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Tax Amnesty Goes Hollywood

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Taxpayers with undisclosed foreign accounts worry about entering the IRS's Offshore Voluntary Disclosure Initiative (OVDI). But it's [not too late](#). The August 31 deadline is rapidly approaching, but an [extension](#) (until the end of November 2011) can provide time if you demonstrate a good faith attempt to produce all materials. See [FAQ 25.1](#). Without the extension, August is the last month to collect foreign bank statements, amend tax returns and complete delinquent Treasury Forms [TD F 90-22.1](#), also known as [FBARs](#).

State Disclosure Too. While focusing on the IRS is appropriate, there's another tax regime to worry about: your state. California's new program is called [Voluntary Compliance Initiative 2](#) (VCI 2), since the state's VCI 1 ran from January 1, 2004 to April 15, 2004. The new amnesty allows those who underreported California income tax liabilities through abusive tax avoidance transactions or offshore financial arrangements to amend their returns for 2010 and prior years and obtain a waiver of most penalties. Use new Forms [621](#) and [622](#), the "participation agreement" for California taxpayers to resolve their liability.

Compared to the IRS OVDI, this may sound too good to be true. In most cases, the OVDI requires a [penalty of 25%](#) of the highest aggregate account balance in your offshore accounts. While it's true that the IRS also requires you to amend tax returns and pick up unreported income,

paying tax, interest and a 20% penalty, it's the 25% miscellaneous Title 26 offshore penalty that's a killer for many.

In California, since there was no state counterpart to the FBAR requirement, there's also no 25% penalty. If you participated in the IRS 2009 Offshore Voluntary Disclosure Program (OVDP) or are pursuing the 2011 IRS OVDI, California's VCI 2 represents a good opportunity. However, as with the IRS programs, there are a number of hurdles.

What you must do depends on whether you're an individual or a business.

Individuals must:

- Amend California tax returns to disclose any income you failed to report.
- Pay all taxes and interest due on those amended tax returns by October 31, 2011. If you can't pay in full, you can enter an installment agreement calling for final payment by June 15, 2012.
- Complete a separate Form [622](#), VCI 2 Participation Agreement and attach it to each amended tax return (Form [540X](#)).

Businesses entities must take the same steps, including filing the requisite amended returns, but they should attach to each amended return a Form [621](#).

Good Results.

- The California Franchise Tax Board (FTB) will waive all penalties (except any paid prior to August 1, 2011, any relevant amnesty penalties, and large corporate understatement penalties).
- The FTB will not pursue criminal action.
- By signing the Forms [621](#) or [622](#) you acknowledge you waive your right to protest, appeal or file a claim for refund.

Interaction With IRS. California's program is just getting started and, like the IRS OVDI, there are wrinkles. According to the FTB's participation agreements, if you were eligible to participate in the IRS's OVDI, you "may" participate in VCI 2. However, the lack of conformity between the Internal Revenue Code (IRC) and the California Revenue & Tax Code may cause problems.

Take the passive foreign investment company ([PFIC](#)) issue that caused so much difficulty with both the 2009 IRS OVDI and the 2011 IRS OVDI. The IRS provided taxpayers with a special mark-to-market solution, applying a 20% tax rate to PFIC investments. See [FAQ 10](#). This seems to be working, but how will the PFIC issue play out in California's VCI 2?

California Revenue & Tax Code Section [24995](#) provides that California does not adopt the PFIC regime. Will taxpayers and accountants who labored through account statements to create mark-to-market calculations have to start over? Will California (which taxes capital gains at ordinary rates) make taxpayers prepare a whole new set of calculations?

As with the 2009 OVDI and the 2011 OVDI from the IRS, additional guidance may already be on its way from the FTB to address these subtleties.

Beware Scope. California's program *only* covers unreported income due to abusive tax avoidance transactions and offshore financial arrangements. An abusive tax avoidance transaction means a:

- Tax shelter as defined under IRC Section [6662\(d\)\(2\)\(C\)](#);
- Reportable transaction as defined under IRC Section [6707A\(c\)\(1\)](#) that is not adequately disclosed in accordance with IRC Section [6664\(d\)\(2\)\(A\)](#);
- Listed transaction as defined under IRC Section [6707A\(c\)\(2\)](#);
- Gross misstatement within the meaning of IRC Section [6404\(g\)\(2\)\(D\)](#); or

- Transaction to which the noneconomic substance transaction penalty applies under California Revenue & Tax Code Section [19774](#).

An offshore financial arrangement includes any transaction designed to avoid or evade California income or franchise tax through the use of:

- Offshore payment cards, including credit, debit, or charge cards issued by banks in foreign jurisdictions; or
- Foreign banks, financial institutions, corporations, partnerships, trusts, or other entities.

If anything ***other than*** an abusive tax avoidance transaction or an offshore financial arrangement caused your lack of California tax compliance you're technically not covered by California's VCI 2.

In contrast, some taxpayers who came clean under the federal 2009 IRS OVDP used the chance to report their offshore income to also address unreported income unrelated to their foreign accounts. Participants in the 2011 OVDI may be allowed a similar opportunity. It's unclear how strictly California will interpret the limited scope of its program, though there would seem to be no incentive for the state to try to throw taxpayers out of the program who are merely trying to clean up inaccurate returns.

For more, see:

[IRS Foreign Account Disclosure: What About The States?](#)

[It's Not Too Late For IRS Amnesty](#)

[Even U.S. Branch Accounts Abroad Trigger FBAR!](#)

[Should You File FBAR For The First Time?](#)

[IRS Voluntary Disclosure A Mistake For Some](#)

["Quiet" Foreign Account Disclosure Not Enough](#)

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