tax analysts special report

Storm Shelter? California's Voluntary Compliance Initiative and Its History

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Introduction

Beginning August 1, California income tax payers that used a tax shelter or that have unreported income from the use of an offshore financial arrangement for tax years beginning before January 1, 2011, will have the opportunity to pay tax and interest on income related to those transactions and avoid a barrage of penalties under California's new voluntary compliance initiative (VCI 2). According to the California Franchise Tax Board, VCI 2 is aimed at "tax schemes that serve no significant purpose other than reducing tax."[1] Taxpayers may recall California's first voluntary compliance initiative (VCI 1), which was enacted in 2003 as part of the state's initial deluge of antitax shelter legislation and in response to what the FTB claimed to be a steady loss of revenue because of tax shelter transactions.[2] Although VCI 2 mirrors its predecessor in many ways, as explained in greater detail below, there are significant differences worth consideration. Moreover, VCI 2 follows closely on the heels of the latest round of FTB notices[3] aimed at identifying some transactions as abusive tax avoidance transactions for purposes of California's widening penalty provisions. Clearly, a storm is on the horizon; however, refuge under cover of voluntary compliance should be taken only after careful consideration of the pros and cons associated with participating in VCI 2.

> ***Although VCI 2 mirrors its predecessor in many ways, there are significant differences worth consideration.***

Before turning to the specifics of VCI 2, a review of the history surrounding VCI 1 is necessary to fully understand and appreciate what is being offered by California under its second compliance initiative.

The First Wave: The Rise of California's Tax Shelter Legislation and VCI 1

California's Comprehensive 2003 Tax Shelter Legislation

In the fall of 2003 the California State Legislature enacted SB 614 and AB 1601 (collectively, the "2003 legislation") into law. Intended to "establish California as a trailblazer in the area of tax shelter reform" and even place California "out in front of the federal government in this area,"[4] the sweeping tax shelter law adopted modified versions of federal rules and added California-specific penalties for some abusive tax avoidance transactions. As characterized by the FTB at the time, the "new California law authorizes the Franchise Tax Board to aggressively combat abusive tax shelters and transactions by adding substantial penalties, along with new registration and reporting requirements for both investors and promoters of abusive tax shelters."[5] Fashioned in

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[1]FTB Bill Analysis of SB 86 (2011), dated Mar. 18, 2011, p. 10; *see also* IRC section 6662(d)(2)(C)(ii).

[2]In considering the 2003 legislation, the FTB estimated that California had lost as much as $500 million a year for the preceding four years "due to abusive tax shelters." FTB Bill Analysis of Amended SB 614 (2003), dated Sept. 15, 2003, p. 8.

[3]FTB Notice 2011-01, Jan. 6, 2011, and FTB Notice 2011-03, Apr. 22, 2011.

[4]California State Assembly Bill Analysis of AB 1601 (2003), Assembly Floor, Sept. 12, 2003, p. 8.

[5]A December 3, 2003, letter from the FTB was mailed to approximately 7,000 taxpayers to bring attention to the FTB's voluntary compliance initiative that was enacted as part of the legislation. *See* Eric Coffill, "An Overview of California's 2003 Tax Shelter and Abusive Tax Shelter Legislation," *The Tax Executive*, January-February 2004, p. 33.

part after proposed federal legislation,[6] California adopted in large part the federal reporting requirements regarding "reportable" and "listed" transactions and then added California-only modifications.[7]

As part of the 2003 legislation, the federal disclosure requirements regarding federal reportable and listed transactions were adopted under California Revenue and Taxation Code (CRTC) section 18407. The 2003 legislation also created California-only comparable versions of the two federal categories. However, the 2003 legislation expanded the FTB's authority beyond identifying transactions "as having a potential for tax avoidance or evasions,"[8] creating California-specific listed transactions for California income or franchise tax purposes,[9] and prescribing a list of tax positions "for which the [FTB] believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper tax treatment."[10] The 2003 legislation also empowered the FTB to prescribe a list of "frivolous" positions for purposes of applying a frivolous return penalty of up to $5,000[11] and broadened the FTB's subpoena power to cover taxpayers contacted by the FTB regarding the use of a potentially abusive tax shelter.[12] Further, if the FTB identified an adjustment regarding an abusive tax avoidance transaction (ATAT), the FTB could notify the taxpayer of a proposed deficiency assessment up to eight years after the taxpayer had filed the return, rather than being limited to the normal four-year statute of limitations.[13]

In addition to increasing the FTB's authority, SB 614 and AB 1601 introduced a torrent of new penalties to combat alleged abusive tax avoidance activities. For example, the legislation imposed penalties for failure to disclose a listed transaction ($30,000) and for failure to disclose other reportable transactions ($15,000) on entities with gross receipts exceeding $10 million and individuals with net worth exceeding $2 million.[14] The 2003 legislation imposed a 30 percent understatement penalty upon nondisclosed transactions in which tax avoidance was a significant purpose and a 20 percent understatement penalty on disclosed transactions in which tax avoidance was a significant purpose.[15]

The 2003 legislation also created California's notorious noneconomic substance transaction (NEST) penalty, which is imposed on any NEST understatement.[16] A NEST understatement is an understatement resulting from "the disallowance of any loss, deduction or credit, or addition to income . . . attributable to a transaction that lacks economic substance."[17] Under the statute, a transaction is treated as lacking economic substance if the taxpayer lacks a "valid nontax California business purpose for entering into the transaction."[18] The NEST penalty is 20 percent of the understatement if the transaction is adequately disclosed and 40 percent of the understatement if it is not. There is neither a reasonable-cause nor adequate-disclosure exception to the penalty; rather, the penalty may be relieved only by the FTB's chief counsel.

Finally, the 2003 legislation imposed an interest penalty for taxpayers who did not participate in VCI 1 but were contacted by the FTB regarding the use of a "potentially abusive tax shelter." For purposes of this penalty, a potentially abusive tax shelter is defined as any tax shelter for which registration is required for federal purposes under IRC section 6111, or any transaction the secretary of the Treasury or the FTB determines by regulations as having a potential for tax avoidance or evasion.[19] The interest penalty imposed on a deficiency arising from a potentially abusive tax shelter is equal to 100 percent of the interest due as calculated from the original filing date to the date of the notice of proposed assessment.[20]

VCI 1

The 2003 legislation enacted VCI 1,[21] permitting taxpayers to file amended returns, pay the tax and interest associated with an ATAT, and avoid criminal prosecution and the imposition of certain penalties. As publicized by the FTB, VCI 1 offered "abusive tax scheme investors, promoters, and organizers" an opportunity to "come clean."[22] Open for tax years beginning before January 1, 2003, participants filed amended returns reporting all income and loss without regard to the ATAT and

[6]AB 1601 (2003) and SB 614 (2003) were modeled on the tax shelter provisions of the federal CARE Act of 2003 (S. 476), which was enacted into law without the tax shelter curtailment provisions. *See* FTB Bill Analysis of Amended Senate Bill 614 (2003), dated Sept. 15, 2003, p. 7.

[7]Calif. Revenue and Taxation Code sections 18407, 18628 (2003).

[8]*Id.,* section 18407(a)(3) (2003).

[9]*Id.,* section 18407(a)(4) (2003).

[10]*Id.,* section 19164(b) (2003).

[11]*Id.,* section 19179 (2003).

[12]*Id.,* section 18407(a)(4)(A) (2003).

[13]*Id.,* section 19755 (2003).

[14]*Id.,* section 19773 (2003).

[15]*Id.,* section 19772 (2003).

[16]*Id.,* section 19774 (2003).

[17]*Id.*

[18]*Id.*

[19]Calif. Revenue and Taxation Code section 19777 (2003).

[20]*Id.*

[21]Calif. Revenue and Taxation Code sections 19751-19754 (2003).

[22]"Abusive tax schemes: California offers tax shelter investors a chance to come clean and avoid penalties," *FTB Tax News*, November/December 2003, p. 1.

paid the tax and interest.[23] The FTB in turn did not impose penalties or bring any criminal action against eligible participants regarding the use of the ATAT for the years the taxpayer participated in the initiative.[24]

VCI 1 presented taxpayers with two options: (1) voluntary compliance without appeal rights or (2) voluntary compliance with appeal rights. Under the first option, the ATAT issue was closed without further dispute and the taxpayer could not later file a claim for refund for amounts paid under the program.[25] Under the second option, taxpayers retained their right to file a claim for refund, subject to timing restrictions, but were subject to the accuracy-related penalty.[26]

At the time of its creation, the FTB estimated VCI 1 would generate more than $90 million in revenue for the state of California for budgetary year 2003-2004.[27] During the January 1, 2004, to April 15, 2004, filing period, the FTB collected approximately $1.3 billion in revenue from 1,138 taxpayers.[28]

The Perfect Storm: The FTB's New Notices and VCI 2

The FTB's New Notices

By the end of 2003, the FTB had issued only one notice or "other published position" under its newfound authority set forth in CRTC section 18407(a)(4)(A). On December 31, 2003, the FTB issued Chief Counsel Announcement 2003-1, titled "Abusive Tax Shelters — California Listed Transactions."[29] Under the terms of Announcement 2003-1, California listed transactions include two "Other California Listed Transactions." Those are (1) "Certain Real Estate Investment Trust (REIT) Transactions" and "Certain Regulated Investment Company ('RIC') Transactions."[30] For the next seven years, the FTB would not identify any additional California-specific listed transactions other than the aforementioned REIT and RIC transactions.

Recently, however, the FTB issued two published positions — FTB Notice 2011-01[31] and FTB Notice 2011-03[32] under CRTC section 18407(a)(4)(A). The stated purpose of both notices is to alert taxpayers and their representatives that some transactions are ATATs and identify those transactions, and substantially similar transactions, as "listed transactions" for purposes of California law.

FTB Notice 2011-01

On January 6, 2011, the FTB alerted taxpayers and their representatives that transactions using abusive sales factor manipulation are considered listed transactions for purposes of the CRTC. The transactions described in the notice generally involve a group of corporations engaged in a unitary business, which files a California combined report. A newly formed, newly acquired, or previously dormant partnership with few or no assets or employees of its own is assigned to perform an existing function that had been previously performed by a corporate member of the group, but often contracts with another member of the group to perform the function on the partnership's behalf. At least one member of the group owns an interest in the partnership (and may or may not conduct any business other than holding the partnership interest), and at least one other member of the group does not own an interest in the partnership.

In those transactions, the partnership sells goods or services to the member without an ownership interest, or vice versa. The taxpayer then excludes all such sales from the combined reporting group's net business income but includes all such sales in the California sales factor denominator under the taxpayer's interpretation of FTB Regulation 25137-1(f)(3)(B).[33] That regulatory provision states:

> Notwithstanding any intercompany eliminations described in subparagraph (A) above, sales made to non-partners shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership but none of those sales are assigned to California for the purposes of the sales factor numerator.

The notice lists eight reasons why the FTB may disallow any tax benefits arising from the transactions described therein, including unfair representation of the taxpayer's in-state business activities and lack of economic substance. The notice also states that the FTB will consider several factors in determining whether to disallow transactions described in the notice and impose penalties. Those factors include whether the partnership has sufficient employees or funds to conduct its alleged business activity; whether the partnership's sales at issue are fictitious or overvalued, or serve a valid, nontax business purpose; and whether the taxpayer can demonstrate that it benefited economically from

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[23] Calif. Revenue and Taxation Code section 19754(a) (2003).

[24] *Id.* section 19752 (2003).

[25] *Id.* section 19752(a) (2003).

[26] *Id.* section 19752(b) (2003).

[27] FTB Bill Analysis of Amended SB 614 (2003), dated Sept. 15, 2003, p. 8.

[28] FTB Bill Analysis of SB 86 (2011), dated Mar. 18, 2011, p. 8, n.4.

[29] FTB Chief Counsel Announcement 2003-1, Dec. 31, 2003.

[30] *Id.*

[31] FTB Notice 2011-01, Jan. 6, 2011.

[32] FTB Notice 2011-03, Apr. 22, 2011.

[33] 18 Cal. Code Regs. section 25137-1(f)(3)(B).

assigning activities to the partnership that previously had been performed by corporate members of the combined reporting group, apart from claimed favorable tax consequences.

FTB Notice 2011-03

On April 22, 2011, the FTB alerted taxpayers and their representatives that transactions involving a parent corporation (Parent) that artificially increases its basis in the stock of its subsidiaries (Subsidiary), without any outlay of cash or property, before Parent's selling the stock of Subsidiary to an unrelated third party are considered "listed transactions" for purposes of CRTC section 18407(a)(4)(A). As described in the notice, the transaction begins with Parent contributing a promissory note or other instrument to Subsidiary in a transaction intended to qualify as a contribution to capital under IRC section 351, which is applicable for California purposes under CRTC section 24451. Subsidiary then takes steps to generate earnings and profits in order for any distributions to Parent to be treated as a dividend and deductible or excludable from Parent's income for California tax purposes. One method identified by the FTB for achieving Parent's stepped-up basis involves Subsidiary then forming a new, second-tier subsidiary and selling Parent's promissory note (now an intangible asset of Subsidiary) to the newly formed subsidiary in exchange for a new promissory note. Because the basis of the intangible asset in Subsidiary's hands is zero, Subsidiary claims earnings and profits for the full value of the intangible asset.

As the transaction continues, Parent pays off the promissory note issued to Subsidiary either in one lump sum payment or in partial amounts close in time to when Subsidiary has generated earnings and profits. Soon thereafter, Subsidiary distributes the cash back to Parent and because Subsidiary has earnings and profits (all or part of which may have been artificially created), Parent claims the distribution is a dividend and deductible or excludable from net income. Also, Parent claims that it does not have to reduce its basis since it is a dividend.

The FTB views these "circular cash flow transactions" as exploiting and abusing California's nonconformity to some federal consolidated return regulations provided under IRC section 1502.[34] Because the earnings and profits of each entity in the California combined report are calculated on a separate accounting basis and do not reflect the earnings of any lower tier subsidiaries,[35] and the cost basis of a unitary subsidiary's stock is not adjusted to reflect the earnings of that subsidiary,[36] the end result is that Parent artificially inflates its basis in its stock in Subsidiary without any actual out-of-pocket cost to Parent. The FTB intends to challenge the purported tax benefits from these transactions based on the sham transaction and step transaction doctrines, a lack of economic substance or valid nontax business purpose, and illusory contribution to capital, among other theories.

Reporting Requirements

Taxpayers engaged in transactions substantially similar to the transactions described in either notice must report the transactions under CRTC section 18407. Taxpayers failing to comply with the reporting requirements are subject to certain noncompliance penalties,[37] and participants in these transactions may be subject to penalties, including, but not limited to, accuracy-related,[38] NEST,[39] 100 percent interest-based,[40] and in some circumstances, fraud penalties.[41]

Material advisers are also subject to reporting and list maintenance requirements.[42] Failure to properly comply with those requirements may subject material advisers to penalties for failure to maintain and/or furnish investor information,[43] failure to disclose reportable transactions,[44] and promoting an abusive tax shelter.[45]

SB 86 and VCI 2

Amnesty bills have been pending in the California Legislature for the last several sessions, but none have been enacted — until now. As part of the discussions between Gov. Jerry Brown (D) and the Legislature, language to implement an amnesty program was included in SB 86, which was introduced in January 2011 and written by the California Senate Budget and Fiscal Committee. SB 86, in part, enacts a "narrow tax amnesty program" for taxpayers that used a tax shelter or that have unreported income from the use of an offshore financial arrangement.[46] The bill is an urgency statute

[34]California has no provisions similar to the investment adjustments allowed regarding earnings and profits and stock basis for federal purposes under Treasury regulations sections 1.1502-32 and -33.

[35]*See Appeal of Young's Market Company*, Cal. St. Bd. of Equal., Nov. 19, 1986.

[36]*See Appeal of Safeway Stores*, Cal. St. Bd. of Equal., Mar. 2, 1962*; see also Appeal of Rapid American Corp.*, Cal. St. Bd. of Equal., Oct. 10, 1996.

[37]Calif. Revenue and Taxation Code section 19772.

[38]*Id.,* section 19164(a).

[39]*Id.,* section 19774.

[40]*Id.,* section 19777.

[41]*Id.,* section 19164(c).

[42]*Id.,* sections 18628, and 18648.

[43]*Id.,* section 19173.

[44]*Id.,* section 19182.

[45]*Id.,* section 19177.

[46]FTB Bill Analysis of SB 86, dated Mar. 18, 2011.

that went into immediate effect when signed by the governor on March 24, 2011.[47] VCI 2 aims in part to address the fiscal emergency declared by the governor early in 2011.[48] The FTB estimates a total revenue impact of $270 million from VCI 2 for budgetary year 2010-2011.[49]

SB 86

Like the 2003 legislation, SB 86 introduces some provisions and imposes some penalties designed to discourage taxpayers from further participating in ATATs and to encourage taxpayers to participate in the latest compliance initiative. For example, SB 86 increases the statute of limitations for the FTB to find and issue an assessment on ATAT cases to 12 years.[50] SB 86 also imposes a 50 percent interest-based penalty on any amended return filed by a taxpayer after being contacted by the FTB and after the VCI 2 compliance period but before the FTB issues a deficiency notice.[51] A penalty equal to 100 percent of the interest payable from the due date of the return through the date of a notice of proposed assessment will be imposed on taxpayers who are contacted by the FTB regarding the use of an ATAT or an offshore financial arrangement but who fail to participate in VCI 2.[52]

Critical to SB 86 is its provision of a uniform definition of ATAT for California tax purposes. Under the new legislation, an ATAT includes a federal tax shelter, a reportable transaction not adequately disclosed, a listed transaction, a gross misstatement, or any transaction to which California's NEST penalty applies.[53] For purposes of VCI 2, SB 86 also defines an offshore financial arrangement as an arrangement that relies in any manner 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.[54]

Finally, SB 86 conforms California's NEST penalty to the newly codified federal economic substance doctrine.[55] Although the FTB's chief counsel may generally compromise all or any portion of the NEST penalty at his discretion,[56] a NEST penalty imposed on a transaction for which a penalty was assessed under the IRC on the portion of an understatement attributable to the disallowance of claimed tax benefits by reason of the transaction lacking economic substance may be abated only if the taxpayer can establish that the imposition of the federal penalty was "clearly erroneous."[57]

VCI 2

SB 86 requires the FTB to administer VCI 2 during the period beginning August 1, 2011, and ending on October 31, 2011, inclusive.[58] VCI 2 covers both personal and corporate income taxes and applies to tax liabilities due and payable for tax years beginning before January 1, 2011.[59] Notably, that includes tax years subject to VCI 1;[60] accordingly, taxpayers who did not participate in VCI 1 will have a second opportunity to "come clean."[61] Program participants are required to file amended returns and pay all unpaid tax and interest resulting from an ATAT or from unreported offshore financial arrangements.[62] Eligible program participants include taxpayers that have ATATs currently under audit, ATAT cases in protest, as-yet unknown or undisclosed ATATs, or unreported income form the use of an offshore financial arrangement. Notably, and in contrast to VCI 1, all issues resolved under VCI 2 will be closed without appeal rights.[63]

> ***Notably, and in contrast to VCI 1, all issues resolved under VCI 2 will be closed without appeal rights.***

For qualified participants, the FTB will waive all penalties except for the large corporate understatement penalty[64] and the amnesty penalty,[65] if the

[47]SB 86, Preamble.
[48]*Id.*
[49]FTB Bill Analysis of SB 86, dated Mar. 18, 2011, p. 16.
[50]SB 86, section 20; Calif. Revenue and Taxation Code section 19755(a)(2).
[51]SB 86, section 24; Calif. Revenue and Taxation Code section 19777(d)(1).
[52]SB 86, section 24; Calif. Revenue and Taxation Code section 19777(a).
[53]SB 86, section 24; Calif. Revenue and Taxation Code section 19777(b).
[54]SB 86, section 21; Calif. Revenue and Taxation Code section 19764(a)(1)(B).
[55]SB 86, section 23; Calif. Revenue and Taxation Code section 19774.
[56]SB 86, section 23; Calif. Revenue and Taxation Code section 19774(d).
[57]SB 86, section 23; Calif. Revenue and Taxation Code section 19774(e).
[58]SB 86, section 21; Calif. Revenue and Taxation Code sections 19761(a), (b).
[59]SB 86, section 21; Calif. Revenue and Taxation Code section 19761(b).
[60]Recall, VCI 1 applied to tax years beginning before January 1, 2003. Calif. Revenue and Taxation Code section 19754(a) (2003).
[61]*Supra* note 24
[62]SB 86, section 21; Calif. Revenue and Taxation Code section 19764(a).
[63]SB 86, section 21; Calif. Revenue and Taxation Code section 19762(b)(4).
[64]Calif. Revenue and Taxation Code section 19138.

participant "fully cooperate[s] in an inquiry" regarding the use of ATAT or offshore financial arrangements.[66] Also, no criminal action will be brought against any qualified VCI 2 participant that, as of July 31, 2011, is not the subject of a criminal complaint or under criminal investigation in connection with an ATAT or unreported income from the use of an offshore financial arrangement.[67] However, penalties imposed by the new legislation will not be waived for taxpayers on notice of a criminal investigation or criminal prosecution or if a court proceeding has already been initiated.[68] No refund or credit will be allowed for any penalty paid before the time a taxpayer participates in VCI 2.[69]

Under SB 86, the FTB is required to "issue forms and instructions"[70] and "publicize the voluntary compliance initiative so as to maximize public awareness of and participation in the initiative."[71] The FTB recently published information regarding VCI 2 on its website, including 25 FAQs, discussing the implementation of and participation in the new program.[72] For example, "Eligibility" FAQ No. 6 confirms that all tax years before 2011 involving ATATs, including those for which amended returns are already on file and the tax and interest has been paid already, are eligible for VCI 2.[73] The FTB's VCI 2 Participation Agreement Form will have an area designed for taxpayers who have already filed amended returns or have audits, protests, or refund claims pending for which the taxpayer can reference the specific year and attach copies of what has been filed with the FTB already.[74] Also, Eligibility FAQ No. 8 states that a taxpayer who participated in VCI 1 and now has amended returns showing a different amount of tax for the same transaction or new amounts of tax for a different transaction for the same tax years (as VCI 1) is not barred from participating in VCI 2 on those amounts and transactions.[75]

Also of note is "Participation" FAQ No. 6, which provides that the FTB "will generally follow a final federal determination based on a federal settlement or federal closing agreement."[76] However, the FAQ makes clear that the FTB "reserves the right to examine the federal closing agreement or settlement to ensure that it resulted in a final federal determination that is consistent with California law and specifically resolved an ATAT or an OFA."[77] In an attempt to encourage participation in the upcoming program, the FTB has identified more than 30,000 taxpayers who may be eligible to participate in VCI 2 and who will receive a letter from the FTB touting the "benefits" of the initiative.[78]

VCI 2 and the 2011 Federal ATAT Disclosure Program

As discussed above, VCI 2 applies to unreported income from the use of an offshore financial arrangement. On February 8 the IRS introduced the 2011 Offshore Voluntary Disclosure Initiative (OVDI) to "bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws."[79] OVDI allows taxpayers to report previously undisclosed foreign accounts, assets, and income through August 31, 2011, and avoid criminal prosecution and limit their exposure to civil penalties if program requirements are met.[80] Eligible participants are required to file amended tax and information returns for the tax years 2003 to 2010, pay all taxes and interest due regarding those returns (including any accuracy or delinquency penalties), and

[65]Calif. Revenue and Taxation Code section 19777.5.

[66]SB 86, section 21; Calif. Revenue and Taxation Code sections 19762(b)(1), 19764(d).

[67]SB 86, section 21; Calif. Revenue and Taxation Code section 19762(b)(2).

[68]SB 86, section 21; Calif. Revenue and Taxation Code section 19763(a).

[69]SB 86, section 24; Calif. Revenue and Taxation Code section 19777(d).

[70]SB 86, section 21; Calif. Revenue and Taxation Code section 19761(c).

[71]SB 86, section 21; Calif. Revenue and Taxation Code section 19761(d).

[72]*See generally* http://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/index.shtml.

[73]*See* VCI 2 FAQs, *available at* http://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/faqs.shtml.

[74]As of the date of writing, the FTB website provides VCI 2 Participation Agreement Forms will be made available online August 1, 2011. *Supra* note 73

[75]*See* VCI 2 FAQs, *available at* http://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/faqs.shtml. However, "Penalties" FAQ No. 6 underscores that a taxpayer who participated in VCI 1 and chose option B (with appeal rights and subject potentially to the accuracy related penalty) may not participate in VCI 2 and now submit the identical amended return as before in an attempt to circumvent the accuracy related penalty. *Id.*

[76]*Id.*

[77]*Id.*

[78]Comments made by FTB Chief Counsel Geoff Way during a chief counsel roundtable at the "Los Angeles County Bar Association State and Local Tax Developments and Other Key Issue" program, June 20, 2011, and materials distributed there.

[79]2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, FAQ No. 2 "What is the objective of this initiative?" *available at* http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

[80]IR-2011-14, IRS, Feb. 8, 2011.

pay a penalty equal to 25 percent of the amount in foreign bank accounts in the year with the highest aggregate account balance covering 2003 to 2010. That penalty may be reduced in some situations.[81]

Taxpayers should consider coordinating voluntary disclosure under the IRS's OVDI and California's VCI 2.

Given the partial overlap between California's VCI 2 and the IRS's OVDI (note OVDI does not cover ATATs) and the information sharing between the IRS and the FTB,[82] taxpayers should consider coordinating voluntary disclosure under those two programs. According to the VCI 2 FAQs, the FTB has said it is willing to give California taxpayers comparable treatment under VCI 2 for ATATs subject to federal determination or adjustment.[83] As such, taxpayers anticipating federal adjustments regarding ATATs may want to finalize those adjustments in time to meet the October 31, 2011, VCI 2 compliance deadline.

Conclusion

Through VCI 2, the FTB is offering shelter from the storm. However, taxpayers want to carefully consider whether to enter the FTB's refuge that, once entered, provides no way out. Taxpayers whose transactions do not come under the FTB's expanded definition of ATATs may trust to the legal foundation on which their respective structures are built. Once October 31 passes, however, taxpayers will find out one way or another if their particular shelters will weather the storm or leave them all wet. ✰

[81]For smaller offshore accounts or assets (up to $75,000 in the aggregate in any calendar year covered by the OVDI), the IRS created a penalty category of 12.5 percent. A 5 percent reduced penalty is also retained from the 2009 Offshore Voluntary Disclosure Program, which some taxpayers may qualify for if specific criteria are met.

[82]California taxpayers are required to report "final federal determination[s]" to the FTB in a timely manner. Calif. Revenue and Taxation Code section 18622

[83]*Supra* note 75