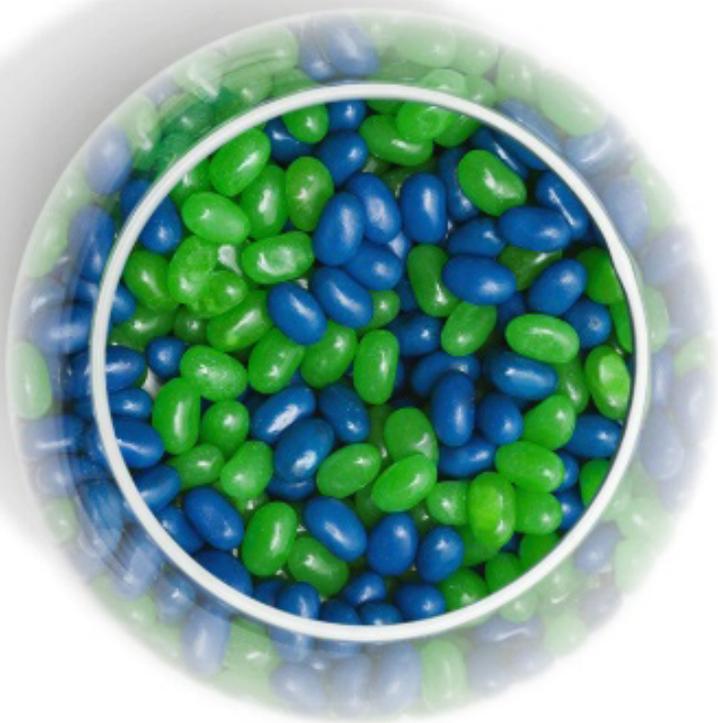


# California Voluntary Compliance Initiative II for “Abusive Tax Avoidance Transactions” and Offshore Financial Arrangements”.



BY VALERIE DICKERSON & MATTHEW JOHNSON

# California Voluntary Compliance Initiative II for “Abusive Tax Avoidance Transactions” and “Offshore Financial Arrangements”

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## I. OVERVIEW

California’s “Voluntary Compliance Initiative II” (“VCI II”) was enacted as part of Senate Bill 86 (“S.B. 86”), which was signed by Governor Jerry Brown on March 24, 2011.<sup>2</sup> Under the terms of this new initiative, qualified participating taxpayers that file the required amended returns, and pay all tax and interest owing, will receive relief from most California tax penalties for pre-2011 “abusive tax avoidance transactions” (“ATATs”) and underreported income from “offshore financial arrangements” (“OFAs”). VCI II will run from August 1, 2011 to October 31, 2011. The legislation effectuates one of Governor Brown’s budget proposals,<sup>3</sup> and is estimated to generate approximately \$270 million during the 2010-2011 fiscal year.<sup>4</sup> This article summarizes the requirements of VCI II, and discusses some of the possible pros and cons of participation.

## II. VCI II SUMMARIZED

Certain taxpayers that have engaged in ATATs and/or have underreported income from the use of OFAs for any taxable year beginning before January 1, 2011, can participate in VCI II and obtain the penalty relief described below.<sup>5</sup> California’s last voluntary compliance program was enacted in 2003 (“VCI I”), and covered taxable years beginning before January 1, 2003.<sup>6</sup>

Under VCI I, an ATAT was defined as “a plan or arrangement devised for the principal purpose of avoiding tax.” Importantly, S.B. 86 modifies the definition of an “ATAT” for purposes of imposing California’s 100 percent interest based penalty (“IBP”) so that the penalty may be imposed upon additional taxpayers.<sup>7</sup> Consequently, participation in VCI II may abate penalties for taxpayers that may not have been eligible to participate in VCI I under the prior definition.<sup>8</sup> An ATAT is now defined to include a tax shelter,<sup>9</sup> reportable transaction,<sup>10</sup> listed transaction,<sup>11</sup> gross misstatement of tax,<sup>12</sup> and a noneconomic substance transaction (“NEST”).<sup>13</sup> This new definition of ATATs unifies the various terms previously used to identify an abusive tax shelter in order to “simplify administration and avoid confusion.”<sup>14</sup> The new definition is operative for notices of proposed assessment mailed on or after the effective date of the bill (March 24, 2011) and applicable to amended returns filed more than 90 days after that effective

date for taxable years for which the statute of limitations for mailing a notice of proposed assessment has not expired as of that date.<sup>15</sup>

For purposes of VCI II, an OFA means any transaction involving financial arrangements that in any manner rely 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.<sup>16</sup>

The Franchise Tax Board (“FTB”) Bill Analysis states that “numerous schemes have been uncovered in which the true ownership of offshore income streams and offshore assets have been hidden or disguised.”<sup>17</sup> In its analysis, the FTB noted that the Internal Revenue Service (“IRS”) has obtained “unprecedented cooperation with other countries” subsequent to a February 2009 deferred prosecution agreement with the Swiss bank UBS. The IRS is running a second voluntary disclosure program until August 31, 2011, on the heels of a similar program that ran during 2009 and attracted 15,000 voluntary disclosures.<sup>18</sup> In fact, the California definition of an OFA largely mirrors the federal definition provided in Revenue Procedure 2003-11, Offshore Voluntary Compliance Initiative,<sup>19</sup> perhaps indicating that the proponents of VCI II seek to capitalize on the success of the IRS initiatives. However, since the OFA definition for VCI II is quite broad, and does not specifically incorporate the federal definition, taxpayers should consider whether arrangements that have a California tax benefit but no federal tax impact may be targeted by the FTB.

The legislation also makes two significant adjustments tying the California NEST penalty directly to the recently codified Federal economic substance doctrine.<sup>20</sup> First, the California NEST penalty is extended to apply to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the federal definition, for California tax purposes.<sup>21</sup> Second, a *per se* presumption imposes the California NEST penalty on understatements resulting from transactions that the IRS

has examined and determined to lack economic substance.<sup>22</sup> Pursuant to the statutory language, assessment of the penalty can be avoided only where the taxpayer can show that the federal determination was clearly erroneous.<sup>23</sup> These changes apply to notices mailed on or after the effective date of the bill (March 24, 2011).<sup>24</sup>

If a taxpayer elects to participate in VCI II, and fully meets its requirements, participation will protect that taxpayer from most California tax penalties and criminal action as a result of using an ATAT or OFA in taxable years beginning before January 1, 2011.<sup>25</sup> However, the 20 percent large corporate understatement penalty (imposed under Revenue and Taxation Code section 19138),<sup>26</sup> the interest-based penalty for failure to participate in the 2005 amnesty program (imposed under Revenue and Taxation Code section 19777.5),<sup>27</sup> and any penalty imposed after July 31, 2011, if attributable to an assessment of taxes that became final prior to July 31, 2011, cannot be waived or abated under VCI II.<sup>28</sup> A participating taxpayer will also be protected from criminal liability.<sup>29</sup> A taxpayer cannot participate if already the subject of a filed criminal complaint or criminal investigation in connection with an ATAT or OFA.<sup>30</sup>

Significantly, in contrast to VCI I, taxpayers only have the option to participate or not participate in VCI II — there is no option for taxpayers to reserve their right of appeal. Further, participation in VCI II forecloses any option for a taxpayer to seek relief in court by filing a refund claim on an amended return.<sup>31</sup> In addition, no refunds or credits will be allowed with respect to any penalty paid prior to participation in VCI II.<sup>32</sup>

Eligible taxpayers that do not participate in VCI II remain subject to tax penalties, including the accuracy related penalty imposed by Revenue and Taxation Code section 19164, the NEST penalty imposed by Revenue and Taxation Code section 19774, and the 100 percent IBP imposed by Revenue and Taxation Code section 19777.<sup>33</sup> The legislation also amends the 100 percent IBP so that a taxpayer contacted by the FTB regarding a potential ATAT assessment can no longer avoid the penalty by filing an amended return prior to the issuance of a notice of proposed assessment.<sup>34</sup> Rather, taxpayers that are contacted by the FTB, but file an amended return prior to the issuance of a notice, will be subject to a penalty reduced from 100 percent to 50 percent of the interest payable with respect to the additional tax attributable to that ATAT.<sup>35</sup>

The FTB is required to publicize VCI II to maximize public awareness and participation, and any correspondence mailed to a taxpayer's last known

address outlining VCI II constitutes “contact” for purposes of imposition of the IBP under Revenue and Taxation Code section 19777.<sup>36</sup> As discussed above, the applicability of the 100 percent IBP was broadened with the new ATAT definition. Furthermore, for FTB notices provided to individual taxpayers or amended returns filed by individual taxpayers on or after January 1, 2012, the interest suspension rules of Revenue and Taxation Code section 19116 do not apply for purposes of computing the penalty.<sup>37</sup>

S.B. 86 also extends the statute of limitations applicable to ATATs. Specifically, for notices of proposed assessment mailed on or after August 1, 2011, the statute of limitations with respect to an ATAT is 12 years from the date the return was filed.<sup>38</sup> Under prior law, the statute of limitations was 8 years. 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 by a statute of limitations, by *res judicata* (final litigation), or otherwise.<sup>39</sup>

To participate in VCI II, a taxpayer must: (1) file an amended tax return for each taxable year for which the taxpayer has previously filed a tax return using an ATAT or OFA, and (2) pay in full all taxes and interest due.<sup>40</sup> No deduction will be allowed for transaction costs associated with the transaction or underreported income.<sup>41</sup> Under certain circumstances, the FTB may enter into an installment agreement, in lieu of full payment, as long as the final payment is made no later than June 15, 2012.<sup>42</sup> If there is a difference between the amount shown on the VCI II return and the “correct amount of tax”, the FTB may assess a deficiency, impose penalties, or initiate criminal action on the difference.<sup>43</sup> Participating taxpayers are also required to fully cooperate with any FTB inquiry related to the use of the ATAT or OFA, or risk loss of the applicable penalty relief and protection from criminal liability.<sup>44</sup>

### **III. OBSERVATIONS—PROS AND CONS**

VCI II is the next stage of California's continued effort to encourage taxpayers to come forward and report certain transactions or positions that shelter income. This program is potentially a way for the FTB to resolve a significant portion of its current tax shelter inventory of over 300 cases (11 in appeals, 199 in protest, 100 in audit).<sup>45</sup> In fact, it appears that VCI II may be most attractive to taxpayers faced with a potential significant NEST penalty that, once asserted by the FTB in a notice of proposed assessment, can only be abated partially or in full by the FTB Chief Counsel at his sole discretion, as well as other tax shelter penalties

or accuracy-related penalties that might apply even in the absence of a tax shelter determination.<sup>46</sup>

Taxpayers considering participation in VCI II must also consider whether greater benefit could be obtained by pursuing settlement or litigation, since coming forward means conceding and paying all of the tax and interest due, as well as the amnesty penalty or large corporate understatement penalty (if applicable).<sup>47</sup> Further, participating taxpayers should be prepared to disclose significant details about their business activities and sources of advice related to the ATAT or OFA.

Certain taxpayers not already a part of the tax shelter “inventory” may also consider that they have only a very narrow window in which to avoid the 100 percent IBP altogether. If a notice of proposed assessment has not yet been sent by the FTB, the IBP can be avoided by filing an amended return reporting the ATAT or OFA within 90 days of the effective date of S.B. 86 (*i.e.*, within 90 days after March 24, 2011).

Taxpayers that have disclosed, or plan to disclose, their participation in the California-only listed transactions, detailed in FTB Notices 2011-01 and 2011-03, should expect to be contacted regarding VCI II. FTB officials have publicly stated an intent to list one additional transaction prior to July 1, 2011. Taxpayers that have participated in the to-be-identified transactions may also be contacted by the FTB and/or face a decision regarding whether to participate in VCI II.<sup>48</sup> Obviously, having a disclosure requirement pursuant to an FTB Notice listing a transaction as an ATAT does not necessarily mean that the transaction or arrangement is, in fact, an ATAT.

Tax professionals should stand ready to consult with clients regarding the pros and cons outlined above, as well as others not discussed.

## ENDNOTES

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2. Senate Bill 86 (“S.B. 86”), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011) is available at: <http://www.leginfo.ca.gov/pub/11-12/bill/>

[sen/sb\\_0051-0100/sb\\_86\\_bill\\_20110324\\_chaptered.pdf](#). S.B. 86 also makes non-substantive changes to Voluntary Compliance Initiative I, a similar tax shelter compliance program provided from January 1, 2004 to April 15, 2004 for taxpayers engaged in ATATs prior to January 1, 2003.

3. VCI II is similar to the Tax Shelter Amnesty program proposed in the Governor’s 2011-2012 Budget Proposal. For more information on that budget proposal, please see the prior Deloitte Tax LLP Multistate Tax Alert: “California Governor Proposes Significant Tax Law Changes in 2011-2012 Budget” (Jan. 12, 2011), available at: [https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us\\_tax\\_CAGovernorProposesSignificantTaxLawChanges\\_011911.pdf](https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_CAGovernorProposesSignificantTaxLawChanges_011911.pdf).

4. Franchise Tax Board Bill Analysis of S.B. 86, dated March 18, 2011, p. 2.

5. S.B. 86, § 21 (adding Rev. & Tax. Code § 19761(b)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

6. Rev. & Tax. Code § 19751.

7. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(b)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

8. S.B. 86, § 21 (adding Rev. & Tax. Code § 19763(c)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

9. A tax shelter is defined, in reference to IRC section 6662(d)(2)(C), as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of income or franchise tax. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(b)(1)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

10. A reportable transaction is defined, in reference to IRC sections 6707A(c)(1) and 6664(d)(2)(A), as any transaction with respect to which information is required to be included with a return or statement because the transaction has the potential for tax avoidance or evasion and for which the disclosure, authority, and reasonable belief requirements of IRC section 6664 are not met. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(b)(2)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

11. A listed transaction is defined, in reference to IRC section 6707(c)(2), as a reportable transaction that is the same as, or substantially similar to, a transaction specifically identified as a tax avoidance transaction. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(b)(3)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011). In addition, the FTB may publish positions for which it believes there is not substantial authority and there is no reasonable belief that the tax treatment is more likely than not the proper tax treatment. Rev. & Tax. Code § 19164(b).

12. A gross misstatement of tax is defined as that term is used in IRC section 6404(g)(2)(D). S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(b)(4)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011)
13. See Rev. & Tax. Code § 19774(c)(2) (“A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.”).
14. Senate Floor Analysis of S.B. 86, dated March 21, 2011, available at: [http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb\\_0051-0100/sb\\_86\\_cfa\\_20110321\\_161413\\_sen\\_floor.html](http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0051-0100/sb_86_cfa_20110321_161413_sen_floor.html).
15. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(e)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
16. S.B. 86, § 21 (adding Rev. & Tax. Code § 19764(a)(1)(B)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
17. FTB Bill Analysis of S.B. 86, dated March 18, 2011, p. 9.
18. FTB Bill Analysis of S.B. 86, dated March 18, 2011, pp. 9-10.
19. See Rev. Proc. 2003-11, 2003-1 C.B. 311.
20. The economic substance doctrine was codified into IRC section 7701(o) by section 1409(a) of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010). Pursuant to IRC section 7701(o), a transaction has economic substance only if the transaction changes the taxpayer’s economic position in a meaningful way and the transaction has a substantial purpose for the taxpayer other than tax effects.
21. S.B. 86, § 23 (adding Rev. & Tax. Code § 19774(c)(2)(B)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
22. S.B. 86, § 23 (adding Rev. & Tax. Code § 19774(e)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
23. *Id.*
24. S.B. 86, § 23 (adding Rev. & Tax. Code § 19774(f)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
25. S.B. 86, § 21 (adding Rev. & Tax. Code §§ 19761-19764), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
26. Revenue and Taxation Code section 19138 imposes a 20 percent strict liability penalty for an understatement of tax that exceeds the greater of \$1 million or 20 percent of the tax shown on the timely filed return for tax years beginning on or after January 1, 2010. For tax years beginning on or after January 1, 2003 and before January 1, 2010, the 20 percent threshold did not exist and the penalty was imposed on an understatement of tax that exceeded \$1 million.
27. Revenue and Taxation Code section 19777.5 imposes a penalty equal to 50 percent of the interest computed on any final amount (including final deficiencies and self-assessed amounts paid after March 31, 2005) for the period beginning with the due date of the return (without extension) and ending March 31, 2005.
28. S.B. 86, § 21 (adding Rev. & Tax. Code § 19762(b)(1)(B) and (b)(3)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011). However, “assessment of taxes” does not include taxes self-assessed on an original or amended return filed before August 1, 2011. *Id.*
29. S.B. 86, § 21 (adding Rev. & Tax. Code § 19762(b)(2)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
30. S.B. 86, § 21 (adding Rev. & Tax. Code § 19763(a)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
31. S.B. 86, § 21 (adding Rev. & Tax. Code § 19762(b)(4)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
32. S.B. 86, § 21 (adding Rev. & Tax. Code § 19763(b)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
33. Note that the FTB has published a handy “Penalty Reference Chart,” current through April 12, 2010, available at: <http://www.ftb.ca.gov/forms/misc/1024.pdf>.
34. Senate Floor Analysis of S.B. 86, dated March 21, 2011, available at: [http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb\\_0051-0100/sb\\_86\\_cfa\\_20110321\\_161413\\_sen\\_floor.html](http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0051-0100/sb_86_cfa_20110321_161413_sen_floor.html).
35. S.B. 86, § 24 (amending Rev. & Tax. Code § 19777(d)(1)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
36. S.B. 86, § 21 (adding Rev. & Tax. Code § 19761(d) & (e)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
37. S.B. 86, § 4 (adding Rev. & Tax. Code § 19116(d)(8) & (h)(3)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
38. S.B. 86, § 20 (adding new Rev. & Tax. Code § 19755(a)(2)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
39. S.B. 86, § 20 (adding new Rev. & Tax. Code § 19755(b)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
40. S.B. 86, § 21 (adding Rev. & Tax. Code § 19764(a)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
41. *Id.*
42. S.B. 86, § 21 (adding Rev. & Tax. Code § 19764(b)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).

43. S.B. 86, § 21 (adding Rev. & Tax. Code § 19764(c)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
44. S.B. 86, § 21 (adding Rev. & Tax. Code § 19764(d)), 2010-2011 Leg. Sess. (Ca. Mar. 24, 2011).
45. Geoff Way, Franchise Tax Board: Caseload Summary (2011), p. 7, available at: [http://www.boe.ca.gov/meetings/pdf/Special\\_Presentation\\_Caseload\\_Summary\\_2011.pdf](http://www.boe.ca.gov/meetings/pdf/Special_Presentation_Caseload_Summary_2011.pdf).
46. Rev. & Tax. Code § 19774.
47. The validity of the amnesty penalty was upheld by the California Court of Appeal, First Appellate District, in *River Garden Retirement Home v. Franchise Tax Board*, 186 Cal. App. 4th 922 (2010), *petition for review denied* 2010 Cal. LEXIS 11603 (Cal. 2010). The applicability of the penalty is being litigated in *Microsoft Corporation v. Franchise Tax Board*, Case No. CGC08471260, and *Frank Cutler v. Franchise Tax Board*, Case No. BC421864. In *Microsoft*, the San Francisco Superior Court issued a February 17, 2011 Statement of Decision upholding the amnesty penalty. A Notice of Entry of Judgment was filed on March 21, 2011 and the case has not been appealed as of the date of this article. *Microsoft* and *Cutler* are appealable to the 1<sup>st</sup> and 2<sup>nd</sup> Appellate Districts, respectively.
48. Revenue and Taxation Code section 18407(a)(4) grants the FTB authority to list transactions that represent potentially abusive tax avoidance transactions and create a disclosure requirement on the part of taxpayers engaged in such transactions.