

## **Voluntary Compliance Initiative Frequently Asked Questions**

### **General Information**

#### **What is an abusive Tax Shelter & Transaction?**

Numerous legitimate transactions can result in minimizing a taxpayer's tax liability. However, abusive tax avoidance transactions encompass transactions principally designed to avoid or evade tax. They include, but are not limited to, transactions designated by the IRS as listed transactions and all similar arrangements.

Generally, an abusive tax avoidance transaction:

- Is promoted with the promise of tax benefits.
- Has predictable tax losses or tax consequences.
- Has no true or correlating economic loss with respect to the taxpayer's income or assets.
- Follows the literal reading of a tax statute in a manner inconsistent with the tax statute.

Characteristics of the transactions may include:

- Separation of income and expenses.
- Use of pass through entities.
- Use of third-party accommodators.
- Double benefit for the same tax loss.
- Transactions conducted over a short period of time.

The law broadly defines the term abusive tax avoidance transaction to allow taxpayers the most flexibility in correcting returns reporting questionable tax positions. The only abusive transactions specifically excluded from qualifying for the Voluntary Compliance (VCI) are offshore financial arrangements that were eligible to participate in the IRS Offshore Voluntary Compliance Initiative. Those arrangements include:

- Financial arrangements that rely on the use of offshore payment cards issued by banks in foreign jurisdictions, or
- Offshore financial arrangements with foreign banks, financial institutions, corporations, partnerships, trusts or other entities.

#### **What is the Voluntary Compliance Initiative?**

The Voluntary Compliance Initiative (VCI) is open to taxpayers who used abusive tax avoidance transactions to underreport their California income tax liabilities. The VCI provides a limited period for these taxpayers to amend their returns and limit the risk of penalties.

The VCI covers all types of abusive tax avoidance transactions, except offshore activities such as offshore payment cards and offshore financial arrangements.

## **When is the VCI and what tax years does it cover?**

- The VCI begins January 1, 2004 and runs through April 15, 2004.
- Tax years beginning before January 1, 2003 are eligible.

## **What is the objective of the VCI?**

The VCI offers taxpayers a final chance to correct their California income tax liabilities before FTB uses the enhanced curtailment provisions recently enacted, such as increased penalties.

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## **Participation and Options**

### **Who is eligible to participate in the VCI?**

Generally, a taxpayer who used abusive tax avoidance transactions is eligible to participate in the VCI if all of the following apply:

- a. The taxpayer previously filed California income or franchise tax returns using abusive tax avoidance transactions to underreport the California tax liability.
- b. The taxpayer is not under criminal investigation for an abusive tax avoidance transaction.
- c. The taxpayer was not eligible to participate in the IRS Offshore Voluntary Compliance Initiative.

### **Why should I participate?**

Participating in the VCI allows you to eliminate your abusive tax avoidance transaction without the added costs of penalties and possible litigation expenses. These penalties and interest can be substantial. For example:

If you participate in the VCI and eliminate an abusive tax avoidance transaction that results in a \$100,000 liability for 1999, you would pay:

- tax of \$100,000, and
- interest of \$30,585
- for a total of \$130,585.

However, if you do not participate in the VCI, you would expect to pay:

- tax of \$100,000,
- interest of \$30,585
- a strict liability penalty of \$30,585 (100 percent of interest),
- an understatement penalty of up to \$40,000 (20-40 percent), and
- possibly a fraud penalty of \$75,000 (75 percent),
- for a total of \$276,170.

## How do I participate?

To participate in the VCI, you must:

- Complete a Participation Agreement form - FTB 621 for Business Entities or FTB 622 for Individuals.
- File an amended return reporting all income and loss without regard to the abusive tax avoidance transaction.
- Write "VCI" in red on top of the first page of the return(s).
- Pay all tax and interest due.
- Mail the Participation Agreement and amended return(s) to the address below during the period January 1, 2004 to April 15, 2004:

Franchise Tax Board  
PO Box 1673  
Sacramento CA 95812-1673

Note: Banks and Corporations required to pay taxes by electronic fund transfers (EFT) must still remit amounts due under the VCI by EFT.

In the amended return, you must state:

- You request to participate in the Voluntary Compliance Initiative and you must attach the Participation Agreement.
- Which filing option you choose under CR&TC section 19752;
- The name and taxpayer identification number of any entity (including but not limited to corporations, partnerships, and trusts) you used in any of the tax avoidance transactions;
- Whether you or any related entities are currently under examination by the IRS.

## What are my filing options?

You can elect one of two options under the VCI. If you are participating in more than one year, you must elect the same option for each year.

- **Option 1** - Voluntary compliance with **No** appeal rights.
  - You amend your California income or franchise tax return to eliminate the abusive tax avoidance transaction.
  - You pay tax and interest due.
  - FTB waives or abates penalties that apply to your use of the tax avoidance transaction.
  - You cannot file a claim for refund for amounts paid under the VCI.

- **Option 2** - Voluntary compliance **With** appeal rights.
  - You amend your California income or franchise tax return to eliminate the abusive tax avoidance transaction.
  - You pay tax and interest due.
  - FTB waives or abates penalties that apply to your use of the tax avoidance transaction, except the accuracy related penalty.
  - You may file a claim for refund for the amounts paid under the VCI, including the accuracy related penalty if assessed.

**How do I file my amended return without including the abusive tax transaction?**

It depends on a detailed analysis of all facts and circumstances surrounding the abusive tax transaction.

In regard to:

- Income earned on the transaction: Report any actual or constructively received income from the transaction (such as interest or dividend income) on your amended return.
- Fees paid for professional services: Generally, the fees, expenses, and other transaction costs incurred in the hope of obtaining unwarranted tax benefits are not deductible losses or expenses. (See *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 292-94 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001)) Evaluate fees paid to determine if any portion of the fees may be deductible under the provisions of Internal Revenue Code sections 162 or 212.
- Basis calculation: Recalculate the basis eliminating the abusive tax shelter components. Your basis calculation should reflect actual costs or other statutorily authorized additions to, or deductions from, basis.

**Can I participate if I am currently under examination by FTB?**

Yes. If you or one of your related entities is already under FTB examination or your case is in protest status, you can still participate. Please notify your FTB auditor immediately if you choose to participate.

**Can I participate if I am currently under IRS audit, or recently completed an IRS audit for an abusive tax avoidance transaction?**

Yes. See below for guidance on how to amend your return depending on whether your IRS determination is final (amounts not in dispute) or pending (audit still open or determination in dispute).

- Under Option 1:
  - *IRS results are final* - amend your California return applying the results of the IRS audit. If the IRS assessed penalties regarding the abusive tax avoidance transaction, we would waive those penalties under this option.

- *IRS results are pending* - amend your California return eliminating 100 percent of the abusive tax avoidance transaction and the transaction issue is closed. Any subsequent final federal determination regarding the transaction and any applicable penalties would not affect your California tax liability for the tax issue closed under Option 1.
- Under Option 2:
  - *IRS results are final* - amend your California return applying the results of the IRS audit and maintain your appeal rights with FTB. You remain subject to the accuracy related penalty. If the IRS assessed the accuracy related penalty on the abusive tax avoidance transaction, FTB will generally follow the IRS's determination.
  - *IRS results are pending* - amend your California return eliminating 100 percent of the abusive tax avoidance transaction. You can file a claim for refund indicating the issue is pending an IRS determination of the abusive tax avoidance transaction. You remain subject to the accuracy related penalty. FTB will generally follow the IRS' determination in regard to the abusive tax avoidance transaction and the accuracy related penalty.

**Can I file a VCI amended return reversing less than 100 percent of the potentially abusive tax transaction?**

If you reverse only a portion of the potentially abusive tax transaction and it is not based on a determination issued by the IRS or the Franchise Tax Board, the portion not reversed is subject to penalties. The penalties include the noneconomic substance transaction penalty or the accuracy related penalty, the interest based penalty, and the fraud penalty.

**If I originally filed a joint return, can I participate without my spouse's signature on the Participation Agreement or amended returns?**

Yes. Whoever signs the documents is liable for the additional amounts owed under the VCI.

**Can my representative who has my power of attorney sign my Participation Agreement and my amended returns?**

Yes. Attach your signed power of attorney form FTB 3520 showing the designated authority to sign agreements and tax returns on your behalf.

**Can I still participate if I don't have the ability to pay?**

Yes. Although the VCI requires you to fully pay the tax liabilities and interest for all years you participate in the VCI, it is possible to submit a request that includes other payment arrangements acceptable to FTB.

However, the burden is on you to establish inability to pay, based on full disclosure of all assets and income sources. Assuming FTB determines your

inability to fully pay is genuine, you must work out other financial arrangements to resolve all outstanding liabilities. These financial arrangements must be acceptable to FTB to qualify for penalty relief included in the VCI.

- Further information regarding installment agreements (Individuals)
- Further information regarding installment agreements (Corporations)

### **Can a unitary group of taxpayers participate in the VCI if the member investing in the abusive tax transaction has no California nexus?**

Yes. Taxpayers eligible for the VCI previously filed a return and understated their California taxable income or liability by the use of an abusive tax transaction. Taxpayers filing a combined report, wherein one or several members invested in abusive tax transactions affecting unitary business income, are each eligible to participate in the VCI as the group's business income apportioned to California was understated due to the abusive tax transaction. A single VCI participation agreement may be submitted on behalf of a unitary group of taxpayers who elected to file a combined report.

### **Does participating in the VCI take care of my disclosure requirements?**

No. Participation in the VCI does not supplant the reporting requirements provided for in California Revenue & Taxation Code sections 18628, 18648, and 18407.

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## **Penalties**

### **What penalties can I avoid if I participate?**

The following is a summary of penalties that may apply to California income and franchise taxpayers involved in abusive tax avoidance transactions.

- Fraud penalties (CR&TC section 19164(c), IRC section 6663):  
Where an underpayment of tax is due to fraud, the taxpayer is liable for penalties that essentially amount to 75 percent of the increased tax.
- Accuracy Related penalty (CR&TC section 19164, IRC section 6662):  
Where an underpayment of tax is due to;
  - negligence,
  - disregard of rules or regulations,
  - substantial understatement,
  - or substantial valuation misstatement,

the taxpayer is liable for penalties of 20 percent of the increased tax.

Note: Taxpayers participating in the VCI who choose to maintain their appeal rights, as described under CR&TC section 19752(b), remain subject to the accuracy related penalty.

- Noneconomic Substance Transaction Understatement penalty (CR&TC section 19774):

Where an understatement of tax is due to a transaction that lacks economic substance, the taxpayer is liable for penalties of 40 percent of the increased tax. If the taxpayer disclosed the transaction on the return, the penalty is reduced to 20 percent.

A transaction is treated as lacking economic substance if the taxpayer does not have a valid non-tax California business purpose for entering into the transaction.

- Tax Shelter penalty (CR&TC section 19777):

Where FTB contacts a taxpayer regarding a potentially abusive tax shelter and assesses a deficiency, the taxpayer is liable for a penalty amounting to 100 percent of the interest payable (computed from the original due date of the return to the date of the notice of proposed assessment).

A potentially abusive tax shelter means:

- any shelter required to be registered under IRC section 6111.
- any entity, investment plan or arrangement, or other plan, which the Secretary of the Treasury or the FTB determines by regulations as having a potential for tax avoidance or evasion.

### **Will I be subject to the late filing penalty and interest on any delinquent filed return?**

If you previously filed a late tax return, FTB will waive the late filing penalty on amounts owed under the VCI. You will be required to pay interest.

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### **Audit Issues**

#### **What happens if, after a taxpayer files a VCI election, FTB adjusts an item unrelated to the abusive tax avoidance transaction?**

The answer depends on the circumstances, so we've put together additional questions and answers to cover possible scenarios. We've also included an example of a post-VCI audit adjustment to help demonstrate the possibilities. Example: A taxpayer files a VCI election, reports additional income of \$100, applies a 30% apportionment factor and pays tax on \$30 of additional income. Upon an audit of items unrelated to an abusive tax avoidance transaction, the apportionment factor is revised to 50%. Therefore, the tax attributable to the VCI of \$100 is based on \$50 of additional income, rather than \$30.

- **Will an audit adjustment made after a VCI election, unrelated to an abusive tax avoidance transaction, disqualify the taxpayer from participating in the VCI?**

No. The taxpayer maintains a valid VCI election if:

- The additional tax paid with the VCI election is based on income, credit, characterization or apportionment factors applicable or finalized at the time the VCI election was filed, and
  - The subsequent unrelated audit adjustments are not attributable to abusive tax avoidance transactions.
- **Since the taxpayer participated in the VCI, will the enhanced penalties apply to the unrelated audit adjustments?**

No. The increase in tax resulting from the audit adjustment described above is unrelated to an abusive tax avoidance transaction and therefore is not subject to the enhanced penalties.

- **Can the taxpayer protest and appeal the subsequent unrelated audit adjustments?**

Yes. Regardless of the VCI option elected, the taxpayer may protest the subsequent audit adjustment described above since it is unrelated to an abusive tax avoidance transaction.

**Am I entitled to interest on the overpayment of tax if I participate in the VCI with right of appeal and successfully appeal?**

Yes. If the taxpayer prevails on the merits of the transaction and a refund is ultimately due, normal rules apply regarding accrued interest and offsetting refunds against other unpaid tax liabilities.

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**Miscellaneous**

**If I have questions regarding my specific situation, whom can I contact?**

If you have questions about your situation, you can contact the VCI Hotline at 916-845-3232 or send an e-mail to [vci@ftb.ca.gov](mailto:vci@ftb.ca.gov). However, FTB employees will not address hypothetical situations because of the potential for misunderstanding that exists when there is no assurance that the hypothetical contains all relevant facts.

**How can I get additional information about the VCI?**

You should direct your questions to the VCI Hotline at 916-845-3232, or by sending an e-mail to [vci@ftb.ca.gov](mailto:vci@ftb.ca.gov). The phones are staffed Monday through Friday, from 9 a.m. until 4 p.m. Pacific Time. After-hours (including weekends) callers may leave a message and will receive a callback within two business days. The VCI unit will also respond to e-mail inquiries within two business days.

**Will FTB share information with the IRS regarding taxpayers participating in the VCI?**

Yes. FTB has a long-standing sharing agreement with the IRS and is collaborating with the IRS to curtail abusive tax shelters and transactions. Accordingly, FTB shares any information the IRS is authorized to receive.

**Will faxed copies of the Participation Agreement or amended returns be accepted?**

No. Original signatures are required on both.

**Is there a limitation on how far back I can file amended returns for the VCI?**

No. There is no statute of limitations to amend your tax returns if you are reporting additional tax liabilities. If amending your return for the VCI results in you requesting a refund of amounts paid before the VCI, you must have an open statute of limitation to request that refund. Refer to CR&TC section 19306.

**Does participation exempt me from criminal prosecution?**

Yes. FTB will not initiate criminal action for amounts reported during the VCI if you are eligible to participate.

**Can I enter into an Offer in Compromise for amounts owed under the VCI?**

No.

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