Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

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Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	March 16, 2017
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SUBJECT: Voluntary Disclosure Program/Expand Eligibility & Penalty Relief/Repeal REIT Penalty

SUMMARY

This bill would do the following:

Provision No. 1: Expand the Voluntary Disclosure Program (VDP) to allow S-corporations and limited liability companies (LLCs) classified as partnerships relief from the failure to file penalty

Provision No. 2: Repeal the “failure to keep records” for material advisors penalty

Provision No. 3: Provide that Section 856(g)(5)(C) (relating to Real Estate Investment Trusts (REITS)) of the Internal Revenue Code (IRC) shall not apply for taxable years beginning on or after January 1, 2005

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for the bill is to eliminate inconsistent treatment among similarly-situated entities by allowing S-corporations and LLCs classified as partnerships relief from the failure to file penalty and remove other penalties that are not working to increase taxpayer compliance.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2018. The specific operative dates of these provisions vary and are addressed separately for each provision.

PROVISION NO. 1: Expand the Voluntary Disclosure Program (VDP) to allow S-corporations and limited liability companies (LLCs) classified as partnerships relief from the late filing penalties

OPERATIVE DATE

This bill would be operative for voluntary disclosure agreements entered into on or after January 1, 2017.

STATE LAW

Existing law allows qualifying entities, certain LLCs, qualified trusts, qualified shareholders, qualified members of LLCs, and qualified beneficiaries of qualified trusts to participate in the VDP. Current state law allows an applicant to request a "voluntary disclosure agreement" (VDA) and to remain anonymous until the signed VDA is returned to the Franchise Tax Board (FTB). These entities are defined as follows:

- A "qualified entity" includes any corporation, including an S-corporation, or LLC not classified as a corporation that has never filed a California income or franchise tax or LLC return, and that voluntarily applies for a VDA prior to any contact from the FTB regarding income, franchise, or LLC tax liability.
- A "qualified shareholder" is a nonresident shareholder of an S-corporation on the signing date of the VDA and for which the S-corporation has disclosed all material facts pertaining to the shareholder's liability.
- A "qualified member" is an individual who is a nonresident on the signing date of the VDA, or a corporation or LLC that is not organized in California nor qualified or registered with the office of the Secretary of State (SOS). A qualified member in all cases is a member of an LLC that has applied for a VDA and disclosed all material facts pertaining to the member's liability.
- A "qualified trust" is a trust that meets both of the following requirements:
    - The administration of the trust has never been performed in California, except for inconsequential in-state administrative services; and
    - For the six taxable years immediately preceding the signing date of the VDA, the trust has had no California resident beneficiaries, except for a CA beneficiary whose interest in that trust during such period was always contingent.
        - If the trust has made any distribution to a California resident beneficiary at any time during the six taxable years before the signing date of the VDA, that beneficiary's trust interest is non-contingent.
- A "qualified beneficiary" is an individual who is a beneficiary of a qualified trust and is a nonresident on the signing date of the VDA and for each of the prior six taxable years.

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 SOS; and
- An entity that maintains and staffs a permanent facility in this state, as specified.

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.
- SOS imposed penalties, pursuant to Corporations Code sections 6810 and 8810(a).

- Failure to furnish information or maintain records, as provided in Revenue and Taxation Code (R&TC) section 19141.5.
- Underpayment of tax.
- Late filing of partnership tax returns; except for LLC's classified as partnerships.
- Failure to file information tax returns.
- Relief from Contract voidability.

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

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

Partnerships

There are three relatively common partnership types: General Partnership (GP), Limited Partnership (LP), and Limited Liability Partnership (LLP). A fourth, the Limited Liability Limited Partnership (LLLP), is not recognized in California. Although California does not allow for an LLLP to be formed in this state, an LLLP formed under the laws of another state is allowed to register with the SOS as a LP.[1]

A partnership is not a separately taxed entity and does not pay tax on or measured by its income. However, LPs[2] and LLPs[3], are subject to an annual tax in an amount equal to the minimum franchise tax (currently $800) for the privilege of doing business in California, being organized in this state, or being registered with the SOS. This annual tax is payable until a notice of cessation or withdrawal of registration is filed with the SOS or the LP or LLP ceases to do business in this state, whichever is later.

Partnership Late Filing Penalty

If any partnership fails to file a return by the original or extended due date, a late filing penalty is imposed. The late filing penalty is $18 per partner, for each month or fraction of the month the return is late or incomplete, up to a maximum of 12 months.[4] The penalty is also imposed for returns which fail to provide complete or required information. This penalty is also known as the per partner penalty, and is in addition to the delinquent filing penalty.

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[1] Corporations Code sections 15901.02(j) and 15909.01(a).
[2] R&TC section 17935.
[3] R&TC section 17948.
[4] R&TC section 19172.

S-corporation Late Filing Penalty

If an S-corporation fails to file a return by the original or extended due date, a late filing penalty is imposed.[5] The late filing penalty is $18 per shareholder, for each month or fraction of the month the return is late or incomplete, up to a maximum of 12 months.[6] The penalty is also imposed for returns which fail to provide complete or required information. This penalty is also known as the per shareholder penalty, and is in addition to the delinquent filing penalty.

THIS PROVISION

For VDAs entered into on or after January 1, 2017, this bill would modify the VDP's provisions to allow penalty relief for S-corporations or LLCs classified as a partnership for late filing penalties.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 813 (Committee on Governance and Finance, 2017/2018), an FTB-sponsored bill, would allow out-of-state partnerships with non-resident partners, and out-of-state administered trusts to participate in VDP, and provide penalty relief for S-corporations and LLCs for the failure to file penalty. This bill was introduced on March 22, 2017.

AB 2692 (Brough and Ridley-Thomas, 2015/2016), would have added a "qualified small business" to the list of applicants that can participate in VDP. AB 2692 failed to pass out of the house of origin by the constitutional deadline.

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 LLCs to qualify for the California's VDP.

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

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[5] R&TC section 19172.5.
[6] IBID.

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), an 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

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, *Illinois*, and *Massachusetts* laws allow participation in VDP as long as there has been no previous contact by the state, the taxpayer has not registered for the tax involved in the disclosure, and the tax has not been collected.

Michigan, *Minnesota*, and *New York* laws specifically allow partnerships, LPs, and trusts to participate in VDP.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Estimating the amount of penalty relief granted for the failure to file a return would depend on the number of out-of-state LLCs and S-Corporations with nonresident partners and the amount of penalty relief granted by the FTB. Because it is difficult to predict the frequency and the value of future applications, the revenue impact is unknown.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that expanding eligibility for the VDP and providing all eligible entities similar penalty relief would encourage entities the department might otherwise fail to identify to become self-compliant.

Opponents: Some could argue that this bill, by benefiting non-compliant entities, may create cynicism among compliant in-state taxpayers and discourage self-compliance.

PROVISION NO. 2: Repeal the “failure to keep records” penalty for material advisors

OPERATIVE DATE

The repeal of the “failure to keep records” would be effective on January 1, 2018, and operative as of that date.

STATE LAW

Current state law provides for various penalties to encourage taxpayer compliance.

Among the penalties allowed under current law, is a “failure to keep records” penalty to any person who has a duty to file returns under Section 18648 and fails to keep the records required, unless it is show that the failure is due to reasonable cause. This penalty for any calendar year shall be $1,000 multiplied by the number of investors with respect to whom that failure occurs in that calendar year reporting period. If the total number of investors cannot be determined by the FTB, the penalty shall be $100,000. However, Section 18648 was repealed and reenacted as a new provision, therefore the requirements of the former 18648 no longer exist.

THIS PROVISION

This provision would repeal the “failure to keep records” penalty on or after January 1, 2018.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

Research of California legislation found no legislation similar to the provisions of this bill.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws provide that a willful failure to keep records may be viewed as tax evasion and may result in a Misdemeanor or Felony charge under state law. However, none have a penalty comparable to the penalty this bill would repeal. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

As discussed above, R&TC section 19174, the failure to keep records, is obsolete. Because this penalty references a section of the R&TC that no longer exists, repealing it would not impact state income or franchise tax revenue.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that the failure to keep records penalty does not encourage taxpayer compliance and should be repealed.

Opponents: Some may argue that taxpayers have a duty to keep appropriate records and should be penalized if they fail to do so.

PROVISION NO. 3: Provide that Section 856(g)(5)(C) (relating to REITS) of the Internal Revenue Code shall not apply for taxable years beginning on or after January 1, 2005

OPERATIVE DATE

This bill would be operative for taxable years beginning on or after January 1, 2005.

FEDERAL/STATE LAW

In general

Real estate investment trusts (REITs) are generally restricted to those entities investing in passive investments, primarily in real estate and securities.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. Whether the REIT meets the asset tests is generally measured each quarter.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is required to comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95 percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75 percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property, and income and gain derived from foreclosure property.

Penalty Information

If a REIT fails to satisfy one or more requirements for REIT qualification, other than the 95 percent and 75 percent gross income tests and other than the new rules provided for failures of the asset tests, the REIT may retain its REIT qualification if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of $50,000 for each such failure.

Excise taxes

Generally, the income that is earned from the REIT is taxable as a dividend to the members’ owners of the REIT. However, when a REIT fails to distribute the income required, federal law provides an excise tax on the undistributed income.

IRC section 856 defines a REIT and its requirements. IRC section 856(g) discusses the impact of the termination of an election by a corporation, trust, or association to be treated as a REIT. In general, IRC section 856(g)(5) is a relief provision that may (if its requirements are met) provide relief to a corporation, trust, or association that, but for this relief provision, potentially would be subject to loss of its tax status as a REIT due to one or more failures to comply with one or more of the provisions of subchapter M, part II, of the IRC (other than IRC section 856(c)(2), (3), or (4)).

IRC section 856(g)(5)(B) provides that the failure(s) to qualify are due to reasonable cause and not due to willful neglect.

IRC section 856(g)(5)(C) provides that the corporation, trust, or association must pay (as prescribed by the Secretary in regulations and in the same manner as tax) a penalty of $50,000 for each failure to satisfy a provision of IRC section 856 through IRC section 859 due to reasonable cause and not willful neglect.

STATE LAW

California law generally conforms to federal law as it relates to REITs. However, California does not impose excise taxes on REITs, and instead generally treats the income as Unrelated Business Income (UBI) that is taxed at corporate tax rates. An entity that is a REIT for any taxable year for federal purposes under the IRC (as applicable for federal purposes) shall be a REIT for California purposes for the same taxable year. California conforms to the penalty issued under IRC section 856(g)(5). Once a REIT pays the federal penalty of $50,000, it is considered a REIT for federal purposes. Under R&TC 24872.6(a), a REIT for federal purposes is considered a REIT for state purposes.

THIS PROVISION

This provision would amend the R&TC Section 24872.6 to correct an inadvertent conformity with federal REIT penalties. IRC section 856(g)(5)(C) provides that a REIT must pay a penalty of $50,000 for each failure to satisfy requirements of IRC section 856 through IRC section 859 due to reasonable cause and not willful neglect in order to not have their REIT election terminated under federal law. Under California law, if an entity is a REIT for federal purposes, it is a REIT for state purposes. A California-only REIT is not allowed. Thus, the $50,000 penalty has no effect for state purposes because California conforms to the federal entity status regardless of if the penalty is paid at the federal level.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

Research of California legislation found no legislation similar to the provisions of this bill.

OTHER STATES' INFORMATION

Review of *Florida, Illinois, Massachusetts, Michigan*, *Minnesota*, and *New York* laws found no comparable penalties on REITS that this bill would exclude. These states were selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would amend R&TC Section 24872.6 to correct inadvertent conformity, as discussed previously in this document. Because the REIT election is made at the federal level, California does not have the authority to revoke this election. As a result, this provision would not impact state income or franchise tax revenue.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that REITS that failed to adhere to the regulations surrounding REITS would already be subject to UBI tax and should not be subject to a penalty as well.

Opponents: Some may argue that this provision would remove a penalty that should not be imposed on REITS because they are already subject to tax.

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