



2007 DRAFTING REQUEST

Bill

Received: 01/19/2007

Received By: jkreye

Wanted: As time permits

Identical to LRB:

For: Administration-Budget

By/Representing: Easton

This file may be shown to any legislator: NO

Drafter: jkreye

May Contact:

Addl. Drafters:

Subject: Tax, Business - miscellaneous

Extra Copies:

Submit via email: NO

Pre Topic:

DOA:.....Easton, BB0404 -

Topic:

Tax shelter voluntary compliance program

Instructions:

See Attached

Drafting History:

<u>Vers.</u>	<u>Drafted</u>	<u>Reviewed</u>	<u>Typed</u>	<u>Proofed</u>	<u>Submitted</u>	<u>Jacketed</u>	<u>Required</u>
/?				_____			State
/1	jkreye 01/23/2007	jdyer 01/24/2007	pgreensl 01/24/2007	_____	cduerst 01/24/2007		State
/2	jkreye 01/28/2007 jkreye 02/05/2007	csicilia 01/28/2007 lkunkel 02/05/2007	pgreensl 01/29/2007	_____	cduerst 01/29/2007		State
/3			rschluet 02/06/2007	_____	mbarman 02/06/2007		

FE Sent For:

<END>

Barman, Mike

From: Kerkman, Samantha

Sent: Tuesday, February 06, 2007 11:19 AM

To: LRB.Legal

Subject: FE to <07-0879feDATCPorg> AB-52 02/06/2007 11:02 A2P2

Release Date: 02/14/2007

PLEASE RELEASE THIS FISCAL ESTIMATE

02/06/2007

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/1	jkreye 01/23/2007	jdyer 01/24/2007	pgreensl 01/24/2007	_____	cduerst 01/24/2007		State
/2	jkreye 01/28/2007	csicilia 01/28/2007	pgreensl 01/29/2007	_____	cduerst 01/29/2007		

FE Sent For:

1/31mk3/5 nwn 2/5 nwn/CS 2/5F

<END>

2007 DRAFTING REQUEST

Bill

Received: 01/19/2007

Received By: jkreyc

Wanted: As time permits

Identical to LRB:

For: Administration-Budget

By/Representing: Easton

This file may be shown to any legislator: NO

Drafter: jkreyc

May Contact:

Addl. Drafters:

Subject: Tax, Business - miscellaneous

Extra Copies:

Submit via email: NO

Pre Topic:

DOA:.....Easton, BB0404 -

Topic:

Tax shelter voluntary compliance program

Instructions:

See Attached

Drafting History:

<u>Vers.</u>	<u>Drafted</u>	<u>Reviewed</u>	<u>Typed</u>	<u>Proofed</u>	<u>Submitted</u>	<u>Jacketed</u>	<u>Required</u>
/?				_____			State
/1	jkreye 01/23/2007	jdye 01/24/2007	pgreensl 01/24/2007	_____	cdurst 01/24/2007		

FE Sent For:

12 cjs 1/28
07
1/28
PV
1/28
pg/ue

<END>

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Received: 01/19/2007

Received By: jkreye

Wanted: As time permits

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By/Representing: Easton

This file may be shown to any legislator: NO

Drafter: jkreye

May Contact:

Addl. Drafters:

Subject: Tax, Business - miscellaneous

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DOA:.....Easton, BB0404 -

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Tax shelter voluntary compliance program

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/?	jkreye	1 1/24 jld	1/24 ps	1/24 ps/JF			
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FE Sent For:

<END>

2007-09 Budget Bill Statutory Language Drafting Request

- Topic: Listing Tax Shelters
- Tracking Code: BB0404
- SBO team: Tax and Local Government
- SBO analyst: Easton
 - Phone: 6-7597
 - Email: Darren.easton@wisconsin.gov
- Agency acronym: DOR
- Agency number: 566
- Priority (Low, Medium, High): High

TAX AVOIDANCE TRANSACTIONS VOLUNTARY COMPLIANCE PROGRAM

71.805 Tax Avoidance Transactions Voluntary Compliance Program. (1) For purposes of this section 71.805, "tax avoidance transaction" means a transaction, plan or arrangement devised for the principal purpose of avoiding federal or Wisconsin income or franchise tax, which is determined to be a "reportable transaction" under section 1.6011-4(b) of the U.S. Treasury Regulations.

(2) There is hereby established a Tax Avoidance Transaction Voluntary Compliance Program (Program) for eligible taxpayers subject to tax under Chapter 71. The Program shall be developed and administered by the Department of Revenue (Department). The Program shall be conducted from October 1, 2007 to December 31, 2007 and shall apply to tax liabilities attributable to the use of tax avoidance transactions for tax years beginning before January 1, 2007. The Department shall adopt rules, issue forms and instructions, and take such other action as it deems necessary to implement the provisions of this section.

(3) The Program shall apply to any taxpayer who, during the period from October 1, 2007 to December 31, 2007, does both of the following:

(a) files an amended Wisconsin tax return for each tax year for which the taxpayer has previously filed a Wisconsin tax return using a tax avoidance transaction to underreport the taxpayer's Wisconsin income or franchise tax liability, reporting the total Wisconsin net income and tax for such tax year computed without regard to any tax avoidance transactions and without regard to any other adjustments that are unrelated to tax avoidance transactions; and

(b) makes full payment of the entire amount of Wisconsin income or franchise tax and interest due for such tax year that is attributable to the use of the tax avoidance transaction.

(4) If an eligible taxpayer elects to participate under this section, then:

(a) the Department shall waive or abate all penalty applicable to the underreporting or underpayment of Wisconsin income or franchise tax attributable to the use of tax avoidance transactions for such tax years for which the taxpayer voluntarily complies;

(b) except as otherwise provided in this section, the Department shall not seek criminal prosecution against the taxpayer for such tax year with respect to tax avoidance transactions for which the taxpayer voluntarily complies;

(c) no penalty may be waived or abated under this section if the penalty imposed relates to an amount of Wisconsin income or franchise tax assessed or paid prior to October 1, 2007, or after December 31, 2007; and

(d) the taxpayer may not file an appeal or claim for credit or refund with respect to the tax avoidance transactions for which the taxpayer voluntarily complies.

(5) Nothing in this section prohibits a taxpayer from filing a separate amended return with respect to adjustments unrelated to any tax avoidance transaction.

(6) The definition of "tax avoidance transaction" in this section shall not imply that a transaction must be a "reportable transaction" under section 1.6011-4(b) of the U.S. Treasury Regulations to be examined by the Department regarding its principal purpose.

how def by "average"

2007?

beginning on

This section doesn't seem to provide for an exception

all of following apply we depend on the all of the following with regard to taxpayer who will file the amended return

does this conflict w/ (a)?

not necessary

En purpose of this section

does not seem to be

in order for department to examine the transactions

obvious

DISCLOSURE OF REPORTABLE TRANSACTIONS

71.81. Disclosure of Reportable Transactions. (1) DEFINITIONS.

(a) "Reportable transaction" means any transaction or arrangement with respect to which certain information is required to be submitted to the Department because such transaction or arrangement was required to be disclosed for federal income tax purposes under section 1.6011-4(b) of the U.S. Treasury Regulations. This includes, but is not limited to, a listed transaction as defined in (b).

(b) "Listed transaction" means any reportable transaction that is the same as, or substantially similar to, a transaction or arrangement specifically identified by the U.S. Secretary of Treasury as a tax avoidance transaction for purposes of Internal Revenue Code section 6011.

(c) "Tax shelter" means a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax or Wisconsin income or franchise tax.

(d) "Material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess of the threshold amount prescribed by the U.S. Secretary of Treasury for purposes of Internal Revenue Code section 6111(b)(1)(A) and U.S. Treasury Regulations section 301.6112-1 for such advice or assistance. For purposes of this section, the threshold amount is

1. \$50,000 in the case of a reportable transaction, other than a listed transaction, substantially all of the tax benefits from which are provided to natural persons.
2. \$10,000 in the case of a listed transaction, substantially all of the tax benefits from which are provided to natural persons.
3. \$250,000 in the case of a reportable transaction, other than a listed transaction, substantially all of the tax benefits from which are provided to entities other than natural persons.
4. \$25,000 in the case of a listed transaction, substantially all of the tax benefits from which are provided to entities other than natural persons.

(e) "Contact" by the Department includes, but is not limited to, any correspondence outlining a voluntary compliance program mailed by the Department to a taxpayer at the taxpayer's last known address.

(2) DISCLOSURE REQUIREMENTS. (a) For each tax year in which a taxpayer has participated in a reportable transaction, ~~including a listed transaction,~~ such taxpayer is required to disclose such transaction as provided in paragraph (2)(b) below.

(b) Reportable transactions, ~~including listed transactions,~~ shall be disclosed by filing with the Department a copy of the federal form or forms prescribed by the Internal Revenue Service for disclosing such transactions for federal purposes. The Department may require these forms to be filed separately from the Wisconsin income or franchise tax return. These forms must be filed with the Department within 60 days of filing such forms with the Internal Revenue Service. If such federal forms have already been filed with the Internal Revenue Service as of the effective date of this section and are required to be filed per par. (2)(c) below, these forms must be filed with the Department

Attachment 3
(Drafting Instructions)

no later than December 31, 2007.

(c) The provisions of this section shall apply to any reportable transaction entered into after January 1, 2002, for any tax year or years for which the transaction remains undisclosed, and for which the statute of limitations on assessment, taking into account the extension provided under subsection (6), has not expired as of 60 days after the effective date of this section.

(3) PENALTY FOR FAILURE TO DISCLOSE. (a) Any person who fails to file information with respect to a reportable transaction which is required under subsection (2) shall pay a penalty, in addition to any other penalty imposed, as follows:

1. If a reportable transaction that is not a listed transaction, the lesser of 10% of the tax benefit obtained from the reportable transaction, or \$15,000;
2. If a listed transaction, \$30,000.

(b) This penalty shall apply to any failure to disclose any listed transaction entered into after January 1, 2002, or any other reportable transaction entered into after the effective date of this section, as required by subsection (2); for any tax year or years for which the transaction remains undisclosed, and for which the statute of limitations on assessment, taking into account the extension provided under subsection (6), has not expired as of 60 days after the effective date of this section.

*redundant
with
sub (2)*

(c) This penalty shall be deemed assessed on the due date of the Wisconsin income or franchise tax return for the period in which the undisclosed reportable transaction took place.

(d) The Secretary ^{revenue} may, in his or her sole discretion, waive or abate all or any portion of any penalty imposed by this subsection with respect to any violation if the violation is with respect to a reportable transaction other than a listed transaction, and rescinding the penalty would promote compliance with the requirements of this section and effective tax administration.

(4) UNDERSTATEMENT PENALTY. (a) If a taxpayer has a reportable transaction understatement for any taxable year, as defined in par. (b), there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.

(b) For purposes of this subsection, "reportable transaction understatement" means the sum of:

1. The product of the highest rate of tax imposed by Chapter 71; and the amount of the increase (if any) in Wisconsin taxable income which results from a difference between the proper tax treatment of a reportable transaction and the taxpayer's treatment of such item as shown on the taxpayer's tax return, including an amended return provided such amended return is filed prior to the date the taxpayer is first contacted by the Department regarding examination of the tax year for which such amended return is filed. The amount of increase for a particular tax year includes any reduction in the amount of loss available for carryforward to the subsequent year; and

2. the amount of the decrease (if any) in the aggregate amount of Wisconsin income or franchise tax credits which results from a difference between the taxpayer's treatment of a reportable transaction (as shown on the taxpayer's tax return) and the proper tax treatment of such item.

(c) For a reportable transaction understatement attributable to a transaction that is not disclosed as required in subsection (2), "30 percent" shall be substituted for "20 percent" in par. (4)(a).

Attachment 3
(Drafting Instructions)

(d) This penalty shall be deemed assessed on the due date of the Wisconsin income or franchise tax return which contains the reportable transaction understatement to which such penalty relates.

(e) The Secretary ^{may}, in his or her sole discretion, waive or abate all or any portion of any penalty imposed by this subsection with respect to any violation if the taxpayer had reasonable cause and acted in good faith with respect to such portion, and the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with subsection (2). A taxpayer failing to fully disclose is eligible for abatement or waiver of this penalty if there is or was substantial authority for such treatment, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

(5) INTEREST PENALTY. (a) For any amended return filed after December 31, 2007 and before the taxpayer is contacted by the Internal Revenue Service or the Department regarding a reportable transaction, there shall be a penalty, in addition to any other applicable penalties, equal to 50% of the interest assessed under Section 71.82 on any reportable transaction understatement for the period covered by the amended return.

(b) If the taxpayer is contacted by the Internal Revenue Service or the Department regarding a reportable transaction before an amended return is filed with respect to that transaction, and such contact occurs after December 31, 2007, "100%" shall be substituted for "50%" in par. (5)(a).

(c) This penalty shall apply to any understatement of tax resulting from a listed transaction entered into after January 1, 2002, or from any other reportable transaction entered into after the effective date of this section; in any tax year or years for which the statute of limitations on assessment, taking into account the extension provided under subsection (6), has not expired as of the effective date of this section.

(d) The Secretary ^{may}, in his or her sole discretion, waive or abate all or any portion of any penalty imposed by this subsection with respect to any violation if the taxpayer had reasonable cause and acted in good faith with respect to such portion, and the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with subsection (2). A taxpayer failing to fully disclose is eligible for abatement or waiver of this penalty if there is or was substantial authority for such treatment, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

(6) EXTENSION OF STATUTE OF LIMITATIONS. If a taxpayer fails to provide any information with respect to a reportable transaction as required under subsection (2), the time for assessment of any tax imposed by Chapter 71 with respect to such transaction shall not expire before six years from the date on which the return was filed for the year in which the reportable transaction took place. If a taxpayer fails to provide any information with respect to a listed transaction, the time for assessment with respect to such transaction shall not expire before the earlier of

(a) six years from the date on which the return for the year in which the listed transaction took place was filed;

(b) 1 year after the date on which the taxpayer provides the information so required; or

(c) 1 year after the date that the taxpayer's material advisor provides the list described in par. (7)(b) upon the request of the Department.

(7) RESPONSIBILITIES OF MATERIAL ADVISOR. (a) Each material advisor

Attachment 3
(Drafting Instructions)

required to disclose a reportable transaction pursuant to Internal Revenue Code section 6111 shall file a copy of such disclosure with the Department. This disclosure must be filed with the Department within 60 days of filing such disclosure with the Internal Revenue Service. If such disclosure has already been made to the Internal Revenue Service as of the effective date of this section and is required to be filed per par. (7)(e) below, this disclosure must be made to the Department no later than December 31, 2007.

(b) Each material advisor with respect to any reportable transaction shall, whether or not required to file a return under subsection (2), maintain a list identifying each Wisconsin taxpayer with respect to whom such advisor acted as a material advisor with respect to such transaction. This list shall include the same information, and shall be maintained in the same form and manner, as required under Internal Revenue Code section 6112 and Treasury Regulations section 301.6112-1.

(c) Any person required to maintain a list under par. (7)(b) shall make such list available to the Department upon written request by the Department, and, except as otherwise provided by the Department by rule, shall retain any information required to be included on such list for 7 years.

(d) The Department may provide that in cases in which 2 or more persons are required to maintain the same list (or portion thereof), only 1 person shall be required to maintain such list (or portion).

(e) The provisions of this subsection apply to reportable transactions, other than listed transactions, with respect to which material aid, assistance, or advice provided after the date of the enactment of this section; and to listed transactions with respect to which material aid, assistance, or advice is provided and which were entered into on or after January 1, 2002, that become listed transactions at any time.

(8) MATERIAL ADVISOR PENALTIES. (a) If a person who is required to file a return or disclosure under par. (7)(a) fails to file such return or disclosure on or before the date prescribed therefore, or files false or incomplete information with the Department with respect to a reportable transaction, such person shall pay a penalty with respect to such return or disclosure, as follows:

1. If a reportable transaction that is not a listed transaction, \$15,000;
2. If a listed transaction, \$100,000.

(b) If any person who is required to maintain a list under par. (7)(b) fails to make such list available upon written request to the Department in accordance with par. (7)(c) within 20 business days after the date of such request, such person shall pay a penalty of \$10,000 for each day of such failure after such 20th day.

(c) Each of the penalties imposed by pars. (8)(a) and (8)(b) is in addition to any other applicable penalties.

(d) The Secretary may, in his or her sole discretion, waive or abate all or any portion of any penalty imposed by this subsection with respect to any violation if the violation is with respect to a reportable transaction other than a listed transaction, and rescinding the penalty would promote compliance with the requirements of this section and effective tax administration; or with respect to a violation of par. (8)(b) if on any day such violation is due to reasonable cause.

(9) PROMOTION OF TAX SHELTERS. (a) Any person who organizes or assists in the organization of a partnership or other entity, any plan or arrangement; or participates (directly or indirectly) in the sale of any interest in such entity, plan or arrangement; and makes or furnishes or causes another person to make or furnish in

Attachment 3
(Drafting Instructions)

connection with such organization or sale a statement with respect to the allowability of any deduction or credit, the excludability of any income, the manipulation of any allocation or apportionment rule, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, shall pay, with respect to each activity described in this paragraph, 50% of the gross income derived or to be derived from such activity by the person on which the penalty is imposed.

(b) No privilege of confidentiality shall apply to any written communication which is between a tax practitioner and any person, director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person, in connection with the promotion of the person's direct or indirect participation in any tax shelter.

(c) The provisions of this subsection shall apply to activities after the date of the enactment of this section.

(10) INJUNCTION OF CERTAIN CONDUCT RELATED TO REPORTABLE TRANSACTIONS AND TAX SHELTERS. (a) For purposes of this subsection, the term "specified conduct" means any action, or failure to take action, which is subject to penalty under this section or in violation of any requirement under rules issued pursuant to this section.

(b) A civil action in Wisconsin to enjoin any person from further engaging in specified conduct may be commenced at the request of the Secretary. Any action under this subsection shall be brought in the Wisconsin circuit court of Dane County. The court may exercise its jurisdiction over such action separate and apart from any other action brought by the State against such person.

(c) In any action under this subsection, if the court finds that the person has engaged in any specified conduct, and that injunctive relief is appropriate to prevent recurrence of such conduct; the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under this section.

Kreye, Joseph

From: Easton, Darren - DOA
Sent: Friday, January 19, 2007 5:10 PM
To: Kreye, Joseph
Subject: FW: Initiative for Tax Fairness Proposal - Final

From: Miller, Wendy J [<mailto:wendy.miller@dor.state.wi.us>]
Sent: Friday, January 19, 2007 5:09 PM
To: Brennan, Audra D - DOR; Easton, Darren - DOA
Cc: Gates-Hendrix, Sherrie L - DOR
Subject: RE: Initiative for Tax Fairness Proposal - Final

See my comments in **bold** below. Let me know if you need further clarification. Thanks.

From: Kreye, Joseph [<mailto:Joseph.Kreye@legis.wisconsin.gov>]
Sent: Friday, January 19, 2007 4:11 PM
To: Easton, Darren - DOA; Miller, Wendy J - DOR; Brennan, Audra D - DOR
Cc: Gates-Hendrix, Sherrie L - DOR
Subject: RE: Initiative for Tax Fairness Proposal - Final

Darren, Wendy, and Audra:

I have a couple of initial questions related to this proposal:

1. With regard to the creation of 71.805, the instructions indicate that the program applies to tax liabilities that are attributable to the use of tax avoidance transactions for taxable years beginning before January 1, 2007. Is that the correct date? **Yes, this is correct.** Which leads to the next question:
2. I'm confused about the timing related to what is being reported and what penalties may be waived versus penalties that may not be waived. A taxpayer is eligible for the program if the taxpayer files an amended return for each taxable year for which the taxpayer previously filed a return using a tax avoidance transaction to underreport his or her tax liability... etc, etc, and makes full payment plus interest. If I'm reading this correctly, in conjunction with the date above, the taxpayer is filing amended returns for taxable years beginning prior to October 1, 2007.

The taxpayer is filing amended returns for taxable years beginning prior to January 1, 2007.

Then, if the taxpayer meets the eligibility requirements under sub. (3), DOR may, under sub. (4) (a), waive or abate all penalties applicable to the underreporting or underpayment of tax attributable to the use of tax avoidance transactions for the taxable years for which the taxpayer satisfies the conditions under sub. (3). However, sub. (4) (b) indicates that no penalty may be waived or abated under this section if the penalty imposed relates to the amount of tax assessed or paid prior to October 1, 2007, or after December 31, 2007. Aren't paragraphs (a) and (b) in conflict? Aren't all of the taxpayers' returns going to be related to taxes assessed or paid prior to October 1, 2007? And is it necessary to say "or after December 31, 2007" if the tax liability must be for taxable years beginning before January 1, 2007 (and the amended return must relate to a "previously filed" return)? Or are you trying to say that if DOR has already "caught" a taxpayer using a tax avoidance transaction for taxable years prior to October 1, 2007, and DOR has already assessed additional tax and penalties, that the taxpayer cannot use this program after-the-fact to avoid paying the penalty? If that's the case, I think the draft should just indicate that as plainly as possible. In any case...

The "taxes assessed or paid" refers to taxes paid after the original filing of a return, as a result of either an audit or amended return reversing the tax benefits of a tax avoidance transaction. (4)(b) means that a penalty may not be waived if it is attributable a tax avoidance transaction and the corresponding tax is assessed or paid outside the 10/1/2007 - 12/31/2007 window).

Perhaps instead of "taxes assessed or paid," it should read "taxes attributable to a tax avoidance transaction and assessed or paid..."

Please advise.

Joe

Joseph T. Kreye
Senior Legislative Attorney
Legislative Reference Bureau
(608) 266-2263

From: Easton, Darren - DOA
Sent: Friday, January 19, 2007 10:27 AM
To: Kreye, Joseph
Subject: FW: Initiative for Tax Fairness Proposal - Final

Joe,

I am sorry we are getting this to you late in the game. I am sending over the hard copy through the official channels this morning, but I wanted to give you a heads up.

Darren
6-7597

From: Brennan, Audra D [<mailto:audra.brennan@dor.state.wi.us>]
Sent: Thursday, January 18, 2007 5:23 PM
To: Easton, Darren - DOA
Cc: Timmons, Anthony A - DOR; Gates-Hendrix, Sherrie L - DOR
Subject: FW: Initiative for Tax Fairness Proposal - Final

From: Miller, Wendy J
Sent: Thursday, January 18, 2007 10:28 AM
To: Brennan, Audra D; Crane, Lili B; Timmons, Anthony
Cc: Hardt, Diane L; Gates-Hendrix, Sherrie; Boldt, Rebecca A
Subject: RE: Initiative for Tax Fairness Proposal - Final

Here is the entire package

<< File: Initiative for Tax Fairness 1-17-07.doc >> << File: Attachments 1 & 2.xls >> << File: Attachment 3.doc >> << File: Attachment 4.pdf >> << File: Attachment 5.pdf >>

From: Brennan, Audra D
Sent: Thursday, January 18, 2007 10:22 AM
To: Crane, Lili B; Timmons, Anthony
Cc: Hardt, Diane L; Miller, Wendy J; Gates-Hendrix, Sherrie; Boldt, Rebecca A
Subject: RE: Initiative for Tax Fairness Proposal - Final

Can you send the other attachments - I only have attachment 3.

January 17, 2007

TITLE: Disclosures and Compliance Initiative to Encourage Tax Fairness

DESCRIPTION OF CURRENT LAW AND PROBLEM

The vast majority of taxpayers pay their fair share of taxes. However, since the economic boom of the 1990's, certain tax practitioners and attorneys have become more aggressive in selling ideas for "tax shelters" to certain clients. Tax shelters create an unfair competitive disadvantage to taxpayers who are paying their fair share of taxes. These tax shelters are transactions which do one or more of the following:

- Create artificial losses or deductions
- Shift income to "tax-indifferent entities" (such as foreign entities)
- Defer income recognition
- Convert taxable income into tax-free income

An abusive tax shelter accomplishes one or more of these, for no economic purpose other than to obtain the tax benefit. Following are just two examples of tax shelters that have been uncovered by the IRS:

Contingent Liability Shelter

Corporation Z owns Corporations X and Y. Corporation X issues stock to Corporation Y and agrees to be responsible for Y's contingent liabilities (in this example, the contingent liabilities are future claims relating to asbestos lawsuits). In return, Y transfers assets with a \$379.2 million fair market value to X. Y then immediately sells the X stock to an unrelated party for \$500,000 and claims a \$378.7 million loss on its tax return.

This shelter was at issue in the cases *Coltec Industries Inc. v. U.S.*, Fed., Cir., No. 05-5111, (7/12/06) and *Black & Decker Corp v. U.S.*, 4th Cir., No. 05-1015, (2/2/06). The facts above are those of the *Coltec* case. However, in both cases, the court ruled that even though the deal met the letter of the law (secs. 357 and 358, IRC), the tax benefit could not be allowed because it was designed for the sole purpose of tax avoidance and had no economic substance.

"Son of BOSS" Shelter (Note: "BOSS" stands for "Bond and Option Sales Strategies")

Partner A contributes a purchased stock option with a strike price of \$20 million to Partnership AB. At the same time, A contributes to AB a "sold" stock option (a contract to sell a share of stock at a given price) with a strike price of \$19.8 million. The two stock options have the same expiration date. Although the net economic worth of these two options is \$0.2 million (\$20 million minus \$19.8 million), Partner A reports his basis in AB as \$20 million. Partner A then withdraws from the partnership and accepts shares of stock C in exchange for his partnership interest. The shares of stock C have a fair market value of \$100,000 and are immediately sold by Partner A. Partner A claims a loss of \$19.9 million (\$20 million minus \$100,000) because the basis of that stock, \$20 million, carries over from the partnership.

Following the letter of the Internal Revenue Code (sec. 752), this transaction is technically feasible. However, the same "economic substance" doctrine that upheld the IRS in the *Coltec* and *Black & Decker* cases applies here also. Realizing this, the IRS conducted a voluntary compliance initiative for taxpayers who used the "Son of BOSS" shelter. Through this initiative, taxpayers came forward and paid \$3.2 billion in tax, interest, and penalties.

Problem Requiring Legislative Action

Since February 28, 2000, the IRS has required taxpayers to specially disclose certain types of transactions that may indicate the existence of tax shelters such as those above. These types of transactions are known as "reportable transactions." Wisconsin has not adopted the federal provisions for reportable transactions. Recently, California, Connecticut, Illinois, Minnesota, New York, Utah, and West Virginia have adopted these provisions. Some have paired voluntary compliance initiatives with these provisions. Of these seven states:

- Three (CT, NY, WV) allow separate entity filing.
- Each has adopted its own version of the federal penalties relating to abusive tax shelters.
- Five have provided voluntary compliance initiatives allowing taxpayers to avoid the new penalties. Avoidance of these penalties proved to be a powerful incentive for taxpayers to participate.
- California's voluntary compliance initiative resulted in over \$1.4 billion in additional revenue, New York's resulted in \$342 million, and Illinois' resulted in over \$133 million.
- Minnesota reports a one-time \$22 million revenue gain from its Voluntary Compliance Initiative (VCI) and estimates additional ongoing revenue of \$1.7 million annually from continued enforcement.

Below is an overview of the federal provisions and how other states have adapted these provisions for their own use.

Overview of Federal Provisions

Definition of "Reportable Transaction"

A federal reportable transaction is any transaction that fits into one of the following five categories:

1. **Listed Transaction:** A transaction that is specifically identified by the IRS as an abusive tax shelter, or "tax avoidance transaction." Currently, the IRS has listed 31 tax avoidance transactions, including the Contingent Liability shelter (Notice 2001-17) and the "Son of BOSS" shelter (Notice 2000-44) mentioned above.
2. **Confidential Transaction:** A transaction that is offered to a taxpayer under conditions of confidentiality, for which the taxpayer paid a tax advisor a minimum fee (a fee of \$250,000 for corporations; \$50,000 for individuals), where the advisor limits the taxpayer's ability to disclose the advisor's tax strategies.
3. **Transaction With Contractual Protection:** A transaction for which the taxpayer has a right to a refund of tax advisor's fees if all or part of the intended tax consequences from the transaction are not sustained.
4. **Loss Transaction:** A transaction that results in the taxpayer's claiming a loss greater than a certain amount on a single transaction. For individuals, the amount is generally \$2 million. For corporations, the amount is generally \$10 million.
5. **Transaction With a Brief Asset Holding Period:** A transaction that results in the taxpayer claiming a federal tax credit of more than \$250,000, if the asset giving rise to the credit was held for 45 days or less.

(Note: Prior to January 5, 2006, there was a sixth category for "Transactions With Significant Book-Tax Difference." This category was eliminated because these types of transactions are now reported on federal Schedule M-3.)

Disclosure Required of Taxpayer

If a taxpayer is party to a reportable transaction for a given year, the taxpayer is required to file federal Form 8886, *Reportable Transaction Disclosure Statement*. Form 8886 must be filed for each year in which a reportable transaction takes place.

Disclosures Required of Material Tax Advisor

For reportable transactions occurring after October 22, 2004, a paid tax advisor that is a "material advisor" is required to make the following disclosures:

- File federal Form 8264, *Application for Registration of a Tax Shelter*. Form 8264 is only required for the first year in which a certain reportable transaction takes place.
- Maintain a list identifying each taxpayer the material advisor advised about each reportable transaction, and furnish this list to the IRS within 20 days of the IRS's request.

(Note: For transactions before October 23, 2004, the advisor was required to file Form 8271, *Investor Reporting of Tax Shelter Registration Number*. This form is no longer required.)

Federal Penalties

Federal penalties relating to reportable transactions may be applied to the taxpayer, to the material advisor, or both. Additionally, the statute of limitations may be extended for assessments resulting from reportable transactions. The Commissioner has discretion to abate these penalties.

- **Taxpayer Penalty – Failure to Disclose Reportable Transaction:** If a taxpayer fails to file Form 8886 (or make a similar statement), the following penalties may apply:
 - For reportable transactions that are not "listed" transactions, \$10,000 for individuals, and \$50,000 for corporations.
 - For "listed" transactions, penalties increase to \$100,000 for individuals and \$200,000 for corporations.
- **Taxpayer Penalty – Income Understatement From Reportable Transaction:** If a taxpayer is found to have a tax deficiency as a result of a reportable transaction, the following penalties may apply:
 - 20% of the tax deficiency caused by the reportable transaction.
 - If the reportable transaction causing the deficiency was not disclosed (for example, if Form 8886 was not filed), penalty increases to 30%.
- **Advisor Penalty – Failure to Register Reportable Transaction:** If a material advisor fails to disclose a reportable transaction (for example, if Form 8264 is not filed), the following penalties may apply to the advisor:
 - For reportable transactions that are not listed transactions, \$50,000.
 - If the transaction is a listed transaction, penalties increase to:
 - The greater of \$200,000 or 50% of the material advisor's fee, or
 - 75% of the material advisor's fee if there was intentional disregard.

- **Advisor Penalty – Failure to Provide Investor Lists:** If a material advisor fails to make the list available within 20 days after the date the IRS requests it, the advisor is penalized \$10,000 for each day of such failure after 20 days.
- **Advisor Penalty – Promoting Tax Shelters:** If an advisor recommends a plan or arrangement and makes a statement about the allowability of tax benefits relating to the plan or arrangement, which the advisor knows or has reason to know is false or fraudulent, the advisor may be liable for a penalty of 50% of the advisor's fee.

Other States' Modifications of the Federal Provisions

The seven states that have a version of the above federal provisions have modified these provisions in the following ways:

- Smaller penalties, to account for the fact that the same event may be subject to penalties in more than one state.
- Differing requirements for the retroactive date from which reportable transactions must be disclosed.
- Differing statutes of limitations for reportable transactions that have not been disclosed.
- For states that have conjoined a voluntary compliance program with these provisions, a penalty (in the form of a higher interest rate) for not self-reporting the transaction within the voluntary compliance period. This is called an "interest penalty."
- Inclusion of abusive transactions other than federal "reportable transactions" in the voluntary compliance program. (These other abusive transactions may be specific to the laws of the state providing the program).

Attachment 1 details the specific provisions enacted by each of these states. The Multistate Tax Commission's model statutes are also summarized on Attachment 1.

RECOMMENDATION FOR ACTION

- Adopt a modified version of the federal provisions for "reportable transactions," including a smaller version of the federal penalties.
- Implement a voluntary compliance program allowing taxpayers who have engaged in abusive tax shelter transactions to avoid the new penalties. Avoidance of these penalties is an important incentive for taxpayers to come forward.
- Follow the lead of our neighboring states (IL and MN) for the specific provisions.
- Attachment 2 summarizes the provisions recommended for Wisconsin and compares them with the federal penalty provisions.

ADMINISTRATIVE IMPACT

- The Department would develop and implement a public relations campaign to administer the voluntary compliance initiative.
- The Department would not develop new forms; it would only require copies of what is already being sent to the IRS.
- To help the Department compile the information received through these forms, the Department would designate a separate mailing address to receive them.

FAIRNESS / TAX EQUITY

This proposal is designed to discourage abusive tax shelter transactions. These types of transactions threaten the fairness of the tax system. The vast majority of taxpayers do pay their fair share of taxes.

FISCAL EFFECT

Minnesota's experience with enacting an abusive tax shelter law and conducting a Voluntary Compliance Initiative (VCI) would appear to be the most instructive for Wisconsin because it is more similar in terms of population, income, and industry mix than some other states that have implemented abusive tax shelter laws.

Minnesota reports a one-time \$22 million revenue gain from its VCI and estimates additional ongoing revenue of \$1.7 million annually from continued enforcement. Based on Minnesota's experience, and adjusting for differences in population, per-capita tax liability, personal income levels, as well as differences in the structure of penalties between Wisconsin's proposal and Minnesota's law, Wisconsin would generate an estimated \$9.4 million in FY08. This one-time revenue increase would primarily come from taxpayers coming forward and paying taxes attributable to any past abusive tax shelter transaction to avoid the penalties that begin after the VCI. Ongoing revenue increases related to continued enforcement are estimated at \$780,000 annually.

It should be noted that Wisconsin may have already seen a revenue effect as a result of the federal reporting requirements beginning in 2000. Taxpayers identified by the IRS as engaging in abusive tax shelters are required to file an amended federal return. Wisconsin statute s. 71.76 requires any taxpayer submitting an amended federal return that affects the net tax due to Wisconsin to file an amended Wisconsin return within 90 days. Thus, Wisconsin may have already collected back taxes from some taxpayers who had engaged in abusive tax shelters.

Moreover, the IRS has shared limited data on individual taxpayers who have reported listed or reportable transactions since the federal law took effect. Wisconsin has also received data on corporate taxpayers from the New York Multi-state Tax Shelter Database, which collects data from states that have had abusive tax shelter voluntary compliance initiatives. This information has resulted in a small number of audits discovering outstanding Wisconsin tax liability.

DRAFTING INSTRUCTIONS

Attachment 2 summarizes the specific provisions recommended for Wisconsin. Drafting instructions are on Attachment 3.

EFFECTIVE DATE AND/OR INITIAL APPLICABILITY

October 1, 2007, with a voluntary disclosure period of October 1, 2007 through December 31, 2007.

INTERESTED/AFFECTED PARTIES

Tax shelter promoters, attorneys, tax practitioners, corporations, partnerships, individuals, fiduciaries.

DOR CONTACT PERSON

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ATTACHMENTS

1. Comparison of states which have enacted similar legislation
2. Summary of provisions recommended for Wisconsin
3. Drafting instructions
4. Detailed report describing California's voluntary compliance initiative in 2004
5. Informational bulletin for voluntary compliance initiative administered by Illinois

States Which Enacted Legislation for Tax Shelter Initiatives

Attachment 1

State	Retro-active to	Voluntary Compliance Initiative (VCI)?	TP Penalty: Failure to Disclose	TP Penalty: Income Understatement	TP Penalty: Failure to Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
California	2/28/00	Yes. By statute. Went from 1/1/2004 - 4/15/2004 in conjunction with the new penalties.	\$15,000. Increases to \$30,000 if the reportable transaction is also a listed transaction. Applies only to large entities or individuals of high net worth.	20% of understatement from reportable transaction if disclosed. Increases to 30% if not disclosed and 40% if not disclosed and also a "noneconomic substance transaction" (a type of listed transaction)	50% of interest assessed prior to time t/p is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after t/p is contacted by State.	\$15,000. Increases to the greater of \$100,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to 8 years for listed transactions
Connecticut	1/1/05	Yes, but not by statute. Went from 6/16/2004 - 9/30/2004. Took place before the Connecticut "tax shelter" penalties became law.	None	75% of understatement from listed transaction, if not disclosed	None	None	None	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to 6 years for failure to disclose a listed transaction
Illinois	2/28/00	Yes. By statute. Went from 10/15/2004 - 1/31/2005 in conjunction with the new penalties.	\$15,000. Increases to \$30,000 if the reportable transaction is also a listed transaction. Limited to 10% of the tax benefit of the reportable transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	50% of interest assessed prior to time t/p is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after t/p is contacted by State.	\$15,000. Increases to \$100,000 if the reportable transaction is also a listed transaction.	\$15,000. Increases to \$100,000 if the reportable transaction is also a listed transaction.	The greater of \$10,000 or 50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to 6 years for failure to disclose a reportable transaction

States Which Enacted Legislation for Tax Shelter Initiatives

Attachment 1

State	Retro-active to (Barring S.O.L.)	Voluntary Compliance Initiative (VCI)?	TP Penalty: Failure to Disclose	TP Penalty: Income Understatement	TP Penalty: Failure to Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
Minnesota	1/1/02	Yes. By statute. Went from 8/1/2005 - 1/31/2006 in conjunction with the new penalties.	\$10,000 for individuals and \$50,000 for corporations. Increases to \$100,000 and \$200,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	None	\$50,000. Increases to the greater of \$200,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to later of 6 years for failure to disclose, or (if listed), 1 year following the date t/p or advisor makes info available to State.
New York	9/9/05	Yes. By statute. Went from 10/1/2005 - 3/1/2006 in conjunction with the new penalties.	\$10,000 for individuals and \$20,000 for corporations. Increases to \$25,000 and \$50,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	100% of total accrued interest after t/p is contacted by State about a reportable transaction.	\$20,000. Increases to the greater of \$50,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to 6 years for listed transactions. If failure to disclose, extended to 1 year following the date t/p or advisor makes info available to State.
Utah	1/1/04	No	\$15,000. Increases to \$30,000 if the reportable transaction is also a listed transaction.	10% of the understatement from reportable transaction	None	\$20,000	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	None	None

States Which Enacted Legislation for Tax Shelter Initiatives

Attachment 1

State	Retro-active to (Barring S.O.L.)	Voluntary Compliance Initiative (VCI)?	TP Penalty: Failure to Disclose	TP Penalty: Income Understatement	TP Penalty: Failure to Self-Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
West Virginia	2/28/00	Yes. By statute. Went from 8/1/2006 - 11/1/2006 in conjunction with the new penalties.	None unless there's an understatement or deficiency	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed. If not disclosed and discovered in audit, appears to be an additional penalty of 70% for listed transactions and 35% for other reportable transactions.	100% of total accrued interest after t/p is contacted by State about a listed transaction.	\$10,000. Increases to \$100,000 if the reportable transaction is also a listed transaction.	\$10,000. Increases to \$100,000 if the reportable transaction is also a listed transaction.	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to 6 years, or 3 years after the filing of an amended return (whichever is later), for failure to disclose a listed transaction
MTC Model (uses federal amounts)	2/28/00	Yes	\$10,000 for individuals and \$50,000 for corporations. Increases to \$100,000 and \$200,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	50% of interest assessed prior to time t/p is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after t/p is contacted by State.	\$50,000. Increases to the greater of \$200,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	1 year following the date t/p or advisor makes information available to State

Recommended Legislation for Tax Shelter Initiatives - Wisconsin

Attachment 2

Retro-active To	Voluntary Compliance Initiative (VCI)?	TP Penalty: Failure to Disclose	TP Penalty: Income Understatement	TP Penalty: Failure to Self-Report in VCI Program	Advisory Penalty: Failure to Register	Advisory Penalty: Failure to Provide Investor Lists	Advisory Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
Wisconsin	1/1/02 Yes. By statute. Recommended for 10/1/2007 - 12/31/2007	\$15,000. Increases to \$30,000 if the reportable transaction is also a listed transaction. Limited to 10% of the tax benefit of the reportable transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	50% of interest assessed prior to time t/p is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after t/p is contacted by State.	\$15,000. Increases to \$100,000 if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to later of 6 years for failure to disclose, or (if listed), 1 year following the date t/p or advisor makes info available to State.
State Modeled After (See Attachment 1)	MN	IL	MN	IL	IL	MN	MN	MN
Federal Penalties		\$10,000 for individuals and \$50,000 for corporations. Increases to \$100,000 and \$200,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	None	\$50,000. Increases to the greater of \$200,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, \$10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	



State of California

2004 Voluntary Compliance Initiative



For Abusive Tax Shelters

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Executive Summary

Inappropriate tax sheltering activity has always existed as a compliance problem for tax administrators. However, in recent years such activities have escalated in size, scope, and sophistication, causing heightened concerns regarding the revenue impacts to state and federal treasuries. This report covers the background of the state tax shelter problem, the results of California's tax shelter amnesty program, and California's strategy to address tax shelters.

In 2004, the State of California offered its first amnesty program aimed at abusive tax shelters. Senate Bill 614 (Statutes 2003, Chapter 656) authorized the Franchise Tax Board (FTB) to administer the Voluntary Compliance Initiative (VCI), which allowed taxpayers that engaged in potentially abusive tax avoidance transactions to correct their state income tax returns. In exchange for full payment of additional tax and interest, participants avoided criminal prosecution and substantial new penalties.

- ◆ The VCI ran from January 1 to April 15, 2004. The final results were 1,202 taxpayers reported \$1.4 billion in additional tax liabilities by filing 2,289 amended returns for tax years 1990 through 2002. Program expenses totaled \$886,000.
- ◆ The majority of the VCI taxpayers were individuals and accounted for 67% percent of VCI participants and 65% percent of total VCI revenues. Corporations, banks, and pass through entities were the remaining participants.
- ◆ Approximately 175 taxpayers audited for tax shelter issues participated in the VCI. They accounted for \$531 million in VCI revenues.

California's strategy to address the tax shelter problem contains three components: compliance, detection, and enforcement. FTB worked closely with the Internal Revenue Service and other state tax agencies in all of these components. This report covers California's activities before, during and after the VCI as of its June 30, 2004 fiscal year end.

Background

Size of the Problem

The FTB administers the Personal Income Tax and the Corporation Tax programs that account for a majority (\$44.7 billion, or 59%, in fiscal year 2003/2004) of California's General Fund revenues. These tax programs rely on taxpayers voluntarily assessing the correct amount of taxes so California can fund state programs such as education, transportation, and public hospitals. However, individuals and businesses increasingly use sophisticated transactions to avoid or evade income tax. This trend poses a serious threat to the efficacy of the tax system because of the loss of revenue and integrity in the voluntary compliance system. Although it is difficult to estimate the fiscal impact of abusive tax shelters on the tax system, the following estimates illustrate the size of the problem:

- Federal government lost about \$85 billion over the last decade¹,
- States lost \$10 to \$17 billion due to corporate income shelters in 2001.²
- California lost \$2.4 to \$4 billion between 1999 and 2003.

Today's Generation of Tax Shelters

The tax shelter schemes that proliferated in the 1980's were relatively simple and straightforward transactions. Promoters promised deductions and credits in over-inflated amounts to tens of thousands of investors sheltering relatively small amounts per person. The current generations of tax shelters are complex technical transactions often coupled with aggressive interpretations of state and federal income tax laws. Tax professionals devised these tax shelters to bury their complexities in multiple layers of entities to escape detection. They packaged them as generic tax products with boilerplate legal opinions for mass marketing, sold them to thousands of taxpayers to generate millions of dollars in fees, and reduced by hundreds of millions of dollars the amounts their clients paid in state and federal taxes³.

The IRS provides public guidance on transactions deemed abusive with a designation known as a "listed transaction". In 1998, there were 5 listed transactions. By 2004, there were 30. Taxpayers and tax professionals ignored the IRS' guidance of unacceptable tax positions, and continued marketing abusive tax shelters at a disturbing rate. For example:

- In December 1999, the IRS issued Notice 99-59 to curtail the Bond and Option Sales Strategies (BOSS). A major accounting firm designed and marketed BOSS to shelter gains through a complex series of sale, loan and dividend arrangements.
- By August 2000, the IRS issued Notice 2000-44 to crack down on variations of BOSS (Son of BOSS) designed to escape provisions of the 1999 IRS Notice. Other accounting

¹ U.S. General Accounting Office Report 04-104T "Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters", October 21, 2003.

² Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, Multistate Tax Commission, July 15, 2003. Estimate updated during June 2004, MTC States Compliance Initiative, Bruce Johnson, Chair of MTC.

³ "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals", Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs (U.S. Senate) dated November 18 & 20, 2003.

or legal firms marketed these BOSS variations and used short sales, digital options, and loan premiums to shelter gains.

- Although the IRS issued new regulations to deter such abuses in 2001 and 2003, promoters continued to design new strategies to escape application of the IRS notices and regulations and more variations of BOSS were born (using different financial instruments to create artificial tax losses, such as market linked deposits).

California State Controller Steve Westly stated, "The transactions we are seeing are so complicated that a typical taxpayer wouldn't dream them up. Financial experts are going to great lengths to devise complex deals and push them on taxpayers through their partners and even through seminars."⁴ The IRS estimates that just one of the listed transactions artificially reduced about \$6 billion in taxes for several thousand taxpayers.⁵

California Takes Action

Taxpayers will continue to engage in tax avoidance transactions and tax professionals will continue to market them as long as the risks are not significant. Previously, California had little effect on deterring investments or promotions of abusive tax transactions since the risk of being caught was low and the penalty regime was insignificant compared to the tax reductions realized by investors. These lost tax revenues had a detrimental effect on California's budget situation since income tax revenues are a large part of California's general fund account. By the end of 2002, California's audit inventory of tax shelter cases rose exponentially. It was apparent California needed stronger measures to reduce the escalating number of tax shelters.

As California considered legislative solutions, United States Senator Charles Grassley introduced legislation⁶ proposing tools to combat abusive tax shelters. Grassley's proposal served as a blueprint for California's legislation. However, California needed to act fast since the shelter activity occurred predominantly in 1999 and 2000, when the California economic capital gain income rose from \$93 billion in 1998 to \$164 billion, and \$200 billion respectively. Many high-income taxpayers sought to reduce their income taxes through shelters during these years. With the state statute of limitations quickly closing for the tax years with the highest levels of abuse, California could not wait for federal legislation and, on October 2, 2003, California enacted its pioneering tax shelter legislation⁷. The new law increased the risks and costs of using and promoting tax shelters, increased California's detection and enforcement tools and authorized a tax shelter amnesty program. The provisions jump-started California's detection and enforcement strategies while the administration of the VCI augmented self-compliance with minimal use of state resources.

The next section discusses the results of California's VCI.

⁴ Statement by State Controller Westly in Press Release dated November 18, 2003.

⁵ "IRS Offers Settlement for Son of Boss Tax Shelter" IR-2004-64, May 5, 2004.

⁶ S.476, the CARE (Charity Aid, Recovery, and Empowerment) Act of 2003 108th Congress, first session) introduced on February 27, 2003 by Senator Charles E. Grassley (R-IA). See Title VII Revenue Provisions. Subtitle A Provisions Designed to Curtail Tax Shelters.

⁷ Senate Bill 614 (Statutes 2003, Chapter 656) authored by Senators Cedillo and Burton and Assembly Bill 1601 (Statutes 2003, Chapter 654) authored by Assembly Member Frommer). Both bills contain identical provisions.

Voluntary Compliance Initiative Results

The goal of the VCI was to promote self-compliance and accelerate revenue. The VCI allowed taxpayers who used an abusive tax avoidance transaction to correct their state income tax returns in exchange for avoiding criminal prosecution, lengthy litigation, and substantial penalties. The FTB conducted the VCI between January 1, 2004 and April 15, 2004.

Analysis of Revenue Received

During the VCI, 1,202 taxpayers reported \$1.4 billion in additional tax and interest from potentially abusive tax shelters. Individuals (804) and trusts (56) reported \$973 million (68%) in Personal Income Tax revenues. Corporations, banks, and pass through entities reported \$465 million (32%) in Corporation Tax revenues.

Table 1: Individuals are Majority of VCI Taxpayers and Revenues

Tax Program	Number of Taxpayers	Amounts (in millions)
Personal income tax	860	\$973
Corporate income tax	342	\$465
TOTAL	1,202	\$1,439

The three most notable outcomes were:

- Total revenues exceed a billion dollars.
- 90% of revenues are currently undisputed.
- 40% of VCI taxpayers waived their rights to appeal VCI amounts.

Total revenues exceed expectations

The billion dollars of self-assessed tax reported in the VCI exceeded expectations. Original estimates of potential VCI revenue were \$90 million. FTB audit staff noticed that relatively few taxpayers were involved in the tax shelter audit cases, but the amount of taxes they underreported were large- often close to a million dollars. While it was not clear how many taxpayers would eventually participate in the VCI, the number of taxpayers was not the key factor in any potential success of the initiative. The key factor to its success and the greatest impact to compliance was the average underpaid tax liability per taxpayer. Although some taxpayers reported overpayments, and some reported additional tax liabilities of tens of millions of dollars, the average VCI underpaid tax liability reported per taxpayer was slightly more than \$1 million. The \$1.4 billion in additional taxes resulted from taxpayers reporting an increase of approximately \$14 billion in California taxable income.

Many taxpayers seek to avoid consequences

California considered different components to spur the highest probability of VCI participation. During its cooperative efforts with tax professionals, California learned that relieving penalties would not suffice to entice taxpayers into compliance when investors and promoters believed detection was unlikely and penalties were inconsequential. To address this concern, California combined the VCI with the highest tax shelter penalties in the nation, applied some of them retroactively, and increased its cooperative enforcement efforts nationally. While raising the

stakes of not participating in the VCI, California also minimized taxpayers' participation risks by providing different options and, in some cases, allowing them to retain the right to dispute any tax agency findings.

Taxpayers had two choices when they participated:

- Avoid all penalties and waive their right to dispute the tax shelter amount (referred to as Option 1), or
- Maintain their right to dispute the tax shelter amount, and remain subject to one penalty (referred to as Option 2).

Table 2: VCI Allows Taxpayers Options to Participate

Is the VCI Taxpayer	VCI OPTION 1	VCI OPTION 2
Subject to New Increased Tax Shelter Penalties?	No	No
Subject to Accuracy Related Penalty?	No	Yes
Able to Appeal?	No	Yes

FTB's historical experience is that taxpayers do not voluntarily change their positions unless they can dispute the result. However, a significant percentage of VCI taxpayers (40%) chose to forego all appeal rights (Option 1) and reported \$355 million in VCI revenues.

Table 3: 40% of VCI Taxpayers Avoid All Penalties

Tax Program	Taxpayers electing Option 1	Taxpayers electing Option 2
Personal income tax	321	539
Corporate income tax	161	181
TOTAL	482	720

Small numbers of taxpayers dispute their VCI amounts

While 720 VCI taxpayers chose Option 2 (\$1.08 billion of VCI revenues) and kept their right to dispute the amounts reported in the VCI, only 36 taxpayers filed claims for refunds totaling \$42 million. As with any other self-assessed return, the remaining Option 2 taxpayers may file claims for refunds within the normal state statute of limitations⁸.

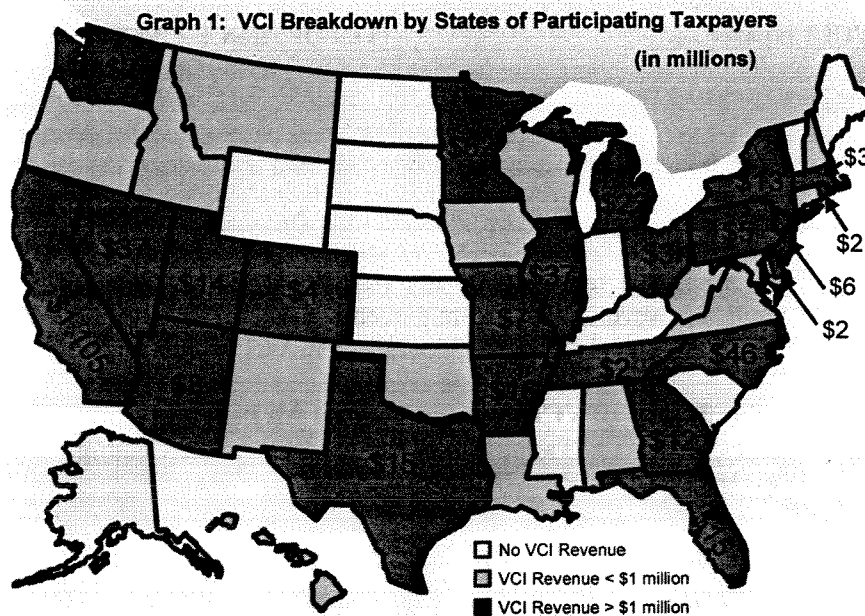
Other notable findings

VCI was applicable for all tax years before tax year 2003. The majority (77%) of the VCI revenues (\$1.1 billion) were attributable to tax years 1999 through 2001. This indicates the majority of VCI revenues came from the tax years with the largest amounts of capital gains. However, a surprising \$148 million (10%) was for tax years normally closed by the statute of limitations (tax years preceding 1999). Some taxpayers may have amended older tax years if

⁸ California Revenue and Taxation Code Section 19306; one year from overpayment, or 4 years from the due date of the original return, or date filed, whichever is later. See CR&TC Section 19311 for filing refunds based on federal changes.

they had an open federal statute of limitation and wanted to protect themselves at the state level. The new tax shelter provisions doubled the length of time for issuing state deficiencies to eight years for tax returns filed after January 1, 2000.

Over \$300 million in VCI revenues came from taxpayers in states other than California. This reinforces government findings that taxpayers across the country are engaged in abusive tax shelters. Graph 1 shows the distribution of California VCI revenues received from around the nation, with amounts greater than \$1 million noted on the map. Appendix B.7.6 provides further detail of amounts reported by states.



Analysis of Accelerated Revenue and Program Costs

Accelerated revenue

At the beginning of the VCI, California had over 400 audits opened or pending with tax shelter issues. About 150 of the taxpayers under audit participated in the VCI and reported almost \$500 million owed. About 25 additional taxpayers protesting or appealing their tax shelter assessments also participated in the VCI. They voluntarily reported \$31 million owed and had \$5 million in accuracy-related penalties waived to close their cases. Overall, the VCI accelerated the resolution of 175 cases for \$531 million.

Potential revenue

Taxpayers who chose Option 2 remain subject to the accuracy-related penalty when FTB disallows any refunds for amounts paid in the VCI. In addition, any proposed deficiency

assessments to VCI taxpayers for tax shelter amounts not reported in the VCI are subject to two of the new tax shelter penalties:

- (1) Noneconomic Substance Transaction penalty⁹
- (2) Interest Based penalty¹⁰.

Forgone Revenue

Under Option 1, California agreed to forgo certain penalties totaling approximately \$55 million. Unlike the general amnesty programs that determine forgone revenue by the amount of penalties assessed but waived under amnesty, the amount of revenue forgone for VCI purposes includes a subjective determination regarding potential penalty amounts. The estimate of forgone revenue is based on the amount of additional tax reported by Option 1 taxpayers and assumes FTB would have:

- Audited and disallowed the tax shelter issue, and
- Assessed the accuracy-related penalty¹¹.

As a result of taxpayers participating in the VCI, FTB waived \$5 million in penalties previously assessed on notices of deficiency. This amount is included in the estimate of \$55 million.

Revenue loss due to redirection of resources from normal audit workloads to abusive tax shelters was addressed as part of the audit workplan process. Since the VCI effort was part of the universe of abusive tax shelter workloads, there is no additional revenue loss¹² from the redirection of resources.

Program costs

To administer the program, FTB staff spent over 19,000 hours (or 11 personnel years) on implementation activities to administer the VCI program for total program costs of \$886,000.

The next section discusses California's strategy for addressing abusive tax shelters.

⁹ California Revenue and Taxation Code section 19774.

¹⁰ California Revenue and Taxation Code section 19777.

¹¹ For this estimate, only the accuracy related penalty is used since that penalty was the only penalty applicable to the audit inventory before the passage of the tax shelter legislation (SB 614). Without the legislation, we would not have the VCI or the increased tax shelter penalties to assess.

¹² This does not include revenue loss from displaced workloads.

California's Strategy for Addressing Abusive Tax Shelters

California used a comprehensive strategy to maximize compliance while conserving resources based on lessons learned from other agencies. Our strategy consisted of three primary components:

- Compliance mechanisms to promote self-compliance and discourage buying and selling of abusive tax shelter products.
- Detection efforts to identify noncompliant taxpayers.
- Enforcement measures to address taxpayers continuing to engage in abusive transactions.

Compliance Strategy

In 2001, California identified about 40 tax shelter cases. In less than two years, this number swelled to 400 tax shelter cases. California sought new compliance strategies since its traditional business approach would not suffice.

Taxpayers were encouraged to voluntarily amend returns for tax shelter items to minimize penalties. When the IRS announced its Offshore Voluntary Compliance Initiative (OVCI) in 2003, California was the first state to support taxpayer participation in the IRS initiative by offering participants similar relief if they also corrected their California tax returns. This resulted in California taxpayers voluntarily reporting over \$5 million in accelerated state tax revenues.

In July 2003, the University of California, Davis Center for State and Local Taxation, the California Research Bureau California State Library, and the FTB held an Abusive Tax Schemes Symposium to an audience of media, legislators, and tax practitioners. The symposium centered on the depth of the tax shelter problem and current government enforcement activities, including the lack of effective deterrents and loopholes that allowed tax shelter investors and promoters to escape significant penalties. The symposium helped convince the media, legislators and tax professionals of the need for tougher measures to encourage self-compliance and penalize those playing "audit roulette."

California officials worked with academia and tax professionals to examine the tax shelter phenomenon and identified ways to combat the problem. Various federal legislative proposals were reviewed and a modified version was chosen to address issues facing California. On October 2, 2003, California enacted tax shelter legislation that provided vital tools needed to curtail abusive tax shelters.

The new law provided a comprehensive approach to combating abusive tax shelters by including incentives to comply and severe consequences for continued noncompliance. The main purpose of the law was creating the VCI, which allowed taxpayers to comply before California advanced its enforcement efforts. The law includes sizeable new penalties and a reporting regime patterned after the federal requirements for disclosing potentially abusive transactions. These provisions are summarized below. The entire text of the new law is at Appendix A.5.

Voluntary Compliance Initiative (Appendix A.1)

- Offered January 1, 2004 through April 15, 2004.
- Provided taxpayers two options to participate.

Penalties (Appendix A.2)

- A retroactive penalty based on 40 percent of understatements lacking economic substance.
- A retroactive penalty equal to 100 percent of the accrued interest on deficiencies related to tax shelters.
- A prospective penalty equal to 30 percent of understatements from undisclosed reportable transactions.
- A prospective promoter penalty equal to 50 percent of the promoter's gross income derived from promoting tax shelters.
- Prospective penalties for failing to report, register, or disclose required information regarding abusive tax shelters and transactions.

Reporting Requirements (Appendix A.3)

- Conformed to federal return disclosure and list maintenance requirements for reportable transactions.
- Expanded California's tax shelter registration requirements.
- Required organizers selling listed transactions after February 28, 2000, and before January 1, 2004, to register those transactions and provide California with a list of their investors by April 30, 2004.

Other Curtailments (Appendix A.4)

- Extended from four years to eight the statute of limitations for California to issue a deficiency notice regarding tax shelters effective for open years.
- Eliminated the suspension of interest provisions for tax shelter assessments.
- Expanded the FTB's ability to issue subpoenas to taxpayers involved in abusive tax schemes.
- Expanded the FTB's ability to obtain an injunction against abusive tax shelter promoters from marketing shelters within California.

The FTB publicized the VCI to maximize public awareness of and participation in the program. FTB staff focused the marketing campaign on the members of the public most likely to participate in the VCI, informing them of the VCI, the consequences of continued failure to comply, and the new reporting requirements. Between December 2003 and March 2004, approximately 32,000 letters¹³ were mailed to taxpayers describing the benefits of the initiative. Recipients included taxpayers, practitioners, partners of law and accounting firms, and leads received from the IRS, other states and other sources. Additional letters were mailed to tax professionals and potential tax shelter promoters outlining the new reporting requirements and penalties.

Taxpayers also were encouraged to participate through news conferences, press releases, and presentations to tax professional organizations. California State Controller Steve Westly held

¹³ See Appendix B.6 Franchise Tax Board VCI Letters

three news conferences publicizing the VCI and encouraged participation to avoid penalties later. Media activities resulted in California obtaining over 100 print stories (some in nationally syndicated papers), 9 radio and television stories, and 20 Internet news stories¹⁴.

We implemented a variety of information resources for taxpayers and tax practitioners:

- An Abusive Tax Shelters webpage on the Internet (FTB's website) provided timely and relevant information for taxpayers, practitioners and promoters. The website contained publications, frequently asked questions¹⁵, summary of relevant penalties, reporting requirements, links to IRS information and other public information on the abusive tax shelter program.
- VCI brochures¹⁶ distributed through public service offices and tax professional forums.
- A VCI telephone hotline and e-mail address answered over 1,100 telephone calls and 100 email inquiries.

Detection Activities

In September 2003, California and 48 other states signed a Memorandum of Understanding (MOU¹⁷) with the IRS for sharing information and coordinating enforcement efforts relating to abusive tax avoidance transactions. The MOU enhances the exchange of information on compliance initiative programs, litigation, types of schemes, investor and promoter lists, staff training and publicity. In February 2004, the IRS provided over 20,000 tax shelter leads to state taxing agencies on taxpayers involved in offshore transactions, abusive trusts, employee leasing, home-based businesses, employment taxes and other tax-avoidance schemes. Through the agreement, the IRS provides information to the states on a semi-annual basis. Publicizing the sharing of these leads and reinforcing the cooperation between tax administrators helped spur taxpayer interest in California's VCI.

On March 4, 2004, California, and other participating states ratified a Memorandum of Agreement (MOA¹⁸) to share information about abusive tax schemes. As of June 2004, 41 states, the District of Columbia and the City of New York joined in the agreement. The MOA streamlines and facilitates the exchange of information among the states, promotes consistency, maximizes resources and prevents duplication of effort. The MOA allows the states to share names of participants in abusive tax schemes, training materials, and other related information. The states share information through a central database.

California's tax shelter legislation increased the reporting and disclosure requirements for potentially abusive tax shelters. It also broadened the number of tax shelters required to register with California to include transactions with any connection (income, business activity, investor) to California. To increase California's knowledge of those who used potentially abusive tax shelters, the legislation added a requirement for organizers who sold any listed transactions since

¹⁴ See Appendix C

¹⁵ See Appendix B.4 for the Frequently Asked Questions

¹⁶ See Appendix B.5 for the Franchise Tax Board VCI Brochure

¹⁷ See Appendix D.1. for a complete copy of the IRS MOU

¹⁸ See Appendix D.2. for a complete copy of the states MOA

February 28, 2000¹⁹ to automatically provide a list of the taxpayers purchasing those transactions.

Enforcement Activities

California is vigorously pursuing tax shelter audits and expanding its focus on curtailing abusive tax shelters. A key strategy is to complement the enforcement activities of the IRS and other states, seeking joint opportunities to maximize efficiencies and avoid duplication by:

- Coordinating audit activities with IRS and other states.
- Utilizing technology solutions to effectively identify audit candidates.
- Conducting joint promoter audits with the IRS and other states to obtain information regarding investors, promoters, marketing strategies, and technical arguments.
- Issuing subpoenas, if necessary, to get information needed to complete our examinations.

Equipped with sizeable new penalties, we began to crack down on promoters of abusive tax shelters. In early 2004, we issued subpoenas and requested client lists from insurance companies believed to be insuring clients who invested in abusive tax shelters against government action.

In August 2004, the FTB jointly hosted an abusive tax shelter symposium with the Multistate Tax Commission and the Federation of Tax Administrators. The symposium enhanced partnering relationships between the 29 attending states and the IRS while accelerating awareness of the national problem and solidified the commitment of the taxing agencies to boost their curtailment efforts. As a result of the success of the VCI program, other states have sought similar legislation.

To further focus our enforcement efforts, FTB formed an Abusive Tax Shelter Unit and supporting teams to keep our information on abusive tax shelters up to date. To ensure we remain have the best information, FTB retained consultants including economists, appraisers and other financial experts to help staff unravel the complex tax schemes.

VCI Lessons Learned

California learned many important lessons while administering the VCI. The knowledge among tax advisors that there is no better deal waiting down the road is critical to the success of any initiative. The following lessons learned may assist other tax officials seeking to administer a tax shelter initiative:

- Dedicate funds and experienced resources to target abusive tax shelters.
- There is no quick fix. Tax shelter issues are constantly evolving, so your overall program strategy must be flexible. In addition to implementing the initiative, long-term resources and funding are needed for detection and enforcement.
- Actively coordinate communications within your department and with other taxing agencies. Information sharing is critical to detection and enforcement efforts. Noncompliant taxpayers thrive on silence.

¹⁹The reference to the February 2000 date is based on the changes to the Treasury regulations involving reportable transactions; Treasury Regulations Sections 1.6011, 1.6111 and 1.6112.

- Gain the authority to take the strong actions needed to influence taxpayer behavior. Adequate enforcement tools are required. Individuals creating, promoting and using abusive transactions are rarely swayed by penalties, reporting requirements or demands for information unless there are significant consequences and those consequences are enforced. . Noncompliant taxpayers and advisors bet that tax administrators will be too strapped and under-funded to take effective action. They must be proven wrong.
- Publicize your department's actions in cracking down on abusive tax shelters to create credibility. Take an active role in directing publicity to those taxpayers most likely to participate. A taxing agency's message must be clearly stated and consistently sent. Inconsistent messages or treatment dilute the effectiveness of any compliance or enforcement effort.
- Detection and enforcement are key to an effective response. An initiative administered without strong detection and enforcement efforts will likely not succeed.

The next section compares California's VCI with the Internal Revenue Service's tax shelter initiatives.

Comparison with Internal Revenue Service Tax Shelter Initiatives

Most state tax amnesty programs are open to the general taxpaying public for various types of taxes. However, no other state had previously opened an amnesty program for taxpayers using abusive tax shelters. Therefore, there are no statistics available to compare California's VCI with tax shelter initiatives from other states (at the time this report was prepared).

The IRS is the only other tax agency that offers initiatives for abusive transactions. They carefully design their tax shelter litigation and settlement strategies for each transaction based on a fair assessment of the litigation hazards to the government and to the taxpayer. A decision to pursue a settlement initiative as to any particular tax avoidance transaction requires careful analysis and balancing of all competing interests and considerations.

Settlement initiatives for abusive tax avoidance transactions may significantly affect taxpayers' voluntary compliance and public confidence. The voluntary compliance system depends on taxpayers knowing tax administrators enforce the tax law against everyone. The IRS increased their enforcement efforts to focus on the rise of abusive tax avoidance transactions and publicized their numerous enforcement successes. The following IRS activities highlighted the size of the problem, the seriousness of the government crackdown, and served as a catalyst for California's success:

- From December 2001 to April 2002, a disclosure initiative resulted in 1,690 transaction disclosures from 1,212 taxpayers. The disclosed transactions involved \$30 billion in claimed losses and deductions.
- From October 2002 through March 2003, other initiatives allowed taxpayers engaged in corporate owned life insurance (COLI), IRC sections 302 and 318 basis shifting, and IRC section 351 contingent liability transactions to resolve their tax consequences arising from their participation in these transactions.
- Since 2002, IRS Large and Mid-Size Businesses Division issued hundreds of administrative summonses in numerous promoter cases. They also obtained court order approval to serve John Doe summonses and the Justice Department filed summons enforcement actions against several promoters.
- From January 2003 through April 2003, an initiative allowed taxpayers using abusive offshore financial arrangements and products to escape criminal prosecution if they disclosed their promoter information. More than 1,300 taxpayers applied and so far the initiative has yielded more than \$170 million in taxes, interest and penalties. The IRS obtained the names of 479 promoters, nearly half of them previously unknown.

The next section concludes this report.

Conclusion

The California Voluntary Compliance Initiative for abusive tax shelters was successful by several measures. While it broke national records for revenues reported during an initiative, the biggest success was self-compliance. During the brief period of the VCI, over 1,200 taxpayers—business entities and individuals—filed over 2,200 amended returns to eliminate tax shelter benefits and comply. Correcting these transactions provided California with \$1.4 billion in income tax revenues.

The VCI's success is largely due to the comprehensive approach of combining a compliance incentive with strong consequences to achieve desired behaviors. The joint efforts with the IRS and other state taxing agencies provided California lawmakers with the information they needed to enact the toughest enforcement and penalty provisions combined with a one-time compliance offer. Together, these provisions have allowed California to make a large impact on abusive tax shelters for returns already filed, while allowing California tax officials to more efficiently pursue future abusive tax shelter transactions.

California remains diligent in its compliance and enforcement efforts and is taking a united approach with the IRS and other state tax administrators in combating abusive tax avoidance transactions.

Addendum

Since April 2004, post-VCI activities at the federal level include:

- IRS offered a settlement initiative for investors of Son of Boss transactions. The IRS announced on May 5, 2004 that taxpayers had until June 21, 2004 to file Notices of Elections to settle. Over 1,500 taxpayers participated, which is about 85% of the Son of Boss taxpayers known to the IRS. See Appendix D.2.3 for more information.
- President Bush signed the American Jobs Creation Act of 2004 that contained tax shelter penalty and curtailment provisions. See Appendix A.6 for a chart comparing the new federal tax shelter provisions to California's current tax shelter provisions.

Since April 2004, post-VCI Activities among the states include:

- California received the following information from their new reporting requirements:
 - 2,000 disclosures of reportable transactions (IRS Form 8886).
 - 950 tax shelter registrations (IRS Form 8264).
 - 9,900 client names who participated in reportable transactions
- Connecticut ran an abusive tax shelter compliance initiative from June 16, 2004 through July 31, 2004. Taxpayers had until September 30, 2004 to submit information. No final results posted.
- Illinois enacted a Voluntary Compliance Program (VCP) to give taxpayers an opportunity to file and pay any tax liability from participating in a tax avoidance transaction before their new penalties related to abusive tax shelters go into effect. The VCP started October 15, 2004 and ends January 31, 2005.
- Four additional states signed the States Abusive Tax Shelter Memorandum of Agreement bringing the total to 45 states plus New York City and District of Columbia. The five

states that had not signed the agreement were Florida, Mississippi, Nevada, New Hampshire, and Wyoming.

- Based on the States Abusive Tax Shelter Memorandum of Agreement, New York Department of Revenue completed the Multi State Tax Shelter (MSTS) Application. The MSTS is a secure web-based database allowing states to exchange data on tax shelter participants and information.

Appendices

Appendix A - California Law Statutes 2003, Chapter 656 (Senate Bill 614)

- A.1 Voluntary Compliance Initiative provisions
- A.2 Penalty provisions
- A.3 Reporting Requirement provisions
- A.4 Other curtailment provisions
- A.5 All provisions of Senate Bill 614
- A.6 Chart comparing federal H.R. 4520 to California SB 614

Appendix B - Voluntary Compliance Initiative

- B.1 Participation Agreement (Individuals) and Instructions (Form FTB 622)
- B.2 Participation Agreement (Business Entities) and Instructions (Form FTB 621)
- B.3 Request for Chief Counsel to Relieve Penalties (Form FTB 626)
- B.4 Frequently Asked Questions
- B.5 Franchise Tax Board VCI Brochure
- B.6 Franchise Tax Board VCI Letters
 - B.6.1 Letters mailed to Promoters in February 2004
 - B.6.2 Letters mailed to Other Leads in February 2004
 - B.6.3 General notification letters mailed in March 2004
- B.7 VCI graphs and charts of statistics
 - B.7.1 Summary of VCI by Options- Chart
 - B.7.2 Summary of VCI Revenues by Options- Graph
 - B.7.3 Summary of VCI Taxpayers by Options- Graph
 - B.7.4 VCI Returns by Tax Year- Graph and Table
 - B.7.5 Analysis of VCI by Taxpayer Type-Graph
 - B.7.6 Summary of VCI Participation by States-Table
 - B.7.7 Summary of VCI Participation by Taxpayer Type
 - B.7.8 Illustration of Tax Shelter Penalties before and after legislation

Appendix C - Media

- C.1 Franchise Tax Board Press Releases
 - C.1.1 July 15, 2004-FTB Adds Tax Expert to Its Abusive Tax Shelter Team
 - C.1.2 June 10, 2004-Westly Tax Cheat Crackdown Shrinks Budget Gap
 - C.1.3 April 22, 2004-Westly Announces \$838 Million Windfall Will Help Budget Deficit
 - C.1.4 April 15, 2004-Penalty-Free Program for Tax Shelters Ends Today
 - C.1.5 April 12, 2004-State to Serve First of Tax Shelter Subpoenas
 - C.1.6 April 09, 2004-Illegal Tax Shelter Crackdown Tops \$200 Million Mark
 - C.1.7 April 7, 2004-Controller Westly, Board Of Equalization Member Chiang, Majority Leader Frommer Warn Corporate Tax Cheats Of Stiff Penalties For Illegal Tax Shelters

- C.1.8 March 25, 2004-CPA Firms Targeted in Abusive Tax Shelter Crackdown
- C.1.9 March 22, 2004-Taxpayers Under IRS Audit Urged to Apply for VCI - Penalty Waiver
- C.1.10 March 17, 2004-Westly Proposes \$1 Billion Plan to Help Close Budget Gap
- C.1.11 March 11, 2004-Latest Tax Shelter Crackdown Targets Promoters
- C.1.12 March 04, 2004-States Sign Anti-Abusive Tax Shelter Agreement
- C.1.13 February 19, 2004-Illegal Tax Shelter Crackdown Hits \$100 Million
- C.1.14 February 9, 2004-FTB Information Releases
- C.1.15 January 22, 2004-States Huddle to Plan Offensive Against Abusive Tax Shelters
- C.1.16 January 07, 2004-Tax Shelter Crackdown Nets \$30 Million
- C.1.17 December 03, 2003-New Program Cracks Down on Illegal Tax Shelters
- C.1.18 November 11, 2003-Controller Westly Sends Tax Shelter Expert to Testify at Congressional Hearing
- C.1.19 September 9, 2003-State and Feds Partner to Crackdown on Illegal Tax Schemes
- C.1.20 August 5, 2003-California Targets Abusive Tax Shelters with New Round of Audits
- C.1.21 March 14, 2003-No Jeopardy for State Taxpayers who participate in the IRS' Offshore Voluntary Compliance Initiative, says FTB
- C.1.22 February 10, 2003-FTB Urges Participants in the IRS' Offshore Voluntary Compliance Initiative to Correct State Returns Too

C.2 Television Programs

- C.2.1 CBS 60 Minutes-transcript
- C.2.2 PBS Frontline-transcript

Appendix D - References

D.1 United States Congress

- D.1.1 United States Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals-Four KMPG Case Studies: FLIP, OPIS, BLIPS, and SC2
- D.1.2 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. I
- D.1.3 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. II
- D.1.4 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. III
- D.1.5 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. IV
- D.1.6 Fishtail, Bacchus, Sundance, & Slapshot: Four Enron Transactions funded by U.S. Financial Institutions January 2, 2003
- D.1.7 Testimony of Debra Petersen of the California Franchise Tax Board before the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs on November 18, 2003

- D.1.8 Testimony of Debbie Langsea of the California Franchise Tax Board before the United States Senate Finance Committee on July 21, 2004
- D.2 Internal Revenue Service
 - D.2.1 Internal Revenue Service Abusive Tax Avoidance Transactions Memorandum of Understanding
 - D.2.2 United States General Accounting Office Report, April 2002, Internal Revenue Service, Enhanced Efforts to Combat Abusive Tax Schemes-Challenges Remain.
 - D.2.3 IRS Son of Boss Settlement Information
- D.3 States
 - D.3.1 State Abusive Tax Avoidance Transaction Memorandum of Agreement
 - D.3.2 State of Connecticut Abusive Tax Shelter Compliance Initiative
 - D.3.3 State of Illinois Voluntary Compliance Program



Tax Shelter Voluntary Compliance Program

Informational Bulletin

August 2004

Brian A. Hamer
Director of Revenue

For information or forms...

- ◆ Call us at:
1 800 732-8866 or
217 782-3336
- ◆ Call our TDD
(telecommunications device
for the deaf) at:
1 800 544-5304
- ◆ Write us at:
Illinois Department of Revenue
P.O. Box 19044
Springfield, IL 62794-9044
- ◆ Visit our Web site at:
www.Iltax.com
- ◆ Call our 24-hour
Forms Order Line at:
1 800 356-6302

This bulletin is written to inform you of recent changes; it does not replace statutes, rules and regulations, or court decisions.

To:

All taxpayers having investments in tax shelters and all tax preparers completing tax returns on behalf of taxpayers who have investments in tax shelters.

As part of an on-going effort between many states and the Internal Revenue Service (IRS), Illinois has passed new laws (Public Act 93-840) to discourage participation in tax avoidance transactions (tax shelters). In general, the new laws mandate specific filing procedures and registration requirements for taxpayers participating in tax shelter activities, as well as the promoters of tax shelter opportunities.

In addition, the laws outline new, stringent penalties for taxpayers and promoters that do not comply with the tax shelter laws. In order to help taxpayers make the transition to the new reporting requirements, Illinois will be offering a Voluntary Compliance Program (VCP) for taxpayers that failed to report their full taxable income because they participated in tax shelter transactions.

The purpose of this bulletin is to provide general information about tax shelters, the VCP requirements, and the new associated penalties for tax shelter abuse.

What is the definition of a tax shelter?

A tax shelter is the common name for a "tax avoidance transaction." A tax avoidance transaction means any plan or arrangement devised for the principal purpose of avoiding federal income tax, and includes

but is not limited to, "listed transactions" as defined by the IRS.

What is a "listed transaction"?

A "listed transaction" is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance.

What is the Voluntary Compliance Program (VCP)?

The VCP is a program that allows taxpayers who underreported their taxable income by participating in tax shelters to come forward and pay the associated Illinois Income Tax liability without incurring any of the new penalties that have been put into effect for participating in tax shelters.

What are the dates for the VCP?

The VCP period for reporting and paying additional Illinois Income Tax liability will be from October 15, 2004, through January 31, 2005.

Who is eligible to participate?

The VCP is available to any taxpayer who

- ◆ filed an Illinois Income Tax return using a tax shelter to reduce their taxable income, or
- ◆ did not file an Illinois Income Tax return as a result of participating in a tax shelter.

What years can I amend?

Any taxable year beginning before January 1, 2004, qualifies for the VCP, if you are filing because of your involvement with tax shelter activities.

How do I participate?

In order to receive any benefit from participating in the VCP, you must

- ◆ report the correct amount of taxable income and tax liability, without regard to any tax shelters, on an Illinois amended return; and
- ◆ pay the total amount of the additional Illinois Income Tax shown on the amended return, plus any applicable interest on the amount of tax that is the result of participating in a tax shelter transaction.

In addition to these requirements, for each year that you amend, you must select one of the following options, indicating your choice of appeal rights. **Once made, this election is irrevocable.**

- ◆ **Option 1 - Voluntary Compliance without Appeal** - Under this option, you forfeit your rights to file a claim for refund of the additional tax you report on your amended return related to tax shelters. In return, the department will not impose any penalty under the Uniform Penalty and Interest Act (UPIA) for the underreporting or underpayment of the additional tax, or the new tax

shelter penalties in the Illinois Income Tax Act (IITA). You also avoid civil or criminal prosecution that may be associated with the use of tax shelter transactions for the taxable year.

- ◆ **Option 2 - Voluntary Compliance with Appeal** - You maintain your right to file a claim for refund for the taxable year that you have amended and shown an additional tax liability. In return, you avoid the new tax shelter penalties. You also avoid civil or criminal prosecution. However, you will remain subject to all other applicable penalties under the IITA and UPIA.

Note → No penalty may be waived under either option 1 or 2 if the penalty relates to an amount of Illinois Income Tax assessed before October 15, 2004.

What forms must I file?

If you did not file an Illinois return because participation in a tax shelter reduced your taxable income, you will need to file an original return.

If you filed an Illinois return, and must amend in order to include income earned from participating in a tax shelter, you must file an amended return.

If you are

- ◆ an **individual** - file Form IL-1040, Individual Income Tax Return, or Form IL-1040-X, Amended Individual Income Tax Return;

- ◆ a **corporation** - file Form, IL-1120, Corporate Income and Replacement Tax Return, or Form IL-1120-X, Amended Corporation Income and Replacement Tax Return;
- ◆ an **S corporation** - file Form IL-1120-ST, Small Business Corporation Replacement Tax Return, or Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1120-ST, Small Business Corporation Replacement Tax Return;
- ◆ a **partnership** - file Form IL-1065, Partnership Replacement Tax Return, or Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1065, Partnership Replacement Tax Return;
- ◆ a **trust or an estate** - file Form IL-1041, Fiduciary Income Tax Return, or Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1041, Fiduciary Income and Replacement Tax Return.

All taxpayers must attach a VCP Participation Agreement. This form is expected to be on our Web site in the near future.

Note → You must mail all Illinois original and amended returns, and the VCP Participation Agreement to the address listed on the VCP Participation Agreement. Do not send any return intended for the VCP to the mailing address listed on the Illinois original or amended return.

What are the new penalties?

- ◆ **Failure to disclose participation in a reportable transaction** - Illinois taxpayers that must disclose their participation in a reportable tax shelter to the Internal Revenue Service (IRS), are required to file a copy of that disclosure with the department. In addition, Illinois taxpayers must also disclose their participation in a transaction entered into after February 28, 2000, that becomes a "listed transaction" at any time.

Disclosure is not required if the taxpayer files an amended Illinois return that reverses the tax benefits of the reportable transaction before disclosure would otherwise be due.

Participating in the VCP will avoid the assessment of this penalty.

- ◆ **Reportable transaction understatement penalty** - This penalty applies to any deficiency of Illinois income tax that is caused by participating in any "listed transaction," or a reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax. This penalty applies to tax years ending on or after December 31, 2004. This penalty may also be applied to any reportable transactions

entered into after February 28, 2000, that become "listed transactions" at any time.

Participating in the VCP will avoid the assessment of this penalty.

- ◆ **100 percent interest penalty** This penalty will be assessed if a taxpayer has been contacted by the IRS or the department regarding the use of a potential tax avoidance transaction. *Participating in the VCP will avoid the assessment of this penalty.*

What are the new penalty rates?

- ◆ **Failure to disclose participation in a reportable transaction** - A penalty in the amount of \$15,000 will be assessed for each instance the taxpayer fails to disclose a reportable transaction. However, if a taxpayer fails to disclose a "listed transaction," the penalty for each instance is \$30,000.

The total of this penalty cannot exceed 10 percent of the increase in net income due to the reporting of any tax shelter activities.

- ◆ **Reportable transactions understatement penalty** - The amount of this penalty is 20 percent of the deficiency, but increases to 30 percent if the transaction was not disclosed as required.

- ◆ **100 percent interest penalty** This penalty is equal to 100 percent of the amount of interest assessed under UPIA from the payment due date through the date that a notice of deficiency is issued.

Are there any changes to how interest is assessed?

Yes. In certain situations where you have not paid your tax liability related to tax shelter activities, your interest rate may be assessed at 150 percent of the current interest rate imposed under UPIA.

Where can I get more information?

As more information regarding the VCP and general filing requirements for tax shelter activities becomes available, we will put the information on our Web site. Visit www.ILtax.com for updates.

You can learn more about federal reporting and registration requirements for tax shelter activities at the IRS's Web site, www.irs.gov.