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IN CALIFORNIA WE TRUST: A SENSIBLE EXPANSION OF THE VOLUNTARY DISCLOSURE PROGRAM

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[1] **The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Taxation Section.**

[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.

EXECUTIVE SUMMARY

Trusts administered outside California often are susceptible to not filing California income tax returns. This is because California has an atypical legal threshold for filing: trusts must file if a trustee or beneficiary resides in California. Trust administrators outside California, for a plethora of reasons, often oversee this requirement and do not file.

This problem with not filing isn't limited to trusts. Individuals, corporations, partnership, and other legal entities all have issues with failing to file. The Legislature has mitigated this problem for all these entities. Through its Voluntary Disclosure Program, California allows these non-filers to come forward and begin paying taxes in exchange for penalty relief and a limited lookback period for catching up on prior non-filing. This fix applies to trusts administered outside California as well.

But there was an oversight. Not all trusts administered outside California could enroll in the program: those that must file in California because a beneficiary resides in the state were overlooked. The Legislative history of the Voluntary Disclosure Program, and public policy ideals of encouraging compliance and raising state revenues, all support allowing these types of trusts to participate in the Voluntary Disclosure Program. Based on that history and the policy behind the program, we believe the Voluntary Disclosure Program statute must be amended to include all trusts administered outside California, including those with beneficiaries in the state.

In this paper, we explore this problem and discuss the simple solution of amending the existing Voluntary Disclosure Program to include this subset of trusts. Doing so will allow previously non-compliant trusts to become compliant and ensure compliance by more trusts going forward.

DISCUSSION

We seek a simple solution to a simple problem. This solution increases tax compliance in the state. But it's not a tax increase. And at the same time, our solution delivers a more business- and resident-friendly atmosphere.

The problem arises because non-California trusts must file California returns and pay California taxes if any non-contingent beneficiary of the trust is a resident of California.[3] Many of these types of trusts have not been filing in the state because they're unaware of any filing obligation. And despite the reasonableness of their non-filing, when they do become aware, these trusts may be subject to substantial penalties, interest, and back-taxes.

California has a Voluntary Disclosure Program (VDP) that the Legislature designed specifically for situations like this. A person or entity may be unaware of a California tax obligation and, because of back-taxes, interest, and penalties, has a disincentive to start filing. The VDP solves this problem by eliminating penalties and reducing the look-back period for the back-taxes and associated interest. This program is extremely successful. But the VDP statute excludes trusts with California resident non-contingent beneficiaries. We ask only that this oversight be corrected.

I. OVERVIEW OF CALIFORNIA TRUST TAXATION

We said above that the problem we address is simple. But the problem requires some background on the taxation of trusts. That's not so simple. So we begin with a primer on the taxation of trusts to explain the type of income that's being taxed. To tax trusts, California follows the federal income tax rules.[4] That's where we begin.

For federal income tax purposes, trusts are treated as separate legal entities.[5] A trust calculates its gross income in the same manner as an individual,[6] with one major distinction: it's allowed a deduction for distributions to beneficiaries.[7] As a result, the trust's income is bifurcated and the beneficiary pays tax on the amount of income that is distributed,

[3] Rev. & Tax. Code §17742.
[4] Rev. & Tax. Code §17731(a).
[5] I.R.C. §641(a)-(b); Rev. & Tax. Code §17742.
[6] I.R.C. §641(b).
[7] I.R.C. §§641, 643.

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capped by something called "distributable net income" (DNI).[8] The trust pays tax on the rest. In determining DNI, if a trust distributes all its income, and no other modification applies,[9] the trust will have no taxable income.[10] Instead, the beneficiary will be taxed on the entire distribution.[11]

This regime is why trusts are often referred to as pass-through entities, much like partnerships or limited liability companies. Each beneficiary pays income tax on his or her share of income. A Schedule K-1— the same schedule used by partnerships — is used to notify beneficiaries of the amounts they must include on their personal income tax returns.[12]

The division of income between the trust and the beneficiary is very important. For federal tax purposes, it's straightforward: the beneficiaries file individual returns showing their portion of the income, and the trust files its own return.

For state taxes, it's still fairly simple on the beneficiary side. The beneficiaries generally must file and pay tax on their respective shares of income in their states of residence.[13]

Trusts, on the other hand, have different rules in each state. Some states require trusts to file and pay tax if the beneficiary is a resident of the state,[14] some require the trustee to be in the state,[15] and some — like

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[8] Treas. Reg. §1.643(a)-0.

[9] DNI is computed as gross income subject to modifications that include the following:

1) no deduction for distributions made to beneficiaries;
2) no deduction for personal exemptions;
3) exclusion of capital gains and losses to the extent they are allocated to trust corpus;
4) exclusion of extraordinary dividends or taxable stock dividends that the fiduciary does not pay or credit to any beneficiary but allocates to corpus;
5) inclusion of tax-exempt interest.

I.R.C. §643(a); Treas. Reg. §§1.643(a)-1-7. There are also modifications for foreign corporations and abusive transactions, which are not discussed here.

[10] I.R.C. §643.

[11] I.R.C. §§651-51; 661-62.

[12] IRS 2013 Instructions for Form 1041.

[13] Rev. & Tax. Code §17041.

[14] *E.g.*, Missouri, North Carolina, Rhode Island, and the District of Columbia impose a state income tax obligation on a trust if any of the trust's beneficiaries are residents of that state. Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts.

[15] *E.g.*, Alabama, Kentucky, Arkansas, Arizona, Delaware, Georgia, Maryland, New Jersey, Oregon, and South Carolina impose a state income tax obligation on a trust if the trustee is a resident of that state. Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts.

California — require either the beneficiary or the trustee to be in the state.[16] The differences in these rules can get a little messy. We'll touch on that later. First, we discuss how trusts are taxed in California.

The federal rules discussed above regarding trusts' and beneficiaries' tax obligations generally apply for California purposes. And the breakdown of income between the trust and beneficiaries is generally the same for federal and California purposes.[17] But as we know, it's not always so simple when it comes to state taxes. There's one threshold layer to consider: the obligation to file and pay in the state.

A trust must file and pay tax in California if either a trustee (fiduciary) or a non-contingent beneficiary is a legal resident of California.[18] Determining California taxability based on the residence of the beneficiary creates a disconnect between out-of-state trustees who administer trusts and in-state beneficiaries who create the filing obligation. As a result of this disconnect, many non-California trusts are unaware that they must file California tax returns.

A similar disconnect occurs because trusts are taxable in California if any trustee — including a trustee who is not administering the trust — resides in California. But, as we'll see later, the problems with that disconnect has been mitigated.

The Legislature was previously made aware that out-of-state trustees may not be aware of the trust's California income tax liability and associated filing obligation.[19] The problem is not uncommon. It was reported that FTB staff regularly received inquiries from trust representatives who had not known of the California filing obligation created by the residency of the trust's beneficiaries.[20] Quite simply, the Legislature was aware that trusts administered outside of California would not always be in a position to know it must file here.

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[16] *E.g.*, Hawaii, Illinois, Tennessee, West Virginia, and North Dakota impose a state income tax obligation on a trust if a trustee or a beneficiary is a resident of that state. Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts.
[17] Rev. & Tax. Code §17731.
[18] Rev. & Tax. Code §17742 (a). A corporate trustee is resident in the place where the corporation transacts the major portion of its administration of the trust. Rev. & Tax. Code §17742 (b). The location of the trustor is not used to determine taxability of the trust.
[19] *See* Draft Amendment to Senate Bill 1185 (2001), Legislative Proposal 01-31, Expand Voluntary Disclosure Program to Trusts, p. 4.
[20] *Id*. at p. 2.

As a result, there are numerous factual situations where an out-of-state trust administrator simply would not factually know that a beneficiary or non-administrating trustee changes his or her legal residence. And, layer on top of that that the administrator outside California may not know of a filing obligation even if they know a beneficiary or trustee changes his or her residence. Indeed, the Legislature recognized that out-of-state trustees may not be aware of the California income tax liability — that because filing requirements and trust taxation are complex areas of law, a trustee might discover the California liability "only after years of presence or activity" in the state.[21]

Of course, not all states impose the same filing requirements on trusts. Other factual variants that result in filing obligations include whether the trust document specifies using the state's governing law;[22] the trust being administered in the state;[23] a fiduciary being a resident of the state;[24] a trustor being a resident of the state;[25] a beneficiary being a resident of the state;[26] the trust assets being located in that state;[27] or the trust receiving source income from the state.[28] Needless to say, with all these variants, it can be a daunting task for a trustee to ensure the trust is filing in every state with a filing obligation.

Of the above, the most common factors that trigger a filing requirement are owning assets in the state (34 states), having a resident

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[21] *Id.* at p. 4. In California, there's one more wrinkle for trusts that don't file. If a trust doesn't pay California tax on its share of income, that obligation ultimately falls on the beneficiary. When the trust distributes income that was taxable to the trust but no tax was paid, the income becomes taxable to the beneficiary when it becomes distributable to him or her. Rev. & Tax. Code § 17445(a). This could, of course, reduce the amount of unpaid tax in California. But, again, for the beneficiary to be aware of the filing obligation, it must have known that the trust owed California tax and that it didn't pay that tax. The beneficiary would only be made aware of this if informed by the trustee. And, to bring it full circle, the trustee in that case wasn't aware of a filing obligation to begin with, so it cannot inform the beneficiary of the untaxed income.

[22] *See* Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts, p. 7.

[23] *E.g.,* Oregon subjects trusts to taxation if "the fiduciary is a resident of Oregon or [if] the administration [ ] is carried on in Oregon." Or. Rev. Stat. §316.282.

[24] *E.g.,* Hawaii subjects trusts to tax if the fiduciary is a resident of Hawaii or if the trust is administered in state. Haw. Rev. Stat. §235-1.

[25] *E.g.,* Missouri specifies that resident trusts subject to taxation are those created by a trustor that was domiciled in Missouri and had at least one beneficiary who was a resident of the state. Mo. Rev. Stat. §143.331(2).

[26] *E.g.,* Tennessee imposes a filing requirement on trustees who "receive income taxable . . . for the benefit or residents of Tennessee." Tenn. Code Ann. §67-2-110(a).

[27] *See* Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts, p. 7.

[28] *E.g.,* Colorado imposes a tax on trusts that have Colorado-source income. Col. Rev. Stat. §39-22-403.

trustor (32 states), and administering the trust in the state (25 states).[29] Those are the factors trustees would typically look at to see whether they must file in a state. But in California, the filing obligation is triggered by the residence of a trustee or beneficiary. Filing based on the residence of a beneficiary is a minority position; only ten states currently have rules indicating that the residence of a beneficiary triggers nexus and filing obligations for the trust.[30] This creates a scenario ripe for inadvertently not filing in California.

Due to the complexities of California law regarding filing taxes in the state, many California trusts inadvertently go without filing. As we'll see next, the California VDP is very well suited to give trusts the gentle nudge they need to start filing once they become aware of the obligation.

II. VOLUNTARY DISCLOSURE: THE FORCE THAT PUSHES NON-FILERS TO START FILING TAXES

In most states, including California, there exists a strong incentive for non-filers to continue in that vein. When taxpayers who should have been filing begin doing so, they owe taxes for an unlimited period of time looking back.[31] On top of that, they also owe interest and penalties for their non-compliance.[32] And these penalties may be extremely harsh. For trusts, the penalty for the failure to file a return can be as high as 100% of the tax due.[33] The result is a taxpayer who owed a mere $1,000 of tax per year from 2004 through 2013 would owe the state more than $24,800 including tax, penalties, and interest through December 31, 2014. Such large charges aren't typically accounted for by trusts. In fact, these surprises may leave a trust owing more money than the total amount on its books.

To provide an incentive for these taxpayers to start filing, tax agencies often offer a voluntary disclosure program. As its name suggests, this is a program where people can voluntarily come forward and inform the government that they owe taxes for back years. In return for coming forward, they can enter into an agreement with the government agency to

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[29] Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts, p. 8.

[30] These states are California, Missouri, North Carolina, Rhode Island, Hawaii, Illinois, Tennessee, West Virginia, North Dakota, and the District of Columbia. Bloomberg BNA Special Report, 2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts, pp. 12-23.

[31] Income taxes are imposed on a year by year basis. And, California law does not provide for a limited look-back period. *See* Rev. & Tax. Code §§19131, 19132.

[32] Rev. & Tax. Code §§19131, 19132.

[33] Rev. & Tax. Code §19131(b).

receive assurances that the agency will relieve the taxpayer of some — but not all — of the tax burdens. This can come in the form of abating penalties, abating interest, or limiting the amount of years the agency will look back to collect taxes.[34]

Voluntary disclosure programs are available in a variety of contexts: the IRS offers them for offshore taxpayer activity,[35] states offer them to the holders of unclaimed property,[36] and state taxing authorities offer them for a variety of non-filers or filers who underpaid for various reasons.[37] These voluntary disclosure programs can be formal or informal. In a formal program a state sets up specific criteria for taxpayers to qualify. These programs typically have statutorily-fixed relief a qualifying taxpayer may receive. In an informal program the taxing authority simply has administrative authority and policies that allow it to enter negotiated agreements with taxpayers who voluntarily pay an agreed-upon amount of tax, interest, and/or penalties, and come into compliance with the state on a going-forward basis.[38]

There are several strong policy reasons to make a voluntary disclosure program available to taxpayers. For one, it encourages taxpayer compliance. A taxpayer might not be filing tax returns for various reasons. Regardless of whether the non-filing was intentional or not, it is a benefit to the state to encourage compliance on an on-going basis.[39] Additionally, a voluntary

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[34] *E.g.*, California's Voluntary Disclosure Program, available for certain taxpayers as discussed at length in this paper, limits the lookback period for the tax, interest, and penalties. Rev. & Tax. Code §19191.

[35] *E.g.*, IRS 2009 Offshore Voluntary Disclosure Program (available for taxpayers with unreported income relating to offshore transactions); IRS 2011 Offshore Voluntary Disclosure Initiative (offering taxpayers with undisclosed income from offshore accounts an opportunity to participate in a voluntary disclosure initiative to get current on their tax returns); IRS 2012 Offshore Voluntary Disclosure Program (offering taxpayers with undisclosed income from offshore accounts another opportunity to get current with their tax returns).

[36] *E.g.*, Delaware offered a voluntary disclosure program for holders of unclaimed property that limits the lookback period to 1996 (as opposed to 1981 with no VDA) and no penalties and interest unless the holder does not act in good faith. *See* 12 Del. C. §1177; http://www.delawarevda.com/ (last accessed Dec. 5, 2014).

[37] *E.g.*, in addition to the Voluntary Disclosure Program discussed in this paper, California offered a Voluntary Compliance Initiative 1 and Voluntary Compliance Initiative 2, which gave an opportunity to taxpayers who underreported California income tax liabilities through the use of abusive tax avoidance transactions or offshore financial arrangements to amend their returns for prior tax years and obtain a waiver of most penalties.

[38] *E.g.*, Maine, New Hampshire, Montana, South Dakota, Alaska, and Nebraska all have informal voluntary disclosure or compliance programs, with varying degrees look-back and subjective criteria for participation in such informal program.

[39] In fact, as initially introduced and enacted, Assembly Bill 2880 declared that "[t]he reasons for a business entity's past noncompliance with . . . franchise or income tax laws vary and sometimes the entity may be less culpable due to reasonable and understandable causes . . . a policy that imposes financial and reporting

disclosure program brings in new revenue to the state that it would not have otherwise received. As discussed above, because of the strong incentive to not comply, many taxpayers will simply continue to be out of compliance even after determining they had to file. A voluntary disclosure program will provide the incentive needed to get these taxpayers in compliance.

A. California's Voluntary Disclosure Program

California has a voluntary disclosure program of its own. The program has been a great success. The problem, however, is that the program has a glaring hole that should be filled. So, as successful as the program has been, it could do more.

Under the terms of the voluntary disclosure program, the FTB waives its authority to assess tax, interest, and penalties for more than six years looking back from the date of signing the voluntary disclosure agreement.[40] The FTB also has discretion to waive penalties for the six years it may collect tax.[41] Based on the FTB's guidance, it always exercises this discretion and it "will waive penalties associated with the [VDP] return filings."[42]

The California VDP is available only to a "qualified entity, qualified shareholder, qualified member, or qualified beneficiary."[43] As relevant here, a "qualified entity" is a corporation, limited liability company, or a "qualified trust."[44] A qualified trust that can participate in the VDP is one that was never administered in California and does not have California resident non-contingent beneficiaries.[45] For VDP purposes, a non-contingent beneficiary is one who has not received a trust distribution within the six years immediately preceding the signing date of the voluntary disclosure agreement.[46] The non-contingent beneficiary limitation is an oversight that doesn't comport with the Legislative purpose for the VDP.

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burdens . . . for past omissions . . . is ultimately harmful to the state's economy." Chapter 367, Statutes of 1994, Section (b)(6), (8) (Feb. 17, 1994).

[40] Rev. & Tax. Code §19191(d)(1)(A).

[41] Rev. & Tax. Code §19191(d)(1)(B).

[42] FTB Voluntary Disclosure Program, https://www.ftb.ca.gov/bills_and_notices/voluntary/voluntary.shtml (last accessed Dec. 1, 2014).

[43] Rev. & Tax. Code §19191(a). In the same vein as the Legislature's purpose for passing the VDP, we believe the VDP should be broad and applicable to all trusts. But this white paper does not request relief for trusts administered in California. That is another subject matter entirely.

[44] Rev. & Tax. Code §19192(a)(1)(A).

[45] Rev. & Tax Code §19192(a)(7).

[46] *Ibid*

B. Purpose of the program: raising revenue and impelling taxpayers to start filing

The California VDP is vital for tax compliance. When passing the VDP, the Legislature declared "that it is in the general public interest that all business entities present and active within this state be lawfully registered with the appropriate authorized public agencies."[47] The Legislature went on to list nine vital findings as its purpose for passing the VDP. We list all nine of these findings in their entirety to underscore their applicability in including trusts with California beneficiaries in the VDP.

> (1) The tax laws of this state should be administered in a manner that encourages, facilitates, and **places a premium on voluntary compliance** by all persons who are subject to those laws.
> (2) The collection of state taxes from all persons who are required to pay those taxes is of vital importance to the citizens of this state.
> (3) The expansion of the number of taxpayers who conduct business in this state and pay taxes to this state on that business activity reduces the tax burden for all citizens of this state.
> (4) An increase in the state revenues collected in accordance with the tax laws of this state **contributes to the public welfare by increasing revenues** available to the state to use in the discharge of its various functions.
> (5) Voluntary compliance with the tax laws of this state by business entities **spares the state the administrative expense** of enforcing compliance through involuntary means.
> (6) The reasons for a business entity's past noncompliance with state business registration and franchise or income tax laws vary and sometimes **the entity may be less culpable due to reasonable and understandable causes, particularly when the determination of a multistate business' obligations to the various states may be subtle and complex**.
> (7) A state tax policy that **encourages good faith efforts by business entities to voluntarily come forward to disclose and pay past tax liabilities**, that distinguishes between voluntary and recalcitrant taxpayers, and that only imposes penalties that

[47] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1(a)(Feb. 17, 1994).

> are commensurate with actions and intent, results in an overall benefit for the state.
> (8) A policy that **imposes financial and reporting burdens on businesses for past omissions** that threaten the future continuance of business activity or discourages business expansion in this state is **ultimately harmful to the state's economy**.
> (9) A program that extends some measure of relief from the potential for tax liabilities and penalties accrued over an unlimited period in the past will result in the **gain of future revenues in the form of taxes paid by business entities who are encouraged to come forward**.[48]

Despite the appropriateness of these reasons for making the VDP a broad program that includes all trusts, the statutory list excluded a subset of out-of-state trusts that most needed the VDP. That's an insensible oversight that should be corrected.

C. Applying the VDP to Trusts

Again, trusts that are taxable in California due to a trustee residing in the state can enter the VDP. But the VDP doesn't extend to trusts that are taxable in California due to a non-contingent beneficiary residing in the state. This contravenes the Legislature's own findings. There's no sensible policy reason for the distinction between trusts taxable in the state because of the residence of a trustee and those taxable because of the residence of a beneficiary. In fact, there's no good reason for basing the trust's eligibility for the VDP on the beneficiary at all. Like the in-state trustee who doesn't administer the trust, the in-state beneficiary doesn't administer the trust. Rather, the trust is administered outside the state. And the Legislature was aware that trusts administered outside the state were vulnerable for not being aware of their filing obligation.[49] That's why only trusts administered outside California are eligible for the VDP.[50]

We have only one statement of why trusts with California resident beneficiaries were not included in the VDP. On balance against all the other Legislative history, it's clear that it was an oversight, not an intentional

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[48] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1 (Feb. 17, 1994)(emphasis added).
[49] *See* Draft Amendment to Senate Bill 1185 (2001), Legislative Proposal 01-31, Expand Voluntary Disclosure Program to Trusts, p. 4.
[50] Rev. & Tax Code §19192(a)(7)(A).

exclusion of an entire class of otherwise qualifying taxpayers. The Legislature acknowledged that "concern was expressed that the waiver of penalties" that the voluntary disclosure program offered for "flow-through entities and their partners/beneficiaries might be viewed as amnesty for a small group of individuals."[51]

But this statement contradicts all other statements made by the Legislature on the subject. First, of course this is amnesty. All voluntary disclosure programs are a form of amnesty. And excluding these trusts by calling it amnesty does nothing but contravene the Legislature's own statement that discourages the state from "[a] policy that imposes financial and reporting burdens on businesses for past omissions that threaten the future continuance of business activity or discourages business expansion in the state…." Harsh and arbitrary rules threaten California's business climate.

Second, this doesn't provide relief to a small group of individuals. That would be the case if the California resident beneficiaries actually receiving the distributions could enter the VDP. They can't.[52]

Reviewing the criteria for eligibility of all other entities and individuals makes clear where the Legislature intended to draw the line between those who qualify and those who don't. Again, other entities that qualify for the program are corporations and limited liability companies that are not organized, qualified, registered, or maintain or staff a permanent facility in California.[53] Shareholders of S corporations can participate as long as they are non-residents.[54] Non-resident individuals qualify as well,[55] as do non-resident beneficiaries of qualified trusts as described above.[56] The recurring theme is that for individuals, non-residents qualify. Entities, on the other hand, qualify if they operate outside California. The only exception is for the trusts at issue in this white paper. That is an oversight.

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[51] Draft Amendment to Senate Bill 1185 (2001), Legislative Proposal 01-31, Expand Voluntary Disclosure Program to Trusts, p. 1.

[52] However, the VDP is available to "qualified beneficiaries" – *i.e.*, beneficiaries who are nonresidents on the signing date of the voluntary disclosure agreement and a nonresident during the six taxable years immediately preceding the signing date of the voluntary disclosure agreement. Rev. & Tax. Code §19192(a)(8).

[53] Rev. & Tax. Code §19192(a)(1)-(2), (5).

[54] Rev. & Tax. Code §19192(a)(3).

[55] Rev. & Tax. Code §19192(a)(5).

[56] Rev. & Tax. Code §19192(a)(8).

When it was enacted in 1994, California's voluntary disclosure program was available to corporations and banks only. But that's not how the bill started. When it was first introduced to the California Legislature, limited partnerships and trusts were eligible participants. They were later removed from the program before the Legislature ultimately passed the VDP.[57]

That original VDP wasn't enough. Both taxpayer representatives and the Legislature realized that the VDP needed to apply to more than just corporations and banks. In 2001, after numerous inquiries to the FTB by trust representatives and other excluded entities, California's VDP was extended to include trusts and other entities. The Legislature framed the need to include trusts in the voluntary disclosure program as follows:

> Out of state trustees may not be aware of the California income tax liability. Because nexus and trust taxation are complex areas of law, **a trustee may 'discover' the California tax liability only after years of presence or activity in California**. The FTB may not readily identify the trusts through its filing enforcement or other compliance programs. Because of the substantial penalties that apply to the delinquent filing of returns and payment of taxes for all years preceding 'discovery,' a trustee may be reluctant to file returns.[58]

These reasons for expanding the VDP are the same as those given when the Legislature first passed the VDP without trusts. And they're the same reasons the VDP was later expanded to include even more entities.[59] And now, they're again the same reasons the VDP should include trusts with California resident non-contingent beneficiaries.

III. THE SIMPLE SOLUTION: EXPAND THE VDP TO INCLUDE TRUSTS WITH CALIFORNIA RESIDENT NON-CONTINGENT BENEFICIARIES

The California rules for taxing trusts aren't simple and not all trusts that must file are aware of that obligation. That problem is confounded by

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[57] Assembly Bill 2880, Sec. 19192.

[58] Draft Amendment to Senate Bill 1185, Legislative Proposal 01-31, Expand Voluntary Disclosure Program to Trusts, p. 4 (emphasis added.)

[59] In 2004, the VDP was expanded a second time to include limited liability companies and their members, for similar reasons that the VDP was expanded to trusts. *See* Assembly Bill 3073 (2004), Legislative Proposal 04-10.

yet another problem: trusts that haven't been filing are dissuaded from filing because of the back taxes, penalties, and interest they would owe. Of course this problem is well known and the Legislature provided a potential avenue for relief — the VDP. But, as it currently stands, that path doesn't extend to the all trusts that are vulnerable to non-filing to include those administered outside California with California resident non-contingent beneficiaries. In light of the Legislature history and a review of other trusts that qualify, it's clear this was an oversight.

Our proposed solution is clear and achievable: remove Revenue and Taxation Code § 19192(a)(7)(B), which defines "qualified trusts" as those with "no resident beneficiaries (other than a beneficiary whose interest in that trust is contingent)." Said another way, allow trusts with resident non-contingent beneficiaries to participate in the VDP.

This proposal adheres to the reasons the Legislature passed the VDP in the first place. This solution "places a premium"[60] on voluntary compliance by giving non-compliant trusts an incentive to file and pay. When these trusts begin paying, it necessarily "contributes to the public welfare by increasing revenues."[61] Of course, by not having to find and audit these trusts, and then collect from them, the solution "spares the state of the administrative expense"[62] of enforcing the tax. And again, the requirement to file in California is complex. The fact that so many trusts aren't filing isn't due to malfeasance. Instead, it's due to "reasonable and understandable causes" where the legal "obligations to the various states may be subtle and complex."[63]

It's clear: including trusts with California beneficiaries in the VDP is in line with all the reasons the Legislature had for passing the VDP and for later expanding its applicability. It's a great, business- and resident-friendly policy. And there has been no reasonable counter-argument for such an inclusion.

IV. CONCLUSION

It's about time California amended its VDP to include trusts with resident non-contingent beneficiaries. Trusts' filing obligations aren't

[60] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1(1) (Feb. 17, 1994).
[61] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1(4) (Feb. 17, 1994).
[62] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1(5) (Feb. 17, 1994).
[63] Assembly Bill 2880, Chapter 367, Statutes of 1994, Section 1(6) (Feb. 17, 1994).

determined by beneficiaries. Separating the people who create the filing obligation from those who must determine whether there is an obligation causes many trusts not to file. Doing so with complex rules that are different than most other states magnifies that problem. This hurts the state. Our solution to this problem is simply to allow these vulnerable trusts to participate in the VDP.

The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Taxation Section.

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