniformly adhere to the federal limitations contained in IRC Section 382. Rather, some states expressly conform to the provisions of Section 382, other states impliedly conform to these provisions, while still others either significantly depart from these provisions or completely disregard the IRC Section 382 limitation and provide their own set of limitations. When determining whether a state NOL limitation based on Section 382 exists, several issues must be addressed, specifically: (1) has there been an ownership change for state tax purposes; (2) to what extent does the state decouple from IRC sections impacting the Section 382 analysis; and (3) does the IRC Section 382 limitation have to be apportioned.<sup>60</sup>

### Determining a change of ownership for state purposes

As described above, for federal purposes an ownership change is deemed to occur when a 5 percent-shareholder shift or an equity structure shift occurs at any time during the testing period.<sup>61</sup> For state income tax purposes, however, in a separate-entity reporting context, the location within the organizational structure in which the "ownership shift" is deemed to occur may be critical. In a tiered corporate ownership structure that has to report on a separate-company basis, the identity of the "shareholder" may be (1) the direct owner of the reporting entity in question (in which the NOL resides), or, alternatively, (2) the ultimate owner, perhaps several tiers up the corporate ladder. For

some separate entity reporting states, resolving the proper identity of the shareholder may determine whether an ownership change has, in fact, occurred, and then whether any IRC Section 382 limitations exist.

### State application of common law limitations

In states that have not explicitly or implicitly adopted IRC Section 382, additional common law limitations may apply after an acquisition. These limitations generally are based on the Libson Shops doctrine, under which the pre-merger NOLs of one business cannot be used to offset the post-merger gains of the successor's business unless there is a continuity of business interest.<sup>62</sup> Libson Shops was decided prior to the enactment of IRC Section 382, and the legislative history surrounding IRC Section 382 acted to repudiate the Libson Shops doctrine for federal purposes. Still, some states have retained some of the concepts embedded in Libson Shops. For example, following certain changes in corporate ownership, New Jersey imposes NOL limitations based on whether the trade or business carried on prior to such ownership change is continued after the change.<sup>63</sup> In addition, some states subscribe to other common law concepts. For example:

- Some states adhere to the concept of an “economic loss,” meaning if a taxpayer seeks to use a state loss through a carryback or carryforward, the taxpayer must offset the amount carried back or forward with any economic income, even if that income is excluded from the state's tax base.<sup>64</sup>
- In certain states, NOL carryforwards or carrybacks can be used to offset only the portion of the state tax base consisting of federal taxable income, and not additions to the tax base caused by state-specific modifications.<sup>65</sup>
- Where a state-specific deduction pushed a taxpayer into an NOL position, the state may limit an NOL carryback to the NOL computed in accordance with federal income tax provisions.<sup>66</sup>

### Does the IRC Section 382 amount need to be apportioned?

As discussed above, IRC Section 382 provides a “limitation” that determines the pre-ownership-change NOL that can be used to offset post-change income. In addition to conformity, a major issue to resolve after determining that an ownership change has occurred in a state is to ascertain whether the annual limitation amount imposed by IRC Section 382 is apportioned among states for purposes of determining the state NOLs that can be used after the ownership change. If the IRC limitation amount is not apportioned, arguably, the full amount could be used without apportionment to determine how much of the pre-change state NOLs can be used in a given year.

As noted above, the IRC Section 382 limitation is (1) the value of the old loss corporation's stock at the time of the ownership change, multiplied by (2) the federal long-term tax-exempt rate.<sup>67</sup> Since apportionment is not a federal tax concept, the federal statutes do not provide for any type of additional calculation that would require state apportionment, or apportionment of any type or form. Rather, IRC Section 382 takes a single-entity approach and imposes a corporate-wide limitation based on the value of the corporation as a whole.<sup>68</sup> For purposes of state corporate income tax, few states provide explicit rules authorizing or requiring apportionment or other state-specific adjustment of the IRC Section 382 limitation.

One state that does provide such guidance is Pennsylvania, which does not allow the federal NOL deduction to be considered in computing the state's corporate net income (CNI) tax base.<sup>69</sup> Instead, Pennsylvania provides for a net loss deduction, which differs from the federal NOL deduction through the application of different carryover and carryback years, a limitation on the prior year's loss that can be applied, and the exclusion of capital losses from the state's net loss calculation.<sup>70</sup>

Nevertheless, although Pennsylvania does not conform to the federal NOL deduction, the state does reference concepts contained in IRC Sections 381 and 382 relating to NOL limitations in certain situations. Specifically, Pennsylvania law provides that in a change in ownership by purchase, liquidation, stock acquisition, or reorganization of a corporation in the manner described in Section 381 or 382, the NOL limitations provided in the IRC apply for purposes of computing the portion of the net loss carryover recognized by Pennsylvania when calculating the CNI tax.<sup>71</sup> Further, if a corporation that is a party to the merger or acquisition filed a consolidated return for federal purposes, the Pennsylvania net loss carryover is determined as if a separate federal return had been filed.<sup>72</sup> For Pennsylvania purposes, the portion of the IRC Section 382 loss limitation to be applied to the net loss deduction is determined by multiplying the loss limitation by the CNI apportionment percentage for the period immediately prior to the change of ownership.<sup>73</sup>

Accordingly, in states that specifically conform to IRC Section 382 without requiring apportionment of the IRC Section 382 limitation, there may be a strong position not to apportion that limitation in those states, based on a plain reading of the state tax statute. A state taxing authority may take the position that apportionment is required, based on the argument that since the NOL is being apportioned, the limitation should be apportioned as well, to allow for an "apples-to-apples" comparison.<sup>74</sup> Absent a state statutory or regulatory mandate, however, the need to apportion the IRC Section 382 limitation for purposes of determining the portion of legacy NOLs that can be used in a given state, after the change date, may be without support because there would be no legal or mechanical basis regarding how the federal limitation should be apportioned for purposes of reporting in that state.

### State issues impacting stock basis

In a consolidated return context, disconnects can arise for federal and state income tax purposes regarding the calculation of a parent's basis in the stock of a subsidiary. Under federal consolidated return rules, the investment adjustment rules modify the determination of basis between a parent and a subsidiary to reflect the impact of distributions, income, gain, deduction, and loss taken while the subsidiary is a member of the consolidated group.<sup>75</sup> In contrast, states do not always follow the federal consolidated rules; certain states do not require combined or consolidated reporting, while other states specifically do not adopt the federal consolidated investment adjustment rules.<sup>76</sup>

### California's deferred intercompany stock account disclosures

California has unique stock basis rules and requirements for the disclosure of certain stock basis issues. In this context, the California Franchise Tax Board (FTB) has issued a notice to remind corporate taxpayers of the state's disclosure requirements pertaining to "deferred intercompany stock account" (DISA) transactions and to advise taxpayers that a form has been issued to facilitate the disclosure requirement.<sup>77</sup>

In general, California law provides that dividends and other distributions between members of a unitary combined reporting group that are paid from (or deemed paid from) income that was included in the recipient's California unitary reporting group are eliminated for all tax purposes.<sup>78</sup>

For tax years beginning after 2000, the FTB promulgated regulations that provide guidance with respect to the tax treatment of intercompany transactions between members of the same unitary combined reporting group.<sup>79</sup> These regulations contain provisions dealing with distributions between unitary combined reporting group members. Specifically, the regulations provide: "DISA is the accounting mechanism that a distributee corporation, which is a member of the combined reporting group, will use to report and track non-dividend distributions in excess of its adjusted basis of the stock of the distributing subsidiary corporation, which is a member of the same combined reporting group, until this intercompany item is required to be taken into account pursuant to this regulation. The balance of each DISA account must be disclosed annually on the taxpayer's return."<sup>80</sup>

If a taxpayer fails to disclose any DISA balance on its annual tax return, the FTB may, at its discretion, require the amounts in the undisclosed DISA accounts to be taken into account, in whole or in part, in any year of such failure.<sup>81</sup>

#### State cancellation of indebtedness income issues

When the cancellation of indebtedness income rules are triggered for federal purposes in situations when the creditor is insolvent, how do states conform to the income exclusion and federal attribute reduction rules? States typically conform to the actual exclusion of income but take widely differing approaches on attribute reduction.

For example, New Jersey does not conform to the federal reduction of tax attributes under IRC Section 108. Specifically, the state NOL deductions are calculated independently of the federal tax attributes.<sup>82</sup> According to the New Jersey Division of Taxation, "at the present time there is no provision to reduce tax attributes connected with discharge of indebtedness. Thus, New Jersey would not require the corporation to reduce New Jersey net operating loss with respect to discharge of indebtedness for corporation business tax purposes."<sup>83</sup>

Another state that provides special rules in this area is Illinois, which implicitly conforms to the federal reduction of tax attributes under IRC Section 108, except for a special modification for NOL treatment for tax years ending on or after Dec. 31, 2008. The Illinois NOL and NOL carryover is reduced by the amount of the NOL attribute used, multiplied by (1) the IRC Section 108(a) exclusion from income that would have been apportionable or allocable to Illinois, over (2) the total IRC Section 108(a) exclusion.<sup>84</sup>

Where a taxpayer receives forgiveness of indebtedness when it is insolvent, if a state's attribution reduction rules do not conform to the federal rules or if the dollar value or categories of state tax attributes differ from their federal counterparts, the result will be nonconformity between state and federal asset basis or a disconnect between state and federal NOL reductions. Tracking these differences can be problematic for multistate taxpayers.

### Applying federal tax attribute rules in a unitary environment

State unitary reporting rules can add a level of complexity to the use of certain state tax attributes. In particular, the use of a state NOL carryforward or carryback is often limited to the entity within the unitary group that generated the NOL.<sup>85</sup>

Further, the use and netting of capital losses in a combined report can often be quite different than the single-entity approach generally used in federal consolidated reporting. California requires that a unitary group combine all classes of capital gains and losses (involuntary conversions, IRC Section 1231, short-term or long-term).<sup>86</sup> In addition, each member of the group must determine its portion of gains and losses based on that member's apportionment percentage; if a net loss results for any member, that member may carry forward the loss for five years.<sup>87</sup>

# The overlay of tax shelter rules

In recent years, the term “tax shelter” seems to have become a catch-phrase for every effort by taxpayers to minimize their state or federal tax liabilities or, conversely, every effort by a tax jurisdiction to close what it perceives to be a “loophole.” In addition, “tax shelter” has entered into the federal Code and many state tax codes and regulations as either a statutory or regulatory trigger for the imposition of significant disclosure and penalty regimes that give rise to taxpayer liabilities without regard to the “intent” of the taxpayer.

As discussed below, these “tax shelter” rules are implicated when taxpayers attempt to claim certain deductions that, intuitively, might not be associated with such rules. Given the sometimes draconian impact of these rules, a discussion of the “tax shelter” impacts of claiming certain deductions is warranted.

## Federal tax shelter rules

IRC Sections 6011, 6111, and 6112 provide “tax shelter” rules that require disclosure, registration, and/or list-maintenance for certain transactions. These sections and the related Treasury regulations define “tax shelters,” “listed transactions,” and “reportable transactions.”

### Reportable transactions

Supplementing the IRC’s statutory definition of a “tax shelter” are six categories of reportable transactions. One of those categories should be of particular interest to state tax practitioners: IRC Section 165 loss transactions in excess of certain specified amounts.<sup>88</sup> Various states rules regarding disclosure of “reportable” or “potentially abusive transactions” carry significant penalty regimes if a taxpayer does not disclose — and, in some circumstances, pay state tax pertaining to — such transactions in advance of final judicial determination of the validity of the transaction or deduction in question.<sup>89</sup>

### Disclosure statement by tax shelter participants

Direct and indirect participants in a reportable transaction are required to disclose their participation on a written statement, generally attached to each income tax return in which participation affects income tax liability. A statement also must be filed with the federal Office of Tax Shelter Analysis in the first year that it is filed with the return.<sup>90</sup>

## State tax shelter rules

Many states have adopted some form of tax shelter rules in either statutory, regulatory, or administrative form.<sup>91</sup> These state tax shelter rules rely heavily on the federal identification of the subject transactions/structures, definitions of key terms, and reporting mechanics. The state tax shelter regimes, however, are often more punitive and potentially more expansive in scope.

What is particularly onerous about these state tax shelter regimes is the litany of potential penalties that can be imposed on taxpayers. As an example, California imposes several potentially overlapping penalties, including penalties for: (1) failure to disclose reportable transactions,<sup>92</sup> (2) accuracy-related reportable-transaction understatements,<sup>93</sup> (3) general accuracy-related understatements,<sup>94</sup> (4) noneconomic-substance-transaction understatements,<sup>95</sup> (5) frivolous returns,<sup>96</sup> and (6) potentially abusive tax shelters for which taxpayers are contacted by the FTB.<sup>97</sup>

## Why this issue is important

An understanding of state tax shelter disclosure rules becomes particularly important when losses that are claimed routinely for federal tax purposes, and that may require federal disclosure, may also require disclosure for state tax purposes and, perhaps, the abdication of the benefit of the loss in order to avoid steep state income tax penalties. In particular, consider that: (1) penalties are not deductible for federal or state income tax purposes; (2) the state penalties can be significant and, often, multilayered; and (3) under many states' "voluntary compliance initiatives" (VCIs), the ability to receive penalty relief is dependent on the disclosure and payment of the arguably related underlying taxes.<sup>98</sup> Accordingly, in an environment when any unexpected cash payouts are going to ring alarm bells within most organizations, these potential issues need to be closely monitored.

## Conclusion

While the financial (and cash) significance of federal tax attributes often outweighs the importance of state tax attributes, companies that are struggling to maintain cash flow and preserve cash-on-hand cannot ignore the state tax issues associated with the tax attributes in play. Taxpayers should pay particular attention to federal and state differences in the areas of NOLs, capital losses, the application of IRC Section 382, and basis rules, in addition to the potential implication of state tax shelter rules when claiming certain losses.

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# Notes

\* Originally published in the *Journal of Multistate Taxation*, July 2009.

1 See, generally, IRC §172(c).

2 IRC §172(b).

3 IRC §1222(10), referencing IRC §§1211 (limiting the use of capital losses to the offsetting of capital gains) and 1212 (the capital loss carryforward and carryback rules). Short-term and long-term capital losses are defined in IRC §§1222(2) and (4), respectively.

4 IRC §§1212(a)(1)(A) and (B).

5 IRC §1012. Contrast this to subsidiary formation transactions under IRC §351. See IRC §358 (basis to distributees).

6 IRC §165(g)(1). For this purpose, a “security” is a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or other evidence of indebtedness issued by a corporation, or by a government or political subdivision thereof, with interest coupons or in registered form. IRC §165(g)(2).

7 IRC §165(g)(3). For this purpose, a corporation is treated as affiliated with a taxpayer only if: (1) the taxpayer owns directly stock in such corporation meeting the requirements of IRC §1504(a)(2) (the 80 percent vote-and-value test); and (2) more than 90 percent of the aggregate of its gross receipts for all tax years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. *Id.*

8 IRC §166(a)(1).

9 The taxpayer should have the proper documentation to show that the debt, in fact, became worthless in the tax year in which it is written off. Treas. Reg. §1.166-2.

10 IRC §1012, with special rules applying to debt governed by §§1273 (original issue discount) and 1274 (debt issued for property). Treas. Reg. §1.1012-1(g)(1). See also Treas. Reg. §§1.1273-2 and 1.1274-2.

11 SFAS 109, ¶17. The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing standards of financial accounting and reporting. These standards, which govern the preparation of financial reports, are officially recognized by the SEC and the AICPA. For more information, see the Board’s website at [www.fasb.org](http://www.fasb.org).

12 *Id.*

13 FIN 48 ¶¶5 and 6. In July 2006, FASB issued its Interpretation No. 48, Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109 (often referred to as “FIN 48”), which clarifies rules regarding income tax accounting for purposes of a company’s financial statements, and provides a recognition threshold and measurement in connection with evaluating and reporting the benefit of an uncertain tax position. FIN 48 is effective for fiscal years beginning after Dec. 15, 2006. The recognition process presumes that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information. The “technical merits” of a tax position are derived from sources of authorities in the tax law, e.g., legislation and statutes, legislative intent, regulations, rulings, and case law, as they apply to the facts and circumstances of the tax position in question. FIN 48 ¶7. For more on this pronouncement with a particular focus on state tax matters, see Sutton, Jorgensen, and Yesnowitz, “State Tax Issues Regarding FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes,” 16 JMT 18 (January 2007).

14 For a nonexclusive list of corporate attributes that are deemed to carry over in certain corporate acquisitions, see IRC §381(c).

15 IRC §172(b). A “tax year” generally means: (1) the taxpayer’s annual accounting period if it is a calendar or fiscal year; (2) the calendar year, for taxpayers that do not keep books or do not have an annual accounting period; or (3) the period for which the return is made, for returns covering less than 12 months. IRC §441(b).

16 IRC §172(b)(3).

17 IRC §1212(a)(1). The carryforward period is extended to eight years for “regulated investment companies” (RICs, defined under IRC §851) and ten years for foreign expropriation capital losses. IRC §1212(a)(1)(C).

18 IRC §1212(a)(1)(A).

19 IRC §382(g).

20 IRC §382(i).

21 IRC §§382(g)(2) and (3)(A). For purposes of certain acquisitive reorganizations, the rules of IRC §384 (limitation on use of preacquisition losses to offset built-in gains) generally apply. See IRC §384(a).

22 A “loss corporation” and an “old” and a “new” loss corporation (which may be the same corporation) are defined in, respectively, IRC §§382(k)(1), (2), and (3).

23 IRC §382(b). The “long-term tax-exempt rate” is described in §382(f).

24 IRC §384(a).

25 IRC §382(h)(3).

26 Id.

27 See *Coloman v. C.I.R.*, 38 AFTR 2d 76-5523, 540 F2d 427, 76-2 USTC ¶9581 (CA-9, 1976), affg TC Memo 1974-78, PH TCM ¶74078, 33 CCH TCM 411 (1974).

28 See, e.g., *G.E. Employees Securities Corp. v. Manning*, 31 AFTR 470, 137 F2d 637, 43-2 USTC ¶9563 (CA-3, 1943).

29 6 AFTR 7019, 22 F2d 6, 1 USTC ¶254 (CA-5, 1927).

30 IRC §6511(d)(1) provides a special seven-year statute of limitations for worthless security (and bad debt) deductions, and in some instances the IRC §§1311-1314 mitigation rules might apply.

- 31 IRC §166(a)(1).
- 32 Treas. Reg. §1.166-2 discusses circumstances that indicate the worthlessness of a debt.
- 33 See *Higginbotham-Bailey-Logan Co. v. C.I.R.*, 8 BTA 566 (1927).
- 34 Treas. Reg. §§1.166-2(a) and (b).
- 35 See *Perry v. C.I.R.*, 22 TC 968 (1954).
- 36 Many of these factors are summarized in *American Offshore, Inc. v. C.I.R.*, 97 TC 579 (1991).
- 37 Treas. Reg. §1.61-12(a).
- 38 IRC §61(a)(12).
- 39 IRC §108(e)(6) and Treas. Reg. §1.1502-13(g).
- 40 IRC §108(a)(1)(B). An exclusion for discharge of indebtedness income is granted also to a taxpayer in a title 11 case under the Bankruptcy Code even if the entity is not technically “insolvent.” IRC §108(a)(1)(A).
- 41 IRC §108(d)(3).
- 42 Treas. Reg. §1.108-7.
- 43 IRC §108(b)(5). As with many tax elections, certain specific procedures must be followed. For purposes of this election, a parent company’s investment in the stock of a subsidiary can be treated as a depreciable asset if the subsidiary agrees to reduce the basis of its depreciable assets. IRC §1017(b)(3)(D). In that situation, parent and subsidiary also must file a consolidated return for the year of the discharge of indebtedness.
- 44 See, e.g., *Washburn v. C.I.R.*, TC Memo 1991-195, 61 CCH TCM 2529 , TCM ¶91195 , aff’d 992 F2d 321 (CA-2, 1993) (unpublished opinion), cert. den. U.S. S.Ct., Oct. 4, 1993.
- 45 See, e.g., Ala. Code §40-18-35.1. See also Cal. Rev. & Tax. Code §24416(d) (no carrybacks for NOLs attributable to years beginning before 2011).
- 46 See, e.g., Iowa Code §422.35.11.a. See also Haw. Rev. Stat. §235-7(d) (generally follows federal two-year carryback); Cal. Rev. & Tax. Code §24416(d) (for NOLs attributable to years beginning after 2010).
- 47 See La. Rev. Stat. Ann. §47:287.86.B; Mont. Code Ann. §15-31-119(3); Utah Code Ann. §59-7-110(2).
- 48 See, e.g., Ariz. Rev. Stat. §43-1123 (five years); 35 ILCS §5/207(a)(3) (12 years).
- 49 See Cal. Rev. & Tax. Code §§24416.3 and 24416.9.
- 50 N.J. Rev. Stat. §54:10A-4(k)(6)(E); N.J. Admin. Code §18:7-5.17. For more on the situation in New Jersey, see Sollie, Gutowski, and Mesigian, “New Jersey NOL Carryovers: Get Four More Years Despite the Tax Division’s Contrary Views,” 18 JMT 22 (January 2009).
- 51 Business income is operational income subject to apportionment. Nonbusiness or investment income is allocable to a specific state, usually the taxpayer’s state of domicile. See, e.g., *Allied-Signal, Inc. v. Director, Division of Tax’n*, 504 US 768, 119 L Ed 2d 533 (1992).
- 52 Fla. Stat. §220.13(1)(b)1.b.
- 53 Utah Code Ann. §59-7-107.

54 Ark. Code Ann. §26-51-815(a). Arkansas taxes net gains, and, under §26-51-424(a)(1), a taxpayer may deduct any loss sustained during the year and not compensated for by insurance or otherwise.

55 Minn. Stat. §290.01, Subd. 19c(7) and 19d(5). The intent behind these provisions is to disconnect from federal taxable income in this area, and to prohibit capital loss carrybacks while allowing a 15-year carryforward period for Minnesota purposes. Also, under regulations (Minn. R. 8019.0500), a unitary group must net the group's capital gains and losses.

56 Haw. Rev. Stat. §235-2.45(e).

57 Tenn. Code Ann. §§67-4-2006(b)(1)(E) and (b)(2)(E); Mont. Code Ann. §§15-31-113 and 15-31-114, Mont. Admin. R. §42.23.411(1).

58 Idaho Code §63-3022(i).

59 Ark. Code Ann. §26-51-706.

60 In addition, separate return limitation year (SRLY) rules or other equitable doctrines may affect state NOL deductions. For example, in Wisconsin any member of a combined group may use a post-apportionment NOL carryforward that was incurred by that same member in a tax year beginning before 2009. Also, a member's share of a Wisconsin NOL computed on a combined report for a tax year beginning after 2008 is subject to the state's statutory carryforward period and limitations, and the member may use such loss, or share it among the members of the unitary business filing the combined report, as specified in Wis. Stat. §71.255(6)(b). Wis. Stat. §§71.255(6)(a) and (b), as added by S.B. 62, Feb. 19, 2009 (Laws 2009, Act 2), §131, effective for tax years beginning after 2008.

61 IRC §382(g).

62 See *Libson Shops, Inc. v. Koehler*, 51 AFTR 43, 353 US 382, 57-1 USTC ¶9691, 1957-2 CB 891 (1957). For more on this case, see Joyner and Windell, "Some State Corporate NOL Carryovers Are Still Governed by Outdated Federal Doctrine," 4 JMT 260 (Jan/Feb 1995).

63 Under N.J. Rev. Stat. §54:10A-4(k)(6)(D), when 50 percent or more of the ownership of a corporation has changed because of redemption or sale of stock and the corporation changes the trade or business giving rise to the loss, no NOL sustained before the changes may be carried over to be deducted from income earned after such changes. Further, where the facts support the premise that the corporation was acquired under any circumstances for the primary purpose of the use of its NOL carryover, New Jersey may disallow the carryover. These "common law" rules are not strictly limited to the state income tax arena. The IRC specifically states that, generally, if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the two-year period beginning on the change date, the IRC §382 limit for any post-change year will be zero. IRC §382(c)(1).

64 See, e.g., *Dayco Corp. v. Clayton*, 153 SE2d 28 (N.Car., 1967) (net economic loss carryback reduced by nontaxable dividends and allocable gain); *St. Louis Southwestern Railway Co. v. Ragland*, 800 SW2d 410 (Ark., 1990) (corporation's NOL carryforward was reduced by interest, rents, dividends, and allocable nonbusiness income).

65 See, e.g., *Brown Group, Inc. v. Administrative Hearing Comm'n*, 649 SW2d 874 (Mo., 1983); *Utica Bankshares Corp. v. Oklahoma Tax Comm'n*, 892 P2d 979 (Okla., 1994); *Maryland Nat'l Bank v. State Dept. of Assessments and Tax'n*, Md. Tax Ct., No. 851, 11/18/93, 1993 WL 483141.

66 *Scholastic Bus Service, Inc. v. New York State Tax Comm'n*, 116 App Div 2d 915, 498 NYS2d 278 (3d Dept., 1986).

67 IRC §§382(b)(1) and (e)(1).

68 See Treas. Reg. §1.1502-91, which generally provides that “an ownership change and the section 382 limitation are determined with respect to these attributes for the group (or loss subgroup) on a single entity basis and not for its members separately.”

69 72 Pa. Stat. Ann. §7401(3)1(m) (in computing “taxable income,” no deduction allowed for NOL taken under IRC §172); also see “Net Loss Deduction Limitations under Internal Revenue Code Section 381 and Section 382” (Pa. Corp. Tax Bulletin 2008-03, Dec. 1, 2008).

70 72 Pa. Stat. Ann. §7401(3)4.

71 72 Pa. Stat. Ann. §7401(3)4(g).

72 *Id.*

73 Pa. Corp. Tax Bulletin 2008-03, *supra* note 69, §4. If the change of ownership results from a stock transaction in which the taxpayer continues operations, the loss corporation must provide a separate schedule showing the calculation of the net loss deduction allowed and an explanation of the transaction that resulted in the limitation, for each year in which the limitation applies. *Id.*, §5.A.

74 For example, for tax years beginning after 2004, Ga. Comp. Rules & Regs. §560-7-3-.06(5)(e)2 provides that an ownership change for federal income tax purposes applies also for Georgia purposes. Therefore, the limitation on using pre-change-years Georgia NOLs in a post-change year is computed by applying the post-change year’s apportionment percentage to the IRC §382 limitation for that post-change year. *Id.*, §560-7-3-.06(5)(e)4. Presumably, this percentage would be based on the acquired entity’s post-change apportionment factors, without regard to the acquirer’s apportionment factors.

75 Treas. Reg. §1.1502-32(a).

76 See, e.g., Appeal of Young’s Market Co., Cal. State Bd. of Equalization, Nov. 19, 1986, 86-SBE-198; Appeals of Safeway Stores, Inc., Cal. State Bd. of Equalization, March 2, 1962, 62-SBE-014. See also Va. P.D. Rul. No. 99-61, April 12, 1999.

77 “Disclosure of Deferred Intercompany Stock Account (DISA) Balance on California Corporate Tax Returns” (FTB Notice 2009-01, Feb. 20, 2009). To assist taxpayers in complying with this annual disclosure requirement, the FTB has issued FTB Form 3726 (“DISA and Capital Gain Information”).

78 Cal. Rev. & Tax. Code §25106.

79 18 Cal. Code Regs. §25106.5-1.

80 18 Cal. Code Regs. §25106.5-1(b)(8) (emphasis added). Dividends are generally defined under IRC §§301, 311, and 312. These federal provisions — to which California conforms (see Cal. Rev. & Tax. Code §24451) — concern corporate distributions and earnings and profits.

81 18 Cal. Code Regs. §25106.5-1(j)(7).

82 “Tax Briefs—Corporation Business Tax,” New Jersey State Tax News (N.J. Division of Tax’n, Vol. 25, No. 4, Winter 1996), citing N.J. Rev. Stat. §54:10A-4(k)(6).

83 *Id.*

84 See 35 ILCS §5/207(c).

85 Under California law, unitary group members can combine taxable income and loss in the current year, but NOL carryover computation and use is on a separate-company basis. Cal. Rev. & Tax. Code §25108. Contrast this with Illinois, where, if an Illinois unitary group elects to be treated as one taxpayer, NOL carryovers can be used by the group as such. 86 Ill. Admin. Code §100.2340.

86 For California purposes, the federal netting rules are then applied to that member's post-apportionment gain or loss and its California allocable portion of capital gain or loss.

87 18 Cal. Code Regs. §25106.5-2.

88 In particular, the following IRC §165 losses: \$10 million in any single tax year or \$20 million in any combination of tax years for corporations and for partnerships that have only corporations as partners (looking through any partners that are themselves partnerships), whether or not any losses flow through to one or more partners. Treas. Reg. §1.6011-4(b)(5).

89 See, e.g., Cal. Rev. & Tax. Code §§18628, 19772, 19777; Conn. Gen. Stat. §§12-233(a)(4), (b)(1); 35 ILCS §§5/1007, 5/1405.5, 5/1405.6; 86 Ill. Admin. Code §100.5080; Minn. Stat. §§289A.60, 289A.121; N.Y. Tax Law §25 and 20 N.Y. Comp. Codes, Rules & Regs. §§2500.1 to 2500.7; S.C. Code Ann. §12-54-155; Utah Code Ann. §59-1-1301 et seq.; W.Va. Code §§11-10E-6, 11-10E-8; W.Va. Code State Rules §110-10J-1 et seq. Non-tax-shelter penalties also can be significant. Specifically, for California corporate taxpayers underreporting income or overstating deductions by \$1 million or more, the underpayment penalty increases from 10 percent to 20 percent. Cal. Rev. & Tax. Code §19138. Further, for unitary corporations filing, or required to file, on a combined basis, the understatement amount is aggregated within the group. (For more on this new penalty, which applies to all open tax years, see Hull, "California: New Large Corporate Understatement Penalty Vexes Taxpayers," 19 JMT 34 (May 2009).)

90 Treas. Reg. §1.6011-4.

91 See supra note 89.

92 Cal. Rev. & Tax. Code §19772. This strict liability penalty applies to the failure to disclose a reportable transaction under the California statute. The penalty is \$15,000, increasing to \$30,000 for failing to disclose a listed transaction, and is in addition to any other penalties imposed.

93 Cal. Rev. & Tax. Code §19164.5 (referencing IRC §6662A). This penalty is 20 percent of the reportable transaction understatement, and is increased to 30 percent if the taxpayer does not properly disclose the item in accordance with Cal. Rev. & Tax. Code §18407 (which generally incorporates IRC §6011, "general requirement of return, statement, or list"). The penalty applies to understatements attributable to: (1) any listed transaction, or (2) any reportable transaction (other than a listed transaction) if a significant purpose of that transaction is the avoidance or evasion of income or franchise tax.

94 Cal. Rev. & Tax. Code §19164 (referencing IRC §6662). This penalty applies to only that portion of an underpayment in excess of any underpayment attributable to a reportable transaction understatement and a noneconomic substance understatement. Both of those understatements are used, however, in determining whether there is a substantial understatement for purposes of the accuracy-related penalty.

95 Cal. Rev. & Tax. Code §19774. This penalty is 40 percent of the relevant understatement but it is reduced to 20 percent if the transaction is adequately disclosed on the return.

96 Cal. Rev. & Tax. Code §19179 (referencing IRC §6702). Taxpayers contacted by the FTB concerning the use of a potentially abusive tax shelter may be assessed a frivolous return penalty of up to \$5,000. This penalty is in addition to any other penalty provided by law. Id., §19179(f).

97 Cal. Rev. & Tax. Code §19777. The penalty is applicable to reportable transactions (referencing IRC §6707A(c)(1)), listed transactions (referencing IRC §6707A(c)(2) ), or gross misstatements (referencing IRC §6404(g)(2)(D)). The penalty equals 100 percent of the interest payable on the unpaid tax for the period beginning on the last date prescribed by law for the payment of that tax (without extensions), and ending on the date the notice of proposed assessment is mailed by the FTB.

98 See, e.g., California’s VCI proposed in 2004. Cal. Rev. & Tax. Code §19754.



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