

BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	Committee on Governance and Finance	SB 813

SUBJECT: Voluntary Disclosure Program/Expand Eligibility & Penalty Relief

SUMMARY

This bill would expand the existing Voluntary Disclosure Program (VDP) to allow out-of-state partnerships with non-resident partners, and out-of-state administered trusts to participate in the VDP. This bill would also provide penalty relief for admitted VDP applicant S corporations and limited liability companies (LLCs), from the failure to file penalty.

On December 8, 2016, the three-member Franchise Tax Board voted 2-0, with the Department of Finance abstaining, to sponsor the language included in this bill.

REASON FOR THE BILL

The reason for the bill is to eliminate inconsistent treatment among similarly-situated entities by allowing most out-of-state partnerships with nonresident partners of: general partnerships (GPs), limited partnerships (LPs), and limited liability partnerships (LLPs), and out-of-state trusts with California resident beneficiaries to participate in the VDP.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative for voluntary disclosure agreements entered into on or after January 1, 2018.

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 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 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.¹

Partnerships

There are three relatively common partnership types: GP, LP, and 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.²

¹ R&TC section 17745.

² 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, LPs³ and LLPs⁴, 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.⁵ 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.⁶ 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.⁷ 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 BILL

For VDAs entered into on or after January 1, 2018, this bill would modify the VDP's provisions to allow:

- Eligibility for out-of-state partnerships with nonresident partners of GPs, LPs, and LLPs; and
- Eligibility for out-of-state trusts with California resident beneficiaries to participate in the VDP.

Additionally, this bill would duplicate the penalty relief for S corporations or LLCs classified as a partnership for failure to file a timely return, as recently enacted by AB 1719.⁸ Because the penalty relief language is identical, a technical amendment is unnecessary.

³ R&TC section 17935.

⁴ R&TC section 17948.

⁵ R&TC section 19172.

⁶ R&TC section 19172.5.

⁷ Ibid.

⁸ Ibid.

LEGISLATIVE HISTORY

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

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

ECONOMIC IMPACT

Estimating the amount of penalty relief granted by the FTB would depend on the number of out-of-state partnerships with nonresident partners of: GPs, LPs, and LLPs, and out-of-state trusts with California resident beneficiaries, and the amount of relief granted by the department.

Current VDP law prohibits the department from approving applications from out-of-state partnerships with nonresident partners of: GPs, LPs, and LLPs, and out-of-state trusts with a California resident beneficiary. 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.

Revenue Discussion

Under the current law, out-of-state partnerships with nonresident partners of GPs, LPs, and LLPs and out-of-state trusts with California resident beneficiaries that are ineligible for the VDP may enter into a filing compliance agreement (FCA). Because the VDP limits the period for filing and payment to the preceding six taxable years, as compared with the unlimited period under FCA, this proposal could result in a revenue loss. Using data from the last five years of executed applications for these two programs, the estimated revenue loss could vary from \$5,000 to \$100,000 per year.

This estimate does not account for out-of-state partnerships with nonresident partners of GPs, LPs, and LLPs, and out-of-state trusts with California resident beneficiaries that withdraw their application during the anonymous application process and thus remain non-compliant under current law. If these entities applied and were approved under the modified VDP, the additional revenue would offset the losses above and if large enough could create a revenue gain.

APPOINTMENTS

None.

SUPPORT/OPPOSITION

Support: Three-Member FTB.

Opposition: None provided.

VOTES

	Date	Yes	No
Concurrence	09/05/17	40	0
Assembly Floor	08/31/17	73	0
Senate Floor	05/31/17	40	0

LEGISLATIVE STAFF CONTACT**Contact**

Marybel Batjer, Agency Secretary, GovOps
Khaim Morton, Legislative Deputy, GovOps
Selvi Stanislaus, Executive Officer, FTB
Diane Deatherage, Legislative Director, FTB

Work

916-651-9024
916-651-9100
916-845-4543
916-845-6333