

**PILLSBURY WINTHROP_{LLP}****Prompt Action Required to Avoid Overwithholding
for New York Nonresident Partners****Michael Richman**

Prompt action is required to qualify for relief from a double New York State withholding problem created for many partners and shareholders of partnerships and Subchapter S corporations with a New York office or otherwise conducting business in New York.

Effective May 15, 2003, New York tax law was amended to impose a new withholding requirement on any entity with New York source income that is treated as a partnership for federal tax purposes (including a limited liability company that does not elect to be treated as a corporation) and a corporation treated as an S corporation for New York tax purposes. Prior to the change in law, a partnership or S corporation was required to withhold and deposit estimated New York taxes with respect only to any nonresident partner or shareholder joining in an authorized nonresident New York "group" return of the partnership or S corporation. The change in law now requires a partnership or S corporation to withhold and deposit estimated New York taxes on behalf of any nonresident individual or C corporation partner who does not join in such a group return as well.

Beginning on September 15 of this year, all affected partnerships and S corporations are required to make these estimated withholding deposits on April 15, June 15, September 15 and January 15 (for the periods ending March 31, May 31, August 31 and December 31) of each

applicable year. For 2003, the first estimated tax deposit is due on September 15 and must include the estimated tax that would have been due on April 15 and June 15, 2003; that is, it must be made for the entire period January 1 through August 31, 2003. Normally, the amount to be deposited must be determined without regard to any estimated tax payments that the partner may have made (and affected partners should adjust their individual New York estimated tax payments accordingly).

Because of the May 2003 enactment date for the law change, however, many nonresident taxpayers have already made April 15, 2003 and June 15, 2003 estimated tax payments. The instructions to the just released NY Form IT-2658 provide a one-time exception, applicable only for 2003, allowing an affected nonresident partner or shareholder to limit the September withholding by the partnership or S corporation to only the normal September 15 quarterly amount (that is, for just the period June 1 through

August 31, 2003) by furnishing the partnership or S corporation with written notification that the partner or shareholder has complied with the New York estimated tax rules for the periods covered by the April 15 and June 15 payments.

In the absence of this notice the partner or S corporation shareholder faces a potential doubling up of New York estimated tax payments with respect to New York source income from the partnership or S corporation for the periods January 1 through March 31, 2003, and April 1 through May 31, 2003. Furnishing the notice to the partnership or S corporation avoids a second withholding with respect to the earlier periods and also limits the total estimated taxes for those earlier periods to the potentially lesser amount that the individual estimated tax rules may permit.

Also in this Bulletin

Legislation Permits Sales and Use Taxpayers to Self-Audit under California's Managed Audit Program, by Richard E. Nielson, page 2.

California Responds to Abusive Tax Schemes, by Kerne H. O. Matsubara, page 4.

Michael Richman is a tax associate in the New York office of Pillsbury Winthrop LLP. This article also appears on the world wide web as part of the firm's Tax Page. William L. Burke and Brian Wainwright, tax partners in the firm's New York and Palo Alto offices, also contributed to this article.

To be effective, the notice should be given by the partner or shareholder before the partnership or S corporation makes the September 15th estimated tax payment.

The New York estimated tax rules for partnerships and S corporations, unlike for individuals, do not permit the annualization of income exception to the application of the penalty for failure to pay estimated taxes.

Nonresident partners and S corporation shareholders who based earlier payments of New York estimated taxes on the annualization method should review those calculations taking into account amounts withheld and paid over to New York as estimated taxes by the partnership or S corporation, as those partners or shareholders may still need to make additional estimated tax payments to New York on September 15, 2003 or January 15, 2004 to ensure that the annualization exception continues to apply.

Legislation Permits Sales and Use Taxpayers to Self-Audit under California's Managed Audit Program

Richard E. Nielsen

On July 22, 2003, the Governor signed Assembly Bill No. 1043 that allows taxpayers to audit themselves in connection with sales and use taxes under the supervision of the State Board of Equalization ("Board"). The bill re-establishes the Managed Audit Program ("MAP") that the Board administered from 1998 to 2002 but it also eliminates certain provisions from the prior law that should result in more taxpayers being eligible to participate in the program. The Board was the sponsor of the bill.

Managed audits are essentially self-audits by the taxpayer of its sales and use tax liability. The original MAP, effective January 1, 1998, contained a sunset provision of January 1, 2001 which was subsequently extended to January 1, 2003. No further legislation was introduced to extend the sunset date beyond January 1, 2003. Thus, the Board was no longer able to utilize the MAP which necessitated the introduction of A.B. 1043. The new law takes effect January 1, 2004, and sunsets January 1, 2009.¹

What Is A Managed Audit?

Managed audits are essentially self-audits. Accounts selected as part of the Board's routine audit program are reviewed to determine if the taxpayer is eligible for the MAP. If the taxpayer is eligible, the auditor

provides the taxpayer with written and oral instructions to enable the taxpayer to perform the audit verification, prepare the working paper schedules necessary to complete a particular portion of the audit and sets a time frame within which the audit is conducted. To be eligible, a taxpayer's business must involve few or no statutory sales and use tax exemptions, and a single or small number of clearly defined taxability issues.

A taxpayer must have the resources necessary to comply with the Board's MAP instructions. Participating taxpayers must examine their books, records, and equipment to determine if there is any unreported tax liability, and make all audit information available to the Board. Taxpayers that participate in the MAP receive a 50 percent reduction in interest due on unpaid liabilities discovered during the audit.

Eligibility Provisions Effective January 1, 2004

Revenue and Taxation Code ("RTC") section 7076(a) provides that the Board determines which taxpayer's accounts are eligible for the MAP in a manner that is consistent with the efficient use of its auditing resources and the maximum effectiveness of the program. It is further provided that taxpayers are not required to participate in the managed audit program.

¹ Effective January 1, 2003, the MAP expired. However, any managed audit started before January 1, 2003, will be completed by the Board and the person whose account is audited shall remain eligible for the adjusted interest rate for that audit.

Richard E. Nielsen is of counsel in the San Francisco office of Pillsbury Winthrop LLP. This article also appears on the world wide web as part of the firm's Tax Page.

RTC section 7076.1 provides that a taxpayer's account is eligible for the managed audit program only if the taxpayer meets *all* of the following criteria:

- (a) The taxpayer's business involves few or no statutory exemptions.
- (b) The taxpayer's business involves a single or small number of clearly defined taxability issues.
- (c) The taxpayer is taxed pursuant to this part and agrees to participate in the managed audit program.
- (d) The taxpayer has the resources to comply with the managed audit instructions provided by the Board.

Differences Between Original and Current MAP

The new MAP statutory provisions differ from the original MAP in two important respects:

1. Eliminates the provision that specified that any taxpayer that is on a prepayment reporting basis does not qualify for the MAP; and
2. Eliminates the provision that specifies that RTC section 6596 (provides relief of tax, interest, and penalty in cases where the taxpayer relied on erroneous advice from the Board) shall not apply to any managed audit conducted.

Benefits of MAP Program — Lower Interest Rate

An incentive for the selected taxpayer to participate in the MAP is that upon completion of the managed audit and verification by the Board, interest on any unpaid liability shall be computed at one-half the rate that would otherwise be imposed for liabilities covered by the audit period. *RTC § 7076.4*. The decreased interest rate is applicable even if the entire audit is not performed under a MAP audit and even if the portion performed by the auditor results in a tax liability. In addition, MAP audits that result in a credit or refund compute interest using the standard running balance method. That is, if the audit has both debit and credit periods, the one-half interest rate would apply for debit periods and the full statutory credit interest rate applies for credit periods.

Other advantages that have been advanced in support of the MAP legislation included:

- Resolution of questions about taxability during the audit process, thus reducing the number of audits requiring resolution through the administrative appeals process.
- More efficient allocation of audit resources to audits and other revenue generating activities.
- Reduction in litigation of protested audits.
- Decreased disruption of a taxpayer's regular business activities since an auditor is likely to spend fewer hours at the taxpayer's place of business.
- Promotion of an ongoing cooperative relationship between the taxpayer and the Board.
- Increased understanding on the part of the taxpayer about the application of sales and use tax to his or her business.

Logistics of the Managed Audit

RTC section 7076.2(a) provides that if the Board selects a taxpayer's account for a managed audit, the following applies:

- (1) The Board shall identify:
 - (A) The audit period covered by the managed audit.
 - (B) The types of transactions covered by the managed audit.
 - (C) The specific procedures that the taxpayer is to follow in determining any liability.
 - (D) The records to be reviewed by the taxpayer.
 - (E) The manner in which the types of transactions are to be scheduled for review.
 - (F) The time period for completion of the managed audit.
 - (G) The time period for the payment of the liability and interest.
 - (H) Any other criteria that the Board may require for completion of the managed audit.

- (2) The taxpayer shall:
- (A) Examine its books, records, and equipment to determine if it has any unreported tax liability for the audit period.
 - (B) Make available to the Board for verification all computations, books, records, and equipment examined pursuant to subparagraph (A).

RTC section 7076.4 provides that payment of the liabilities and interest shall be made within the time period specified by the Board. If the requirements for the managed audit are not satisfied, the Board may proceed to examine the records of the taxpayer in a manner to be determined by the Board under law.

Finally, RTC section 7076.3 provides that nothing in the MAP provisions limits the Board's authority to

examine the books, papers, records, and equipment of a taxpayer under RTC section 7054.

The Future of MAP

It is contemplated that reinstating the MAP without the restrictive criteria with respect to prepayment accounts will mean that more audits will be eligible for the MAP.² A survey by the Board indicated participation was limited in the original MAP primarily because of the restrictions contained in the prior law with respect to taxpayer eligibility to participate in the program. Also, taxpayers were reluctant to participate due to the provision which prohibited the Board from granting relief of liability under RTC section 6596 in cases where taxpayers participated in the MAP relied on erroneous advice from the Board and failed to pay amounts due. Elimination of this provision is expected to provide consistency with the relief provisions extended to those taxpayers who have been audited by the Board under its normal audit selection process.

² 151 MAP audits were initiated during the period 1/1/99 to 6/30/00. The Board estimates that without such restrictions there would have been 584 MAP audits during the same period.



California Responds to Abusive Tax Schemes

Kerne H. O. Matsubara

California recently has stepped up its efforts to crack down on "abusive" tax shelters, which have been estimated to cost the State of California as much as \$1.3 billion annually in lost tax revenue. Abusive tax shelters or schemes generally are defined as transactions promoted for the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. The California Legislature has proposed two bills aimed at discouraging investment in abusive tax schemes and providing the State with more tools to combat tax avoidance behavior. In addition, the California Franchise Tax Board (FTB) and the Internal Revenue

Service (IRS) have joined forces in an attempt to end illegal tax shelters. While these current legislative and administrative efforts ostensibly are aimed specifically at illegal tax shelters and abusive schemes, such efforts may impact California corporate taxpayers generally, in both transactional and controversy areas.

Pending Legislation

Two tax shelter bills, S.B. 614 and A.B. 1601, are pending before the California Legislature.¹ S.B. 614 mirrors recent federal legislation by broadening reporting and disclosure requirements and imposing greater penalties

Kerne H. O. Matsubara is a tax partner in the San Francisco office of Pillsbury Winthrop LLP. This article also appears on the world wide web as part of the firm's Tax Page.

¹ The text of the most current versions of S.B. 614 and A.B. 1061 is available at

<http://www.leginfo.ca.gov/bilinfo.html>.

relating to abusive tax shelter transactions. Specifically, S.B. 614 would:

- Create a regime of penalties and reporting requirements for investors, promoters, tax advisors and tax preparers involved in abusive tax shelter transactions to identify existing abusive tax shelter transactions on tax returns filed in prior years and to curtail the use of abusive tax shelter transactions in future years.²
- Provide for a voluntary compliance initiative permitting a taxpayer to file an amended return and pay the tax and interest associated with the abusive tax shelter transaction.
- Codify the economic substance doctrine, which is a common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction lacks economic substance or a business purpose.
- Extend the statute of limitations for taxpayers involved in abusive tax shelter transactions from four years to eight years.
- Expand the FTB's ability to issue subpoenas.
- Expand the rules to obtain a court order to enjoin abusive tax shelter transactions from being marketed within California.

A.B. 1601 similarly would increase existing tax shelter penalties and lengthen the statute of limitations for prosecution of tax evaders.

FTB and IRS Cooperation

The IRS has announced that it will ask states in August 2003 to enter into a memorandum of understanding (MOU) that would allow greater sharing of information about promoters and investors in illegal tax shelters and more cooperation in enforcement against such shelters. At a July 15, 2003 symposium on abusive tax schemes, which was sponsored in part by the FTB, Dale Hart, Commissioner of the IRS Small Business/Self-Employed

Division, stated that the MOU would enable IRS and state tax administrators to share more information sooner.

Although the IRS and state tax authorities currently may share information regarding a taxpayer, usually such sharing of information occurs at the end of an audit. The MOU, however, would provide a more systematic way to share information at the beginning of an audit or investigation. Under the MOU, the IRS would share information with state tax authorities on promoters of tax shelters and taxpayers who have invested in tax shelters. The states would share the same type of information with the IRS and perhaps other states. The IRS and the states would determine which agency should work on the case or whether both agencies would investigate.

At the July 15 symposium, Caglar Caglayan, Assistant Chief Counsel in the FTB Legal Department, described the MOU as a united front in tax agency efforts to crack down on shelters by providing the means for a very early sharing of names of investors and promoters of abusive tax schemes. Caglayan indicated that the FTB not only would be entering into the MOU with the IRS' Small Business/Self-Employed Division, but would also seek to enter into a similar MOU that would deal with mid-sized businesses with assets of more than \$10 million.

Abusive Tax Schemes: FTB's View

The FTB appears to have adopted a fairly broad view as to the types of transactions that should be considered abusive tax schemes, at least with respect to state franchise and income taxes. At the July 15 symposium, Caglayan identified the following transactions as potentially abusive:

- Corporate shareholders in a regulated investment company (RIC) – the shareholders eliminate the RIC dividends from income pursuant to RTC § 25106, even though the RIC receives a deduction for dividends paid.
- Shareholders in a real estate investment trust (REIT) with IRC § 565 consent dividends – the REIT gets a deduction for the consent dividends, but the shareholder does not include such dividends in income for California franchise and income tax purposes.
- Corporations that create or use insurance subsidiaries to shelter income by, for example, transferring the corporation's treasury functions to the insurance subsidiary.

² The terms "tax shelter," "reportable transaction" and "listed transaction," for example, would be defined by reference to federal *or state* income taxes as well as by transactions that are determined by the IRS *or FTB* to have a tax avoidance purpose or potential.

Potential Impact on Corporate Taxpayers

Although current Congressional and IRS efforts to crack down on tax shelters are well known,³ corporate taxpayers should keep in mind the recent legislative and administrative developments occurring in California. Taxpayers should not assume that a business transaction that is not a tax shelter or a reportable transaction for federal purposes will not be one for California purposes. First, the California Legislature is moving forward with legislation on abusive tax shelters, some of which may not entirely conform to federal legislation. Second, ordinary transactions that are not tax shelters for federal purposes could be considered by the FTB to be a tax shelter or reportable transaction for California purposes, such as those transactions cited by Caglayan above. Thus, business transactions and their impact on California franchise or income taxes need to be analyzed carefully to determine whether such transactions will be subject to California's tax shelter rules.

In addition, California's pending legislation may impact transactions offered under conditions of confidentiality. Under S.B. 614, "reportable transactions" would be defined by reference to Treasury Regulations issued under IRC § 6011 and would also include transactions determined by the FTB as having a potential for tax avoidance and evasion. Transactions under conditions of confidentiality are included in the Treasury Regulations' definition of reportable transactions, though an exception has been provided for confidentiality agreements that permit disclosures of the tax treatment and tax structure of the transaction. In light of California's pending legislation, confidentiality agreements may need to permit disclosures of the state income tax treatment and structure of a transaction to avoid treatment as a reportable transaction for California purposes.

Furthermore, while California has taken the lead among the states in addressing abusive tax schemes, pending legislation or administrative actions in other states also should be considered when entering into business transactions. The Multistate Tax Commission (MTC) also has been involved in studying the effect of tax shelters on state tax revenues, especially from transactions involving offshore entities.⁴

Finally, under this climate of increased enforcement efforts to crack down on abusive tax shelters, corporate taxpayers undergoing an FTB audit could encounter greater challenges to their transactions. While federal tax shelter legislation and regulations target illegal or abusive tax shelters, the FTB could broaden the attack to reach even benign transactions, including transactions that happen to be affected by differences in the federal and California tax laws or involve nexus considerations such as under Public Law 86-272. Assuming that the Legislature soon will enact tax shelter legislation, focus should turn to the FTB and its proposed regulations regarding abusive tax schemes.⁵

³ Information on IRS activity on tax shelters is available at

<http://www.irs.gov/businesses/corporations>.

⁴ The text of the MTC report, Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, is available at

<http://www.mtc.gov/statebudgetcrisis.html>.

⁵ The FTB has issued a series of articles on abusive tax schemes which are available at

<http://www.ftb.ca.gov/education/taxnews/Index.html>.

