

California Offers New Voluntary Compliance Initiative for Abusive Tax Avoidance Transactions and Offshore Financial Arrangements



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On March 24, 2011, Governor Jerry Brown approved Senate Bill 86, which institutes a second voluntary compliance initiative (VCI 2) for California taxpayers with offshore financial arrangements or who participated in abusive tax avoidance transactions (ATATs). The new initiative is “designed to collect taxes previously unpaid but otherwise due to the state’s General Fund and would result in both new and accelerated revenues.” VCI 2 is the first California state amnesty program which allows taxpayers involved in offshore financial accounts to resolve their cases with the FTB. Per the Senate Floor Analysis, California’s first voluntary compliance initiative (VCI 1) in 2004 generated approximately \$1.3 billion in revenue. The Governor included a tax shelter amnesty program in his budget proposal, and, thus, VCI 2 is designed to fulfill that commitment.

VCI 2 will run from August 1, 2011 to October 31, 2011 and will apply to corporate and individual income taxpayers. Those who choose to participate in VCI 2 will avoid most penalties except the large corporate understatement penalty and the penalty for not complying with California’s prior voluntary compliance initiative, VCI 1. Participants must file amended income tax returns and pay all tax attributable to the transactions eligible during the VCI 2 participation period. No deductions will be

permitted for transaction costs associated with the tax avoidance transactions or the offshore financial arrangements.

Important Provisions of VCI 2

There are many key provisions to VCI 2:

- **Eligible Transactions.** VCI 2 applies to “abusive tax avoidance transactions” and offshore financial arrangements.
 - The legislation defines ATATs as a tax shelter, reportable and listed transactions and a “gross misstatement,” as those transactions are defined under federal law. ATATs also include any transaction for which the Franchise Tax Board has asserted the noneconomic substance penalty (NEST), which is 40% of the tax generated from the transaction. The FTB’s determination of what is an ATAT is much broader than the IRS would determine for similar transactions. Moreover, the NEST penalty applies to any transaction that the FTB determines lacks economic substance and if the taxpayer does not have a valid nontax California business purpose for entering into the transaction. Thus, certain estate planning and income tax deferral transactions have been determined to be ATATs by the state of California while the IRS does not find them to be reportable, listed or lacking in economic substance.
 - Offshore financial arrangements are also eligible for VCI 2. Under SB 86, an offshore financial arrangement is an arrangement that in any manner relies upon banks in foreign jurisdictions and other arrangements with other foreign entities.
- **Compliance Period.** Between August 1, 2011 and October 31, 2011, taxpayers must file amended returns and report income with respect to ATATs and from the use of offshore financial arrangements. VCI 2 forms must be filed with the FTB as well.
- **Eligible Tax Years.** VCI 2 covers tax years beginning before January 1, 2011, which also includes any tax year which was previously eligible for VCI 1.
 - **Penalties Waived.** VCI2 waives most penalties, with the exception of the large corporate understatement penalty and the penalty for failing to participate in the 2005 amnesty program (the “post-amnesty penalty”). The penalty for failing to take advantage of the FTB’s 2005 amnesty program is imposed at the rate of 50% of the existing unpaid interest amount on years for which the taxpayer could have applied for amnesty. Moreover, penalties which become final prior to July 31, 2011 cannot be waived or abated under the new initiative. Participating taxpayers will be protected from criminal prosecution, except where a criminal complaint has already been filed or the taxpayer is already under criminal investigation. Thus, taxpayers who participate in VCI 2 have the ability to have the following onerous California penalties waived:
 - The 20-40% accuracy related penalty under Cal. Rev. & Tax Code Sec. 19164.
 - The 40% NEST penalty under Cal. Rev. & Tax Code Sec. 19774.

- The 100% interest-based penalty under Cal. Rev. & Tax Code Sec. 19777.
- The 30% penalty for nondisclosed reportable transactions under Cal. Rev. & Tax Code Sec. 19164.5.
- The \$30,000 failure to disclose a listed transaction penalty under Cal. Rev. & Tax Code Sec. 19182.
- The new initiative also amends the 100% interest-based penalty and changes the ability of taxpayers to avoid this penalty if they are contacted by the FTB regarding a potential ATAT assessment. Thus, waiver of the interest-based penalty under the new initiative should be an attractive incentive to participate in VCI 2.
- **Appeal Rights.** VCI 2 is markedly different from VCI 1 in one major respect. If a taxpayer participates in VCI 2, the initiative specifically provides that the taxpayer must waive rights to appeal and taxpayers have no option to file a claim for refund after filing an amended return in connection with VCI 2. Thus, unlike VCI 1, there is no option for taxpayers to participate in VCI 2 and preserve appeal or claim for refund rights.
- **No Deduction for Transaction Costs.** Taxpayers who file amended returns in connection with their participation in VCI 2 are not permitted a deduction for transaction costs associated with ATATs or offshore financial arrangements.

New Legislation in SB 86

In addition to the new initiative, Senate Bill 86 has important additional legislation which will affect many California taxpayers who are involved in ATATs and offshore financial arrangements. For example, the statute of limitations period for the FTB to mail a notice of proposed assessment related to an ATAT is now extended from 8 years to 12 years from the due date of the return or the date the return was filed. This provision applies retroactively for any return filed on or after January 1, 2000, for any taxable year not already closed as of August 1, 2011. Additionally, SB 86 amends the NEST penalty to include in its definition any transaction lacking economic substance within the meaning of the newly codified federal economic substance doctrine. If a penalty is assessed by the IRS on an underpayment attributable to a transaction lacking economic substance, as set forth in IRC Sec. 7701(o), then the NEST penalty is assessed for the portion of the understatement attributable to that transaction.

The NEST penalty cannot be abated in this scenario unless the taxpayer can establish that the imposition of the federal IRC Sec. 7701(o) penalty was “clearly erroneous.” Thus, SB 86’s new legislation has significantly increased the penalties which would apply to transactions the FTB believes are abusive tax avoidance transactions and has given the FTB an added 4 years to the statute of limitations to audit these transactions.

Conclusion

The state of California’s push to collect revenue given the state’s budgetary crisis is driving VCI 2. Penalties in California for participating in ATATs and offshore financial arrangements are dire and are only getting worse, given newly-enacted

legislation in SB 86. Moreover, the FTB's ability to send deficiency notices to taxpayers for tax years as far back as 12 years is daunting and will give substantial power to the FTB to audit more taxpayers suspected to be involved in ATATs or offshore financial arrangements. This is a potent power because California's definition of what constitutes an ATAT is much broader than the federal definitions of abusive tax shelters and transactions which lack economic substance.

VCI 2 is attractive to both the state of California and some taxpayers; however, it is not for everyone. Those who have valid transactions being challenged by the FTB as an ATAT should carefully weigh the chances of succeeding on the merits against the benefits of participating in VCI 2. For example, participants will receive waiver of most extreme California tax shelter penalties, but will also waive all rights to appeal their case or to pursue a claim for refund.

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