

Abusive Tax Shelters: Impact of Recent California Legislation

LEGISLATIVE ANALYST'S OFFICE

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ABUSIVE TAX SHELTERS: IMPACT OF RECENT CALIFORNIA LEGISLATION

EXECUTIVE SUMMARY

In recent years, the prevalence of illegal or “abusive” tax shelters (ATS) has increased dramatically. These ATS transactions have resulted in very substantial revenue losses in California.

In an effort to curb the use of ATS activity, the Legislature enacted Chapter 654, Statutes of 2003 (AB 1601, Frommer), and Chapter 656, Statutes of 2003 (SB 614, Cedillo). This legislation contained provisions that:

- Provided a limited amnesty for participants in certain ATSs who came forward and paid the associated tax liabilities.
- Expanded reporting requirements for ATS participants and increased penalties following the amnesty period.
- Expanded the state’s ability to take legal action against ATS participants.

According to the Franchise Tax Board (FTB), the response of taxpayers to the amnesty program—known as the voluntary compliance initiative (VCI)—was much higher than anticipated. The VCI, which was in effect from January 1, 2004 through April 15, 2004, resulted in payments from business and individual taxpayers of about \$1.4 billion. After deducting the portion of these monies that would have been received anyway through normal audit activities or will be returned to taxpayers upon resolution of their tax disputes, the state’s net revenue gain is anticipated to be about one-half that total—or roughly \$700 million.

Despite the success of the VCI program, the problems posed by ATSs have not been fully resolved. In fact, it is likely that ATSs will continue to pose tax-related policy issues for the state. Given this, it will be important that the Legislature stay on top of the ATS situation. As one approach to accomplishing this, it may want to periodically review FTB’s ATS-related activities, including how well it is allocating its budgeted resources to get the best return on ATS activities and informing the Legislature about programmatic changes that will help address the ATS problem.

INTRODUCTION

Chapter 654 and Chapter 656 established a number of programs to penalize the use of ATSs and to discourage their further use. The statutes: (1) created new ATS-related penalties and reporting requirements, (2) provided for a limited amnesty for participants in certain ATSs, and (3) expanded the state’s ability to take legal action against ATS participants. The measures also require the Legislative Analyst’s Office (LAO) to prepare a report for the Legislature regarding their impacts. Specifically, the LAO is required to include in its report an assessment of the impact of the legislation on (1) tax shelters, (2) state tax collections, and (3) the state’s business climate.

This report presents a description of California’s ATS efforts with respect to the adopted legislation and the findings of our analysis of the program. The report contains the following information:

- Discussion of ATSs.
- Discussion of California’s general amnesty and voluntary compliance initiatives.
- Discussion of amnesty approaches in selected other states and at the federal level.
- Description of California’s ATS legislation.
- Participation in California’s VCI.
- Revenue impacts of California’s VCI and other ATS measures.
- Issues raised by the ATS legislation and potential follow-up steps.

ABUSIVE TAX SHELTERS

Under both the state’s personal income tax (PIT) and the corporation tax (CT), taxpayers are able to shelter certain income from taxation. Some of these forms of sheltering are explicitly allowed under the tax code. Other types of tax sheltering activities, however, are not specifically identified in federal or state tax law. Some of these activities are not considered allowable by FTB or the U.S. Internal Revenue Service (IRS) and are, therefore, treated as ATSs.

Inappropriate tax sheltering activity has always existed to some degree as a compliance problem under the PIT. However, in recent years such activities have proliferated and have grown in size, scope, and sophistication. As a result, there have been substantial concerns raised at both the state and federal levels regarding the magnitude and revenue impacts of ATS activity.

The first generation of ATSs—which flourished in the 1980s—represented transactions that were relatively straightforward in structure. The current generation, however, is characterized by legally complex, opaque, and financially technical transactions, coupled with an aggressive interpretation of state and federal tax law.

The ATSs are usually marketed by accounting, banking, and consulting firms, and frequently involve several entities “teaming up” in order to provide a tax shelter program, legal opinion regarding the transaction, and other financing assistance.

What Is an ATS?

As noted above, there are many types of ATSs, with their exact characteristics varying considerably depending upon a taxpayer’s situation. They can be quite difficult to identify and often even harder to understand, even for trained tax auditors. Despite the

absence of a uniform and exact standard as to what constitutes an ATS, there exist statutory provisions, judicial doctrines, and administrative guidance that limit and define such transactions. Based on these rules and guidelines, the FTB and the IRS have arrived at an operational definition of an ATS. According to this definition, the key feature with respect to ATSs is that they have *no true economic purpose but exist solely for reason of tax avoidance*. As such, they generate no economic loss with respect to a taxpayer's income or assets that would justify a tax savings.

Administrative and court decisions have required that financial and related transactions must have *economic substance* or *business purpose* to avoid being considered an ATS. These requirements have been interpreted to mean that the transaction in question must have economic advantages other than those related merely to tax savings, and its business purpose must be separate and distinct from any tax consequences. This is known as the *economic substance doctrine* (ESD).

While clear in concept, the application of the ESD can often be imprecise and generate substantial debate. There have been attempts to codify the ESD to provide additional certainty for taxpayers. However, given that determination of the legality of tax sheltering activity depends often on facts and circumstances associated with the individual case at hand, these efforts were abandoned.

In addition to their working definition, the FTB and the IRS have identified certain characteristics that typify such ATSs. Such transactions usually have some or all of the following characteristics, in that they:

- Involve separation of income and expenses.
- Use pass-through entities (such as partnerships) in terms of the disposition of their income.
- Use third-party facilitators.
- Employ offshore foreign accounts or facilitators.
- Allow double benefits from a single tax loss (for example, a deduction from both personal and business-related income).
- Involve short-term transactions.

A couple of very simplified examples of ATSs are provided in the nearby shaded box. These examples and the descriptions above provide only a general outline of an ATS transaction. In actuality, such shelters tend to be highly complex and extremely sophisticated, involving multiple layers of transactions and numerous participants.

Recent Growth of ATSs

In 2001, California tax officials identified about 40 individual ATS cases. In less than two years, the number of identified cases ballooned to over 400 ATS cases. Similar increases were experienced at the federal level and in certain other large urban states as well.

There are a number of reasons for the recent proliferation of ATSs. Tax analysts generally believe that the increase was due in large part to the substantial stock market-related capital gains that were occurring during the late 1990s, as well as other large income gains on the corporate side. In response, there developed an increasingly sophisticated ATS industry that relies on complex tax and income optimization modeling and legal and financial structures to offer tax-avoidance schemes.

In addition, some factors leading to the increase in ATS activity resulted from institutional changes and other considerations associated with the tax collection agencies. These institutional factors included: (1) a decline in the rate of federal tax agency compliance and auditing activities due to budgetary limitations and a shift of resources to taxpayer services, (2) the lack of meaningful disclosure requirements, and (3) an absence of sizeable penalties on ATS promoters and investors who are caught, relative to the magnitude of tax savings achievable.

Illustrative Examples of Abusive Tax Shelters

There exists a wide variety of tax sheltering schemes, making it impossible to capture the common characteristics of all such types of transactions. Nevertheless, the two examples below are representative of the types of abusive tax shelter (ATS) transactions that have occurred in the recent past.

- ***Personal Income Tax ATS: The Roth IRA Expansion Kit.*** One of the more recent ATSs on the market essentially allows individual taxpayers to contribute to a Roth Individual Retirement Account (IRA) more than the annual contribution level explicitly allowed by state and federal laws. The Roth ATS involves the establishment of a closely held corporation owned by the IRA. Valuable assets are then transferred to the Roth corporation and subsequently sold, with no taxes being paid by the Roth corporation. The result is that income from such sales escapes taxation, since no tax was paid on the transfer of the asset and Roth account funds are not taxed upon withdrawal. This activity is now an IRS “listed transaction” (see later box) and thus is a prohibited ATS.
- ***Corporation Tax ATS: Commercial Domicile.*** This ATS typically involves incorporating a business in a state without an income tax (for example, Nevada or New Hampshire). Stock or other intangible assets are then transferred by individual business owners in California to the corporation and subsequently sold. The proceeds would not be taxed (due to the business’s incorporation in a state without an income tax) and the proceeds of the sale at some later date may or may not be subject to California taxation. (Some versions of this ATS have been restricted by previous legislative action.)

Impacts of ATs on Revenue Systems

Revenue Losses From ATs. Estimates of the revenue impact of ATs represent approximations primarily due to the difficulty of measuring revenues that are never paid to the federal or state governments. Nevertheless, there have been a number of studies conducted regarding the revenue impacts of ATs that provide a rough gauge as to the likely revenue magnitude.

- *Impacts on Federal Revenues.* The IRS-compiled data indicate that between January 2003 and September 2003, the number of ATs transactions increased by 42 percent. The estimate of the revenue losses associated with these shelters increased from \$74 billion to \$85 billion.
- *Impacts on California's Revenues.* Prior to the adoption of Chapters 654 and 656 in 2003, FTB's estimate of the revenue impact of ATs transactions was something in the range of \$600 million to \$1 billion annually. Thus, continued ATs activity poses a significant ongoing challenge to California's revenue system.

Tax System Effects. In addition to revenue losses, the concerns at the state and federal levels about ATs activity are related to fundamental principles that underlie tax and revenue systems. In particular, there is the principle that individual and business taxpayers should each remit what is appropriately owed by them. Tax avoidance by some taxpayers shifts the relative tax burden towards taxpayers already in compliance. This principle of fairness has ramifications for the tax system itself. A perception that the tax system is not equitable could result in noncompliance and tax avoidance by an increasing proportion of taxpayers.

WHAT HAS BEEN DONE ABOUT THE ATs PROBLEM?

At both the state and federal level, tax administration agencies have been focusing on the ATs problem. As part of this effort, state and federal officials have developed cooperative programs to coordinate tax compliance activities and avoid any duplication of enforcement efforts, thereby making the programs more efficient and effective.

Federal Policies Regarding Tax Shelters

General Federal Efforts. For the most part, the IRS has chosen to focus on the *promoters* of tax shelters—including accounting firms, law firms, financial advisory firms, and certain banking institutions—as a means of curtailing tax abuse. As part of its efforts, the IRS established an Office of Tax Shelter Analysis, which has specifically identified types of tax shelter transactions that it considers abusive. The IRS has also required promoter firms to disclose and register transactions deemed to be potential ATs and established an audit program for this requirement. Also, taxpayers are required to notify the IRS if they have used such identified transactions. Finally, the IRS recently completed a memorandum of understanding with 33 states (including California) to share information and coordinate enforcement efforts regarding ATs activity.

In addition, the IRS has pursued claims against the purveyors of ATSS. In the largest criminal tax case ever filed, the IRS sued the firm of KPMG for developing false tax scenarios, filing fraudulent tax returns, and concealing various information from tax authorities. According to the IRS, KPMG developed tax shelter transactions and marketed them to wealthy individuals. The KPMG admitted to criminal wrongdoing and paid \$456 million in fines to the federal government.

Federal ATS Approach. Legislation at the federal level was introduced that included tools to restrict the use of tax shelters, increase auditing of certain tax activities, and enact an amnesty program. However, Congress failed to pass it. Instead of a broad-based amnesty program, the IRS has designed its tax shelter litigation and settlement strategies for each transaction based on an assessment of litigation risks. The decision to pursue a settlement initiative regarding a particular tax avoidance transaction involves weighing various factors, such as the impact on existing ATS activities and the effect on future taxpayer behavior. The IRS also increased its enforcement activities along with its targeted settlement program for ATSS.

The IRS pursued disclosure and settlement activities for certain types of transactions between December 2001 and April 2002. Between October 2002 and March 2003, in a targeted approach it allowed taxpayers involved in certain life insurance, basis-shifting, and contingent liability transactions to resolve the associated tax issues. It also allowed taxpayers involved in certain off-shore ATS transactions to come forward, reconcile their tax account with the IRS, and avoid penalties on the use of this ATS. Most recently, from October 2005 through January 2006, it has allowed taxpayers participating in an additional 21 specific types of transactions to pay the associated taxes and avoid most penalties.

California's Approach to Tax Shelters

The ATS-related enforcement efforts of the FTB have focused *both* on investors in and promoters of ATSS. The state maintains its own compilation of listed ATS transactions, which includes those on the IRS schedule but also contains certain other shelter schemes of particular importance to California. As noted above, FTB also cooperates with the IRS with respect to the federal ATS initiatives and participates in a number of multistate task forces and organizations (including the Multistate Tax Commission and the Federation of Tax Administrators) focused on particular ATS activities. California is participating in the IRS's current ATS program for the purpose of the state's income taxes. In addition to the legislation discussed here, California has recently taken certain administrative steps to curb the use of ATSS. For example, the FTB has redirected certain tax compliance resources to the auditing of ATS transactions, and has in place an Abusive Tax Shelter Task Force—a legal and auditing approach to identify ATSS.

Other States' Approaches to Tax Shelters

When California adopted its ATS legislation in 2003, no other states had attempted to target ATSS through such a focused and sustained effort. Most states simply pursued such cases as tax returns came up for audit for other reasons, or the states were notified of the use of a particular ATS transaction by the IRS.

After California adopted its ATS initiative, several other states adopted similar programs, including:

- Connecticut (effective June 2004 through July 2004).
- Illinois (effective October 2004 through January 2005).
- Arizona (effective February 2005 through April 2005).
- Minnesota (effective August 2005 through January 2006).
- New York (effective October 2005 through March 2006).

In virtually all of these cases, the tax shelter enforcement efforts coupled a voluntary compliance program—or targeted amnesty—together with increases in various penalties and increased legal tools. These states were also able to benefit from lessons that California learned regarding the implementation and administration of its program, along with certain information California can share with other states pursuant to existing understandings or agreements.

CALIFORNIA'S ATS LEGISLATION

Origins of California's Legislation

Chapters 654 and 656 were largely an outgrowth of the state's somewhat limited efforts to curtail the use of ATS transactions. As we discuss below, tax-sheltering activity had become increasingly sophisticated, rendering ineffectual many of the state's existing tools to limit these schemes. In addition, the sheltering activity had become larger in scale and scope, resulting in potentially billions of dollars of revenue losses to the state.

At the federal level, the IRS had also become aware of the ballooning use of such ATSs, and was seeking through various means to prevent these from having a deleterious impact on federal revenues. California officials had monitored limited efforts regarding such shelters made at the federal level over some period of time, and discussions began several years ago as to whether it would be appropriate for the state to begin its own programs as well—especially given the federal government's lack of comprehensive action. By the end of 2002, it was apparent that the use of sophisticated tax shelters had expanded rapidly and posed a threat to state revenues as well as the integrity of the tax system itself. Using the proposed federal legislation as a model, the California Legislature considered a statutory remedy for the state. In the fall of 2003, the state enacted Chapters 654 and 656, which established various measures to curb the use of ATSs.

Features of California's ATS Legislation

California's legislative approach to battling the burgeoning use of ATSs constituted a multi-pronged effort and piggybacked to a large extent on existing federal efforts. The cornerstone of the legislation was the VCI, a targeted amnesty which allowed busi-

nesses and individuals who had participated in specific identified ATSS to pay the tax liability associated with this ATS and thus avoid any future tax enforcement actions and noncompliance penalties. (This VCI amnesty program is separate and distinct from the broad-based amnesty adopted by the Legislature that was in effect from February 1, 2005 through March 31, 2005.) In addition, the bill increased penalties for investors, promoters, tax advisors, and tax preparers involved in ATSS, extended the statute of limitations for pursuing taxpayers involved in ATSS, expanded the FTB's ability to issue subpoenas to taxpayers involved with ATSS, and expanded the rules preventing tax shelter promoters from marketing tax shelters in California.

Voluntary Compliance Initiative Specifics. The heart of Chapters 654 and 656 was the establishment of a one-time VCI, which allowed taxpayers to file amended tax returns and pay the tax liability and interest associated with the ATS and thus avoid current and increased penalties. Other specific features of the VCI were that it:

- Offered a limited amnesty period extending from January 1, 2004 through April 15, 2004 (for a general discussion of state tax amnesties, see nearby box).
- Was available to PIT taxpayers and CT taxpayers.
- Applied to tax years beginning before January 1, 2003.
- Was available for virtually all ATSS, except for those involving off-shore accounts (these were addressed by a prior federal-state amnesty in 2003).
- Provided for two filing options:
 - *Option A* allowed a taxpayer to file with *no* appeal rights. All penalties would be waived and no refund claims or deficiency assessments could be made.
 - *Option B* allowed taxpayers to file and *retain* appeal rights. The taxpayer could file a claim for a refund of the tax paid under the VCI but also could be subject to additional taxes.

Increased Penalties for Investors and Tax Professionals. Chapters 654 and 656 created a whole range of new penalties to both provide an incentive to participate in the VCI as well as discourage additional ATS-related behavior. Major penalty increases were included for:

- Failure to report a “reportable transaction” (see nearby box).
- Understated liabilities for transactions lacking economic substance.
- Violations of accuracy for tax returns with reportable transactions.
- Failure to report or register a tax shelter.

- Failure to maintain and file lists of tax shelter investors.
- Promoters of ATs and for submitting frivolous tax returns.
- Carrying costs (interest charges) for amended tax returns involving ATs.

Legal Changes Addressing Tax Shelters. The measures also eased various legal restrictions regarding the enforcement of tax laws and the prosecution of ATs-related activity by:

- Loosening confidentiality rules regarding tax shelters.
- Requiring registration of tax shelters.
- Expanding the ability to issue injunctions for tax shelters.
- Tightening standards of behavior for tax preparers.
- Expanding the FTB's ability to issue subpoenas.

State Tax Amnesties

State tax amnesties are typically of the following three general types.

General Amnesties. The most common version is a general amnesty that applies to virtually all taxpayers who wish to clean up their tax accounts. For example, a taxpayer who did not declare income from a prior year could pay the tax liability on this amount of income. In other situations, taxpayers may have dropped out of the tax system altogether and wish to reestablish their legal standing. In most cases, general amnesties allow for reduced or waived penalties and interest in exchange for the taxpayer's participation in the amnesty program.

Targeted Amnesties. In other cases, tax amnesties are offered to address particular instances of taxpayer noncompliance due to ambiguous laws or regulations, changes in laws or regulations that affect existing financing structures that taxpayers may have previously entered into, or for other specific reasons. Certain states have adopted limited amnesties of this type to address particular tax situations that have arisen in their state.

Tax Shelter Amnesties. Tax amnesties to address the use of abusive tax shelter (ATs) activities that were adopted by California and a number of other states represent a combination of both of the above two approaches. Like general amnesties, these ATs tax amnesties typically were or are open to a broad range of business and individual taxpayers. However, they are quite narrowly drawn and apply only to specific circumstances and sets of facts. Thus, the ATs tax amnesties apply only to taxpayers who participated in specific identified transactions.

- Extending the period of time during which FTB can prosecute cases involving an ATS.

Multiple Goals of ATS Legislation. California’s ATS legislation had multiple goals. First, it was designed to curtail the use of the *existing* assortment of illegal tax shelters by offering an amnesty period and increasing penalties and enforcement. Second, it sought to restrict the availability of *new* tax shelter activities by increasing detection efforts and enforcement activities. Third, it sought to increase the level of *overall* tax compliance by taxpayers (not just ATS compliance). Finally, the ATS legislation was undertaken in the hope that it would generate substantial revenue for the state.

What Is a “Reportable” Tax Shelter Transaction?

A reportable transaction for state and federal tax purposes is one that has the potential of being an abusive tax shelter (ATS) and falls into one of six categories:

- **Listed Transactions.** The Internal Revenue Service (IRS) lists some thirty transactions that are considered to be ATs, and California lists an additional two that only affect California income.
- **Confidential Transactions.** Some transactions are marketed and offered to taxpayers with explicit or implied conditions of confidentiality regarding their structure.
- **Contractual Protection.** Certain transactions are coupled with insurance provisions that protect the taxpayer in the event the intended tax consequences of the transaction are found invalid by tax agencies or the courts.
- **Loss Thresholds.** These are transactions that result in or are expected to result in a certain amount of tax loss—for example, a loss of \$10 million or more in one year by a non-business taxpayer.
- **Tax and Book Differences.** This category involves transactions where the tax impacts are substantially different from the “book” or accounting impacts.
- **Tax Credits and Holding Periods.** This category relates to any transaction where the purchased asset is held for a 45-day period or less and results in a tax credit of \$250,000 or more.

Not all reportable transactions constitute illegal tax shelters. In fact, the IRS indicates that most reportable transactions and most tax shelters constitute legitimate business transactions.

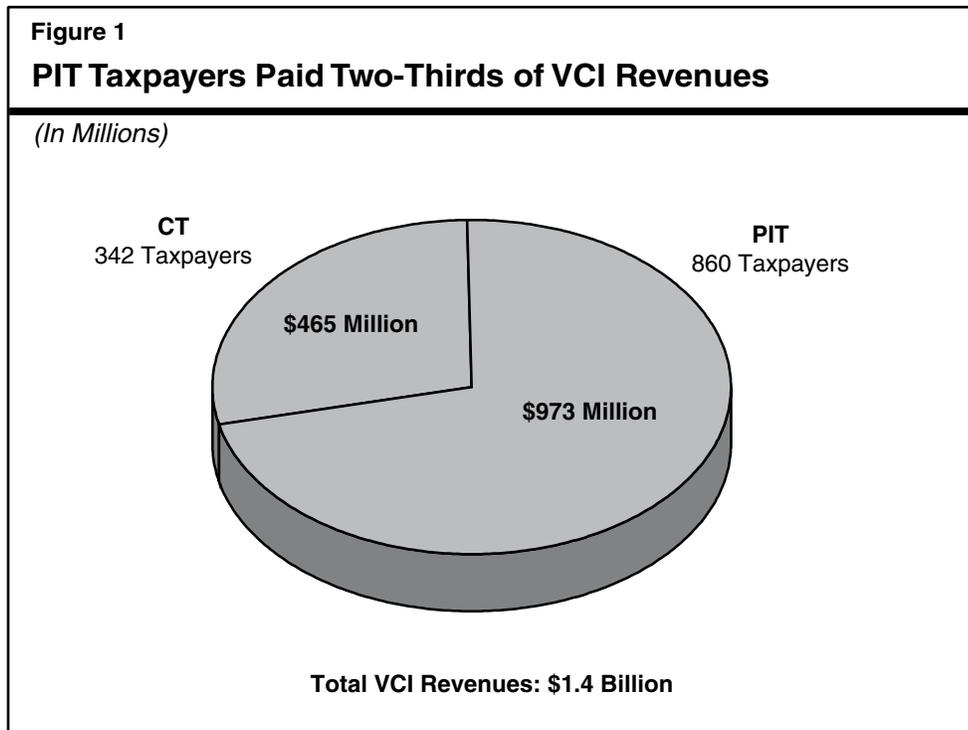
IMPACTS OF CALIFORNIA'S ATS INITIATIVE

Participation and Revenue Impact of the VCI

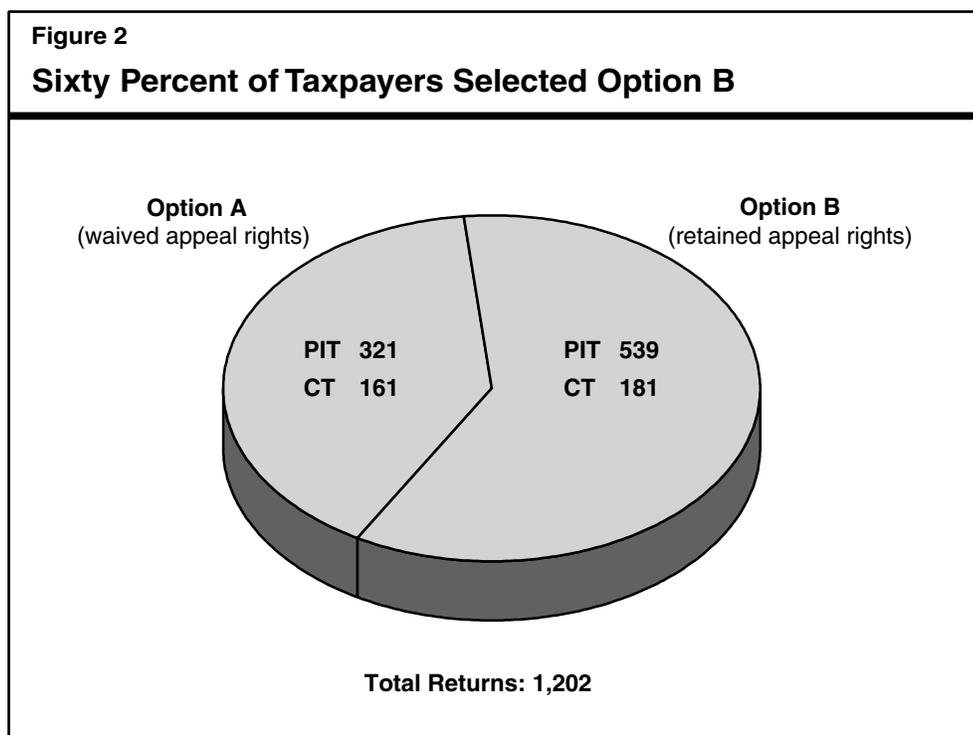
The FTB mailed out over 32,000 announcements to taxpayers, tax practitioners, and tax shelter promoters in order to publicize the VCI. It also held several forums on the topic of tax shelters, issued press releases, held news conferences, and made presentations to tax professional organizations. These efforts—coupled with the expanded penalties—provided inducements for taxpayers to participate in the program.

The results of California's ATS efforts and the VCI in particular, have generally been considered a success—in terms of revenues, information gathered about specific types of shelters, and useful knowledge about the industry itself. The results of the program also demonstrate the sheer size of the tax-compliance problems involved, the prevalence of ATSS among taxpayers, and the threat ATS activity poses to the state's tax system.

Gross Revenues and Participants. A total of 1,202 taxpayers participated in the VCI with total payments of over \$1.4 billion, resulting in an average participant payment of over \$1 million. As shown in Figure 1, just over 70 percent of participants were PIT taxpayers and they accounted for over two-thirds of the revenues. The number of participants was relatively small given that California has over 14 million PIT taxpayers. The significant revenue impact, however, was driven by the large amount of sheltered income per case.



Filing Options. A crucial issue for the state in recording revenues from the VCI program is the extent to which participants either waive their appeal rights (Option A) or retain them (Option B). As shown in Figure 2, about 40 percent of taxpayers filed under Option A, representing revenues of about \$360 million. The remainder filed under Option B, indicating that at least some of the remaining \$1.1 billion will be returned to taxpayers to the extent that they are successful in their appeals.



Gross Revenues. The original estimate of the revenue gain from the VCI was approximately \$230 million, to be received over a three-year period. As indicated above, the VCI brought in a gross amount of over \$1.4 billion in additional taxes and interest.

Net Revenues. The amount of net revenue the state will keep is still unknown, pending appeals and federal or FTB action. All revenues resulting from Option A (\$360 million) will be kept. On an additional \$285 million from Option B no further state or taxpayer action is pending. Thus, this amount will be retained by the state unless federal action results in a refund to these related taxpayers. (Federal action could trigger a similar action at the state level.) These two amounts total \$645 million.

The remaining \$794 million from Option B (\$1.4 billion less \$645 million) is associated with tax cases the resolution of which depends on future state and federal actions. The extent to which the state retains any or all of this revenue is also dependent on the resolution of these cases—as well as actions taken by the taxpayers involved.

In addition, a substantial portion of the \$1.4 billion would have been received by the state even absent the VCI. For example, at the beginning of the VCI, FTB had over 400

active cases associated with tax shelters. About 150 of those taxpayers and an additional 25 taxpayers protesting or appealing their cases participated in the VCI. Altogether, the VCI resulted in accelerating the resolution of these 175 cases for a total of \$531 million.

As a result of these factors, any accounting of net revenues from the program must await resolution of pending FTB or federal action, as well as any action taken by participating taxpayers. Thus, for a true accounting, such an estimate should net out the amounts of revenue that were under audit and appeal prior to the VCI.

After adjusting for the above factors, we estimate that net revenue or “new money” from the program appears to be in the range of \$700 million.

We note that there are certain indirect revenue impacts that could also occur. To the extent that Option B taxpayers are subject to the new tax shelter penalties, this would increase revenue somewhat. In addition, revenues forgone due to Option A taxpayers avoiding penalties would have been \$55 million. Furthermore, redirecting resources to work on the VCI resulted in minor revenue losses due to unprocessed workload in other compliance-related areas. Finally, total VCI program administrative costs were about \$1 million.

Impacts of Other ATS Provisions

In addition to the VCI program, there were a number of other legal and penalty provisions designed to discourage participation in ATSs. While the results of the VCI can be quantified, the impacts on tax shelters and taxpayer behavior of these other components of the legislation are less certain and require a more qualitative appraisal. Overall, however, the department indicates that the additional components of the legislation have resulted in improvements in its tax administration.

Penalty Changes. Increases in penalties were put in place to emphasize the importance that the state places on curbing illegal shelter activity. Between January 2004 and November 2005, the state received \$9 million in penalty income linked to ATS activity. Audit and legal staff at FTB have indicated that increased penalties have also had significant deterrent effects in other tax areas.

Legal Changes. From an administrative perspective two significant changes were made to provide sufficient time to pursue ATS cases as well as the authority to compel the production of taxpayer documentation. Specifically:

- **Statute of Limitations.** The department reports that the actions taken to extend the statute of limitations from four years to eight years for its tax cases will make a significant difference in the effectiveness of its ATS efforts. This time extension will allow FTB to more fully develop cases that represent ATS activity and result in a greater sustainment rate at the appeal level.

- **Subpoena Power.** The department was also given additional authority to compel taxpayers to cooperate. The department reports that this additional authority has already resulted in positive consequences. Although only a few subpoenas have been pursued through the courts, the mere existence of this authority has resulted in more taxpayer compliance.

Disclosure Requirements

The FTB indicates that it is unable to provide significant information regarding the impact of the disclosure requirements on ATS activity. To date, the department has received about 50,000 disclosures of tax shelters along with 15,000 tax-shelter investor names—both of which have been provided by tax-shelter promoters. No additional investor names have been revealed over the last few months, largely due to the fact that promoters now claim that they have stopped selling ATSs. In addition, some 1,255 taxpayers have registered their participation in an ATS on their own.

Impacts on the Business Climate

There have been some concerns raised regarding the impact of ATS legislation and FTB's implementing regulations on the business climate in California. In general, ATS efforts could potentially have an adverse impact on the business climate to the extent that they:

- Create uncertainty regarding the types of sheltering that are legal versus the types that are illegal.
- Are overly aggressive and thus dissuade businesses from undertaking unusual but allowable tax planning.

Regarding the first issue, in many cases, the difference between what constitutes a legitimate tax planning and an ATS can hinge on rather small and apparently minor distinctions. Thus, the more that tax administrators can introduce precision and certitude into their regulatory and enforcement functions, the more equitable the outcomes. Regarding the second issue, tax administrators should be conscious of the adverse impact on legitimate tax-planning activities that an overly aggressive tax enforcement stance is likely to have and adjust their policies accordingly.

In terms of the state's business climate, if legitimate tax planning were to be inadvertently caught in the same net as ATSs, this could dissuade businesses in the state from engaging in legitimate tax planning. Similarly, businesses that employ such transactions might be dissuaded by the tax agency's aggressive stance against tax shelters from investing further in the state.

With two minor exceptions, however, California has only pursued those shelters that have been designated as listed transactions by the IRS. Given the legal scrutiny undertaken prior to their classification as listed transactions, the uncertainty facing the taxpayer is limited. Nevertheless, as California moves forward in its attempts to rein in ATS activity, it should be mindful of legitimate tax planning by business entities.

Follow-Up Issues for FTB

The VCI program has raised important questions and provided significant information about ATS activity. This information should be used by FTB to consider various “action” steps in the following areas.

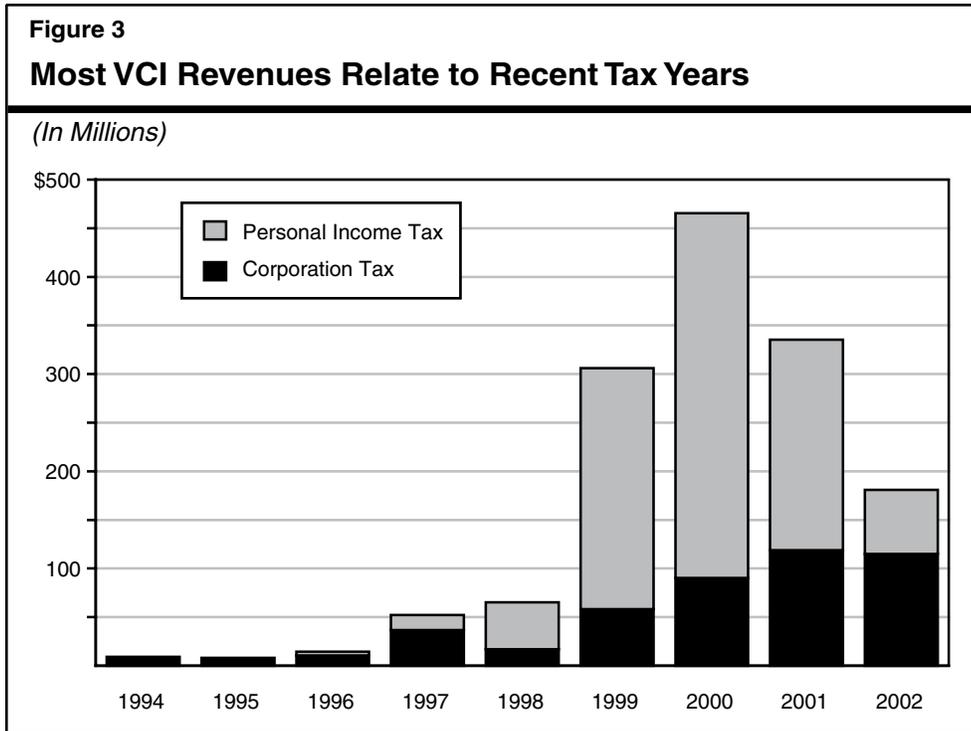
Penalties. The ATS legislation increased dramatically the penalties levied on taxpayers for participating in illegal tax shelters as well as on their promoters. Given that the existence of penalties is designed to discourage tax noncompliance, FTB may want to assess whether these penalties are in line with other penalties that are in place for other types of noncompliance. In general, the level of the penalty should correspond with the severity of the tax avoidance or noncompliance—regardless of the type.

Other States. A significant portion of the VCI revenues were received from taxpayers located in other states but liable for California taxes. Specifically, California received over \$300 million from out-of-state taxpayers with California-sourced income. The four states with the largest revenues submitted under the VCI program were Minnesota (\$62 million), North Carolina (\$46 million), Illinois (\$37 million), and Nevada (\$37 million). These data suggest the value not only of continuing and deepening information sharing among and between the states, but also of making efforts to analyze why the above-noted state-to-state VCI relationships occurred and whether the observed concentrations resulted from a few large transactions or from more systematic factors at work.

Tax Year. As shown below in Figure 3, the great majority of the VCI revenue is attributable to the tax years 1999, 2000, and 2001. Over three-quarters of the revenue received is attributable to this three-year period. While this may be due primarily in part to the fact that these years are very recent, the response may also be related to spikes in income or income growth related to capital gains. Data indicating the correlation of VCI revenue within large income from capital gains may deserve additional attention. To the extent that certain characteristics of capital gains are similar to those for other forms of income, these types of income may deserve additional audit attention. Also, as a general practice, jumps in income from isolated or unusual sources may warrant further analysis as to whether these sources are susceptible to illegal tax sheltering.

Industry, Occupational, or Geographic Concentration. About two-thirds of the revenues from the VCI are attributable to business entities that pay either the PIT or the CT. There may exist some correlation between types of industries that tend to involve themselves in ATSs that suggest a common characteristic. In addition, reviewing occupations or the geographic location of VCI participants may provide similar data that would assist in audit selection or other compliance measures.

Taxpayer Compliance. Additional follow-up on VCI participants may reveal whether there is an aspect to the VCI that has encouraged ongoing compliance with the tax system. To the extent that this has occurred, such compliance should be considered as a continuing benefit of a VCI-type program.



CONCLUSION

The state’s VCI program aimed at addressing the ATS problem has been very successful—generating an estimated \$700 million in net revenues. At the same time, though, the complex nature of ATS transactions and the extensive staff time required to pursue such cases has placed new and increased demands on FTB’s existing enforcement efforts. The VCI program, increased penalties, and expansion of statutes of limitation have addressed some of these issues. Although progress has been made in dealing with ATSs, these transactions are likely to continue to pose policy issues for the state. As a result, it will be important for the Legislature to stay on top of the ATS situation. As one means of accomplishing this, the Legislature may want to review FTB’s ATS efforts on a periodic basis, including how well it is allocating its budgeted resources to get the best return on ATS activities and informing the Legislature about programmatic changes that will help address the ATS problem.



This report was prepared by Mark Ibele, and reviewed by Dave Vasché. The Legislative Analyst’s Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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