Why California Should Adopt a Voluntary Compliance Program for Taxpayers With Unreported Foreign Bank Accounts and Entities

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WHY CALIFORNIA SHOULD ADOPT A VOLUNTARY COMPLIANCE PROGRAM FOR TAXPAYERS WITH UNREPORTED FOREIGN BANK ACCOUNTS AND ENTITIES

EXECUTIVE SUMMARY

U.S. citizens who have foreign financial interest are required to report foreign financial accounts to the IRS on annual basis by filing Form TD 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"). The failure to timely file an FBAR may result is severe civil and criminal penalties under both the Bank Secrecy Act and the Internal Revenue Code. Furthermore, the Foreign Account Tax Compliance Act of 2010 (FATCA) places furthered pressure on taxpayers to disclose foreign financial accounts because FATCA requires foreign financial institutions to make disclose data about U.S. taxpayer account holders to the IRS.

In January of 2012 the IRS enacted the third in a series of voluntary disclosure programs, known as the Offshore Voluntary Disclosure Program (OVDP). Under the OVDP taxpayers with foreign financial accounts may disclose the information to the IRS in exchange for waiver of some penalties and criminal prosecution. Unlike previously offered voluntary disclosure programs the 2012 voluntary disclosure program is open for an indefinite period of time.

Currently California taxpayers who participate in OVDP do not have a similar program offered for state tax purposes. The last voluntary disclosure program offered by California, known as Voluntary Compliance Initiative 2 (VCI2), expired in October 31, 2011. VCI 2 allowed California taxpayers to voluntarily disclose previously underreported California income tax liabilities through the use of abusive tax avoidance transactions (ATATs) or offshore financial arrangements. VCI 2 produced over 1,000 participants raising approximately $350 million.

A lack of a program in California that runs parallel in time to the federal program creates an uncertainty for California taxpayers due to the information sharing program between state authorities and the IRS. Californians have a strong interest in minimizing risks by opting into a state voluntary disclosure program. On the state side, California will benefit from additional revenue, a decrease in enforcement efforts, and greater efficiency created as more taxpayers are in compliance with state laws.

We propose that California act immediately in adopting a program for California taxpayers to voluntarily cooperate with state authorities by disclosing offshore financial arrangements. The last section of this proposal sets forth the details for a Voluntary Compliance Initiative 3.

DISCUSSION

I. OVERVIEW OF VOLUNTARY DISCLOSURE PROGRAMS

A. Introduction to Voluntary Disclosure Programs – Legislative History

During the months of August 1, 2011 through October 31, 2011 California established a Voluntary Compliance Initiative (hereinafter "VCI 2") which provided an amnesty period for taxpayers to come forward by filing amended state returns and remitting unpaid tax and interest resulting form unreported offshore financial arrangements. In exchange for entering VCI 2, the

FTB would waive all penalties, other than the Large Corporate Understatement Penalty and the Amnesty Penalty, and grant qualified participants protections from criminal action.

However, VCI 2 was not the first attempt by CA to encourage taxpayers to come forward with offshore financial arrangements used to underreport California income tax liability. In 2003, CA enacted the first Voluntary Compliance Initiative (hereinafter "VCI 1") that permitted taxpayers to file amended returns, pay the tax and interest associated with abusive tax avoidance transactions. Similar to VCI 2, the VCI 1 was available for a limited period of time from January 1, 2004 through April 15, 2004.

VCI 1 and 2 in some ways conformed to the federal program by the IRS, the Offshore Voluntary Disclosure Initiative (OVDI), available to taxpayers at the same time. The IRS enacted OVDI to encourage taxpayers with undisclosed foreign accounts and undisclosed foreign entities used to evade or avoid tax to come forward and be in compliance with United States tax laws. Similarly, California enacted a voluntary disclosure programs to offer California taxpayers an opportunity to correct their California income tax liability.

B. Why Voluntary Disclosure Programs

Under the Internal Revenue Code (IRC) U.S. taxpayers are taxed on income earned worldwide, including income earned in offshore bank accounts in foreign jurisdictions. California has a similar approach to taxing worldwide income of California residents. In addition to reporting and paying tax on foreign income, U.S. taxpayers are also required to disclose foreign financial accounts to the IRS under various reporting requirements, under the Bank Secrecy Act including Report of Foreign Bank and Financial Accounts (FBAR) and under the IRC report Specified Foreign Financial Assets (Form 8938) and also identify foreign financial accounts on Schedule B of Form 1040. The Foreign Account Tax Compliance Act (FATCA), IRC §1471-1474 adopted as part of the HIRE Act is and will have monumental effects on foreign account and foreign asset disclosure and cause many California taxpayer to come forward and enter the federal Offshore Voluntary Disclosure Program (OVDP) .

1. Report of Foreign Bank and Financial Accounts Requirements

U.S. citizens who have financial interest in or signature authority over a foreign financial account are required to report the account to the IRS on annual basis by filing a Report of Foreign Bank and Financial Accounts, Form TD 90-22.1. The United States government utilizes FBARs to identify persons who may be using foreign financial accounts to circumvent United States law. In cases where taxpayers willfully fail to file an FBAR reporting interest in a foreign account the IRS may impose civil and criminal penalties. The civil penalty for a "willful" failure to file an FBAR is the greater of $100,000 or 50 percent of the account's highest value, per year. The "non-willful" penalties range from a Warning Letter (Form 3800) to 10% of the highest account balance per year. Criminal penalties may result in incarceration for 2-5 years per count and fines. These penalties are in addition to the income tax, and income tax penalties imposed under the Internal Revenue Code. Taxpayers who previously failed to file required FBARs can avoid the high penalties by currently choosing to enter the IRS's Offshore Voluntary Disclosure Program.

California does not have an FBAR statute requiring state residents to disclose foreign financial account for state purposes and therefore cannot impose penalties for failure to disclose foreign financial arrangement earning foreign income. However, California does tax income on a worldwide basis, which includes income earned in foreign financial accounts. And even though California residents are not required to file state FBARs, they are nevertheless at a risk for state civil income tax and criminal penalties for failure to report foreign earned income and possible criminal sanctions for filing false or fraudulent returns. Because of information exchange agreements between the IRS and the FTB, the risk of being prosecuted for state tax crimes increases as CA residents choose to participate in the federal voluntary disclosure program and expose previous failure to disclose foreign financial arrangements.

2. FATCA

In 2010 Congress enacted the FATCA, IRC § 1471-1474, effective beginning January 1, 2014. Under the provisions of the FATCA, U.S. taxpayers holding financial accounts outside the United States will be required to consent to reporting of those assets to the IRS by their foreign financial institutions. Furthermore, under FATCA foreign financial institutions must (1) report directly to the IRS information about financial accounts held by U.S. taxpayers or their entities, or (2) they can report to their governments designate agency which will report to the IRS under the provisions of an "Inter-governmental Agreement".

Foreign financial institutions required to report under FATCA, that fail to comply with the reporting requirements will be subject institutions to withholding on their U.S. investment income at the rate of 30% and possibly face loss of correspondent banking privileges.

As a result of the FATCA, foreign financial institutions are requiring U.S. taxpayers to certify that they are in compliance with income tax reporting and FBAR reporting or their accounts may be frozen until proof is provided (Example: Bank Leumi, Israel). California residents (which includes those who have unfiled income tax returns) who have unreported foreign financial accounts may find that information reported to the IRS will be shared with the FTB.

C. Federal Voluntary Disclosure Program

Taxpayers with undisclosed foreign accounts and unreported income have the option of seeking protections from criminal prosecution and avoiding certain penalties by entering the OVDP. The federal program has had at least three versions. The first program, which ran from March 23, 2009, through October 15, 2009; the second offshore voluntary disclosure program was announced on February 8, 2011 and closed on September 9, 2011. In 2012, the IRS reopened the offshore voluntary disclosure program, and unlike the previous two programs, the 2012 program has no set deadline for taxpayers to apply.

1. Requirements for entering IRS's Offshore Voluntary Disclosure Program

OVDP offers a civil settlement structure for taxpayers with offshore financial arrangements. The current program, as with previous programs, requires participants to apply and be accepted (pre-cleared) into the program. A pre-clearance is generally granted if the taxpayer is not the subject of a pending investigation, audit or criminal proceeding. Once taxpayers have been

preliminarily accepted into the program, they must submit certain information including eight years of original or amended tax returns, FBARs, and information returns as well as information about their offshore accounts. In addition, taxpayers must submit amended returns and full payment of the income tax, interest on the tax due, and a 20% accuracy –related penalty.

The current OVDP also imposes a civil miscellaneous penalty, in lieu of FBAR penalties, of 27.5% of the highest single aggregate balances in foreign financial accounts, plus the 27.5% of the Fair Market Value of all other "Tax Non-Compliance Assets". The OVDP requires amended returns and FBAR's for an eight-year period tracing back for the current year.

2. Number of Participants Federally and in California

According to the IRS, the 2009 and 2011 OVDP produced a total of 33,000 voluntary disclosures. As of January 9, 2012, the IRS reported a total of $3.4 billion collected from participants in the 2009 voluntary disclosure program. In addition to another $1 billion from up front payments under the 2011 program. As of June 2012, the IRS announced that in total the offshore voluntary disclosure programs have exceeded $5 billion.

Some percentage of the filed offshore voluntary disclosures involve Californians. The number of Californians participating is not publically available. However, the FTB reported that more than 1,000 taxpayers participated in VCI 2. Individual taxpayers made up 90 percent of VCI participants. VCI 2 raised approximately $350 million in revenue for California.

D. OPTIONS AVAILABLE FOR CA TAXPAYERS

1. Filing Amended Returns

Without a voluntary disclosure program, taxpayers are simply left with the sole choice of filing amended returns with the state without any assurance of protection from criminal prosecution or civil relief by waiver of certain penalties (as discussed below). Furthermore, some taxpayers will be discouraged to disclose the information voluntarily to state authorities by relying on the fact that the FTB ultimately will issue a Notice of Deficiency once information is learned from the IRS.

Currently California does not have a voluntary disclosure program that is comparable to the IRS's OVDP program announced in January 2012. Those taxpayers who opt into the OVDP program and disclose information California taxpayers who are filing an amended federal tax return to correctly report income related to offshore bank accounts or other offshore activity are strongly urged to file an amended return with California at the same time.

In 2009, the FTB reminded California taxpayers who choose to participate in the IRS's voluntary disclosure process of the information sharing agreement between the IRS and FTB. Under the information sharing agreement, information received by the IRS from federal amended returns and from foreign governments will be shared with California authorities.

2. Waiver of Penalties

Under VCI 2, taxpayers who came forward on voluntary basis were granted relief of certain

penalties by the FTB. However, with the expiration of VCI 2, California taxpayers lost all benefits associated with filing amended returns and voluntarily disclosing previously unreported taxable income to state authorities. Loss of this benefit may discourage some taxpayers to come forward.

Taxpayers in California are responsible for penalties imposed by R&TC Section 19131, Failure to make and file a return, and Section 19132 Failure to pay any amount due by the date prescribed for payment. The FTB is bound by statute with regards to imposition of penalties and may only waive penalties if the taxpayer is able to show reasonable cause and not willful neglect. Without a voluntary disclosure program the FTB would lack any authority to waive penalties for individuals filing amended returns and disclosing previously unreported income from foreign financial arrangements.

Currently, the FTB offers a Voluntary Disclosure Program for qualified entities, qualified shareholders, or beneficiaries that have incurred an unpaid California tax liability or an unfulfilled filing requirement to disclose their liability voluntarily. The program is available for nonresident shareholders, beneficiaries, and entities that have never filed a return with the FTB. The FTB is authorized to waive any or all penalties related to a failure to make and file a return and any penalty related to a failure to pay any amount due to the FTB. Waiver of penalties requires full compliance with the Voluntary Disclosure Program by participants.

In addition, if participants do not qualify for the Voluntary Disclosure Program the FTB also offers a Filing Compliance Agreement. Similar to the Voluntary Disclosure Program, the Filing Compliance Agreement is available for out of state businesses and nonresident shareholders/ beneficiaries. Taxpayers may request for Filing Compliance Agreement from the FTB but the FTB has authority to determine who may participate. Furthermore, the FTB has authority to waive penalties and interest on case-by-case basis where reasonable cause is a defense.

A VCI 3 would provide statutory authority for FTB to abate certain penalties to in state residents and business entities who choose to come forward on voluntary basis but do not qualify for the Voluntary Disclosure Program or the Filing Compliance Agreement currently offered by the FTB.

II. NEED FOR ACTION

In the last decade the IRS has increased its focus on enforcement efforts to bring U.S. taxpayers in compliance with tax filing and information reporting obligations with regards for offshore financial interests. Additionally, newly enacted FATCA places further pressure on U.S. taxpayers to come forward with previously unreported foreign income and disclose foreign financial assets. In the past California has ran concurrent voluntary disclosure programs with the federal government to provide taxpayers coming forward with foreign financial arrangements a sense of certainty with regards to state related penalties and criminal exposure associated with good faith participation with the federal government.

Currently CA residents who choose to participate in the federal voluntary disclosure program do not have a conforming program available for state tax purposes. The FTB's VCI 2 expired in October 31, 2011 and the Federal OVDP program, currently in place, has no set time for

participants to enter the program. Taxpayers who come forward with the IRS are placed in a compromising situation of escaping federal sanctions and exposing themselves to state penalties and possible criminal prosecution. In addition to lack of a parallel program in California to provide comfort to state residents, federal reporting requirements are further pressuring U.S. residents to come clean with foreign financial situations.

A. Information Sharing with IRS

With increased pressure by the federal government to disclose offshore accounts and FATCA requiring foreign financial institutions to enter into information exchange agreements with the IRS and/or inter- governmental agreements, an increase in U.S. taxpayers choosing to enter the offshore voluntary disclosure program with the IRS can be expected to increase. This should result in many Californians coming forward as their offshore banks put pressure on them to disclose in order to comply with FATCA and FBAR requirements

IRC Section 6103(d) authorizes the IRS to share any tax return information with State agencies. California taxpayers who amend federal returns for voluntary disclosure purposes expose themselves to enforcement actions by the FTB as the information released to the IRS during the voluntary disclosure process will ultimately shared by the with California authorities.

California can elevate the uncertainties for taxpayers by enacting a voluntary disclosure program for state tax purposes similar to the VCI programs of the past. California taxpayers can voluntarily provide the same information to California authorities during the voluntary disclosure process and eliminate future actions taken by the FTB.

B. Interest of Taxpayers at Risk

When California taxpayers were given an opportunity to come forward with foreign financial arrangements through participation in the VCI 2 program over 1,000 chose to do so. It is presumed that all of participants who participated in the VCI 2 also participated in the parallel program offered by the IRS.

The number of participants demonstrates that California taxpayers have an interest in becoming compliant with California law by disclosing prior unreported taxable income from foreign sources. Additionally, by coming forward taxpayers were able to minimizing certain penalties and interest, criminal prosecution and the cost of litigation.

With the introduction of the 2012 voluntary disclosure program by the IRS, California taxpayers who choose to participate in OVDP to minimize any risks associated with previously unreported FBARs and foreign sourced income will not have the same opportunity on the state level as previously available with VCI 1 and 2. Without a comparable program in California, those taxpayers who participate in OVDP are left with uncertainty as to the sanctions they face on the state level. Furthermore, some taxpayers may even be discouraged to participate in the federal program once they weigh in the exposure of criminal prosecution and penalties in California.

As enforcement efforts by the IRS continue to increase it is certain that number of Californians will choose to cooperate with the IRS via opting into the voluntary disclosure program. The taxpayers who come forward have a very strong interest in minimizing all risks associated with disclosure. It is imperative that California act immediately in implementing a VCI 3 program which will grant relief and allow taxpayers in California to fully cooperate with state authorities.

C. Interest of California

In 2011 California took measures to enhance revenue collection by enacted VCI 2. To make the program attractive to taxpayers the FTB enhanced its power to assess taxpayers by extending the statue of limitations for issuing deficiency notices from 8 years to 12 years in situations involving ATATs and offshore financial arrangements. Furthermore, taxpayers who were able to participate and failed to do so faced higher penalties under the new laws. VCI 2 proved to be a success raising approximately $350 million of much needed revenue.

The IRS has not set a time limit for participating of OVDP and it is likely that the IRS will not close the program in the near future. With increased pressure by the IRS and the newly enacted FATCA more taxpayers will choose to participate in the federal program. However, lack of a program on the state level will create a missed opportunity for California to collect revenues from participants.

A new program will allow an opportunity for taxpayers who underreported their California income tax liabilities to amend previously filed tax returns and pay tax and interest on the income. Even though VCI 3 will grant relief of certain penalties, similar to VCI 2, certain taxpayers will be subject to penalties such as amnesty penalties and large corporate understatement penalties. VCI 3 will be revenue generator for the state of California as taxpayers choose to voluntarily come forward and comply with state laws.

Furthermore, by coming forward on a voluntary basis the need for enforcement by state authorities will be on a decline. Examinations and audits as the FTB become privy to information revealed to the IRS via OVDP program will decrease. In turn, the FTB will not expand resources to bring California taxpayers in compliance if a voluntary disclosure program is also available for state purposes. Lastly, a participant in a voluntary disclosure program will give up rights to protest, appeal and claims for refund which further will decrease administrative costs for the FTB. Therefore, a VCI 3 program will be a great benefit to the state of California by generating much needed revenue, increasing efficiency in collecting income tax, and increasing number of taxpayers in compliance with the state laws.

III. PROPOSED ACTION

For the reasons discussed above we recommend that California adopt a Voluntary Compliance Initiative (VCI 3). Our proposal would be for California to adopt an ongoing program that conforms to the federal program currently in place.

We recommend the FTB take the following actions with regards to implementing a VCI 3

program for California residents.

A. VCI 3 Proposal

VCI 3 should be implemented as soon as administratively feasible in order to ensure Californians who have undisclosed offshore financial accounts and who wish to come forward would be able to do so without risk of prosecution and with a defined penalty structure. As with previous programs, VCI 3 would be eligible for both individual income taxpayers and business entity taxpayers.

1. Who May Participate

Individuals and business entities who have previously filed or not filed a California state tax return and have failed to accurately reported their world wide income are candidates who may participate in VCI 3 under our proposal.

2. Eligibility to Participate in VCI 3

To be eligible for VCI 3, taxpayers must first certify that they are not under examination/audit by the FTB, or IRS, or under criminal investigation. Any examination, regardless whether it relates to undisclosed foreign accounts or foreign entities, would make the taxpayer ineligible for VCI 3 even if the taxpayer is eligible for OVDP. However, a taxpayer may participate in VCI 3 even though the taxpayer is ineligible for OVDP because participation in OVDP is not a prerequisite for VCI 3 eligibility. For example, a California taxpayer may be under criminal investigation and ineligible for OVDP purposes but eligible for VCI 3 because the taxpayer is not under criminal investigation for California purposes.

Taxpayers who have previously attempted a "quiet" disclosure by filing amended returns and paid the tax and interest related to previously unreported income would also be eligible to opt into VCI 3. However, if the amended returns filed during "quiet" disclosure are currently under examination by the FTB than taxpayers would be ineligible to participate in VCI 3 for those years under examination.

3. How to Participate in VCI 3

The proposed program would require the following from taxpayers who choose to enter voluntary program:

• Timing: Unlike VCI 2, VCI 3 would not have a set expiration date for participation. VCI 3 would be an ongoing program with FTB reserving the right to terminate the program completely or for a particular group of taxpayers. Participants must request acceptance into VCI 3 within a set time period after opting into IRS OVDP. Our proposal recommends that taxpayers who opt into the federal program have either one of the following options available for submitting Participation Agreement [FTB Form 621 (Business Entity Taxpayers) or Form 622 (Individual Income Taxpayers) or Form)]:
i. Within 60 days of submitting federal amended returns. OR

ii. Within 60 days from receipt of fully executed Form 906, Closing Agreement.

However, if a taxpayer has submitted a voluntary disclosure to the IRS prior to the enactment of VCI 3, than the 60-day deadlines above would be waived. In those particular cases, the FTB should set a deadline after the enactment date allowing California taxpayers currently in OVDP to file for VCI 3.

• Filing Requirements: Participants would be required to file amended state income tax returns for preceding eight years and report all previously unreported income, including offshore-unreported income and unreported domestic income from any lawful source. A Participation Agreement, FTB Forms 621 (for Business Entity Taxpayers) and Form 622 (for Individual Income Taxpayers) will be required for each amended return filed.
o As with VCI 2, the FTB would make available a Voluntary Compliance Initiative 3 Participation Agreement. Each amended return would be accompanied with a Participation Agreement signed by the taxpayer.
o If taxpayers are in a federal voluntary disclosure program, these taxpayers should also be required to attach federal amended tax returns. Also, any settlement/closing agreements with the IRS should be submitted to the FTB with the Participation Agreement.
o Participation Agreement, on its face, should include a checklist of documents that are required to be attached.

• Payments: Participants must submit full payments of tax and interest on previously unreported income with each amended return filed for VCI 3. Taxpayers unable to pay the full amount of tax and interest with Participation Agreement should have the option of requesting an installment agreement to extend final payment due date by six months from date of filing amended returns and Participation Agreement. As with VCI 2, taxpayers must submit a request for installment agreement by filing FTB 9310D, Statement of Financial Condition, pay a fee to establish an installment agreement, and pay at least 10 percent of the liability due with each amended return accompanied by VCI 3 Participation Agreement.

• Penalties: Participants would be subject to accuracy related penalties and/or delinquency penalties as provided by statute.

4. Rights and Benefits of Participating in VCI 3

By participating in VCI 3, taxpayers will waive any right to protest, appeal, or file a claim for refund for amounts paid under VCI 3. As with VCI 2, participants in VCI 3 would be required to sign and submit a Participation Agreement, which on its face would include the rights waived by the taxpayer.

In exchange the FTB would grant participants relief from prosecution for all disclosed acts and limit civil penalties to those to be stated in the VCI 3. Relief from criminal action would be for tax years for the FTB accepted in VCI 3 and only for those acts disclosed. In addition, by signing the Participation Agreement taxpayers would agree to cooperate with the FTB regarding offshore financial arrangements. Failure to cooperate fully with FTB inquiries would grant the FTB a right to make waiver of penalties under VCI 3 null and void.

B. Differences from IRS's disclosure program

One key difference for Californians who choose to participate in the proposed VCI 3 program and the IRS's OVDI program would be the amount of penalties. Unlike the IRS, California does not have reporting requirement for foreign financial accounts and assets, and therefore in return cannot assess penalties for failure to disclose to California any offshore financial arrangements.

Our proposal does not have a provision paralleling IRS's 27.5% penalty on the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the eight year period covered by the voluntary disclosure.

C. Administrative Costs

The proposed VCI 3 would have similar administrative costs as the previous two programs implemented by the FTB. As proposed, VCI 3 would differ from VCI 2 in that it will not have a set expiration date for California residents who choose to opt into voluntary disclosure. Therefore, costs for the proposed program would be ongoing for additional personnel and processing. The cost forecast is left up to the FTB budget analysts.

IV. CONCLUSION

The federal government has taken a strong stance in raising awareness and enforcement efforts with regards to offshore financial arrangements. California residents are at higher risk now then ever before for prosecution and/or fraud penalties for coming forward in good faith on the federal level and reporting foreign income and foreign assets. Without a parallel action by California a great uncertainty is created for state residents. A parallel program, which appropriately conforms to the federal voluntary disclosure program, is a vehicle for California to provide certainty for Californians who make a good faith effort to come forward and report previously unreported income from offshore financial accounts.