Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Brough and Ridley-Thomas	Analyst:	Jane Raboy	Bill Number:	AB 2692
Related Bills:	See Legislative History	Telephone:	845-5718	Amended Date:	April 26, 2016
		Attorney:	Bruce Langston	Sponsor	

SUBJECT: Extend Voluntary Disclosure Program to Qualified Small Businesses and Limited Partnerships and Modify the Definition for Qualified Trusts

SUMMARY

This bill would modify the Franchise Tax Board's (FTB's) Voluntary Disclosure Program (VDP).

This analysis only addresses the provisions of the bill that impact the department's programs and operations and not the provisions that impact sales and use tax.

RECOMMENDATION

No position.

Summary of Amendments

The April 26, 2016, amendments removed provisions of the bill related to the tax penalty and fee waiver amnesty programs, and replaced them with the provisions discussed in this analysis.

The department's analysis of the bill as introduced February 19, 2016, no longer applies.

REASON FOR THE BILL

The reason for the bill is to encourage participation by small businesses', limited partnerships, and trusts in the VDP.

EFFECTIVE/OPERATIVE DATE

The bill would be effective on January 1, 2017.

FEDERAL LAW

Although there are self-compliance programs under Federal law, there is no program comparable to the California's VDP.

STATE LAW

Under current state law, the FTB is authorized to enter into a voluntary disclosure agreement (Agreement) with any qualified entity, qualified shareholder, qualified member, or qualified beneficiary that is binding on both the FTB and the qualified entity, qualified shareholder, qualified member, or qualified beneficiary (collectively referred to as "applicant").

The VDP defines a “qualified trust” as a trust that has never been administered in California and that has had no resident beneficiaries in California for six taxable years ending immediately preceding the signing date of the Agreement. However, “qualified trust” includes a trust with a resident beneficiary whose interest in the trust is contingent and who has never received a distribution from the trust.

A qualified entity specifically excludes any of the following:

- An entity that is organized and existing under the laws of this state;
- An entity that is qualified or registered with the office of the Secretary of State; and
- An entity that maintains and staffs a permanent facility in this state, as specified.

The applicants that choose to participate in the VDP may anonymously apply to the FTB. As part of the VDP application the applicant must disclose their California tax liability, as specified, for the immediately preceding six taxable years, known as the “look back period”, as specified.

For the purposes of considering offers from applicants under VDP, the FTB may take into account the following:

- The nature and magnitude of a qualified entity’s previous presence and activity in this state and the facts and circumstances by which nexus was established by the applicant;
- The extent to which the weight of the factual circumstances demonstrate that a prudent business person exercising reasonable care would conclude from its previous activities and presence in this state that the entity was or was not immune from taxation in this state under P.L. 86-272;
- Reasonable reliance on the advice of a person in a fiduciary position or other competent advice that an applicant was immune from taxation in this state;
- Lack of evidence of willful disregard or neglect of tax laws of this state;
- Demonstrations of good faith of the applicant; and
- Benefits that will accrue to the state by entering into an Agreement.

Under the VDP, the following penalties may be waived:

- Failure to make and file a tax return.
- Failure to pay any amount due by the date prescribed for payment.
- Underpayment of estimated tax.
- Secretary of State penalties imposed pursuant to Corporations Code sections 6810 and 8810(a).
- Failure to furnish information or maintain records.
- Underpayment of tax.
- Late filing of partnership tax returns.
- Failure to file information tax returns.
- Relief from Contract voidability.

To satisfy the terms of the Agreement, approved taxpayers must return a signed agreement to the FTB, make all payments, and submit all returns to the FTB within 30 days from the signing date of the Agreement. The FTB may grant an extension for filing tax returns and paying amounts due to 120-days from the signing date of the Agreement, or the latest extended due date of the tax return for a tax year where relief is granted, whichever is later. Failure to perform timely renders the Agreement null and void.

The three-member Franchise Tax Board must approve all Agreement recommendations from the Executive Officer and Chief Counsel.

THIS BILL

This bill would add "qualified small business" to the list of applicants (qualified entities, qualified shareholders, qualified members, qualified trusts, and qualified beneficiaries) that can participate in the VDP.

In addition, the bill would do the following:

- Modify the definition of qualified entity to include a limited partnership;
- Modify the definition of a qualified trust by removing the following requirement:
    - For the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreements, the trust has had no resident beneficiaries (other than a beneficiary whose interest in that trust in contingent; a beneficiary's trust interest is not contingent if the trust has made any distribution to the resident beneficiary at any time during the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement); and
- Define "qualified small business" to mean an entity with a total income of less than $1,000,000 in the previous tax year.

For the purposes of considering offers from applicants under VDP, the FTB could not take into account the following factors for qualified small business applicants:

- The nature and magnitude of the qualified entity's previous presence and activity in this state and the facts and circumstances by which nexus was established by the applicant.
- Reasonable reliance on the advice of a person in a fiduciary position or other competent advice that an applicant was immune from taxation in this state.

In addition, the bill would not require the qualified small business to, with respect to each of the six taxable years ending immediately preceding the signing date of the written agreement:

- Voluntarily and fully disclose on the application all material facts pertinent to the qualified small business's tax liability.
- Within 30 days from the signing date of the voluntary disclosure agreement unless extended by the FTB:

- File all returns required.
- Pay in full any tax, interest, fee, and penalties, other than those penalties specifically waived by the FTB.

The qualified small business would not need to comply with all franchise and income tax laws of this state in subsequent years by filing all returns required and paying all amounts due.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill lacks a specific operative date, which makes it unclear whether the agreements are operative for a specific taxable year or for agreements that are executed after the operative date. The lack of an operative date could lead to disputes with taxpayers and would complicate the administration of this bill.

This bill uses terms that are undefined, i.e., "total income", and "previous taxable year". For clarity, ease of administration, and to ensure consistency with the author's intent, this bill should be amended.

Because this bill fails to specify otherwise, the definition of "qualified small business" could be interpreted to include business activity reported on a Schedule C. If this is contrary to the author's intent, this bill should be amended.

Unlike other business entities eligible for the VDP, a "qualified small business" would be excluded from the six-year look-back limitation on the assessment of tax due, the 30 day time period for filing returns and paying tax, interest, fees, and penalties, and the agreement to comply in subsequent years. If this is contrary to the author's intent, the author may wish to amend this bill to limit the look-back requirement.

The bill adds limited partnership to the definition of a qualified entity, but does not add a qualified partner to the list of nonresident applicants that could apply for the VDP.

TECHNICAL CONSIDERATIONS

Department staff has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

In defining "limited partnership" this bill would provide an incorrect cross reference to the tax on limited partnerships. If the author's intent is to cross-reference to the subdivision defining "limited partnership", this bill should be amended.

This bill would allow the limitation on assessment for any taxable year and the waiver of any penalties to be binding on the FTB, even under the circumstances which render the agreement null and void. If the author's intent is to prevent noncompliance with the agreement, this bill should be amended.

LEGISLATIVE HISTORY

SB 1492 (Senate Revenue & Taxation Committee, Chapter 492, Statutes of 2010), allowed taxpayers to file the most recent tax return as late as the extended due date, eliminated the underpayment of estimated tax penalty if the agreement was signed after the quarterly tax payment date, and allowed applicants requesting an Installment Payment Arrangement (IPA) additional time to satisfy the agreement if the IPA requested was denied after the agreement period ended.

AB 3073 (Assembly Revenue and Taxation Committee, Chapter 354, Statutes of 2004), allowed limited liability companies to qualify for the California's VDP.

SB 1185 (Senate Revenue & Taxation Committee, Chapter 543, Statutes of 2001), a FTB sponsored bill, added trusts and nonresident beneficiaries to California's VDP.

SB 38 (Lockyer, Chapter 954, Statutes of 1996) added S corporation shareholders to California's VDP. To limit the concern that applying the waiver authority to S corporation shareholders could be viewed as amnesty for these individuals, participation in the California VDP was limited to those S corporation shareholders who were nonresidents on the day that the agreement was signed.

AB 2880 (Caldera, Chapter 367, Statutes of 1994), a FTB sponsored bill, established a California VDP for certain out-of-state banks and corporations. In addition to corporations, AB 2880, as introduced, applied to limited partnerships, certain trusts, and certain partners and beneficiaries. During the legislative process, however, because concern was expressed that waiver of penalties for flow-through entities and their partners and beneficiaries might be viewed as amnesty for a small group of individuals, these entities were eliminated from the bill. S corporations, which are also pass-through entities, were included in the bill as corporate entities, but the status of their shareholders was not addressed.

OTHER STATES' INFORMATION

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found that all of the states provide a form of VDP. The laws of these states were reviewed because of similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

This bill, as amended April 26, 2016, may have a significant revenue impact but the amount is unknown. The FTB is unable to estimate the revenue impact until the implementation concerns discussed above have been resolved.

LEGAL IMPACT

This bill would allow a qualified small business to participate in the VDP based on the threshold of "total income". Because "total income" is an unapportioned amount, in the case of qualified small businesses with income from sources both within and outside the state, this bill could raise constitutional concerns. In Northwest Energetic Services, LLC v. Franchise Tax Board (Northwest), the Court of Appeals held that the LLC fee imposed was unconstitutional as applied to Northwest because the fee was calculated by reference to the "total income" of an LLC that conducted no business in California.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that expanding the VDP to include qualified small businesses, limited partnerships, and modifying eligibility for trusts would encourage taxpayer compliance.

Opponents: Some could argue that this bill may create cynicism among compliant taxpayers who would see tax debtors benefiting from recurring noncompliance.

POLICY CONCERNS

This bill would provide a tax benefit for qualified small businesses that would not be provided to other business classifications or types.

This bill would allow a qualified small business that is organized and existing under the laws of this state or qualified or registered with the office of the Secretary of State to be eligible for VDP. However, these activities are internally inconsistent with the VDP's requirements that prohibit a qualified entity from being qualified or registered with the office of the Secretary of State. For example, because the Secretary of State is aware of the existence of the entity, it is highly unlikely that the FTB has not previously become aware of the existence of the entity.

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