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California enacts "VCI Two," piggybacks federal economic substance codification

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On March 25, Governor Jerry Brown signed a budget trailer bill that establishes an amnesty/voluntary compliance initiative (VCI) for taxpayers that either have utilized an "abusive tax avoidance transaction" (ATAT) or have unreported income from the use of an offshore financial arrangement. The amnesty will run from August 1, 2011 through October 31, 2011, and applies to tax years beginning prior to January 1, 2011. Among other changes, the legislation conforms the existing California noneconomic substance transaction penalty to the federal codification of economic substance, and extends the statute of limitations from eight to twelve years where an abusive tax avoidance transaction is involved. Further, the bill establishes a system to match delinquent tax debtor records with the financial institutions' customer records. ([S.B. 86](#), enacted, 3/25/11)

VCI details

The legislation establishes an amnesty program identified as "VCI Two," to distinguish it from the VCI that California offered in 2004. Under the new VCI, participants will have all penalties other than the 20 percent large corporate understatement penalty and the 50 percent interest-based penalty (California's post-2005 amnesty penalty) waived. In addition, criminal prosecution is barred, provided the participant was not the subject of an existing criminal complaint or investigation. Non-participants in the VCI that are contacted by the FTB regarding an ATAT and have a deficiency attributable to the ATAT will be subject to a 100 percent interest-based penalty for the period beginning on the last date prescribed by law for the payment of the tax (determined without regard to extensions) and ending on the date the notice of proposed assessment is mailed.

The program will be available to personal income and corporate taxpayers who have ATATs currently under audit, ATAT cases in protest, unknown ATATs, or unreported income from the use of an offshore financial arrangement. To qualify, a taxpayer will be required to file amended returns and pay all tax and interest resulting from an ATAT or the underreporting of income from the use of offshore financial arrangements.

Further, no deduction will be allowed for transaction costs associated with an ATAT or for transaction or other costs associated with unreported income from the use of an offshore financial arrangement. Tax bills that are paid under the VCI would be closed, and there are no appeal rights. Installment payment arrangements will be allowed, but all outstanding liabilities associated with the VCI must be paid by June 15, 2012.

Under Cal. Rev. & Tax. Code Sec. 19777, as amended by the legislation, an ATAT includes: a California tax shelter, a reportable transaction not adequately disclosed, a listed transaction, a gross misstatement, or a transaction subject to the California non-economic substance (NEST) penalty under Cal. Rev. & Tax. Code Sec. 19774.

An "offshore financial arrangement" 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.

Enhanced Enforcement Measures

The legislation also makes several changes in the law intended to aid in tax enforcement, including:

- Extends the statute of limitations from 8 to 12 years, for the California Franchise Tax Board (FTB) to issue a tax assessment for ATAT activity. This extended statute of limitations applies to notices mailed on or after August 1, 2011, for taxable years that have not been closed by a statute of limitations as of that date.
- Imposes the 50 percent interest-based penalty in cases where an amended

return reporting an ATAT is filed after the taxpayer is contacted by the FTB, but prior to the FTB issuing a deficiency notice. Under prior law, a taxpayer could avoid the penalty completely if it filed an amended return after being contacted, but prior to the FTB issuing a deficiency notice.

- Amends the California NEST penalty to include any transaction for which a penalty has been assessed for federal income tax purposes under the federal codification of economic substance. The penalty will be imposed for that portion of the California understatement attributable to the noneconomic substance transaction, and will not be abated unless the taxpayer can establish that the imposition of the *federal* penalty under I.R.C. Sec. 6662 for an underpayment attributable to the transaction was clearly erroneous.
- Further amends the definition of "noneconomic substance transaction" for purposes of the NEST to include any disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of I.R.C. Sec. 7701(o) (the federal codification of economic substance), by substituting the phrase "apart from state income tax effects" for the phrase "apart from Federal income tax effects." For purposes of determining if a transaction has economic substance, the legislation treats any federal or local income tax effect "related" to a state income tax effect the same as a state income tax effect.

Other changes

The legislation authorizes certain taxpayers to use a "look-up" table to determine the amount of use tax to report on a personal income tax return, and makes the refundable child and dependent care credit against personal income tax nonrefundable for post-2010 tax years. Further, the legislation requires the FTB, in coordination with California financial institutions, to operate a Financial Institutions Records Match (FIRM) system to match delinquent tax debtor records with the financial institutions' customer records.

PwC observes

"While the 'VCI Two' may contain onerous provisions for taxpayers, there are some that

may stand to substantially benefit from the VCI's limited penalty relief," says Kathy Freeman, National Tax Services - State and Local Tax Director with PwC in Sacramento. "For example, taxpayers that have already been assessed the NEST penalty clearly have an opportunity to mitigate their penalty exposure under the program. Unfortunately, a large number of taxpayers will likely be contacted by the FTB before the VCI begins, exposing them to the imposition of the enhanced 50 percent interest penalty, which is not waived under the program. Further, taxpayers that are contacted by the FTB regarding 'VCI Two' and choose not to participate will be assessed a penalty equal to 100 percent of interest due from the due date of the return (without extension) until the date a notice of proposed assessment is issued related to the transaction. Taxpayers should also note that the FTB will have 12 years, going forward, to audit these transactions and issue an assessment."

"Regarding the federal codification of economic substance, conformity to these provisions may not have a substantial impact due to the state's 2003 adoption of its NEST penalty. Still, it is troubling that the legislation adopts what amounts to a presumption that any federal economic substance penalty is correct and applies the California NEST penalty automatically in such cases. Further, taxpayers will also have to consider how the mechanics of the federal noneconomic substance transaction statute will impact the California tax consequences on a variety of transactions, which could differ from the common law analysis previously used for the California NEST."

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