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ALERT

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Still On the Hook: How Calif. Taxpayers Often End Up With Ongoing Tax Liability

It is surprising how often a California taxpayer receives a notice from the Franchise Tax Board (FTB) asserting an unpaid tax liability years after the general statute of limitations period has passed. Taxpayers who receive these notices are shocked to learn that seemingly simple oversights have given the FTB extended time to seek assessment of tax deficiencies. Here are a few common traps that all taxpayers and their tax advisers should remember:

1. Notification of IRS adjustments or amended return

California Revenue & Taxation Code (R&TC) § 18622 requires taxpayers to inform the FTB within six months of either a federal tax adjustment initiated by the Internal Revenue Service (IRS) or the filing of an amended federal tax return. If the taxpayer properly notifies the FTB within the six-month period of the change or amendment, or if the IRS itself notifies the FTB, then the FTB is given two years to issue a notice of proposed deficiency assessment under R&TC § 19059.

However, if the FTB is not informed by the taxpayer or IRS of the federal change, then R&TC § 19060(a) allows the FTB to send a deficiency notice at any time. If the taxpayer or IRS informs the FTB of any change outside of the statutory six-month notification window, then the FTB is allowed four years in which to issue a deficiency notice.

In practice, it is not uncommon for a taxpayer to forget to inform the FTB about changes made to his or her federal tax return or of the filing of an amended tax return. But that oversight can lead to an extended (or even indefinite) period for the FTB to seek assessment of alleged deficiencies with a penalty.

A State Board of Equalization (SBE) summary decision from earlier this year highlights the harsh consequences to a taxpayer of failing to follow R&TC § 18622 to the letter. In *Barry Rossum*, No. 695903 (3/25/2014), the SBE allowed the FTB to proceed with assessment against a taxpayer 11 years after the original state tax return was filed, which is many years beyond the normal four-year statute of limitations period set forth in R&TC § 19057. Rossum had timely filed his federal and state tax returns for the 2000 tax year. After an audit, the IRS increased his Schedule C business income (along with penalties), to which Rossum consented. Although Rossum claimed he filed an amended return and payment with the FTB following the federal audit, the FTB never received either. In 2011, the IRS notified the FTB of the federal adjustments for Rossum's 2000 tax return, which caused the FTB to issue a notice of proposed adjustment in April 2012.

In its decision, the SBE noted that the California Supreme Court has held that the specific language of R&TC § 19060 applies notwithstanding R&TC § 19057. *See Ordlock v. Franchise Tax Bd.* (2006) 38 Cal.4th 897, 909-912. Thus, Rossum's failure to timely report the federal adjustments to the FTB gave the agency four years from the IRS's notification to assess the deficiency, which it did. The SBE determined that Rossum had not provided any evidence of mailing an amended return to the FTB and was on notice that no payment had been received by the FTB because of the lack of bank activity on the alleged check payment sent.

Takeaway: Taxpayers and their professional advisers must diligently ensure that any federal tax return changes, whether created by an audit or from an amended return (such as an offshore voluntary disclosure), are passed along to the FTB in order to start the running of the limitations period under the R&TC. Otherwise, deficiencies from long-ago filed returns are still possible (along with significant penalties and interest).

2. <u>Aggressive interpretation of abusive transactions</u>

Like Congress, California has also enacted an extended statute of limitations (SOL) period for "abusive tax avoidance transactions." R&TC § 19755 provides for an eight-year limitations period for abusive transactions when the proposed deficiency assessment is made before Aug. 1, 2011, and increases that period to 12 years for notices on or after Aug. 1, 2011.

While seemingly alike in scope, the tax shelter SOL provisions outlined in the IRC and R&TC differ materially. Although Congress, motivated by a similar desire to attack tax shelter transactions, gave the IRS extended time to issue deficiency notices in IRC § 6501(c)(10), that authority is much more limited in scope than the wide-ranging latitude given to the FTB.

For example, IRC § 6501(c)(10) only permits a longer SOL period for "listed transactions," which are defined in IRC § 6707A(c)(2) as a reportable transaction similar to one identified by the IRS as a tax avoidance transaction. But the term "abusive tax avoidance transaction" in the R&TC appears to be much broader, giving the FTB wider latitude in arguing that § 19755 applies to any given situation the FTB deems abusive. R&TC § 19753 refers to an "abusive tax avoidance transaction" as "a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, 'listed transactions.'" Thus, while listed transactions are supposed to be identified by the FTB and published on its website (see R&TC § 18407), there is no statutory requirement or administrative guidance as to how the FTB is to handle non-listed transactions deemed "abusive tax avoidance transactions."

Indeed, the FTB has articulated a wide range of circumstances in which R&TC § 19755 might apply to allow an eight- or 12-year assessment period. In several official publications, the FTB has stated that the extended assessment period may apply "if the assessment is related to any plan or arrangement whose principal purpose is tax avoidance. This includes both listed and non-listed transactions." *See* California FTB Tax News, No. 09/01/2010 [emphasis added].

Takeaway: Even though a taxpayer might assume that a tax return is subject to the normal four-year limitations period in R&TC § 19057, it is possible under existing statutory law for the FTB to argue that a transaction reflected on the return is abusive and subject to the 12-year assessment period in R&TC § 19755. The taxpayer would be on notice of that possibility if the FTB has publicly identified the transaction as a listed transaction. But the FTB's interpretation of R&TC § 19755 as covering non-listed transactions too, which do not require public identification, could mean aggressive application without normal due process in some situations. A taxpayer would have no recourse to challenge the FTB's assertion of an "abusive tax avoidance transaction" until after audit, notice of proposed assessment and protest, or possibly to court.

3. Strict Liability Penalty for Noneconomic Substance Transactions

Another cause for concern is the potential for assertion by the FTB of a strict liability penalty for noneconomic substance transactions (NEST). The NEST penalty in R&TC § 19774 is imposed on any understatement attributable to a transaction that lacks economic substance or if an entity is disregarded due to a lack of economic substance. A transaction is treated as lacking economic substance if the taxpayer cannot show a valid nontax business purpose for it.

The NEST penalty is a so-called strict liability penalty because there is no provision allowing the penalty to be abated for reasonable cause and good faith on the part of the taxpayer. Not only is the penalty 40 percent of the tax understatement (which can be decreased to 20 percent if the taxpayer adequately disclosed the transaction on a filed return), but there are limited circumstances to appeal the penalty. The FTB chief counsel is the only one granted authority to compromise the NEST penalty after it has been assessed, but the taxpayer has no recourse (either before the SBE or a court) to challenge the FTB's refusal to abate. Only after a taxpayer has paid the penalty in full may he/she file a refund claim that can be appealed to the SBE or court if the claim is denied.

The penalty can be applied to a wide range of taxpayer activity as the FTB defines a "noneconomic substance transaction" as any in which a loss, deduction or credit is disallowed because the agency determines a lack of economic substance exists due to an absence of a valid California business purpose other than tax savings. For tax years after March 24, 2011, the NEST definition expands to cover any disallowed tax benefit under federal law (*see* IRC § 7701(o)). And R&TC § 19774 requires an automatic NEST penalty if a similar penalty is applied at the federal level under IRC § 6662(b)(6), which can only be abated if the taxpayer shows that the federal penalty was "clearly erroneous."

The degree of latitude to which the FTB may invoke the NEST penalty was recently highlighted in a case before the SBE. In *Joseph Francis*, No. 523692 (5/22/2013), the taxpayer appealed an FTB assessment arising from the disallowance of a claimed flow-through loss generated by a tax shelter, as well as disregarding of a related entity and assertion of a NEST penalty. The taxpayer agreed to a stipulated settlement in U.S. Tax Court with the IRS to be bound by an IRS-favorable ruling in a similar case. The FTB argued that regardless of the outcome of the federal appeal, it would maintain its position that the taxpayer's transactions lacked economic substance for California tax purposes, indicating that the FTB

will aggressively make its own NEST determinations apart from how the IRS might approach the same facts in a case.

In following federal case law, the SBE held that the taxpayer had not provided sufficient evidence to overcome the presumption of correctness attached to the FTB's determination, and thus R&TC § 19774 expressly applied to the understatement amounts, a terrifying result with broad reaching application.

Takeaway: The opinion in *Francis* confirms that the FTB may not hesitate to assert a NEST penalty when it considers the facts to fall within either the federal standard for lacking economic substance or even the FTB's own separate guidelines, which are much broader than narrowly-defined federal standards.

4. Failure to submit entity withdrawal paperwork

Taxpayers with business operations in California often overlook all of the necessary steps required in order to effectively foreclose future tax liability when the business ceases to exist, either as the result of a sale, merger or reorganization. Two mandatory steps that are frequently missed include indicating to the FTB that a tax return represents the entity's "final tax year," as well as filing withdrawal paperwork with the secretary of state. A taxpayer's failure to comply with either action can lead to ongoing tax liability even if business operations have ceased.

Informing the FTB of a business entity's last tax year is very simple but easy to miss. The taxpayer (or the return preparer) must check the box on the state tax return indicating that the return is a "final" return by the entity. If this box is not checked, the FTB will continue to treat the business as an operating entity subject to any required filing requirements, leading to notices, assessments of tax penalties, and demands by the FTB that can cause reputational damage and administrative headaches to resolve.

In addition to notification to the FTB, a taxpayer ceasing to do business within California must also apprise the secretary of state of the entity's intentions. This requires a domestic or foreign (out–of–state or out–of–country) business entity to file the applicable form with the California secretary of state in order to dissolve, surrender or cancel its authority to do business in the state. Absent this dissolution/withdrawal step, the FTB takes the position that the entity is still subject to any applicable return filing requirements under the R&TC. Practically, this can mean that a business may be liable for minimum annual fees or taxes (along with penalties and interest) until the appropriate paperwork is tendered to the SOS and processed.

Takeaway: Business taxpayers ending their activities in California must satisfy both the FTB and SOS notification requirements in order to end all tax compliance obligations under California law.

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