

## The 2005 California Tax Amnesty

**ON AUGUST 16, 2004, GOVERNOR SCHWARZENEGGER SIGNED** into law California's latest version of tax amnesty. The new legislation grants taxpayers a penalty-free opportunity—for two months beginning February 1, 2005—to pay delinquent California income, franchise, sales, and use taxes for tax years 2002 and before. The new legislation encourages compliance with the tax laws and is expected to generate badly needed revenue for the state.

The amnesty under the new legislation is not a full pardon; it only applies to penalties. To earn this waiver of penalties, taxpayers must pay in full, including interest, the delinquent taxes. Nevertheless, penalties may be significant and even become a substantial portion of the total amount due. Moreover, the new legislation includes increased penalties for those who are eligible to participate in the new amnesty program but fail to do so. These penalties include double civil penalties, additional interest-based penalties, and even criminal prosecution. Given this reality, the new amnesty program warrants the serious consideration of all California taxpayers, including corporations and other taxpaying entities.

California's new amnesty program is part of a recent trend among many states and is the latest installment of amnesty programs California has enacted over the last two decades. In 1984, California conducted a similar program that covered individual income tax and sales tax. The 1984 amnesty program generated \$197 million in revenue.<sup>1</sup> In 1994, California enacted the Employment Tax Amnesty, administered by the Employment Development Department, to collect unpaid state employment taxes. Although no final statistics are available, the 1994 Employment Tax Amnesty was expected to generate \$15.1 million.<sup>2</sup> The new amnesty program is expected to generate \$333 million over the next three years.<sup>3</sup>

The legislation grants the Franchise Tax Board (FTB) and the State Board of Equalization (BOE) the authority to administer a tax amnesty program with regard to their respective tax collection responsibilities.<sup>4</sup> The FTB is the governmental agency responsible for collection of all state-imposed income and franchise taxes.<sup>5</sup> The BOE is the agency responsible for collection of all state-imposed sales and use taxes.<sup>6</sup> Thus, income, franchise, sales, and use taxes are all eligible for inclusion in the amnesty program, if these tax liabilities arose in 2002 and earlier tax years.<sup>7</sup> The amnesty program is to take place for the two-month period of February 1 through March 31, 2005, or some other period that ends by June 30, 2005.<sup>8</sup>

The advantages of participating in the amnesty program are significant. Taxpayers can avoid penalties by paying all past-due taxes, plus interest.<sup>9</sup> Even though the state was willing to make a good-faith effort to resolve unpaid tax liabilities by creating the amnesty program, it did not wish to provide taxpayers with an interest-free loan for outstanding tax liabilities. Another benefit is the avoidance of criminal prosecution.<sup>10</sup> However, the amnesty program is not available

to taxpayers who are under, or have been given notice that they are under, criminal tax investigation or who have had a civil tax court proceeding initiated against them.<sup>11</sup>

The benefits of the amnesty program are available to all taxpayers with tax liabilities that result from nonfiling of returns, underreported income on filed returns, claimed excessive deductions, or any unpaid tax liabilities from previously determined or proposed-to-be-determined amounts.<sup>12</sup> However, the amnesty program does not apply to those tax liabilities arising from tax shelter items that could have been reported pursuant to the FTB's Voluntary Compliance

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Initiative, which took place in early 2004, or the IRS Offshore Voluntary Compliance Initiative (described in Revenue Procedure 2003-11), which occurred in early 2003.<sup>13</sup>

### Requirements for Participation

To participate in the amnesty program, taxpayers must meet multiple requirements. The threshold requirements are that taxpayers must have no criminal matters pending and the taxes at issue must be for tax years 2002 or before.<sup>14</sup> Next, taxpayers must complete the appropriate amnesty application, sign it under the penalty of perjury, and file the application with the appropriate state agency with a postmark of no later than April 1, 2005.<sup>15</sup> The FTB Web site indicates that the amnesty application will be made available on January 15, 2005.<sup>16</sup> Third, taxpayers must file all necessary tax returns (original or amended) and pay all tax and interest due on these tax returns by May 31, 2005.<sup>17</sup> Taxpayers who have filed for bankruptcy protection must also obtain an order from the U.S. Bankruptcy Court allowing the taxpayer to participate in the amnesty program and submit a copy of the order with the amnesty application.<sup>18</sup>

Some taxpayers may be in a position to take advantage of both the FTB and BOE amnesty programs. Although it is advisable for these taxpayers to file amnesty applications with both agencies, the legislation does not appear to condition the successful amnesty application with one agency on the application for amnesty with the other.<sup>19</sup> However, if only one application is filed, the taxpayer remains exposed to penalties and possible criminal sanctions from the other agency.

Taxpayers who are unable to fully satisfy their outstanding tax lia-

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bilities within the prescribed 60-day period (March 31 to May 31, 2005) may be able to enter into an installment payment agreement under specific terms.<sup>20</sup> If an installment payment agreement is executed, taxpayers will have until June 30, 2006, to make all payments of tax and interest owed.<sup>21</sup> Interest will accrue on the outstanding liability during the installment payment agreement period.<sup>22</sup> Taxpayers who default under the agreement will become immediately liable for all tax, interest, and previously waived penalties.<sup>23</sup> However, a taxpayer can avoid this sanction by demonstrating that the failure to comply with the installment agreement was due to reasonable cause and not willful neglect.<sup>24</sup>

The new legislation left the task of creating the forms and instructions to the FTB and the BOE.<sup>25</sup> In addition, the legislation requires the FTB and BOE to publicize the amnesty program so that all potential participants are given the opportunity to take advantage of its benefits, as well as become aware of the consequences of not participating.<sup>26</sup> Further, the FTB and the BOE must make reasonable attempts to identify taxpayers with eligible liabilities and notify these taxpayers in writing of their ability to participate in the amnesty program.<sup>27</sup> However, the failure of the FTB or BOE to notify eligible taxpayers will not prevent them from participating in the amnesty program.<sup>28</sup>

Taxpayers who have already paid fees or penalties for the tax years covered by the amnesty program are prevented from applying for refunds or credits of these amounts.<sup>29</sup> In addition, taxpayers who participate in the FTB amnesty program forfeit all appeal rights with respect to amounts paid pursuant to the amnesty program.<sup>30</sup>

There may be taxpayers who, for a variety of reasons, feel compelled to begin the process of correcting past errors before the amnesty period begins. The question arises whether one can obtain the benefits of amnesty by filing the necessary or corrected returns before the amnesty period. The legislation is quite clear that the amnesty application and accompanying tax returns must be filed after February 1, 2005.<sup>31</sup> A taxpayer who cannot wait until February 1, 2005, however, should consider sending in designated advance tax and interest payments to the tax agency to begin the process and then follow up with the formal amnesty application and tax returns. A taxpayer in this situation should first seek advice from an experienced tax professional to help ensure that all matters are handled appropriately.

### **Not Coming Forward**

The consequences of not participating in the amnesty program can be dire, including

increased interest-based and other penalties, potential criminal prosecution, and other possible sanctions.<sup>32</sup> The interest-based civil penalty will require taxpayers to pay an additional 50 percent of the accrued interest on any deficiencies.<sup>33</sup> This interest-based penalty is in addition to any other penalties that may be imposed on taxpayers who owe back amounts.<sup>34</sup> The interest-based penalty will not apply to taxpayers who executed an installment payment agreement at the start of the amnesty period.<sup>35</sup> In addition, no refund claims will be permitted with respect to the interest-based penalty.<sup>36</sup>

The new legislation contains penalties that are unique to the BOE and its enforcement responsibilities. First, for those taxpayers who are eligible for the amnesty program but choose not to participate, the BOE will impose penalties at double the normal rate.<sup>37</sup> This new rule results in penalties equal to 20 percent of the tax owed, and in the case of fraud, a 50 percent penalty.<sup>38</sup> In addition, the BOE can institute criminal action against these taxpayers.<sup>39</sup> These penalties would also apply to taxpayers who participate in the amnesty program but fail to completely and accurately report their income.<sup>40</sup> Furthermore, for eligible taxpayers who do not file accurate amnesty returns or choose not to participate in the amnesty program, the BOE has been given an extended statute of limitations of 10 years to make a deficiency determination.<sup>41</sup>

The FTB is also armed with new penalties for those taxpayers who are eligible but do not participate in the amnesty program. An increased accuracy-related penalty, determined pursuant to Revenue and Taxation Code Section 19164, would be imposed on taxpayers who fail to make an amnesty application.<sup>42</sup> Section 19164 normally provides for a 20 percent penalty on any "substantial understatement of income tax." The new amnesty legislation increases the Section 19164 penalty from 20 percent to 40 percent for any proposed deficiency arising in taxable years beginning before January 1, 2003.<sup>43</sup> This penalty will not apply to those taxpayers who are under audit by the FTB, have filed a protest or an appeal, are engaged in settlement negotiations, or who have a pending judicial proceeding.<sup>44</sup> A "substantial understatement of income tax" is an understatement in any taxable year that exceeds the greater of 10 percent of the tax required or \$5,000,<sup>45</sup> or in the case of a corporation, \$10,000.<sup>46</sup> But, for those corporations that the FTB has already contacted regarding the use of a potentially abusive tax shelter, a "substantial understatement of income tax" exists if the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return, or \$5 million.<sup>47</sup>

Additionally, the new legislation provides

the FTB with mechanisms for dealing with amnesty participants who are not completely accurate and compliant. For example, if a taxpayer who participates in the amnesty program fails to fully pay taxes owed for the 2005 and 2006 tax years, the taxpayer would lose all the previously received benefits of the amnesty program.<sup>48</sup> Thus, all the penalties and fees previously waived pursuant to the amnesty program would become immediately due and payable, along with any associated interest.<sup>49</sup> If a taxpayer who participates in the amnesty program does not divulge all the amounts of unreported or underreported income, the FTB has the authority to impose fees, penalties, and criminal action as warranted with regard to the amounts that were not disclosed.<sup>50</sup>

It is important to note that the new legislation presents a quandary for taxpayers who were eligible but did not participate in the FTB Voluntary Compliance Initiative in early 2004 or the IRS Offshore Voluntary Compliance Initiative in early 2003. These taxpayers are prohibited from participating in the new amnesty program; yet, because they will not have participated, they will be subject to increased penalties pursuant to Section 19164 for deficiency determinations made after the close of this latest amnesty program. Presumably, without the new legislation, these taxpayers would be subject to a 20 percent accuracy-related penalty pursuant to Section 19164, unless other penalty sections apply.<sup>51</sup> The new legislation doubles the accuracy-related penalty to 40 percent.<sup>52</sup> Thus, the amnesty program would impose increased penalties upon those taxpayers who did not participate in the previous FTB and IRS settlement programs.

The possibility of penalties, increased interest-based penalties, as well as criminal sanctions are enough encouragement for most taxpayers to participate in the amnesty program. Furthermore, in the current environment of heightened tax-compliance enforcement, tax agencies are likely to impose the complete spectrum of possible sanctions, from civil to criminal. Governor Arnold Schwarzenegger has stated his intent to balance the state budget without raising taxes, and taxpayers may find themselves the subject of fairly aggressive enforcement actions to collect revenues for a state that is in great need of money. However, California is not alone in its pursuit to enact and administer an amnesty program, and California taxpayers who pay taxes in other jurisdictions should be aware of other state programs as well.

### **Other State Programs**

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that this is an opportune time to enact tax amnesty programs. States that have enacted such programs include Arkansas, Connecticut, Illinois, Maryland, Mississippi, Nebraska, New Jersey, South Carolina, and West Virginia.

The details of each state initiative vary, but all the programs provide an extremely limited time frame within which taxpayers may participate. These programs vary in penalties and fees imposed, duration of the program period, types of taxes involved, and the taxpayer eligibility requirements that must be met. However, a common theme to all these programs is that taxpayers are required to file amended returns and promptly pay the additional tax and interest. Another common theme of amnesty legislation is the increased enforcement mechanisms that will be used against those taxpayers who choose not to participate.

Arkansas enacted a tax amnesty program that took place from July 1, 2004, through September 30, 2004.<sup>53</sup> Taxpayers could come forward, apply for amnesty, file all the applicable tax forms, and pay all taxes owed. The result was that taxpayers were able to avoid paying any penalties and interest. Mississippi is conducting a tax amnesty program from September 1, 2004, through December 31, 2004, for all types of taxes that arose in tax years 1999 and later.<sup>54</sup> Participants receive a waiver of all civil and criminal penalties for nonpayment of taxes. Nebraska conducted a tax amnesty program from August 1, 2004, through October 31, 2004, for all types of taxes that were due on or before April 1, 2004.<sup>55</sup> All interest and penalties were waived for participants. West Virginia's amnesty program ran from September 1, 2004, through November 1, 2004.<sup>56</sup> Participants had to pay the tax owed and 50 percent of the applicable interest. In return, participants avoided the imposition of penalties, criminal action, and the remaining 50 percent of the accrued interest on any outstanding liabilities.

On June 16, 2004, Connecticut announced that it was administering an abusive tax shelter compliance initiative through July 31, 2004, for all taxpayers that participated in any potentially abusive tax shelters.<sup>57</sup> Eligible taxpayers were permitted to come forward, disclose their investment in any abusive shelter, and avoid the imposition of civil penalties as well as criminal sanctions. Similarly, on July 30, 2004, Illinois enacted an amnesty program for taxpayers who invested in tax shelters.<sup>58</sup> The program is running from October 15, 2004, through January 31, 2005. During the program period, eligible taxpayers must come forward, file amended returns reporting their income without the benefit of the tax shelter transaction, and pay all required tax and interest. The bene-

fit of participation in the program is the avoidance of penalties and criminal prosecution.

New Jersey also conducted a tax amnesty program specific to taxpayers that invested in tax shelters.<sup>59</sup> New Jersey's program, which ran through September 15, 2004, required taxpayers to concede 100 percent of the tax and pay all interest on the tax owed. Taxpayers who participated in the amnesty program avoided penalties, but they also forfeited the right to deduct fees related to participation in the transaction. South Carolina's amnesty program encouraged investors in abusive tax shelters to make a disclosure in return for avoidance of penalties.<sup>60</sup> South Carolina's amnesty program expired on September 1, 2004.

Maryland enacted its version of tax amnesty, though it was limited in scope. The Maryland law sought to entice disclosure only from corporations that used payments to out-of-state affiliates to shelter income from Maryland taxes.<sup>61</sup> The program was administered from July 1, 2004, through November 1, 2004. Eligible taxpayers were required to complete an application, file all amended returns with the application, and pay all tax due. In return for their participation, taxpayers were assessed at a reduced interest rate, avoided all penalties, and avoided any tax incurred prior to 1995.

Generally speaking, an amnesty program is the government's best offer with respect to a tax issue. The bureaucratic nature of a government institution, especially a tax-collecting agency offering an amnesty program, does not easily permit different treatment for similarly situated taxpayers. Thus, taxpayers who believe they can obtain a better result from the FTB or the BOE by not participating in the amnesty program face a very difficult, if not impossible, task. ■

<sup>1</sup> A.B. 2203, 2003-04 Sess. (Cal. 2004).

<sup>2</sup> A.B. 2664, 1993-94 Sess. (Cal. 1994).

<sup>3</sup> SENATE BUDGET AND FISCAL REVIEW COMMITTEE, S.B. 1100 SENATE FLOOR ANALYSIS (July 28, 2004).

<sup>4</sup> REV. & TAX. CODE §§7070 and 19730, added by 2004 Cal. Stats. 226, §§6, 11, (effective Aug. 16, 2004). This authority exists in two separate parts of the Revenue and Taxation Code, which makes it necessary, where applicable, to cite to two code sections in each citation.

<sup>5</sup> REV. & TAX. CODE §19501.

<sup>6</sup> REV. & TAX. CODE §7051.

<sup>7</sup> REV. & TAX. CODE §§7071 and 19731.

<sup>8</sup> *Id.*

<sup>9</sup> REV. & TAX. CODE §§7072(a) and 19732(a).

<sup>10</sup> *Id.*

<sup>11</sup> REV. & TAX. CODE §§7072(b) and 19732(b).

<sup>12</sup> REV. & TAX. CODE §§7072(a) and 19732(a).

<sup>13</sup> REV. & TAX. CODE §19732(c). See also Charles P. Rettig and Steven Toscher, *Deadline Looms to Come Clean on Offshore Credit Card Tax Schemes*, LOS ANGELES LAWYER, Apr. 2003, at 12.

<sup>14</sup> REV. & TAX. CODE §§7073(a) and 19733(a).

<sup>15</sup> *Id.* An appropriate application must be completed.

A payment of tax and interest or an application for a refund will not qualify as an application for the amnesty program. REV. & TAX. CODE §§7073(e) and 19733(c).

<sup>16</sup> *California Tax Amnesty Quick Reference, available at* <http://www.ftb.ca.gov/amnesty/faq.html> (visited Aug. 25, 2004).

<sup>17</sup> REV. & TAX. CODE §§7073(a) and 19733(a).

<sup>18</sup> REV. & TAX. CODE §§7073(a) and 19733(a).

<sup>19</sup> REV. & TAX. CODE §§7070 and 19730.

<sup>20</sup> REV. & TAX. CODE §§7073(b) and 19733(b).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* The additional requirement to disprove "willful neglect" is a standard that only exists with respect to the amnesty program administered by the FTB.

<sup>25</sup> REV. & TAX. CODE §§7073(e) and 19733(c).

<sup>26</sup> REV. & TAX. CODE §§7077 and 19736(a).

<sup>27</sup> REV. & TAX. CODE §§7078 and 19736(b).

<sup>28</sup> *Id.*

<sup>29</sup> REV. & TAX. CODE §§7072(c) and 19732(d).

<sup>30</sup> REV. & TAX. CODE §19732(e).

<sup>31</sup> REV. & TAX. CODE §§7071 and 19731.

<sup>32</sup> REV. & TAX. CODE §§7074(a) and 19777.5(a).

<sup>33</sup> *Id.*

<sup>34</sup> REV. & TAX. CODE §§7074(b) and 19777.5(b).

<sup>35</sup> REV. & TAX. CODE §§7075 and 19738.

<sup>36</sup> REV. & TAX. CODE §§7074(d) and 19777.5(e).

<sup>37</sup> REV. & TAX. CODE §7073(c).

<sup>38</sup> REV. & TAX. CODE §§6511, 6514, and 6591.

<sup>39</sup> REV. & TAX. CODE §7073(c).

<sup>40</sup> *Id.*

<sup>41</sup> REV. & TAX. CODE §7073(d). The normal time period for the BOE to make a deficiency determination is three years. REV. & TAX. CODE §6487.

<sup>42</sup> REV. & TAX. CODE §19164(a)(1).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> REV. & TAX. CODE §19164(a)(3).

<sup>48</sup> REV. & TAX. CODE §19737(a).

<sup>49</sup> *Id.*

<sup>50</sup> REV. & TAX. CODE §19733(d).

<sup>51</sup> Under the California Voluntary Compliance Initiative, persons who were eligible but did not participate may be liable for an interest-based penalty, REV. & TAX. CODE §19777; an accuracy-related penalty, REV. & TAX. CODE §19164; a noneconomic substance transaction understatement penalty pursuant, REV. & TAX. CODE §19774; and possibly a fraud penalty, REV. & TAX. CODE §19164.

<sup>52</sup> REV. & TAX. CODE §19164(a)(1).

<sup>53</sup> H.B. 1100B, 84th Gen. Assem., 2d Extraordinary Sess. (Ark. 2004).

<sup>54</sup> H.B. 1279, 2004 Reg. Sess. (Miss. 2004).

<sup>55</sup> L.B. 1017, 98th Legislature, 2d Reg. Sess. (Neb. 2004).

<sup>56</sup> S.B. 148, 79 Legislature (W. Va. 2004).

<sup>57</sup> Connecticut Department of Revenue Services, *Abusive Tax Shelter Compliance Initiative*, Conn. AN 2004(5) (June 16, 2004).

<sup>58</sup> S.B. 2207, 93d General Assembly (Ill. 2004).

<sup>59</sup> New Jersey Department of Taxation, *New Jersey Offers Settlement Initiative for "Son of Boss" Tax Shelters and Other Abusive Tax Transactions* (July 13, 2004), available at <http://www.state.nj.us/treasury/taxation/pdf/sbossrelease.pdf> (visited Sept. 1, 2004).

<sup>60</sup> South Carolina Department of Revenue, *Revenue Department Announces Tax Shelter Amnesty Period* (July 22, 2004), available at <http://www.sctax.org/News+Releases/2004+News+Release/tax+shelter+amnesty.htm> (visited Sept. 1, 2004).

<sup>61</sup> S.B. 187, 418th Sess. of the General Assembly, 2004 Reg. Sess. (Md. 2004).