



## **Analysis of Original Bill**

Author: Committee on  
Governance and Finance

Sponsor:

Bill Number: SB 1508

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Related Bills: See Legislative  
History

**Subject:** Voluntary Disclosure Program

### **Summary**

This bill would, under the Administration of Franchise and Income Tax Laws (AFITL), amend the provisions of the existing Voluntary Disclosure Program (VDP).

**Recommendation – No position.**

### **Reason for the Bill**

The reason for the bill is to allow foreign corporations and foreign limited liability companies (LLCs) into the VDP even if they have already registered with the Secretary of State (SOS).

### **Effective/Operative Date**

This bill would be effective on January 1, 2019, and specifically operative for taxable years beginning on or after January 1, 2019.

### **State Law**

Current state law allows an applicant requesting a “voluntary disclosure agreement” (VDA) to remain anonymous until the signed VDA is returned to the Franchise Tax Board (FTB). 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. These entities are defined as follows:

- A “qualified entity” includes any corporation, including an S corporation, an LLC not classified as a corporation, and a qualified trust 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 or a corporation or LLC that is not organized in California nor qualified or registered with the office of the 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 California 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; or
- 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 LLCs 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.

### ***Trusts***

Under federal law, trusts are generally treated as separate taxpayers and are taxed in the same way as an individual to the extent income is retained by the trust. Where trust income is retained by the trust, that income is taxed to the trust at specified trust rates.

However, trust income is not normally retained by the trust, but is distributed to the trust beneficiaries. The income retains the same character and tax attributes in the hands of the beneficiary as in the hands of the trust.

State law generally conforms to federal law governing the taxation of trusts. Exceptions to the federal provisions applicable to trusts are Personal Income Tax Law provisions that do not conform to federal law and provisions on taxing certain trust income on the basis of the residency of the fiduciaries and the beneficiaries.

All income of the trust derived from California sources and not distributed is taxable to the trust, irrespective of the residence of the fiduciaries or the beneficiaries. The taxability of non-California source income retained by a trust and allocated to principal depends on the residence of the fiduciaries and non-contingent beneficiaries, not the residence of the person who established the trust.

The entire income of a trust is subject to tax by California if either all the fiduciaries or all the beneficiaries are residents. Contingent beneficiaries are not considered for purposes of determining taxability of a trust. The residence of a corporate trustee is the place the corporation transacts the major portion of its administration of the trust.

State law outlines specific rules for the taxability of the trust depending on the combination of resident and nonresident fiduciaries, as well as contingent and non-contingent beneficiaries.

A special provision provides that a California resident beneficiary is required to pay tax if the trust failed to previously pay income taxes due to California or the beneficiary receives income that was not previously taxed by California because the beneficiary had a contingent interest at the time it was accumulated.<sup>1</sup>

### ***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 (LLLLP), 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.<sup>2</sup>

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<sup>1</sup> R&TC section 17745.

<sup>2</sup> Corporations Code sections 15901.02(j) and 15909.01(a).

A partnership is not a separately taxed entity and does not pay tax on or measured by its income. However, LPs<sup>3</sup> and LLPs<sup>4</sup>, 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.<sup>5</sup> 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.

### ***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.<sup>6</sup> 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.<sup>7</sup> 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.

For VDAs entered into on or after January 1, 2018, the VDP's provisions allow out-of-state partnerships with nonresident partners of GPs, LPs, and LLPs; and out-of-state trusts with California resident beneficiaries, to participate in the VDP.

### **This Bill**

This bill would, under the AFITL, allow foreign corporations and foreign LLCs that have registered with the SOS to participate in VDP as long as the registration was 6 months or less from the date the corporation or LLC signs the VDP agreement.

Any tax liability for the period the foreign corporation or foreign LLC is qualified or registered to do business in this state would be excluded from relief under the voluntary disclosure agreement.

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<sup>3</sup> R&TC section 17935.

<sup>4</sup> R&TC section 17948.

<sup>5</sup> R&TC section 19172.

<sup>6</sup> R&TC section 19172.5.

<sup>7</sup> Ibid.

## **Implementation Considerations**

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

An otherwise eligible applicant would be unable to participate in the VDP if the application remains outstanding when the 6-month period expires, which may be beyond the applicant's control. To preserve eligibility for applications received within 6 months of the date of registration or qualification with the SOS, this bill should be amended.

It is unclear whether and to what extent the taxpayer anonymity inherent to the VDP would be preserved once an entity had registered or qualified with the SOS.

It is unclear how the VDP would apply when the 6-month period fell into two taxable years. Would both taxable years be included in the VDP? Only the first of the two taxable years?

## **Legislative History**

SB 813 (Committee on Governance and Finance, Chapter 288, Statutes of 2017) modified the VDP provisions to allow out-of-state partnerships and nonresident partners of GPs, LPs and LLPs and out-of-state trusts with California resident beneficiaries to participate in the VDP.

AB 1719 (Assembly Committee on Revenue & Taxation, Chapter 176, Statutes of 2017), modified the VDP provisions to allow S corporations or LLCs classified as partnerships penalty relief from the late filing penalties.

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.

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 LPs, 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**

The VDP is a manual process, expanding eligibility for the program is expected to increase the number of applicants thus requiring additional staffing and training. 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.

### **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 (foreign) corporations or LLCs with non-resident members and the amount of the 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 or for the net final payment method of accrual.

## **Support/Opposition**

Support: None provided.

Opposition: None provided.

## **Arguments**

Proponents: Some may argue that foreign corporations or foreign LLCs that register or qualify with the SOS should remain eligible for tax relief under the VDP.

Opponents: Some may argue that this bill would benefit foreign corporations and foreign LLCs at the expense of similarly situated California-based entities which is contrary to current tax policy.

## **Policy Concerns**

This bill would provide a tax benefit for foreign corporations and foreign LLCs that would be unavailable to similarly situated California-based business entities. Thus, this bill would provide differing treatment based solely on classification.

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