

New California Tax Shelter Law Has Far Reaching Effects

Overview

In a move designed to curtail the rise of abusive tax shelters, California has enacted new legislation that requires reporting and registration of tax shelters, increases the time the state has to bring actions against abusive tax shelters, and increases the penalties for selling and participating in abusive shelters. The new law also provides taxpayers the ability to voluntarily report previously sheltered money and avoid the increased penalties. **Unfortunately, the transactions caught up in this new legislation includes many ordinary course transactions that would never be thought of as tax shelters.**

California law is now ahead of the federal law in this arena. For example, in addition to increased penalties for certain understatements of tax, **failure to disclose a "reportable transaction" can result in significant penalties, even in the absence of an understatement of tax.**

Analysis

On October 2, 2003, California Governor Gray Davis signed into law two companion bills, Assembly Bill 1601 and Senate Bill 614, designed to shut down abusive tax shelters in California.

Disclosure of reportable transactions

The new legislation adopts (with modification) and adds penalties to the IRS "reportable transaction" regime (Section 6011 of the Internal Revenue Code and the regulations thereunder), which requires a taxpayer to disclose with its tax return and,

organizers, sellers and material advisors to maintain certain records relating to, transactions that

- ▶ are the same or substantially similar to transactions listed by the IRS or the California Franchise Tax Board as having previously been determined to be a tax avoidance transaction;
- ▶ are offered under conditions of confidentiality;
- ▶ have contractual protections if all or a part of the intended tax consequences from the transaction are not sustained or which involve fees that are contingent upon the taxpayer's realization of tax benefits from the transaction;
- ▶ result in a loss under Section 165 of the Internal Revenue Code of certain specified dollar amounts, varying according to the status of the taxpayer;
- ▶ subject to certain exceptions, have a difference in tax and accounting treatment of more than \$10 million;
- ▶ involve the taxpayer claiming a tax credit exceeding \$250,000 if the asset giving rise to the tax credit is held by the taxpayer for 45 days or less; or
- ▶ the IRS or the California Franchise Tax Board has determined have a potential for tax avoidance or evasion. (Section 18407 of the California Revenue and Taxation Code).

Unlike the current federal law, the California legislation creates a new penalty for any large entity and high net worth individual taxpayer who fails to include with any return or statement the required disclosure with respect to a Reportable Transaction (as defined below). The penalty is \$15,000 for

basic failure to disclose a Reportable Transaction on a tax return, increased to \$30,000 if the disclosure is with respect to a Listed Transaction (as defined below). The new penalty applies without regard to whether or not the Reportable Transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed, as discussed below. (Section 19772 of the California Revenue and Taxation Code).

"Reportable Transaction" is any transaction determined by the Internal Revenue Service under Section 6011 of the Internal Revenue Code or the California Franchise Tax Board to have a potential for tax avoidance or evasion.

"Listed Transaction" is any transaction that is the same as or substantially similar to a transaction that has been identified by the Internal Revenue Service or the California Franchise Tax Board as a tax avoidance transaction.

State registration of tax shelters

The new legislation requires registration of "tax shelters" (as defined under Section 6111 of the Internal Revenue Code) plus Listed Transactions with the California Franchise Tax Board if the transactions have certain minimal contacts with the State of California (any of: organized in California; doing business in California; deriving income from California; or at least one of its investors is a California taxpayer). (Section 18628 of the California Revenue and Taxation Code). The penalty for failure to register, failure to provide all

information required by the registration or failure to furnish the required statement to each investor is \$15,000, or if a Listed Transaction, the greater of \$100,000 or 50% of the gross income that the organizer derived from the activity, increased to 75% of gross income in the case of intentional disregard. (Section 19173 of the California Revenue and Taxation Code).

Maintenance of list of investors in tax shelters

The California legislation also adopts the federal obligation for organizers and sellers of potentially abusive tax shelters to maintain a list of investors (Section 6112 of the Internal Revenue Code) if the transactions have certain minimal contacts with the State of California, as noted above. Such list must be maintained in the form and manner to be prescribed by the California Franchise Tax Board, and must be produced and/or filed with the Franchise Tax Board. (Section 18648 of the California Revenue & Taxation Code). The failure to provide a list required to be maintained for Reportable Transactions is \$10,000 per day for each day after the 20th day following written request by the Franchise Tax Board, and for Listed Transactions is the greater of \$100,000 or 50% of the gross income of the organizer or material adviser derived from that activity. (Section 19173 of the California Revenue and Taxation Code).

Increased accuracy related penalties; new penalties for Reportable Transaction and Listed Transaction understatements

The new law increases the accuracy related penalties (Section 6662-6665 of the Internal Revenue Code) applicable to Listed Transactions and Reportable Transactions with a significant tax avoidance purpose, and elevates the standards for legal authority supporting the taxpayer's position that is required to avoid the accuracy related penalties. (Section 19164 of the California Revenue and Taxation Code).

It also adds a new tax penalty of 20% of the amount of any understatement (or a 30% tax penalty where all the relevant facts affecting the tax treatment of the item are not disclosed) in any Listed Transaction or

any Reportable Transaction that has a significant tax avoidance purpose. (Section 19773 of the California Revenue and Taxation Code). If a taxpayer has a non-economic substance transaction (that is, a transaction that does not have a valid non-tax California business purpose) there is a tax penalty of 40% of the understatement (or 20% with respect to a transaction for which the relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return). (Section 19774 of the California Revenue and Taxation Code).

Increased interest rates

For taxpayers contacted by the Franchise Tax Board, the rate of interest is increased by 100% for under payments of tax due to a potentially abusive tax shelter. (Section 19777 of the California Revenue and Taxation Code). For taxpayers not contacted by the Internal Revenue Service or the California Franchise Tax Board, the rate of interest on any understatements of tax related to Reportable Transactions is increased by 50%. (Section 19778 of the California Revenue and Taxation Code).

Elimination of interest suspension

The existing suspension of the imposition of certain interest, penalties or additions to tax when the California Franchise Tax Board fails to issue a notice to the taxpayer of a return modification within certain specified periods is made inapplicable for taxpayers with taxable income greater than \$200,000 that have been contacted by the Franchise Tax Board regarding the use of a potentially abusive tax shelter. (Section 19116 of the California Revenue and Taxation Code).

Return preparer penalties

For tax return preparers a penalty of \$1,000 is imposed for understatements of any taxpayer's liability for taxpayers that have been contacted by the California Franchise Tax Board regarding the use of a potentially abusive tax shelter. The new legislation also imposes a penalty of \$5,000 if there was a willful attempt to understate the lia-

bility or reckless or intentional disregard of the rules or regulations. (Section 19166 of the California Revenue and Taxation Code).

The standards that must be met to avoid these penalties have been raised as well. The "reasonable possibility" standard has been replaced with a "more likely than not the proper treatment" standard, and the "not frivolous" standard has been replaced with a "reasonable basis" standard.

Penalty for promoting abusive tax shelters

The penalties for furnishing a false or fraudulent statement in the promotion of a tax shelter (Section 6700 of the Internal Revenue Code) are increased to 50% of the gross income derived or to be derived from that activity by the promoter. (Section 19177 of the California Revenue and Taxation Code).

Penalties for frivolous returns

Frivolous return penalties (Section 6702 of the Internal Revenue Code) are broadened to include all taxpayers and the penalty is increased to \$5,000. Positions deemed "frivolous" will be identified by a list published by the IRS or the Franchise Tax Board. (Section 19179 of the California Revenue and Taxation Code).

Penalties for frivolous submissions

New penalties of \$5,000 are imposed upon frivolous submissions made in certain tax controversy filings. (Section 19179 of the California Revenue and Taxation Code).

Subpoena and injunctive powers

The subpoena and injunctive powers of the Franchise Tax Board are expanded (Sections 19504 and 19715 of the California Revenue and Taxation Code).

Statute of limitations

The statute of limitations for deficiency assessments related to abusive tax avoidance transactions are extended to eight years after the return is filed. (Section 19755 of the California Revenue and Taxation Code).

Confidentiality

The confidentiality privileges for communications relating to tax shelters between tax practitioners and individual taxpayers are eliminated. Corporate tax shelters already have no privilege. (Section 21028 of the California Revenue and Taxation Code).

Voluntary compliance initiative

The California legislation is generally effective January 1, 2004. It, however, authorizes the Franchise Tax Board to conduct a voluntary compliance initiative for eligible taxpayers during the period January 1, 2004, to April 15, 2004, relating to unpaid tax liabilities attributable to the use of abusive tax avoidance transactions for taxable years beginning before January 1, 2003. Under the initiative taxpayers may report and pay past underpayments together with interest thereon, and, if the taxpayer waives all rights of appeal, have all penalties waived, or if the taxpayer elects to retain its rights to appeal, have all existing and new penalties waived except the accuracy related penalty (as in effect immediately before the new legislation). In both cases most criminal penalties will be barred. (Section 19751-19754 of the California Revenue and Taxation Code).

The foregoing is only a brief summary of AB1601 and SB614. For the actual text of the new legislation see http://info.sen.ca.gov/pub/bill/sen/sb_0601-0650/sb_614_bill_20031002_chaptered.pdf

Conclusion

The new California legislation constitutes a broad attack on tax shelters, greatly raising the stakes for taxpayers and their advisers who participate in aggressive tax planning. Unfortunately even those taxpayers and their advisers who scrupulously avoid tax shelters will be caught in this enforcement dragnet by the overbroad inclusion of Reportable Transactions within the disclosure and tax penalty framework of the new legislation.

Taxpayers enter into Reportable Transactions numerous times in the ordinary course of their businesses. Non-disclosure

agreements, contractual protections, transactions that have tax losses, transactions that have book-tax differences, etc., are all routine non-tax motivated business transactions that can fall into the definition of Reportable Transactions. Failure to properly report these Reportable Transactions now carries heavy penalties, \$15,000 per violation, even though there has been no under-reporting or underpayment of taxes. Careful coordination between the taxpayer, its counsel and the taxpayer's return preparer with regard to Reportable Transactions will be required to avoid expensive failures to report.

Should you have any questions please contact any of the attorneys listed below. ■

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