Making Sense of the FTB Settlement Initiative for Abusive Micro-Captive and Conservation Easement Transactions

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The FTB issued 2023-02 (Notice) on May 31, 2023 providing taxpayers a time-limited opportunity to resolve tax matters relating to potentially abusive Micro-captive Insurance (MCI) and Syndicated Conservation Easement (SCE) Transactions in return for zero or reduced penalties. The Notice requires participants to reverse their deductions and related transaction costs and enter into extensive closing agreement process, in addition to making payment in full for all taxes, interest, and penalties due under the terms of this agreement. The terms of the penalty regime differ depending on: 1) Whether participation occurs prior to or after "contact" by the FTB or IRS, 2) whether there has been an issuance of a FTB Notice of Proposed Assessment (NPA), and 3) whether the taxpayer has participated in an announced IRS program. Previously, the FTB offered settlement terms for these transactions on an informal basis that differ from the Notice depending on where the taxpayer stood in the audit process.

We consider this initiative as important compliance opportunity for the right taxpayer.

What Transactions are Eligible?

The announcement only applies to an Eligible Transaction, which the Notice limits to MCI or SCE transactions. The Notice defines MCI transactions to include transactions in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, by using contracts the parties treat as insurance contracts and a related company the parties treat as a captive insurance company. The Notice defines SCE transactions to include transactions where a taxpayer participates in an investment opportunity which purport to grant investors charitable contribution deductions with respect to conservation easement or fee simple donations in amounts that significantly exceed the amounts invested.

Who is an Eligible Taxpayer?

Most taxpayers who claimed state tax benefits on an original or amended return from an Eligible Transaction may participate in the resolution, including those taxpayers currently under examination by the FTB and IRS (or who is in IRS Appeals). The Notice also applies to taxpayers in litigation with the IRS with respect to Eligible Transactions but does not include taxpayers who are in litigation with the FTB regarding these transactions.

The Notice has broad applicability to taxpayers with Eligible Transactions. The Notice however does not apply to other matters that may be considered tax avoidance transactions by the FTB. In those cases, the qualified amended returns process should be considered.

What is the Participation Period?

The Notice affords taxpayers approximately a four-month period to comply. Eligible taxpayers must submit a complete and signed Notice 2023-02 closing agreement to the FTB between July 10, 2023, and November 17, 2023. It is not clear why this particular date range was selected, or whether the program period can be extended. Taxpayers seeking to participate, however, should assume that no extensions will be afforded.

What are Terms of the Settlement?

The terms of the settlement are somewhat complex and differ depending on whether the participant has been contacted by the FTB or IRS, whether a NPA has already been issued, and whether the participant previously resolved their matter pursuant to a formal IRS settlement initiative. A brief summary follows:

A. No Contact - No Penalties

General speaking, participants who have not yet been "contacted" by the FTB or IRS with respect to a tax return on which the participant claimed tax benefits from an Eligible Transaction, the participant must pay the self-assessed taxes and interest attributable to the reversal of the tax benefits previously claimed. In this situation, the FTB states it will not assess an accuracy-related penalty under RTC Section 19164, an accuracy-related reportable transaction understatement penalty under RTC Section 19164.5, a NEST penalty under an RTC section 19774, or an interest-based penalty under RTC Section 19777 in this situation.

The FTB defines "contacted" within the meaning of Treasury Regulation Section 1.6664-2(c)(3)(ii) and includes contact by the FTB or the IRS of a partnership in which the participant includes a direct or indirect interest.

Understandably, the FTB places a premium on those participants who voluntarily correct without the need for the FTB to utilize its enforcement resources. In the world of heightened penalty enforcement, a zero-penalty resolution for those seeking a reasonable escape from the ill effects of misreporting an Eligible Transaction may be a welcomed relief.

B. Contact But Before NPA Issuance - 20% Penalty

Generally speaking, participants who have been "contacted" by the FTB or the IRS, but that has not received an NPA adjusting the tax benefits claimed from the Eligible Transaction prior to the date of this Notice, must pay the self-assessed taxes and interest attributable to the reversal of the tax benefits claimed from the transaction and pay a 20% accuracy-related penalty under RTC Section 19164 for each year. The FTB will not assess an accuracy-related reportable transaction understatement penalty under RTC Section 19164.5, a NEST penalty under RTC Section 19774, or an interest-based penalty under RTC Section 19777 in this situation.

The FTB seemingly considers a participant who forced government contact as less worthy for penalty relief, thereby requiring imposition of an accuracy-related penalty and thus keeping in place an incentive for those to come forward and correct prior to "contact."

C. After NPA has Been Issued – 20% Penalty Plus Interest-Based Penalty

Generally speaking, for participants who received a NPA adjusting the tax benefits claimed from the Eligible Transaction prior to the date of this Notice, the participants must pay the full amount of tax and interest shown on the NPA relating to those adjustments. If the NPA includes an interest-based penalty under RTC section 19777, the participant must pay the interest-based penalty. However, if the NPA includes a NEST penalty under RTC section 19774, the FTB's Chief Counsel will reduce the NEST penalty to zero pursuant to the authority under RTC section 19774, subdivision (d).

The Notice does not specifically reference the imposition of the 20% accuracy-related penalty when discussing this category of participant, but we can assume that if asserted in the NPA it will be required to be paid as part of the initiative as well, although this may be open for interpretation.

Obviously, the FTB considers a participant who expended the resources of a full examination required to issue an NPA, should receive the least penalty relief of those who avail themselves of the initiative.

D. Participants who Resolved IRS Matter Pursuant to a Formal IRS Settlement Initiative

For those participants who previously resolved their case pursuant to a formal IRS settlement initiative with respect to an Eligible Transaction, the Notice distinguishes between those whose received a NPA and those who did not. The Notice describes a "formal IRS settlement initiative" is a settlement initiative announced by IRS notice or Chief Counsel announcement or other official IRS communication and does not include a settlement reached solely in a particular IRS audit or in a federal court settlement.

1. Formal IRS Program, But No NPA

For those participants who did not receive a NPA, such participant must reverse tax benefits previously claimed on the participant's California tax returns with respect to the Eligible Transactions to the same extent the tax benefits were reversed for federal purposes under the formal IRS settlement initiative. The participant in this resolution will be required to pay an accuracy-related penalty at the same rate that the participant was required to pay pursuant to participating in the formal IRS settlement initiative.

In essence, the Notice allows the participant to mirror the results of IRS Settlement on both the deduction and the penalty items. This can be especially valuable if the IRS Settlement allowed for the deduction of out-of-pocket expenses (i.e., contribution for charitable deduction) and allowance of a portion of the transaction as part of a form IRS initiative (i.e., the 10% insurance premium deduction afforded to some MCI transaction) or for reduced penalties (i.e., like we have seen afforded in an earlier MCI IRS program of 0%, 5% or 10% depending on whether taxpayer participated in multiple transactions or had independent advisors).

2. Formal IRS Program and NPA

For those participants who have received an NPA, such participants must reverse the tax benefits previously claimed on the participant's California tax returns to the same extent the tax benefits from the Eligible Transactions were reversed pursuant to the formal IRS settlement initiative for the same taxable years. However, such participants will still be subject to the same penalties described above for those participants who have received an NPA.

The Notice essentially sets forth a hybrid approach for this participant. On one hand, the participant benefits from the IRS Settlement on the tax computation, such as the allowance of certain out-of-pocket expenses. On the other hand, the Notice imposes a price in terms of penalty for requiring the FTB to incur the trouble and expense of conducting the audit and issuing an NPA.

E. Participants who Resolved IRS Matter Not Pursuant to a Formal IRS Settlement Initiative

For a participant who has resolved Eligible Transactions pursuant to final federal changes other than pursuant to a formal IRS settlement initiative, such participant is required to reverse the tax benefits for such federally resolved years generally to the same extent as provided in the final federal changes. However, a participant described in this section is subject to the applicable penalty resolution terms of the Notice described above, depending upon whether the participant has received an NPA. This means that a participant in this category would be subject to 20% accuracy-related penalty. In addition, in those cases where an NPA has been issued, the participant would also be subject to the interest-based penalty under RTC section 19777.

Participation Procedures

Eligible Taxpayers who want to participate in the resolution described in this Notice and avail themselves of the penalty relief described herein must enter into a detailed closing agreement and provide extensive information to the FTB. Moreover, the Taxpayer must submit payment in full for all taxes, interest, and penalties due under the terms of this agreement. For those participants with financial hardship, payment alternatives to allow for full payment over a period not to exceed 12 months might be allowed. Further details of the information and documentation required as part of the participation and closing agreement process may be the subject of a future Blog.

Making Sense of the FTB Resolution

The FTB should be applauded for its efforts affording taxpayers an opportunity to seek resolution substantially mitigating potential penalties. Many clients on their own or though the assistance of their trusted advisors have entered into MCI and SCE transactions in good faith. Moreover, the FTB must recognize that each transaction needs to be judged on its own set of facts and circumstances and every client has a varying decree of knowledge or sophistication about the transactions they entered. That is to say some transactions are well grounded in Congressional authorized provisions that enhance the public good, such as those that promote green spaces, historic building conservation and the ability to self-insure against liabilities and may, in fact, withstand the test of audit or litigation. Of course, many other transactions may not. The settlement initiative gives taxpayers a chance to critically examine the transaction and decide whether to resolve their transaction and mitigate additional penalty exposure.

Taxpayers with Eligible Transactions who do not participate in the resolution face the undesirable prospect of the full array of potential penalties, including the non-economic substance penalty. It should be noted that the FTB has plenty of time to audit any taxpayer it deems warranted, as State has 12 years after the return file date to assess additional tax and penalties relating to an abusive tax avoidance transaction under RTC Section 19755.

The IRS has not yet issued its own broad-based settlement initiative for SCE transactions (as it has done for MCI transactions) and our view is that the pressure is mounting for it do so. The release of this comprehensive initiative by the FTB will intensify this discussion, as tax administrators see the benefits of participation by taxpayers in the State.

As with most things, timing is everything. For those clients with Eligible Transactions not already contacted by the FTB or IRS, a penalty-free option now exists and should be considered by an independent professional with the knowledge of MCI and SCE transactions, and quick and decisive considered action should be taken. A similar approach is needed for those clients already under examination, as participation can reduce the penalties that otherwise might be asserted once an NPA has been issued. The clock is ticking, and now is the time to act.

For more information regarding this topic please contact Michel R. Stein – stein@taxlitigator.com Mr. Stein is a principal at Hochman, Salkin, Toscher & Perez, P.C. He is a former Attorney-Adviser of the U.S. Tax Court and is a Certified Specialist in Taxation Law by the State Bar of California, Board of Legal Specialization. Mr. Stein represents clients throughout the United States and elsewhere involving federal and state, civil and criminal tax controversies and litigation. He has extensive experience with defending Micro-captive and Conservation Easement Transactions before the IRS and FTB and in court, and he frequently lectures throughout the country on these and other tax related topics. Additional information is available at www.taxlitigator.com.