California's Voluntary Compliance Initiative Two

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California's Voluntary Compliance Initiative Two.
R&T §19761 enacted as part of SB 86, signed March 24, 2011 established the Voluntary Compliance Initiative Two (VCI) which runs from August 1, 2011 – October 31, 2011. The VCI is targeted at two discrete groups. The initiative applies to tax liabilities attributable to the use of abusive tax avoidance transactions (ATAT) and to unreported income from the use of offshore financial arrangements. The program covers all tax years beginning before January 1, 2011. The FTB estimates that in the first year for the VCI the state will collect approximately $270 million. A reduction in assessable penalties in subsequent years will reduce the net revenue realization by approximately $82 million .
An abusive tax avoidance transaction (ATAT) is commonly referred to as a tax shelter. Tax shelters are tax plans that serve no significant purpose other than reducing tax. R&T § 19774 imposes a noneconomic substance transaction (NEST) understatement penalty of 20 percent if the transaction is adequately disclosed and 40 percent if it is not. A noneconomic substance transaction understatement is a loss, deduction, credit or addition to income that is the result of a transaction that lacks economic substance.
Offshore financial arrangement mean 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, trusts or other entities to avoid or evade income or franchise tax
The VCI requires taxpayers who are qualified and elect to participate to do the following: file amended returns and pay all unpaid tax and interest resulting from an ATAT or from an unreported offshore financial arrangement, and agree that the VCI would be closed without appeal rights. A qualified taxpayer includes a taxpayer who has

• ATAT's in audit
• ATAT case in protest
• Unknown ATAT's
• Unreported income from the use of an offshore financial arrangements

If a taxpayer is qualified and elects to participate all penalties are waived except for the large corporate understatement penalty and the amnesty penalty.
In addition, no criminal action would be brought against a qualified VCI participant if the taxpayer is not currently the subject of a criminal complaint or under criminal investigation with an ATAT or unreported income from the use of an offshore financial arrangement.
The effect of not electing to participate in the VCI is that the statute of limitation on assessment on ATAT cases is increased from eight to twelve years. In addition, if a taxpayer in an ATAT has been contacted by the FTB and files an amended return prior to the issuance of a notice of deficiency there is an addition to tax of 100 hundred percent of the interest payable under Section 19101
The VCI differs in some material ways from the Second Supplemental Voluntary Disclosure Initiative (OVDI) announced by the IRS February 8, 2011 . The OVDI expires on August 31, 2011, subject to a 90 day extension for reasonable cause. The OVDI covers years 2003-2010. The OVDI covers only account holders in foreign financial institutions and does not include ATAT or any other issues.
The OVDI is the deal with two statutory schemes, the Bank Secrecy Act (Title 31) and the Internal Revenue Code (Title 26). The Bank Secrecy Act (BSA) requires U.S. persons who have foreign financial accounts which aggregate $10,000 or more to report the existence of

those accounts on Form TD 90-22.1 (FBAR) annually. There are severe penalties, both civil and criminal for non-compliance . In addition, the Internal Revenue Code requires taxpayers to report interests in foreign financial accounts, foreign trust and foreign corporations annual on their tax returns . There are separate penalties for subscribing to a false return in not disclosing a foreign financial account and for not reporting the income on such accounts. Further, failure to file information returns for (a) controlled foreign corporations Form 5471, (b) transfers to or gifts from foreign trusts (Form 906 and Form 3520) have their own penalty regimes. The OVDI provides that in exchange for payment of a miscellaneous civil penalty base upon 25% of the highest single year foreign financial account balance (in some cases the penalty is 12.5% or 5%) plus filing, previously unfiled FBAR's and amended returns for years 2003 -2010 and report any and all unreported income, plus payment of the tax on the unreported income plus an accuracy related penalty of 20% plus interest on the tax, all other penalties and criminal prosecution are waived.

The reporting requirements of the OVDI exceed those of the VCI in that the State of California does not have an FBAR equivalent filing requirement. The VCI scope exceeds that of the OVDI by including ATAT's. The VCI program covers all tax years in which there is unreported income from an ATAT or foreign financial arrangement whereas the OVDI limits the coverage to 2003-2010. The complex question given the differing scopes of the programs is whether a taxpayer who is an investor in an ATAT should enter the VCI program. If the ATAT is under federal exam or is part of a program that is under federal exam the answer is probably yes. The result of the federal exam will be provided to the FTB by the IRS pursuant to information sharing agreements and the result will be imposition of the enhanced penalties when the FTB assess the case. If the taxpayer is not in an ATAT but is a participant in or should be a participant in the OVDI then they probably should enter the California VCI. The cases where the taxpayer enters the OVDI and opts out in order to dispute the 25 percent miscellaneous civil penalty are a bit more complex. In order to participate in the OVDI a taxpayer must file amended returns and pay the tax, interest and 20 percent accuracy related penalty on unreported income. The reasonable course is to include amended California returns and pay the tax and interest at the same time. The failure to amend the California returns will likely give rise to a deficiency assessment down the road when the IRS provides the information to the FTB.

The decision to enter the VCI must be balanced by the risks of continuing non disclosure/non-compliance. The risks are for the most part civil penalties but criminal prosecution cannot be absolutely ruled out.