

## New Voluntary Compliance Initiative in California for Tax Shelters Creates New Dilemma for Taxpayers

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The California Legislature recently passed Senate Bill 86.<sup>1</sup> The law adopts another voluntary compliance initiative for "abusive tax avoidance transactions." This initiative is "[d]esigned to collect taxes previously unpaid but otherwise due to the state's General Fund and would result in both new and accelerated revenues."<sup>2</sup> The Senate Floor Analysis also notes that "The State ran the first VCI program in 2004 and generated approximately \$1.3 billion revenues from this effort."<sup>3</sup> Governor Brown included a tax shelter amnesty program in his budget proposal and, therefore, this bill is expected to be signed into law in short order. This new initiative (VCI 2) is similar to the 2004 initiative (VCI 1). It provides both carrots (penalty waivers) and sticks (penalties) as incentives to pay disputed taxes. Like the last initiative, compliance with this program has its benefits and drawbacks. However, as discussed below, it does differ from the 2004 initiative in several ways.

### Key Provisions

Compliance period. Between August 1, 2011 and October 31, 2011, taxpayers must file amended returns with respect to "abusive tax avoidance transactions" and unreported income from the use of offshore financial arrangements. VCI 2 forms may also have to be filed with the Franchise Tax Board.

Tax years subject to VCI 2. Tax years beginning before January 1, 2011 are subject to VCI 2. This includes tax years subject to VCI 1. We will discuss the implications of this overlap below in "interaction with VCI 1."

Transaction at issue. VCI 2 applies to "abusive tax avoidance transactions" and offshore financial arrangements.

The legislation defines "abusive tax avoidance transaction" as a tax shelter, a reportable transaction, a listed transaction, or a gross misstatement, as those terms are defined in federal law. It is also any transaction subject to California's own Noneconomic Substance Transaction (NEST) penalty. These changes represent an expansion of the definition of the term as set forth in VCI 1.<sup>4</sup> Under SB 86, an offshore financial arrangement is an arrangement that in any manner relies on banks in foreign jurisdictions and other arrangements with other foreign entities.

Waiver of penalties. VCI 2 waives most penalties. According to the bill language, the 40 percent NEST penalty, the 100 percent interest-based penalty, and the 20 percent accuracy-related penalty are waived. The legislation sets forth two exceptions to penalty waiver for: (1) The large corporate understatement penalty (the 20 percent strict-liability penalty for understatements of tax of more than \$1 million applicable to tax years beginning on or after January 1, 2003);<sup>5</sup> and (2) The 50 percent interest penalty for noncompliance with the 2005 Amnesty Program.<sup>6</sup> Criminal penalties are also waived (with exceptions for penalties subject to pending cases and pending investigations).

Noncompliance penalties. If a taxpayer is contacted by the FTB on an abusive tax avoidance transaction and does not participate in VCI 2, an additional penalty will be imposed, equaling 100 percent of the interest payable from the due date of the return without extension, through the date the Notice of Proposed Assessment ("NPA") is mailed. If the taxpayer files an amended return after the compliance period but before an NPA is issued, the penalty is 50 percent.

No refunds. No refunds or credits are allowed for amounts paid during the amnesty period in connection with abusive tax avoidance transactions or unreported income from the use of offshore financial arrangements. In essence, a taxpayer participating in VCI 2 gives up refund and appeal rights regarding the amounts paid with respect to the compliance initiative in exchange for penalties being waived on those same amounts. Unlike VCI 1, there is no option for a taxpayer to pay and keep appeal rights.

No deductions for transaction costs. Taxpayers who file amended returns are not permitted a deduction for transaction costs associated with transactions or arrangements that are subject to VCI 2.

Extended statute of limitations. The statute of limitations period for the FTB to mail a notice of proposed deficiency assessment related to an abusive tax avoidance transaction is extended from eight years to 12 years from the due date of the return or the date the return was filed under extension.

Conformity with Federal Economic Substance Doctrine. This legislation would amend Section 19774 (the NEST penalty) to include in the definition of a "noneconomic substance transaction," any transaction lacking economic substance within the meaning of the newly codified federal economic substance doctrine. Also, if a penalty is assessed under the federal income tax on an underpayment attributable to the disallowance of claimed tax benefits by reason of the transaction lacking economic substance, as set forth in Internal Revenue Code Section 7701(o), then the NEST penalty is assessed for the portion of an understatement attributable to that transaction. The penalty cannot be abated unless the taxpayer can establish that the imposition of the federal penalty was "clearly erroneous."

## **Interaction with VCI 1 and 2005 Amnesty Program**

VCI 1 applied to tax years beginning before January 1, 2003.<sup>7</sup> VCI 2 applies to tax years beginning before January 1, 2011, including those years subject to VCI 1. Thus, taxpayers who did not, for any reason, participate in VCI 1 will get another bite at the apple. However, two new penalties enacted after VCI 1 will not be waived or abated. The 20 percent large corporate understatement penalty, which applies to understatements of tax in excess of \$1 million beginning in tax years on or after January 1, 2003, will not be abated. Further, the penalty for not participating in the 2005 Amnesty Program (50 percent of the interest from the due date of the return without extension through March 31, 2005)<sup>8</sup> will also not be waived or abated.

The penalty for noncompliance can have substantial implications, especially on taxable years between eight and 12 years in the past. The FTB may now identify a transaction that was previously statute-barred as an "abusive tax avoidance transaction," and subject the taxpayer to substantial penalties.

## **New Issues Raised**

VCI 2 raises new issues and points of awareness for taxpayers. Some taxpayers may have already either paid the tax or filed amended returns on transactions that the FTB deems abusive. However, based on the language of Senate Bill 86, taxpayers who have done so may

still be eligible to participate in VCI 2. This is because under the new statute, a taxpayer has not complied with VCI 2 unless it files an amended return that does not deduct transaction costs associated with an abusive tax avoidance transaction. Thus, taxpayers who have already filed amended returns may still be required to file new amended returns excluding these deductions. If these taxpayers file such returns during the compliance period and make corresponding payments, they may arguably still be entitled to the benefits of VCI 2.

Further, some taxpayers may be anticipating federal adjustments to tax that may now be deemed "abusive tax avoidance transactions" under California law. Depending upon the circumstances, such taxpayers should consider pushing to receive their federal adjustments well before October 31, 2011 to properly file amended California returns before that date. Also depending upon the circumstances, if taxpayers have federal changes to tax prior to August 1, 2011, they should consider reporting such changes within the compliance period to ensure that all penalties, other than the large corporate understatement penalty and the amnesty penalty, are abated.

As always, taxpayers must note that VCI 2 is not for everyone. The carrots may be tempting and the sticks severe, but given the lack of appeal rights for VCI 2 participants, taxpayers that have strong legal arguments with respect to the underlying transactions should carefully weigh the chances of success on the merits against the benefits of participating in VCI 2.

For more information on how to handle VCI 2 for your specific tax situation or to discuss other penalty matters in California, contact the authors of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's California tax practice, visit [www.reedsmith.com/CAtax](http://www.reedsmith.com/CAtax).

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<sup>1</sup> S.B. 86, 2011 Gen. Assem., Reg. Sess. (Ca. 2011) (the discussion in this alert pertains to Sections 21 through 23 of this Senate Bill).

<sup>2</sup> Senate Budget and Fiscal Review Committee, Office of the Senate Floor Analyses on Senate Bill 86, as amended on 3/17/11.

<sup>3</sup> Senate Budget and Fiscal Review Committee, Office of the Senate Floor Analyses on Senate Bill 86, as amended on 3/17/11.

<sup>4</sup> Section 19753(c) currently defines "abusive tax avoidance transaction" as "a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, 'listed transactions' as described in paragraph (4) of subdivision (a) of Section 18407."

<sup>5</sup> R&TC § 19138.

<sup>6</sup> R&TC § 19777.5.

<sup>7</sup> R&TC § 19731.

<sup>8</sup> R&TC § 19777.5.

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