

California Amnesty Program Available for Abusive Tax Shelter Cases and Unreported Offshore Financial Trust Income; Accuracy Penalty Goes to 40%

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Summary: Taxpayers in 2011 now have a limited window to enter into a California amnesty program to avoid penalties from either a possible abusive tax shelter transaction or an offshore financial arrangement. In addition, Taxpayers will now see California's accuracy related penalty increase to 40%.

For a few Californians the enactment of SB86 on March 24, 2011 is good news. For others, SB86 may be very bad news.

Narrow Tax Amnesty Program. First, SB86 creates a narrow "tax amnesty program" from August 1, 2011 to October 31, 2011 aimed only at transactions considered a possible abusive tax shelter or an unreported offshore financial arrangement. Those taxpayers who fall within these two categories who choose to not participate may become subject to more severe consequences in the past if challenged by the FTB, including higher penalties and a much longer statute of limitations for FTB assessments. **Because these changes are complex, they are discussed in detail below.**

Partial Interest Relief. Second, SB 86 provides partial interest relief on certain FTB tax adjustments. Given that the FTB has a much longer statute of limitations to make adjustments than the IRS, this bill provides partial relief from interest on tax adjustments. The basic concept is that if the FTB fails to make a tax adjustment within 36 months of the later of a return filing or the return due date, then no interest will be charged during the period beyond 36 months until 15 days past the adjustment notice issuance.

This new interest relief provision, however, contains several twists and turns. To name just a few, there are special rules that apply to taxpayers who are required to report to the FTB an IRS tax adjustment. In addition, there are a number of circumstances where relief will not be given. For example, in addition to not allowing relief in cases involving a fraud penalty assessment, relief is also not allowed taxpayers who report high taxable income (>\$200,000 taxable income) if they have been contacted regarding a potentially abusive tax shelter.

Accuracy Penalty. Third, SB86 raises the FTB accuracy penalty from 20% to 40%. The accuracy penalty generally applies to a tax adjustment which is considered to result from a substantial underpayment of tax (the greater of 10% of the reported tax or a stated minimum amount.) The higher 40% accuracy penalty will apply to all open tax years and specifically is stated that it may apply to FTB assessments made for individual tax years beginning on or after January 1, 2003 (and for corporate tax years beginning on or after January 1,

1990 (and for assessments made after July 16, 1991.)

FTB's Listed Transactions. Fourth, the FTB is authorized to create its own set of "listed transactions", independent of the IRS list, as to transactions in which the FTB believes that there is no substantial authority or there is no reasonable belief that the transaction is more likely than not the proper tax treatment.

Other Changes. Fifth, SB86 adopted various other changes, including, for persons not required to hold a sales/use tax license to employ a Board "AGI adjusted table" to self-assess use taxes and a phase-out of a credit for household/dependent care services needed for employment.

Obviously, many of these changes are complex. While we are outlining the Tax Amnesty Program below, our office is equipped to advise on many of the recent tax changes and their impact to you.

Tax Amnesty Program

Overview. SB86 adopted both a limited tax amnesty program and higher penalties for those not participating. This limited tax amnesty program is unique in that it only applies to two types of transactions. FTB believed that taxpayers have been avoiding California taxes through both abusive tax shelters and offshore financial arrangements and that these have become extensive problems in California. Accordingly the tax amnesty program was limited to these two areas and no other type of transaction. For example, a taxpayer who wishes to report previously unreported income from an offshore bank account apparently will not qualify for this program.

For the few taxpayers who may be eligible, the benefit of this program is the level of relief that will be granted. First, no criminal action will be brought against any taxpayer who participates in the program, provided that as of July 31, 2011: (i) no criminal complaint has been filed against the taxpayer in connection with the issues disclosed, and (ii) the taxpayer is not the subject of a criminal investigation in connection with the issues disclosed. Second, and more importantly, those participating will not be subject to civil tax penalties, other than the penalty under R&TC Section 19138 (large understatements of income by corporations) and R&TC Section 19777.5 (interest penalty for failing to participate in the previous broader amnesty period, which ended on April 15, 2004).

Who Qualifies. Because this program is narrow, it is important to know who qualifies. The legislature adopted a rather broad definition which, while intended to simplify administration and avoid confusion, may have the opposite result of capturing taxpayers who thought their transaction safe. The definition includes as possible abusive tax shelters, any transaction covered by Internal Revenue Code Section 6662(d)(2)(c) – i.e., an abusive tax shelter, Section 6707A(c)(1) – i.e., a reportable transaction, not reported, Section 6707A(c)(2) – i.e., a listed transaction, Section 6404(g)(2)(D) – i.e., a gross misstatement and Revenue & Taxation Code Section 19774 – i.e., a transaction the FTB deems to not have economic substance. For example, even if a transaction is not challenged by the IRS, a transaction will be considered to be within this program if the FTB considers the transaction to lack economic substance. Our experience is that the FTB is challenging transactions that are not being challenged by the IRS on audit and therefore a favorable IRS audit may not provide protection.

The program also applies to “offshore financial arrangements.” These are not unreported bank accounts, but rather any transaction involving a financial arrangement that relies on the use of offshore payment cards, including credit, debit, or charge cards, issued by banks in foreign jurisdictions or offshore financial arrangements, including arrangements with foreign banks, financial institutions, corporations, partnerships, trusts, or other entities to avoid or evade income or franchise tax.

How to Elect. For those who believe the California amnesty program will be of help, there are six elements to electing relief:

1. The taxpayer must elect to participate; once elected, the tax amount is conceded.
2. The case must involve either an abusive tax shelter cases or unreported income from an offshore financial arrangement.
3. Between August 1, and October 31, taxpayer must file an amend return and “report all income from all sources, without regard to the abusive tax avoidance transaction.”
4. Taxpayer must formally elect amnesty – the form is yet to be issued.
5. Taxpayer may not deduct any transaction costs associated with an abusive tax avoidance transaction.
6. The tax amount due (including interest) must be paid in full; the FTB may, but is not required to, agree to installment payments to be completed by June 15, 2012.

Uncertainties. While these elements are fairly basic, there remain several uncertainties. First, it would appear that merely submitting an amended return with missed deductions or other unreported income (not offshore trust income) may not qualify. Second, there may be a “Catch 22” for those who wish to participate, but do fail to pay the taxes and interest as this should cause the amnesty to fail, and all penalties to become due. Third, and most importantly, once amnesty is elected, the taxpayer no longer has the right to challenge the FTB as to whether the transaction or offshore financial arrangement was properly reported in the first place. Fourth, the statute imposes a duty to cooperate possibly greater than witnesses granted immunity to testify. Namely, the taxpayer must fully cooperate in any inquiry and the FTB may void the waiver if the FTB deems responses by the taxpayer fail to “fully cooperate” with the FTB’s investigation.

Consequences of Not Electing. For those not participating, the SB86 has consequences, including extending the statute of limitations from 8 to 12 years with respect to assessment of tax on abusive tax shelters. There is also a 50 percent penalty for the filing of an amended return after being contacted by the FTB, but prior to the FTB’s issuance of a deficiency notice.

For those not participating in the program, the tax amnesty program is intentionally designed to “raise the stakes”. In many cases, the FTB has already assessed or will on new assessments charge its 40% Noneconomic Substance Transaction (NEST) penalty. If a taxpayer proves that the transaction had economic substance, but loses on appeal, the FTB will argue that the new 40% substantial understatement penalty should be charged, leaving the taxpayer with no better result. In addition, a 100% interest penalty may be imposed, which can only be reduced to 50% if an amended return is filed after the taxpayer is contacted by the FTB but before an assessment is made.

No Federal Counterpart. In deciding whether this program is appropriate, one should keep in mind that

California's program is wholly unrelated to the Federal 2011 Offshore Voluntary Disclosure Initiative ("OVDI"). OVDI is a federal, non-statutory penalty reduction program that covers reporting of undisclosed foreign accounts and assets. The OVDI program will expire August 31, 2011. Under OVDI, partial penalty relief is granted for certain federal filings, including failure to file Form TD F 90.22.1 (foreign accounts), Form 3520/3520A (foreign trusts), Form 5471 (CFCs), Form 5427 (25% foreign owned US Corporation OR FC in US), Form 926 (transfer of US prop to FC), and Form 8865 (US investor in foreign partnership). California generally has no counterpart to these filing requirements.

Whether to Elect. The FTB's amnesty program is voluntary, it may not be right for everyone. On the other hand, the program should be seriously considered if there is unreported offshore trust income as this program may offer the best option for relief.

Example. Taxpayer is currently challenging a transaction as not being an abusive tax shelter. To pursue their challenge, including with the FTB's protest unit (and its settlement unit) as well as before the State Board of Equalization, the taxpayer cannot elect the amnesty program.