



05.31.2023

FTB NOTICE - 2023-02

SUBJECT: Resolution of Micro-Captive Insurance Transactions and Syndicated Conservation Easement Transactions

PURPOSE:

The purpose of this Notice is to announce the Franchise Tax Board (FTB)'s creation of a resolution process that will allow Eligible Taxpayers to resolve Eligible Transactions that may be subject to the non-economic substance transaction understatement penalty (NEST penalty) under Revenue and Taxation Code (RTC) section 19774 by providing reduced penalties. This Notice sets forth the procedures for taxpayers to participate in this resolution.

BACKGROUND:

Taxpayers who have engaged in the transactions described below may be subject to the NEST penalty under RTC section 19774 as well as other penalties. These transactions described below are Eligible Transactions for purposes of this notice.

ELIGIBLE TRANSACTIONS

A. Micro-Captive Insurance Transaction

Micro-Captive Insurance Transactions include transactions in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, by using contracts the parties treat as insurance contracts and a related company the parties treat as a captive insurance company. Each entity the parties treat as an insured entity under the contracts claims business expense deductions for the premiums it pays for purported insurance coverage. The company the parties treat as a captive insurance company elects under Internal Revenue Code (IRC) section 831(b) to be taxed only on investment income. Therefore, the captive insurance company excludes the payments directly or indirectly received under the contracts from its taxable income for federal income tax purposes. The captive insurance company uses the premium income for purposes other than administering and paying claims under the contracts, and instead uses the premium income to benefit the taxpayer, the insured entities, or related persons, such as through transfers of the premium income to them in a manner the taxpayer contends is not taxable, such as via loans. The manner in which the parties interpret, administer, and apply the contracts is not consistent with arm's length transactions and sound

business practices. The arrangement does not constitute insurance for purposes of the deductibility of the payments as business expenses for federal and California income tax purposes because the arrangement or contracts fail one or more of the requirements for insurance, which include insurance risk, risk shifting, risk distribution, and insurance in the commonly accepted sense.

B. Syndicated Conservation Easement Transaction

Syndicated Conservation Easement Transactions include transactions where a taxpayer participates in an investment opportunity which purport to grant investors charitable contribution deductions with respect to conservation easement or fee simple donations in amounts that significantly exceed the amounts invested.

For taxpayers subject to the Personal Income Tax Law under Part 10 of Division 2 of the RTC, California conforms to Section 170 of the IRC in effect as of January 1, 2015, except as otherwise provided.¹ IRC section 170(f)(3)(B)(iii) allows a deduction for a qualified conservation contribution. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.² A qualified real property interest includes a restriction, granted in perpetuity, on the use of real property.³ For purposes of this Notice, a qualified real property interest is referred to as a conservation easement.

In a typical syndicated conservation easement transaction, an investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction for conservation easement donations that generally equal or exceed an amount that is two and one-half (2.5) times the amount of the investor's investment. The promotional materials may be oral or written. For purposes of this Notice, promotional materials include, but are not limited to, documents described in Section 301.6112-1(b)(3)(iii)(B) of the United States Treasury Regulations.

The investor purchases an interest directly or indirectly, (i.e., through one or more tiers of pass-through entities), in the pass-through entity that holds real property. The promoter receives fees and/or other consideration with respect to the promotion, which may be in the form of an interest in the pass-through entity. The promoter obtains an appraisal that purports to be a qualified appraisal as defined in IRC section 170(f)(11)(E) but that greatly inflates the value of the conservation easement placed on the property based on unreasonable conclusions about the development potential of the real property.

¹ RTC sections 17024.5 & 17201. Substantially similar charitable deduction rules with respect to contributions of conservation easements apply for taxpayers subject to the Corporation Tax Law under Part 11 of Division 2 of the RTC. See RTC sections 24357 through 24359.1.

² See IRC section 170(h)(1) - (5) and Treas. Reg. section 1.170A-14.

³ See IRC section 170(h)(2)(C).

After an investor invests in the pass-through entity, either directly or through one or more tiers of pass-through entities, the pass-through entity donates the conservation easement encumbering the property to a tax-exempt entity. The pass-through entity allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor. Following that contribution, the investor reports a charitable contribution deduction with respect to the conservation easement on the investor's federal income tax return. In addition to syndicated conservation easement transactions that promote a deduction equal to or greater than two and one-half (2.5) times the investor's investment, syndicated conservation easement transactions in which the promotional materials do not specify a charitable deduction multiple of the investor's investment will also be considered Eligible Transactions for purposes of this Notice.

ELIGIBLE TAXPAYERS

Eligible Taxpayers who claimed state tax benefits on an original or amended return from an Eligible Transaction may participate in the resolution covered in this Notice. Eligible Taxpayers include:

1. Taxpayers currently under examination by the FTB or under examination by the Internal Revenue Service (IRS) or at IRS appeals with respect to their participation in Eligible Transactions.
2. Taxpayers who have received a notice of proposed assessment from FTB with respect to their participation in an Eligible Transaction and are at protest with FTB or are at appeal before the Office of Tax Appeals.
3. Taxpayers in litigation with the IRS with respect to Eligible Transactions, but do not include taxpayers who are in litigation with the FTB regarding an Eligible Transaction.
4. Taxpayers who are a direct or indirect partner⁴ in a partnership⁵ that is currently under examination by the IRS or FTB or that is in litigation with the IRS.
5. A partnership that is required to report final federal adjustments pursuant to RTC section 18622.5, or which has reported such adjustments, with respect to Eligible Transactions.

⁴ For purposes of this Notice, partner includes a beneficial owner of any entity classified as a partnership for California franchise and income tax purposes. "Direct partner" means a partner that holds an interest directly in a partnership. "Indirect partner" means a partner in a partnership or pass-through entity that itself holds an interest directly, or through another indirect partner, in a partnership.

⁵ For purposes of this Notice, partnership includes any entity classified as a partnership for California franchise and income tax purposes.

6. A "tiered partner," as defined under RTC section 18622.5(b)(12), of a partnership required to report or which has reported final federal adjustments pursuant to RTC section 18622.5, or which is a tiered partner required to separately report or which has separately reported final federal adjustments under RTC section 18622.5, with respect to Eligible Transactions. However, a tiered partner's participation must be consistent with any valid election under RTC section 18622.5(d)(1) or (2) that has been made by the partnership and/or tiered partnership (of which the tiered partner is a direct or indirect partner) as of the date of acceptance of the Notice 2023-02 closing agreement, or the tiered partner will not be an Eligible Taxpayer. Taxpayers that are direct or indirect partners, other than "tiered partners," in partnerships required to report or which have reported final federal adjustments pursuant to RTC section 18622.5(a), are Eligible Taxpayers regardless of whether the federally adjusted partnership and/or tiered partnership have made elections under RTC section 18622.5(d)(1) or (2) as of the date of acceptance of the Notice 2023-02 closing agreement.

Partnerships that are Eligible Taxpayers as described in this section must compute their taxes due with respect to Eligible Transactions under the applicable provisions of RTC section 18622.5. FTB may apply the provisions of RTC section 18622.5(e) to any accepted Notice 2023-02 closing agreement that is submitted by a partnership that is an Eligible Taxpayer as described in this section.

Taxpayers who directly or indirectly entered into an Eligible Transaction(s) prior to the date of this Notice but have not yet realized the tax benefits from any Eligible Transaction(s) are not eligible to participate in the resolution described in this Notice. These taxpayers should be aware that they will be subject to all applicable penalties if at a later date they file a return claiming the tax benefits of an Eligible Transaction and all relevant statutes of limitations will apply, including the 12-year statute of limitations provided for in RTC section 19755, subdivision (a)(2).

PROCEDURE:

1. PARTICIPATION PERIOD

Eligible Taxpayers have from July 10, 2023, until November 17, 2023, (the Participation Period) to submit Notice 2023-02 closing agreements to the FTB to resolve the tax treatment of the Eligible Transaction(s), to pay all tax, interest, and reduced penalties, as set forth below, resulting from the concession of all previously claimed tax benefits pertaining to the Eligible Transaction(s), and to provide documents related to the Eligible Transaction(s).

2. TERMS OF RESOLUTION

Eligible Taxpayers must submit a complete and signed Notice 2023-02 closing agreement to the FTB between July 10, 2023, and November 17, 2023, which concedes all claimed tax benefits (except to the extent specifically allowed as provided below), relating to the Eligible Transaction(s). A Notice 2023-02 closing agreement will not be considered complete unless it also includes each of the following schedules:

- Schedule I – Transaction information.
- Schedule II – Information document requests, including the identities of other parties to the transaction(s) and detailed transaction information, as described in the Notice 2023-02 closing agreement.
- Schedule III – Computation of the tax, penalties and interest relating to the resolved transaction(s). This schedule is in lieu of filing an amended return solely for the purpose of participating in this resolution.

A. Participants who received Notice(s) of Proposed Assessment (NPAs):

For participants who received NPA(s) adjusting the tax benefits claimed from the Eligible Transaction(s) prior to the date of this Notice, the participants must pay the full amount of tax shown on the NPA relating to those adjustments, plus interest accrued up to the date of payment with the submission of the completed and signed Notice 2023-02 closing agreement. In addition, if the NPA includes a NEST penalty under RTC section 19774, the FTB's Chief Counsel will reduce the NEST penalty to zero pursuant to the authority under RTC section 19774, subdivision (d). If the NPA includes an interest-based penalty under RTC section 19777, the participant must pay the interest-based penalty. (Participants who received an NPA from FTB but who have resolved Eligible Transactions through a formal federal settlement initiative, please see 2.B. below.)

If the FTB assessed a NEST penalty that the participant paid prior to the date of this Notice, FTB's Chief Counsel will reduce the NEST penalty to zero. After first applying the resulting overpayment to any outstanding balances due and payable, including for other taxable years, the FTB will then refund any overpayment if the taxpayer fully complies with the requirements of this Notice and the taxable year is within the applicable statute of limitations or the amounts previously paid were paid within the applicable statute of limitations.

B. Participants who have received NPA(s) and who have resolved their reporting of tax benefits from the Eligible Transactions pursuant to participating in a formal IRS settlement initiative⁶:

For participants who have received NPAs and who have resolved the reporting of their tax benefits from the Eligible Transactions pursuant to participating in a formal IRS settlement initiative for taxable years for which the participants received NPAs from FTB, such participants must reverse the tax benefits previously claimed on the participants' California tax returns to the same extent the tax benefits from the Eligible Transactions were reversed pursuant to the formal IRS settlement initiative for the same taxable years. Such participants will be subject to the penalty

⁶ A "formal IRS settlement initiative" is a settlement initiative announced by IRS notice or Chief Counsel announcement or other official IRS communication and does not include a settlement reached solely in a particular IRS audit or in a federal court settlement.

resolution terms of this Notice provided under 2.A. above.

In order to receive tax benefits to the same extent as allowed pursuant to a formal federal settlement initiative, the participant must additionally provide the following documents with the FTB Notice 2023-02 Closing Agreement:

1. A copy of the IRS settlement initiative offer letter.
2. A copy of the federal closing agreement with all schedules, attachments, and affidavits.
3. A copy of any other documentation that makes clear the participant resolved its federally claimed tax benefits from Eligible Transactions in accordance with a formal IRS settlement initiative.

Unless such substantiating documentation is provided, the taxpayer will be required to reverse the tax benefits in full in order to participate.

C. Participants who have been "contacted" by the FTB or the IRS with respect to an examination of a return on which they claimed tax benefits from an Eligible Transaction, but who have not yet received an NPA:

A participant that has been "contacted" by the FTB or the IRS, but that has not received an NPA adjusting the tax benefits claimed from the Eligible Transaction(s) prior to the date of this Notice, must pay the self-assessed tax(es) shown on Schedule III to the FTB Notice 2023-02 Closing Agreement attributable to the reversal of the tax benefits claimed from the transaction(s), pay a 20 percent accuracy-related penalty under RTC section 19164 for each year the Schedule III reports an amount of additional tax due attributable to the Eligible Transaction, and pay interest accrued up to the date of payment. For this purpose "contact" has the meaning provided in United States Treasury Regulation section 1.6664-2(c)(3)(i) as applicable under the RTC, regarding a tax return on which the participant claimed tax benefits from an Eligible Transaction, and shall include contact by FTB or the IRS of a partnership in which the participant holds a direct or indirect interest.⁷ The FTB will not assess an accuracy-related reportable transaction understatement penalty under RTC section 19164.5, a NEST penalty under RTC section 19774, or an interest-based penalty under RTC section 19777 in this situation.

D. Participants who have not been contacted with respect to a return reporting tax benefits from an Eligible Transaction:

For a participant who has not been contacted within the meaning of United States Treasury Regulation section 1.6664-2(c)(3)(i) by the FTB or the IRS regarding a tax return on which the participant claimed tax benefits from an Eligible Transaction, the participant must pay the self-assessed tax(es) shown on Schedule III attributable to the reversal of the tax benefits previously claimed. The FTB will not assess an accuracy-related penalty under RTC section 19164, an accuracy-related reportable

⁷ IRC section 6664 and regulations thereunder are generally incorporated by reference by RTC sections 19164(d)(1), 17024.5(d) and 23051.5(d).

transaction understatement penalty under RTC section 19164.5, a NEST penalty under an RTC section 19774, or an interest-based penalty under RTC section 19777 in this situation.

E. Participants who have participated in a formal IRS settlement initiative with respect to their use of Eligible Transactions and who have not received NPAs from FTB with respect to such Eligible Transactions:

If an Eligible Taxpayer or a partnership in which an Eligible Taxpayer has a direct or indirect interest has participated in a formal IRS settlement initiative regarding the use of an Eligible Transaction, the taxpayer and/or partnership, if the partnership is an Eligible Taxpayer, may also participate in this resolution, including with respect to the same Eligible Transactions resolved in the formal IRS settlement initiative. For taxable years resolved pursuant to the formal IRS settlement initiative regarding Eligible Transactions, the participant must reverse tax benefits previously claimed on the participant's California tax returns with respect to the Eligible Transactions to the same extent the tax benefits were reversed for federal purposes under the formal IRS settlement initiative. For Eligible Transactions in taxable years not resolved pursuant to a formal IRS settlement agreement, the participant must reverse the tax benefits in accordance with this Notice other than section 2.E.

The participant in this resolution will be required to pay an accuracy-related penalty at the same rate that the participant was required to pay pursuant to participating in the formal IRS settlement initiative or at the same rate the partnership was required to pay an accuracy-related penalty with respect to the participant's distributive share of the underpayment. To obtain treatment under section 2.E of this Notice, the participant must additionally provide with the FTB Notice 2023-02 Closing Agreement the documents listed under 2.B. above relating to the formal IRS settlement initiative. Unless such substantiating documentation is provided, the participant will not receive treatment under section 2.E of this Notice.

Participants who resolved Eligible Transactions pursuant to a formal IRS settlement initiative but who were also issued NPAs by FTB with respect to those same Eligible Transactions for the same IRS settlement taxable years are subject to treatment under section 2.B. of this Notice.

F. Participants who have resolved Eligible Transactions pursuant to final federal changes other than pursuant to a formal IRS settlement initiative.

For a participant who has resolved Eligible Transactions pursuant to final federal changes other than pursuant to a formal IRS settlement initiative, such participant is required to reverse the tax benefits for such federally resolved years generally to the same extent as provided in the final federal changes. The participant must submit with its Notice 2023-02 closing agreement a complete copy of the final federal adjustments, final court decision, or court settlement as required in Schedule II. A participant described in this section is subject to the applicable penalty resolution terms of this Notice provided under section 2.A. or 2.C. above.

For all participants (Eligible Taxpayers under Sections 2.A.–F.):

Eligible Taxpayers who fully comply with the requirements of this Notice will be subject to their respective treatment as set forth in Terms of Resolution 2.A.–F. FTB will not impose on Eligible Taxpayers who fully comply with the requirements of this Notice penalties assessable under RTC sections 19164(c) and 19164.5, and increased interest under RTC section 19778. The large corporate income tax underpayment penalty (LCUP) under RTC section 19138 will be imposed to the extent the penalty applies. Participants will not be relieved of the previously imposed penalties under RTC section 19772 through participation in this Notice. In circumstances in which the FTB has imposed the penalty under RTC section 19772, the participant can pay the penalty and file a claim for refund and/or request Chief Counsel relief of the penalty under subdivision (f)(1) of RTC section 19772.

Participants in the resolution described in this Notice are not entitled to any suspension of interest under RTC section 19116.

Except to the extent provided pursuant to final federal changes or under the terms of any formal IRS settlement initiative agreement in which the participant directly or indirectly participated, participants will not be allowed to treat as an ordinary loss, capital loss, deduction, expense, capitalized cost or addition to basis, any fees or other amounts paid to promoters, material advisors, attorneys, accountants, appraisers or others, to plan and carry out the transaction(s), including, but not limited to, accounting, legal, promotion, or spread commission fees, any account fees for opening, establishing or reactivating an account, any commissions, or any other transaction costs associated with the Eligible Transaction(s).

In addition, except as otherwise provided in this Notice or in the Notice 2023-02 closing agreement, as an express condition of the resolution described in this Notice, no refund or overpayment related to amounts paid in connection with the resolution will be allowed. Participants also waive any statutory right to appeal or otherwise contest the validity of the Eligible Transaction(s) resolved by the Notice 2023-02 closing agreement or the amounts paid in connection with the Notice 2023-02 closing agreement in any forum, whether administrative or judicial.

Eligible Taxpayers who do not participate in the resolution described in this Notice, or taxpayers who fail to comply with all the requirements of this Notice, will be subject to all penalties and interest applicable to that transaction. Taxpayers should be aware that under RTC section 19755, subdivision (a)(2), the FTB has 12 years after a taxpayer files a return to assess additional tax and penalties relating to an abusive tax avoidance transaction.

If the taxpayers have other unreported income unrelated to the Eligible Transactions, applicable penalties may be imposed.

3. PARTICIPATION PROCEDURES

Eligible Taxpayers who want to participate in the resolution described in this Notice and avail

themselves of the penalty relief described herein must do all of the following:

- A. Closing Agreement: Complete and sign the Notice 2023-02 closing agreement and submit it to the FTB by the last day of the Participation Period. The Notice 2023-02 closing agreement shall provide that a participant specifically agrees to all of the following, except as otherwise provided under Procedure Section 2:

- (1) the disallowance of all claimed tax benefits associated with the Eligible Transaction(s);
- (2) the denial of any deductions for any transaction costs relating to the transaction(s);
- (3) no refunds or overpayments related to amounts paid under this Notice; and
- (4) the waiver of any rights to contest/appeal the validity of the transaction(s) resolved pursuant to the Notice 2023-02 closing agreement.

The Notice 2023-02 closing agreement will also include provisions addressing the penalty relief described in this Notice. Except in the event of fraud, malfeasance, misrepresentation and/or omission of a material fact by a participant, an executed Notice 2023-02 closing agreement cannot be reopened by the FTB or the taxpayer. The Notice 2023-02 closing agreements will permanently resolve all tax, penalties, and interest associated with the taxpayer's participation in the Eligible Transaction(s). Subsequent federal adjustments with respect to the Eligible Transaction(s) will have no effect on the terms or finality of an executed Notice 2023-02 closing agreement.

If the parties in the Eligible Transaction(s) include a partnership, S corporation, or other pass-through entity, the persons or entities that received the tax benefits from the transactions should submit completed Notice 2023-02 closing agreements. One Notice 2023-02 closing agreement should be submitted per taxpayer.

Notice 2023-02 closing agreements and applicable schedules will be available upon request and online at <https://www.ftb.ca.gov/tax-pros/abusive-tax-shelters/resolution-of-transactions.html> .

- B. Payment: The participant must submit payment in full of all taxes, interest, and penalties due under the terms of the resolution described in this Notice with the completed and signed Notice 2023-02 closing agreement and make payment in a form and manner required by the FTB.

If the participant has a financial hardship, the participant may request with the Notice 2023-02 closing agreement to enter into an installment payment arrangement with the FTB to pay the full amount over a period not to exceed 12 months. The FTB will not execute a submitted Notice 2023-02 closing agreement without payment in full or the acceptance of a valid installment payment arrangement.

The FTB will verify the mathematical computation of the tax, penalties, and interest, and either bill the taxpayer for amounts owing or refund any excess amount paid. A participant who is required to make payment by electronic funds transfer must do so and is not eligible to submit the payment by check with the Notice 2023-02 closing agreement.

- C. Required Information: Participants must: (1) complete Schedule I; (2) complete Schedule II and submit all information and documents required; (3) complete Schedule III and compute additional tax, applicable penalties, and interest; and, (4) upon request, provide any other information necessary to determine the proper tax liabilities. The FTB will not enter into a Notice 2023-02 closing agreement with any taxpayer without the taxpayer completing Schedules I, II and III and submitting those schedules and supporting documentation with the Notice 2023-02 closing agreement to the FTB on or before the last day of the Participation Period.
- D. Processing: The FTB will examine the information and documents provided in Schedules I and II and will verify the calculations in Schedule III. After the Notice 2023-02 closing agreement has been accepted as accurate and complete by the FTB, the Notice 2023-02 closing agreement will be executed by the Executive Officer of the FTB. The FTB will send to the taxpayer a copy of the fully executed Notice 2023-02 closing agreement. If the initial submission is incomplete or inaccurate or payment is incomplete, FTB will request the taxpayer complete or correct the Notice 2023-02 closing agreement or payment, as applicable, and resubmit the completed and corrected Notice 2023-02 closing agreement and/or payment to FTB within 30 days. If the taxpayer fails to do so, the FTB will send notice to the taxpayer of any rejection.
- E. Mailing Address: Taxpayers should submit a signed Notice 2023-02 closing agreement, schedules, required information and payment (if not subject to electronic transfer requirements) to:

ABS 389
Notice 2023-02 Coordinator, Mail Stop F340
Franchise Tax Board
PO Box 1673
Sacramento CA 95812-9900

For Courier Service Delivery or Private Courier Mail:

ATTN: Notice 2023-02 Coordinator
BH ABS 389 Mail Stop F340
Franchise Tax Board
9646 Butterfield Way
Sacramento CA 95827

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