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Next Up – The California Tax Amnesty Initiative

The federal 2011 Offshore Voluntary Disclosure Initiative (“2011 OVDI”) ended on Friday, September 9, 2011. Taxpayers who participated in either the 2009 Offshore Voluntary Disclosure Program or the 2011 OVDI were required to file amended federal income tax returns to report previously unreported income as far back as the 2003 tax year. As a result of filing those amended federal income tax returns, taxpayers will typically have to file amended state income tax returns for those same years as well. In the rush to comply with the September 9, 2011 deadline, taxpayers often left filing their amended state tax returns to a later date.

Earlier this year, California announced its own version of the 2011 OVDI, called the Voluntary Compliance Initiative 2 (“VCI2”). The VCI2 amnesty is broader than the federal 2011 OVDI which focused exclusively on unreported foreign financial accounts. The VCI2 applies to taxpayers who participated in either an abusive tax avoidance transaction (“ATAT”) or an offshore financial arrangement (“OFA”). ATATs include transactions that qualify as tax shelters for federal income tax purposes, reportable transactions under IRC Section 6707A(c)(1) or listed transactions under IRC Section 6707A(c)(2), and transactions to which the California noneconomic substance transaction (“NEST”) penalty applies under RTC Section 19774. OFAs include transactions designed to avoid or evade California income tax through the use of (i) offshore payment cards, including credit and debit cards, issued by foreign banks, or (ii) foreign banks, financial institutions, corporations, partnerships, trusts or other entities. Accordingly, OFAs include a much broader range of transactions than the FBAR form which is limited to reporting foreign financial accounts.

The good news for participants in the VCI2 is that they can participate even if they are currently under examination by the Franchise Tax Board, including having matters under administrative protest or appeals with the state, or under examination by the IRS. In addition, participants in the VCI2 will not be subject to the many California penalties that might otherwise apply, including the NEST penalty and the fraud penalty. They will, however, be subject to interest on any unpaid taxes.

Participants in either an ATAT or an OFA who wish to participate in the VCI2 should file amended California income tax returns and pay all unpaid taxes and interest before Monday, October 31, 2011. VCI2 applies to tax years up to and including the 2010 tax year. Participants must attach a Participation Agreement form to each amended California tax return for the years they filed amended federal tax returns, and include payment of all unpaid taxes and interest.

Participants in the 2011 OVDI who filed amended federal tax returns are required to file amended California income tax returns for those same years as well even if they do not elect to participate in the VCI2. Although the California statute of limitations is typically four years, special rules apply where the taxpayer files amended federal income tax returns. In such cases, the taxpayer has an obligation to file amended California tax returns for those same tax years; the California statute of limitations remains open if an amended California tax return is not filed. If an amended California tax return is filed within six months of filing the amended federal tax return, then the California statute of limitations for audit purposes is two years, otherwise the statute of limitations is four years. Note that typically, the IRS will notify the Franchise Tax Board when a California resident files amended federal tax returns.

For additional information, please contact the authors or any member of the **Venable Tax and Wealth Planning Group**.

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