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A Proposed Voluntary Disclosure Program for the California FTB

by Steven L. Walker and Sanford I. Millar

This is proposed voluntary disclosure program for individuals and businesses seeking to become tax compliant with the California Franchise Tax Board.

This proposal was prepared by Steven L. Walker and Sanford I. Millar, both members of Tax Procedure and Litigation Committee of the State Bar of California's Taxation Section. The authors wish to thank reviewer Betty Williams for her helpful comments.

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Executive Summary

This paper provides a framework for discussing the implementation of a voluntary disclosure program for individuals and businesses with the California Franchise Tax Board. The Internal Revenue Service has had a voluntary disclosure program for more than half a century, and it provides a mechanism for taxpayers to get back into compliance by making a truthful, timely and complete disclosure, showing a willingness to cooperate, and making good faith arrangements to pay in full the tax, interest and penalties. Taxpayers benefit because the program enables them to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution.

Yet unlike the Internal Revenue Service, the California Franchise Tax Board has no similar procedure for voluntary disclosure communications. The current practice is to file amended state tax returns with a brief statement regarding the omitted income and payment of the tax and interest. The case could end there, after the filing of the state tax returns with little or no communication back from the Board. However, if the Franchise Tax Board decides to impose civil penalties or there is a final federal determination as a result of an Internal Revenue Service civil examination, the case could reemerge. There should be a better way to efficiently resolve and bring early closure to these cases.

A state program can be as simple as posting a series of frequently asked questions and answers on the Franchise Tax Board's website with procedural rules regarding how and when to make a voluntary disclosure, along with the Franchise Tax Board's policy concerning what constitutes a voluntary disclosure. Regardless of the mechanics, there is little doubt that a genuine need exists in California for a clear disclosure policy, as illustrated by the examples in this paper.

The Franchise Tax Board surely stands to gain by implementing a voluntary disclosure program because it acts as a revenue accelerator and works to efficiently resolve tax disputes and reduce case inventories. The state benefits from receiving substantial sums of delinquent civil taxes, while obtaining future tax compliance by prior offenders. Notably, the Board already has the authority to develop and implement a program, based on the existing Revenue and Taxation Code without needing legislative action or approval. Taxpayers, in turn, benefit from having the opportunity to clear past tax debts on favorable terms and generally avoid criminal prosecution.

Clearly, a state voluntary disclosure program has an important place in the administration of California income taxes, and now, more than ever, with the

increased global financial and business activities of taxpayers, is the time to implement one.

Discussion

I. There Is a Genuine Need for a State Voluntary Disclosure Program

Tax attorneys in California are first and foremost problem solvers for their clients, using both expertise and creativity to resolve tax controversies efficiently and cost effectively. Most clients generally wish to become tax compliant and make good faith arrangements to pay their delinquent taxes, to the extent financially feasible, as clients typically seek to move forward with their lives and build a brighter future without fear of enforced collection action. Yet the road to reach that desired result is not always easy, and better procedural solutions should exist to assist these clients.

The following paragraphs present three fact patterns commonly encountered by tax professionals in California that could greatly benefit from a voluntary disclosure program, either formal or informal, with the California Franchise Tax Board. Each of these cases is illustrated below, along with a discussion of how a voluntary disclosure program could not only benefit a taxpayer wishing to become tax compliant, but also the Franchise Tax Board by serving as a revenue accelerator as well as a means to reduce its audit workload, bring taxpayers into compliance, and increase agency efficiency.

A. Resident Aliens Living and Working in California with Foreign Source Income

California is unique, and also fortunate, in the sense that it has a large and ever expanding population of individuals who have emigrated from other parts of the world to improve their lives and work for some of the world's most innovative companies in Silicon Valley. These taxpayers, not surprisingly, can be unfamiliar with the tax and reporting requirements with respect to their world-wide income, and they may have good faith misconceptions and a lack of understanding regarding their California reporting requirements. At times coming from countries where corruption is a widespread concern and government mistrust is the social norm, some individuals understandably have a different value system and point of view with respect to their dealings with the government — especially when it comes to tax matters.

Let's take a hypothetical fact pattern. Ravi and his wife Sanjya Chopra were born, raised and educated in New Delhi, India, and immigrated to Fremont, California to work in Silicon Valley. Ravi has an advanced degree in engineering and his wife is a computer programmer.

Back home, their parents who are still alive, have deposited funds into bank accounts on their behalf and made investments in various foreign mutual funds and stocks in an effort to financially assist Ravi and Sanjya. The Chopras' parents also have placed Ravi and Sanjya Chopras' names on the parents' bank accounts in the event of an emergency — a common practice in India to avoid costly and time-consuming probate proceedings. For the most part, children have had little or no contact with the financial accounts in India with the exception of occasional phone calls to their parents about the investment activity. Yet the Chopras are listed as the owners of record or holders of legal title in the banking records and signature cards, even though their parents primarily exercise dominion and control over the Indian accounts.

Ravi Chopra, along with his brother, Rick, own rental property in Mumbai, India, and Rick deposits the rental income into a Mumbai bank account. Ravi uses the funds in the account when traveling to India. Sanjya Chopra also owns a foreign bank account, in which she wire transfers after-tax funds to financially assist her elderly parents.

Several years after immigrating to the United States on work visas, the Chopras obtained green cards and are now lawful permanent residents of the United States and on their way to United States citizenship. The Chopras have always timely filed federal and state tax returns reporting their U.S. source income from their jobs in California. Recently, however, when completing their income tax return with their return preparer, they learned of the need to report and pay tax on at least some of the income from the bank accounts and investments in India and the potential steep penalties that could apply for not being tax compliant. The Chopras, who always thought that they were fully tax compliant, are caught off guard.

The Chopras may have believed in good faith that they were not legally required to report and pay tax on the foreign source income in light of the foreign tax credit and/or because taxes were paid in India on the foreign source income. Alternatively, the Chopras may simply have been unaware that they were required to report and pay tax on their world-wide income. In either case, the Chopras now have a tax-compliance issue that should be remedied, and as relatively recent immigrants, they may be motivated to immediately resolve the matter out of concern that violating the tax laws could trigger enforcement action and even possibly place their jobs and immigration status at risk.

At the federal level, one option to resolve the Chopras' tax non-compliance is to participate in the IRS Offshore Voluntary Disclosure Program, which reopened in January of 2012. Under this program, the Chopra would file amended federal income tax returns, among other requirements, and pay reduced penalties in exchange for a closing agreement with the IRS that resolves with finality their tax

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noncompliance. The program is not inexpensive, but it buys the Chopras economic freedom and solves the problem.

Yet surprisingly, there is little or no guidance from the California Franchise Tax Board on how to assist the Chopras with respect to their state tax compliance issue. A quick glance at the Franchise Tax Board's website reveals little, if any information, with respect to handling individuals like the Chopras, who have unreported income from foreign sources.

One option for the Chopras is simply to file four years of amended state income tax returns (there is a four year limitation period under Rev. & Tax Code § 19032) with full payment of the tax and interest and wait for a response and hope for the best. Yet still another option is to file the tax returns with an accompanying cover letter providing basic information on the tax periods, the types of tax involved, and a brief description of the omitted income.

Should the Franchise Tax Board subsequently impose penalties, such as the failure to timely pay tax under Rev. & Tax Code § 19132, or an accuracy-related penalty under Rev. & Tax Code § 19164, the matter could turn into a penalty abatement case — a part two case where Chopras may need to retain a tax professional to advance arguments and justifications as to why the penalties should be abated under reasonable cause. Penalty abatement cases understandably take time to resolve with the Franchise Tax Board and are not an inexpensive solution for the client and of course, there are no guarantees of a favourable result for the Chopras.

If the Internal Revenue Service subsequently makes changes to the Chopras' amended federal income tax returns as a result of a civil examination (a final federal determination), the Chopras must report the federal adjustments to the Franchise Tax Board and pay any additional tax or run the risk of receiving a notice of proposed adjustment from the Board. *See* Rev. & Tax Code § 18622 (report of federal income changes; filing amended return); § 19059 (notice of proposed deficiency assessment resulting from federal adjustment). In short, the state case could continue for some time after filing the amended state income tax returns.

In summary, a more efficient procedure, for both the Franchise Tax Board, and the taxpayers, should exist to resolve these relatively routine and common cases that are so prevalent here in Silicon Valley.

B. The Non-filer

Another fact pattern often encountered by California tax professionals is the non-filer. This is the individual who, for one reason or the other, has dropped out of the system and failed to file California income tax returns for several years.

Here is a typical case. Carl had a steady job working as an IT consultant for several years and always reported and paid tax, both state and federal. When the economy began to slow in late 2007, Carl, along with several of his co-workers, was laid off by his technology company, and Carl had difficulty for some time re-entering the workforce on a more permanent basis. The loss of self-esteem and confidence associated with being laid off, coupled with mounting credit card debts, spired Carl into depression and ultimately caused him not to file tax returns for several years. Carl recently has seen some light by landing a job as a consultant at a small technology company in Menlo Park, California, but the Franchise Tax Board garnished his wages in an effort to satisfy his unpaid tax debts. Carl would like to get back into the system, stop the wage garnishments, and put his life back on track, but Carl is unsure how to resolve his issue.

One option for Carl is simply to file his delinquent tax returns with the Franchise Tax Board and then enter into an installment agreement to pay the tax over time; alternatively, if Carl does not have the income, assets or means to pay the tax liability now or in the foreseeable future, Carl could file an offer in compromise application. Yet there is no standard procedure in place to efficiently resolve this type of case. Carl must first file his delinquent tax returns with the Franchise Tax Board, and then, once the returns are processed, contact the Franchise Tax Board a second time to negotiate a collection alternative, such as an installment agreement, after providing a complete financial statement disclosure. And surprisingly, there is no guidance whatsoever on the Franchise Tax Board's website for how tax professionals should assist non-filers such as Carl.

In short, Carl's solution can be a lengthy and drawn out process, and not an inexpensive one, especially for a client with limited means. Understandably, there should be a more streamlined procedure in place at the Franchise Tax Board for resolving Carl's tax compliance problem — a problem commonly encountered in today's uncertain economic times as the country slowly rises out of one of the worst economic recession since the 1930s.

C. Individuals With Actions That May Rise to the Level of a Criminal Tax Offense

A more serious case, and one that presents a compelling case for a state voluntary disclosure program, is the individual or business entity that has either failed to file tax returns or filed false tax returns with some affirmative conduct that may rise to the level of a criminal tax case.

Here is a hypothetical case for illustrative purposes. Wei Long Chen is a successful business owner of an import-export business with operations in mainland China and San Mateo, California. Mr. Chen frequently travels to Shanghai for business, where he operates a manufacturing and distribution company. Mr. Chen imports goods manufactured in

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China to various California retail distributors. And for many years, Mr. Chen has consistently underreported his gross receipts from his overseas activity, using a false invoicing scheme and depositing the unreported income proceeds into foreign accounts opened in the names of various entities and individuals in China. Mr. Chen also has invested his unreported gains from his business at brokerage accounts in Hong Kong and the United States.

Recently, Mr. Chen's name came to the attention of the Internal Revenue Service as a result of enforcement actions with respect to one of Mr. Chen's foreign financial institutions. Mr. Chen read about it in a Chinese newspaper while on return flight from Hong Kong and is concerned about his exposure, but the Service has not yet contacted Mr. Chen. Mr. Chen should have reported and paid tax on his world-wide income, which includes his business ventures in China and foreign banking activity. Mr. Chen is quite concerned and is even considering renouncing his green card status and leaving his family in California to work permanently in Shanghai to allegedly fix his problem.

One of the most commonly charged federal tax crimes, and the criminal offense that could be facing Mr. Chen is tax evasion, which is a felony offense. 26 U.S.C. § 7201. Tax evasion requires proof of willfulness, a tax deficiency, and an affirmative act constituting an evasion or attempted evasion of tax. *United States v. Barker*, 556 F.3d 682, 687 (8th Cir. 2009) (citations omitted). If Mr. Chen maintained a double set of books, used false invoices, or covered up sources of income, his actions technically could support a felony charge, which is a serious matter. *Spies v. United States*, 317 U.S. 492 (1943).

At the federal level, an option for Mr. Chen is to participate in the IRS Offshore Voluntary Disclosure Program to resolve his federal tax non-compliance. Yet there is no similar safe-harbor procedure in California to resolve Mr. Chen's tax non-compliance. Mr. Chen can afford to report and pay the tax, interest and penalties on the previously unreported California income, but does doing so expose Mr. Chen to criminal tax enforcement at the state level? What assurances or guarantees does the Franchise Tax Board offer Mr. Chen in exchange for making a voluntary disclosure and getting back into the system? Presently, there are no easy answers to resolve Mr. Chen's issues with the state. It would seem that the Franchise Tax Board would have an interest in Mr. Chen making good faith arrangements to pay in full the tax, interest and any penalties reasonably determined to be applicable in exchange for not pursuing criminal enforcement. Yet currently there are is no procedural guidance from the Franchise Tax Board to help Mr. Chen.

The plot thickens and the risks mount for the business owner who sits on the sidelines in light of the increased international tax enforcement by the IRS. As a result of the Foreign Account Tax Compliance Act (FATCA), taxpayers with specified foreign financial assets that exceed certain thresholds must report those assets to the IRS on Form 8938. This form must be attached to the taxpayer's annual tax return and filed by the annual tax return due date (including extensions). I.R.C. Code sec. 6038D(a); Temporary Reg. §1.6038D-2T(a). In addition, FATCA will require foreign financial institutions to report directly to the IRS information about financial accounts held by U.S. taxpayers, or held by foreign entities in which U.S. taxpayers hold a substantial ownership interest. There now is a heightened risk — especially individuals like Mr. Chen — that the IRS will discover unreported income previously hidden in foreign bank accounts and open a criminal investigation.

The business owner also may be motivated to get back into compliance with the tax laws for yet another reason — the relatively new IRS Whistleblower Office. Disgruntled employees or even former business associates with inside knowledge of a business' operations may seek to cash in by reporting the tax avoidance scheme in exchange for obtaining a large whistleblower payout by the Department of the Treasury. The IRS Whistleblower Office was established in 2007, in response to amendments to the legal authority for paying awards to individuals who report suspected tax compliance issues. Since that time, thousands of whistleblowers have reported hundreds of millions of dollars in suspected tax compliance issues, resulting in a wide range of audits and investigations. An award worth between 15 and 30 percent of the total proceeds that the Internal Revenue Service collects could be paid, and the total amount of awards paid in 2011 exceeded $8 million.

In short, individuals and business owners now live in a target rich environment for federal prosecutors and an unprecedented era where there is a genuine legitimate need for a voluntary disclosure system — a system that offers protection to individuals who make a truthful, timely and complete disclosure, are willing to cooperate, and make good faith arrangements for payment of the tax, interest and any penalties determined to be applicable. Contemporaneous with the making of a federal voluntary disclosure, practitioners should be able to initiate a state voluntary disclosure with the Franchise Tax Board, and yet surprisingly no such procedure exists today.

II. Current Franchise Tax Board Policy and Law

The Franchise Tax Board has a criminal investigation program staffed with approximately 42 Special Agents charged with the mission to identify, investigate and effect prosecution of tax evasion, fraud and employee misconduct.

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The Franchise Tax Board has a voluntary disclosure program, but it is limited to out-of-state taxpayers who conduct business in California and may not be aware of their California franchise or income tax liability or filing requirements. Rev. & Tax Code § 19191. The statutorily authorized program allows qualified entities, qualified shareholders or qualified beneficiaries that have unfulfilled California franchise/income tax return filing requirement and/or unpaid tax and/or fee liability to voluntarily come forward. *Id*. In exchange, the Franchise Tax Board is authorized by statute to limit the imposition of tax and/or fee liability to a six-year period immediately preceding the signing date of a voluntary disclosure agreement, and the discretion to waive penalties. *Id*.

The Franchise Tax Board also ran a short-lived and narrowly tailored voluntary compliance initiative in 2011. Known as "VCI II", the program allowed taxpayers who were engaged in abusive tax avoidance transactions or had unreported income from the use of offshore financial arrangements to report those transactions by filing amended tax returns between August 1, 2011, and October 31, 2011, to avoid most penalties and criminal prosecution. While the program offered relief to certain taxpayers with foreign source income, the program raised concerns by characterizing transactions as "offshore financial arrangements" when most cases simply involved individuals like the Chopras with unreported interest and investment income from foreign bank accounts.

In summary, there is a genuine need for the Franchise Tax Board to develop and administer a program that allows eligible taxpayers, who may have incurred an unpaid California tax liability or an unfulfilled filing requirement, to disclose their tax liability voluntarily in exchange for reduced penalties and no criminal enforcement.

III. Specific Recommendations

A. Technical Considerations

As a threshold matter, the Franchise Tax Board has the authority to develop and administer a voluntary disclosure program under the existing California Revenue and Taxation Code without needing any additional statutory authority from the California legislature.

The touchstone of this proposal is that it does not seek to broaden or expand the Board's authority with respect to determining the amount of tax, interest and any applicable penalties due and owing. The proposal works within the existing statutory framework and simply seeks to establish some common sense procedures, whereby a taxpayer can make a voluntary disclosure of his or her tax noncompliance and have the case efficiently handled by the Franchise Tax Board in exchange for no criminal prosecution. The Franchise Tax Board has broad authority to develop and administer such a program under Part 10.2 of the Revenue and Taxation Code.

The rules are already in place to implement a program. State voluntary disclosures, which often take the form of simply filing amended California income tax returns with the Franchise Tax Board, are often made contemporaneously with the making of a federal voluntary disclosure. Rev. & Tax Code § 18622 contemplates that a taxpayer filing an amended tax return with the IRS shall also file an amended tax return with the Franchise Tax Board. Rev. & Tax Code § 19032 provides that the Franchise Tax Board shall examine the amended tax return as soon as practical after the return is filed and determine the correct amount of tax. Rev. & Tax Code § 19059 sets forth the period of limitations the Franchise Tax Board has to issue a notice of proposed deficiency with respect to the taxpayer's amended tax return. Rev. & Tax Code § 19059 allows the Franchise Tax Board to enter into a closing agreement with a taxpayer who has filed an amended tax return to finally and conclusively resolve the matter, and Chapter 7, Article 1 of the Code grants other broad powers and duties to the Franchise Tax Board with respect to the administration and enforcement of the Franchise and income tax.

The Franchise Tax Board also has authority based upon the authority granted under Rev. & Tax Code § 19442 (settlement of tax disputes) and Rev. & Tax Code § 19443 (compromise of any final tax liability).

In sharp contrast, the voluntary disclosure program for business entities under Rev. & Tax Code section 19191 is a statutorily authorized program because it expands the Franchise Tax Board's authority by allowing the Board to administratively waive certain penalties and provide other forms of relief. This paper, however, does not suggest expanding authority, at least initially.

In short, the authority exists to implement a general voluntary disclosure program to assist taxpayers who wish to become tax compliant.

B. Benefits

Clearly, there are significant benefits to having a state voluntary disclosure program. One of the main advantages is that the program would act as a revenue accelerator. The program also would bring finality to the matter if, for example, the program included a provision requiring the taxpayer to give up certain appeal rights, and the Franchise Tax Board agreed not to pursue criminal investigation. The program also would clean up the workload in audit and legal by efficiently resolving certain cases upfront without a prolonged procedural delay. The taxpayer obtains the benefit of no criminal prosecution and the ability to efficiently resolve the case with one point of contact without having to wait for the Franchise Tax Board to process the amended tax

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returns and subsequently respond to a notice of tax due received in the mail, or worse, a notice of proposed assessment if there are issues with the amended tax return. The taxpayer also receives the benefit of being able to raise reasonable cause arguments if penalties are asserted upfront in the process as opposed to having to subsequently seek to abate penalties in some later proceeding before the Franchise Tax Board. In short, a compelling case exits for a state voluntary disclosure program.

C. Fiscal Impact

The fiscal impact of a voluntary disclosure program would not be significant in terms of additional personal, processing and system-change costs to implement a program. In reality, there are not that many taxpayers seeking to initiate a voluntary disclosure with the state in any one year, and while the IRS has re-opened the Offshore Voluntary Disclosure Program in January 2012, most tax practitioners saw a sharp decrease in the number of participants in 2012 as opposed to prior years. Yet clearly a program should be offered for those taxpayers seeking to make a disclosure for the reasons discussed above.

D. Mechanics of the Program

No specific format should be required to make a voluntary disclosure. An example of a voluntary disclosure before the Franchise Tax Board could include, for example, a letter from an attorney which encloses amended returns from a client which are complete and accurate, which offers to pay the tax, interest, and any penalties determined by the Franchise Tax Board to be applicable in full and which meets certain timeliness standards. Alternatively, the Franchise Tax Board could develop an intake letter similar to the one used by the Internal Revenue Service. A central address should be used to submit voluntary disclosures.

A key aspect of the program should be some ability to contact the Franchise Tax Board and request pre-clearance into the voluntary disclosure program before actually making a full disclosure. There is no point in making a full disclosure if, for example, the taxpayer is already under criminal investigation or civil examination. One way to accomplish this is to allow a taxpayer to send in a facsimile with certain identifying information (name, date of birth, social security number, and address). The Franchise Tax Board would then notify the taxpayer in writing whether or not he or she is eligible to make a voluntary disclosure. In general, a taxpayer would be pre-cleared so long as the Franchise Tax Board has not initiated a civil examination or criminal investigation. The IRS has a similar procedure, as illustrated in IRS FAQ 23.

After a taxpayer sends in his or her voluntary submission, the case should be assigned to a civil examiner to certify the amended tax returns for accuracy, completeness and correctness. To the extent that the Franchise Tax Board determines that penalties are applicable, the taxpayer would be given the opportunity to raise reasonable cause arguments. Notably, the Franchise Tax Board would not have discretion or authority to waive penalties as in the statutorily authorized program under Rev. & Tax Code § 19191, absent additional legislative action.

At the end of the civil examination, the taxpayer would execute a closing agreement to finally resolve the matter. Rev. & Tax Code § 19411 (authority to enter into closing agreements). This is particularly helpful to the taxpayer, who would not have to wait to resolve the case until he or she receives a final federal determination from the IRS. And, by resolving the case early, the Board is placed in the advantageous position of being first in line when it comes to obtaining payment for the tax, interest and applicable penalties due and owing — whether the payment is in the form of a lump sum payment, a negotiated installment agreement, or a combination of both.

The Internal Revenue Service has published an extensive set of frequently asked questions and answers with respect to its voluntary disclosure program, along with various forms and documents that must be completed to participate in the program. These IRS materials can provide a working model for purposes of drafting a state program and can be found at the Service's website.

V. Conclusion

The California Franchise Tax Board should develop and implement a voluntary disclosure program to assist individuals seeking to become compliant with their state tax obligations. The recommendations set forth in this paper would be beneficial to taxpayers and the Franchise Tax Board in efficiently and fairly administering and enforcing the California income tax laws ✰

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