

Nixon Peabody LLP State and Local Tax Advisor

Developments in State and Local Tax Law

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California Takes The Initiative Against Abusive Tax Shelters

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Introduction

Although federal legislation had been introduced in 2003 to reign in abusive tax shelters, such efforts have been stalled in Congress. California, however, has picked up the ball and run with it. Signed into law on October 2, 2003, this new law adopts existing federal law regarding tax shelters and provides a comprehensive set of changes designed to: (1) curtail abusive tax avoidance transactions; (2) enhance penalties for investors, promoters, and organizers of abusive tax shelters, including a new penalty for transactions that lack economic substance; and (3) provide a state voluntary compliance initiative. The new legislation is generally effective January 1, 2004; however, it applies to all penalties levied after that date. Accordingly, the increased penalties described below can be levied for transactions that occurred in open tax years.

Curtailing Abusive Tax Avoidance Transactions

Conformity with Federal Law. The new legislation conforms California law to existing federal law regarding the requirements for tax shelter organizers, sellers, material advisors, and promoters to register tax shelters, maintain investor lists, and provide information returns. In addition, the new legislation modifies this conformity to apply registration and reporting requirements to organizers, sellers, material advisors, and promoters with respect to any shelter that meets any of the following criteria: (1) organized in California; (2) does business in California; (3) derives income from sources in California; or (4) has a California taxpayer as at least one of its investors.



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Reportable and Listed Transactions. The California law defines a “reportable transaction” as any transaction with respect to which information is required to be included with a return or statement because that transaction is of a type that the Secretary of the Treasury (i.e., the Internal Revenue Service (“IRS”)) or the California Franchise Tax Board (“FTB”) determines as having a potential for tax avoidance or evasion. It also defines a “listed transaction” as a reportable transaction that is the same or is substantially similar to a transaction specifically identified by the IRS for federal income tax purposes or by the FTB for federal or state income tax purposes as a tax avoidance transaction. Because the definitions of reportable transactions and listed transactions for California purposes are tied to transactions identified by the IRS, these definitions will automatically be revised when such changes are addressed by the IRS.

Duplicate Registration and Reporting Requirements. Tax shelter organizers are required to send a duplicate of the federal registration information, if applicable, or the same information required for federal tax shelters, to the FTB. This duplicate information must be sent to the FTB no later than the occurrence of the first offering for sale of interests in that tax shelter. Although not entirely clear, it appears that this duplicate information is only required for tax shelters first offered for sale after January 1, 2004. However, with respect to (1) transactions entered into on or after February 28, 2000 that become listed transactions (as defined by the federal law) at any time, or (2) transactions entered into on or after September 2, 2003, that are specifically identified by the FTB as a “listed transaction” at any time, the registration requirements must be met by the later of: (a) 60 days after entering into the transaction; (b) 60 days after the transaction becomes a listed transaction; or (c) April 30, 2004. Moreover, any person who receives a tax registration number from the IRS must file a statement of that registration number with the FTB within 30 days after such request. The federal requirement to include tax shelter identification numbers on returns applies for California returns filed after January 1, 2004.

Maintaining and Filing Lists. In addition to the requirement for organizers, sellers, or material advisors of potentially abusive tax shelters to maintain lists of investors in those shelters, the new California law requires that such lists be provided to the FTB. For transactions entered into on or after February 28, 2000, that become listed transactions (as defined by the federal law) at any time, or for transactions entered into on or after September 2, 2003, that are specifically identified by the FTB as a “listed transaction” at any time, the list shall be provided to the FTB by the later of: (1) 60 days after entering into the transaction; (2) 60 days after the transaction becomes a listed transaction; or (3) April 30, 2004.

Statute of Limitations. The statute of limitations is extended from four years to eight years for abusive tax avoidance transactions deficiencies. An “abusive tax avoidance transaction” means a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, listed transactions. This extended statute of limitations is effective for returns filed on or after January 1, 2000.

Enhanced Penalties

Failure to Register or Disclose Reportable Transactions. Unlike the current federal law, the new California law imposes significant penalties on any tax shelter organizer, seller, material advisor, or promoter that is required to register a tax shelter, file an information return, or maintain an investor list and that fails to do so. The penalty for failure to maintain an investor list is \$1,000 per investor (\$100,000 if the number of investors cannot be determined by the FTB). The penalty for failing to furnish the list to FTB on request is \$10,000 per day beginning on the 21st business day after FTB requests the list. The penalty for failure to register or to file an information return is \$15,000 if the transaction is reportable. If the transaction is listed, the penalty is the greater of \$100,000 or 50% of the gross income that the organizer or material advisor derives from that activity. This penalty increases to 75% if failure to provide the list is due to intentional disregard of the law.

Large Entities and High Net-Worth Individuals. For this purpose, a large entity is a taxpayer other than an individual whose gross receipts exceed \$10 million during the taxable year or preceding taxable year in which the transaction occurs, and a high net-worth individual is one whose net worth exceeds \$2 million immediately before the transaction. If these taxpayers fail to disclose their investment in a reportable transaction, a penalty is imposed equal to \$30,000 if the transaction is a reportable transaction and is listed, and \$15,000 if the transaction is reportable but not listed.

Understatements Relating to Reportable and Listed Transactions. Penalties are imposed on taxpayers who understate their tax liabilities as a result of investing in a listed transaction or in a reportable transaction a significant purpose of which is the avoidance or evasion of tax. The penalty is 20% of the understatement if the taxpayer adequately discloses all relevant facts on his or her tax return. The penalty rate increases to 30% if all relevant facts are not disclosed on such return. A penalty can be waived if the taxpayer meets a “reasonable cause” and “good faith” exception. This exception can be met only if all of the following requirements are met: the transaction is disclosed, there is “substantial authority” in favor of the taxpayer’s position, and the taxpayer has a “reasonable belief” that the position was correct. By comparison, the substantial understatement penalty under IRC section 6662 can be avoided if *either* disclosure is made *or* there is substantial authority and a reasonable basis for the taxpayer’s position (under recently finalized federal regulations, however, disclosure is required if the taxpayer’s position is that a regulation is invalid). An opinion of counsel cannot be relied upon to establish reasonable belief if, among other items, it is from an attorney who is a material advisor or is compensated by a material advisor.

Understatements Relating to “Non-economic Substance” Transactions. The new law imposes a novel 20% penalty for understatements attributable to non-economic substance transactions. The term “economic substance” is purposely undefined so as to tie the term to evolving judicial doctrines. A transaction lacks economic substance either because it lacks an economic benefit or because there is no bona fide nontax California business purpose for entering the transaction. The reference to a “nontax California business purpose” is intended to preclude an assertion that a transaction whose only effect is to save California taxes has a valid business purpose and therefore satisfies the economic substance requirement. The penalty increases to 40% for nondisclosed transactions.

Standards of Conduct for Return Preparers. The new law modifies the standards of conduct that must be met by an income tax return preparer and increases the penalty rate for failure to meet this standard. The law replaces the “realistic possibility” standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The penalty for failure to meet this standard is \$1,000. The new law also replaces the “not frivolous” standard with the requirement that there be a “reasonable basis” for the tax treatment for the position. The penalty for failing to meet this standard is increased to \$5,000. Thus, unless there is at least a “reasonable basis” for the tax treatment of the position, such position must be disclosed on the return. Unfortunately, the new law does not provide a definition of “reasonable basis.”

Effective Date and Amnesty Initiative

Effective Date. The new tax shelter provisions generally apply to all penalties levied after January 1, 2004. Thus, penalties may be levied for all open tax years of a taxpayer. Note that a taxpayer who satisfied the federal disclosure regulations as they existed when the return was filed is exempt from the California failure-to-disclose penalty to the extent that such penalty solely relies on federal conformity.

Amnesty Initiative. The new legislation establishes a one-time voluntary compliance initiative (“VCI”) during the period from January 1, 2004 through April 15, 2004. The VCI applies to tax liabilities attributable to the use of abusive tax avoidance transactions for taxable years beginning before January 1, 2003. Under the VCI, any taxpayer who is not the subject of a criminal complaint or investigation in connection with abusive tax shelter avoidance transactions may elect one of two options described below.

- 1. Voluntary Compliance Without Appeal.* Under the first option, the FTB will waive all penalties attributable to the underreporting of tax liabilities due to the use of abusive tax avoidance transaction for all taxable years that the taxpayer elects to participate in the VCI. This waiver of penalties does not apply to penalties that become final before December 31, 2003. The FTB may not bring criminal action against the taxpayer for the taxable years covered by the VCI. However, taxpayers may not file claims for refund for amounts paid in connection with abusive tax shelter transactions.

- 2. Voluntary Compliance with Appeal.* Under this option, the same provisions described above will apply, except that taxpayers may file claims for refund. However, taxpayers who do not prevail on their claims for refund are subject to enhanced, tax-shelter, and accuracy-related penalties on their understatements.

If you have any questions or require further information regarding California's new tax shelter rules or any other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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