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California SB 86 is Now Law: An Analysis of California SB 86 (signed on March 24, 2011) and its wide-ranging compliance and enforcement initiatives

By Sanford I. Millar, ESQ., MBT

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On March 24, 2011 Governor Brown approved Senate Bill No. 86 which has three, apparently independent, statutory regimes. A common denominator of all three is California's effort to maximize revenues and minimize tax avoidance mechanisms.

The new laws (1) implement changes to the Sales and Use Tax Law (USE Tax); (2) create a Financial Institution Record Match System (FIRM) which requires financial institutions to match a list of delinquent taxpayers with their own account holder lists and report matches back to the Franchise Tax Board (FTB) and (3) create a voluntary compliance initiative (VCI) applicable to abusive tax avoidance transactions and unreported income from the use of offshore financial arrangements. This note briefly discusses these three provisions.

Use Tax

Currently, a California use tax is imposed on anyone who purchases tangible personal property for use, consumption, or storage in California if the purchase is not otherwise subject to sales tax. Generally, use tax is owed when a purchase of tangible goods is made outside of California (whether online or off line) and the item is used in California. For example: A personal computer is purchased online from an out of state retailer by a California buyer for use in California.

The use tax rate is the same as the sales tax rate for the county and city within California in which the purchase occurs. In those instances where the use tax is not collected and remitted by the retailer, a taxpayer may either report and pay the tax directly to the Board of Equalization (BOE) or report and pay the use tax on their California income tax return.

Law Offices of Sanford I. Millar

Office: 310-556-3007
Fax: 310-556-3094
Address: 1801 Avenue of the Stars, Suite 600
Los Angeles, CA. 90067
Email: smillar@millarlaw.net

www.millarlawoffices.com

As amended R & T § 6452.1 requires the FTB to include in income tax returns for tax years beginning on January 1, 2011, a use tax table that would allow taxpayers to determine the amount of use tax they owe. The table may be used for non-business purchases of individual items of tangible personal property, each with a purchase price of less than $1,000. Taxpayers would still have the option of reporting actual use tax due. If taxpayers utilize the table, the BOE is precluded from making any determinations for understatements of use tax.

The big question is whether the majority of Californians will elect to report use taxable purchases by using the tax table or whether they will continue to avoid reporting. What this approach attempts to do is (a) raise revenue and (b) create a relatively equal playing field between brick and mortar retailers based in California and retailers who are out of state and without a physical presence in California. There are some economists that suggest that for every billion dollars of revenue generated or lost in the consumer sector 25,000 to 40,000 jobs are created or lost. If California is unable to collect use tax at the source from on-line retailers then the simplified collection method created by the use tax table may be a partial solution. The question of course is whether the revenue generated will exceed the costs of enforcement. If not, then the online purchase incentive (discount price by avoidance of use tax) will remain a loophole that will require Congressional action to close.

Financial Institution Record Match System

The model for FIRM is the federal Financial Institution Data Match (FIDM) which is used for the collection of delinquent child support. Under FIDM financial institution records are matched against customer records to determine if a person on the FIDM list has an account subject to levy. From this process comes the new California system R& T § 19266(a) establishing the Financial Institution Record Match System (FIRM). FIRM requires that all financial institutions (with some exceptions) doing business in the state provide to the FTB on a quarterly basis the name, record address and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor, as identified by the FTB, who maintains an account at the institution. Unless required by other law, the financial institution providing the information is prohibited from disclosing to an accountholder that it has furnished the information to the FTB. Just how expansive the record match will need to be for the very large financial institutions is unclear. The financial institutions may need clarification on whether they need to do nationwide record searches, regional searches or statewide searches. FIRM is intended to comply with the California Right to Financial Privacy Act (the Act) by meeting an exception to the Act, in that the use of the information provided by the financial institutions is limited to the collection of delinquent taxes or other debts referred to the FTB for collection. All other uses are expressly prohibited.

“Financial Institutions” are broadly defined to include depository institutions, institution-affiliated parties (like captive brokerage affiliates and private banks), federal and state credit unions and benefit associations, insurance companies, safe deposit companies, money market funds or similar entities authorized to do business in California.[1]

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“Account” is just as broadly defined and includes, demand deposit accounts, share or share drafts accounts, checking or negotiable withdrawal order accounts, savings accounts time deposit accounts or money market mutual fund accounts, regardless of whether the account bears interest.[2]

A “delinquent tax debtor” means any person liable for any income or franchise tax or other debt referred to the FTB for collection where the obligation remains unpaid after 30 days from demand for payment and the person is not making timely installment payments under an agreement pursuant to R & T §19006.[3]

There is an analogy between what FIRM has done with respect to record searches and the federal governments action in enacting the Foreign Account Tax Compliance Act (IRC §1474-1474). FATCA requires foreign financial institutions that have U.S. investments to enter into agreements with the Internal Revenue Service which provide that they will search their records and provide record information to the Service for all customers who are U.S. persons. FATCA is in essence a class reporting system as opposed to an individual reporting system. The class in question is (in general) all U.S. persons with accounts in a foreign financial institution. A record match system may occur later when the IRS compares FATCA reports with income tax return disclosures required under new IRC§6038D.

The focus of enforcement is now clearly on financial institutions as a tool of compliance.

Voluntary Compliance Initiative

The third part to SB 86 is also a collection statute. R&T §19761 established the Voluntary Compliance Initiative (VCI) which runs from August 1, 2011 – October 31, 2011. The VCI is targeted at two discrete groups. The initiative applies to tax liabilities attributable to the use of abusive tax avoidance transactions (ATAT) and to unreported income from the use of offshore financial arrangements.[4] The program covers all tax years beginning before January 1, 2011. The FTB estimates that in the first year for the VCI the state will collect approximately $270 million. A reduction in assessable penalties in subsequent years will reduce the net revenue realization by approximately $82 million.[5]

An abusive tax avoidance transaction (ATAT) is commonly referred to as a tax shelter. Tax shelters are plans that serve no significant purpose other than reducing tax. R&T § 19774 imposes a noneconomic substance transaction (NEST) understatement penalty of 20 percent if the transaction is adequately disclosed and 40 percent if it is not. A noneconomic substance transaction understatement is a loss, deduction, credit or addition to income that is the result of a transaction which lacks economic substance.

Offshore financial arrangement means any transaction involving financial arrangements that in any manner rely on the use of offshore payment cards (credit, debit or charge cards) issued by banks in foreign jurisdictions or offshore financial arrangements, including arrangements with foreign banks, financial institutions, trusts or other entities to avoid or evade income or franchise tax.[6]

The VCI requires taxpayers who are qualified and elect to participate to do the following: file amended returns and pay all unpaid tax and interest resulting from an ATAT or from an unreported offshore

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financial arrangement, and agree that the VCI will be closed without appeal rights. A qualified taxpayer includes a taxpayer who has:

- ATAT's in audit
- ATAT case in protest
- Unknown ATAT's
- Unreported income from the use of an offshore financial arrangements

If a taxpayer is qualified and elects to participate, all penalties are waived except for the large corporate understatement penalty and the amnesty penalty.

In addition, no criminal action will be brought against a qualified VCI participant if the taxpayer is not currently the subject of a criminal complaint or under criminal investigation with an ATAT or unreported income from the use of an offshore financial arrangement.

The effect of not electing to participate in the VCI is that the statute of limitation on assessment on ATAT cases is increased from eight to twelve years. In addition, if a taxpayer in an ATAT has been contacted by the FTB and files an amended return prior to the issuance of a notice of deficiency there is an addition to tax of 100 percent of the interest payable under Section 19101.[7]

The VCI differs in some material ways from the Second Supplemental Voluntary Disclosure Initiative (OVDI) announced by the IRS February 8, 2011[8]. The OVDI expires on August 31, 2011, subject to a 90 day extension for reasonable cause. The OVDI covers years 2003-2010. The OVDI covers only account holders in foreign financial institutions and does not include ATAT or any other issues.

The OVDI results from two statutory schemes, the Bank Secrecy Act (Title 31) and the Internal Revenue Code (Title 26). The Bank Secrecy Act (BSA) requires U.S. persons who have foreign financial accounts which aggregate $10,000 or more to report the existence of those accounts on Form TD 90-22.1 (FBAR) annually. There are severe penalties, both civil and criminal, for non-compliance.[9] In addition, the Internal Revenue Code requires taxpayers to report interests in foreign financial accounts, foreign trust and foreign corporations annually on their tax returns.[10] There are separate penalties for not disclosing a foreign financial account and for not reporting the income on such accounts. Further, failure to file information returns for (a) controlled foreign corporations Form 5471, (b) transfers to or gifts from foreign trusts (Form 906 and Form 3520) have their own penalty regimes. The OVDI provides for the waiver of certain penalties and criminal prosecution provided that the taxpayer pays a miscellaneous civil penalty (in general, based upon 25 percent of the highest single year foreign financial account balance, or in some cases a 12.5 percent or 5 percent), files previously unfiled FBAR's and amended returns and pays tax, interest, and the accuracy related penalty.

The reporting requirements of the OVDI exceed those of the VCI in that California does not have an FBAR equivalent filing requirement. The VCI scope exceeds that of the OVDI by including ATAT's.

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The VCI program covers all years in which there is unreported income from an ATAT or foreign financial arrangement whereas the OVDI limits the coverage to 2003-2010.

The complex question given the differing scopes of the programs is whether a taxpayer who invested in an ATAT should enter the VCI program. If the ATAT is under federal exam or is part of a program that is under federal exam the answer is probably yes. The result of the federal exam will be provided to the FTB pursuant to information sharing agreements and the result will be imposition of the enhanced penalties when the FTB assesses. If the taxpayer is not in an ATAT but is a participant in or should be a participant in the OVDI then they probably should enter the California VCI. Cases where the taxpayer enters the OVDI and opts out in order to dispute the 25 percent miscellaneous civil penalty are a bit more complex. In order to participate in the OVDI a taxpayer must file amended returns and pay the tax, interest and 20 percent accuracy related penalty on unreported income. The reasonable course is to include amended California returns and pay the tax and interest at the same time. The failure to amend the California returns will likely give rise to a deficiency assessment down the road when the IRS provides the information to the FTB.

The decision to enter the VCI must be balanced by the risks of continuing non disclosure/non-compliance. The risks are for the most part civil penalties but criminal prosecution cannot be ruled out.

Conclusion:

The State of California is going to take all measures possible to enhance revenue collection and the three provisions of SB 86 discussed are likely to be just steps along the path to additional measures to increase collections. Consider the following possibilities: (a) as and when FATCA is implemented and if the IRS shares the FATCA data reports California will likely follow the IRS with aggressive compliance actions; (b) will California impose a reporting obligation on online retailers to collect information from purchasers and report sales subject to use tax? The suggestion is not that farfetched if one considers that a significant percentage of online purchases are made with credit cards.

Imposing a reporting requirement on merchant payment processors to report California online purchases to the customer and then require the customer to attach a schedule to their state income tax returns may seem intrusive, but is it out of the question? These are just examples of where the trend in reaching for additional revenues may lead the state.

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