Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Frommer	Analyst:	Jeff Garnier	Bill Number:	AB 1297
Related Bills:	See Legislative History	Telephone:	845-5322	Amended Date:	June 7, 2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Prohibit Tax Shelters from Being an Insurable Risk

SUMMARY

This bill would:

- Prohibit insurance companies from issuing insurance policies that insure losses resulting from or in connection with an abusive tax shelter.
- Create a penalty equal to 75% of the proceeds received for insurance, guarantees, stop loss agreements, or other similar indemnity arrangement relating to any loss resulting or in connection with an abusive tax shelter.

SUMMARY OF AMENDMENTS

This is the department's first analysis of the bill. Prior to the June 7, 2004, amendments the bill affected insurance brokers under the Insurance Code and did not impact the department. The June 7, 2004, amendments deleted the previous Insurance Code amendments and inserted the provisions discussed in this bill.

PURPOSE OF THE BILL

The author's staff has indicated the purpose of the bill is to discourage taxpayers from investing in an abusive tax avoidance transaction.

EFFECTIVE/OPERATIVE DATE

The Revenue and Taxation Code provision of the bill relating to a 75% penalty would be effective January 1, 2005. The penalty would apply to amounts received from specific insurance contracts in taxable years beginning on or after January 1, 2005.

POSITION

Pending.

Board Position:			Department Director	Date
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______ N	______ OUA	__X__ PENDING	Gerald H. Goldberg	6/21/04

ANALYSIS

Tax Shelters Background

There are many kinds of tax shelters. Various tax planning strategies are legal, but some cross the line and are abusive and, therefore, are punishable by civil and criminal penalties. An abusive tax shelter lacks economic substance, or the underlying transaction is a sham having as its primary purpose evading taxes. Recently abusive tax shelters have proliferated to the point that experts believe our self-reporting tax system is threatened.

In November of 2003, the U.S. Senate Permanent Subcommittee On Investigations, Committee on Governmental Affairs, issued a report entitled U.S. Tax Shelter Industry: The Role Of Accountants, Lawyers, and Financial Professionals. The overall conclusion of the 131 page report is that the marketing, promoting, and executing of abusive tax shelter schemes involves the coordination and collusion of several business professions. Without these professions acting in concert, the report concludes that the abusive tax shelter industry would not exist today.

The U.S. Senate report discusses the fact that tax shelter promoters are enlisting mainstream insurance companies for help in marketing abusive tax shelters. Promoters package abusive tax shelters with insurance for “investors” to guarantee the promised tax benefits. These insurance policies are designed to indemnify the investor from the tax, fines, and penalties that might be potentially assessed by the Internal Revenue Service (IRS) or the department.

Insurance Background

The California Insurance Code allows insurers to offer insurance against any contingent or unknown event that may cause injury, loss, or damage. The general rule is that parties may contract to insure against risk as they please, so long as they do not violate any law or public policy that applies to insurance contracts. The California Insurance Code prohibits insurance coverage for a variety of risks and identifies some risks or actions that insuring would constitute being against public policy. For example, the California Insurance Code states that any policy that insures or indemnifies the payment of any fine, penalty, or restitution from any criminal action or proceeding is contrary to public policy and is void. This “public policy” acts as another deterrent for persons to avoid committing a criminal offense. Additionally, the California Insurance Code provides that insurance coverage for punitive damages are against public policy and, therefore, void. The purpose of punitive damages is to punish and deter sufficiently culpable conduct.

The US Senate Subcommittee on Investigations received copies of insurance policies that were offered to potential investors in abusive tax shelters. The tax shelter promoter used insurance policies to market tax shelters by making the shelter appear to be risk free from the investor's perspective. It appears that some of the insurance contracts contained a clause that specifically excluded coverage for transactions lacking economic substance.

Current Federal Tax Law

Insurance premiums paid or incurred to insure business property are generally deductible and insurance claims (reimbursements or proceeds received) are excluded from income if the insured loss is reduced by the insurance proceeds. If the insurance proceeds exceed the taxpayer's basis in the insured property (the maximum deductible loss), the insurance proceeds in excess of the property's basis are excluded from income only if the taxpayer spends all of the insurance proceeds on suitable replacement property. Insurance can be in the form of guarantees, stop loss agreements, or other similar arrangements.

Current State Tax Law

California tax law conforms to the federal deductibility of insurance premiums and the exclusion of insurance proceeds from gross income.

Existing state tax law imposes a penalty for underpayments related to transactions that lack economic substance and provides a definition for a listed transaction.

This Bill

Under the Insurance Code, this bill would make any insurance policy issued to cover risk associated with abusive tax avoidance transaction or a listed transaction against public policy and void. Any premiums received by the insurance company would be required to be returned to the policyholder. The bill defines an abusive tax avoidance transaction as one that lacks economic substance and a listed transaction by reference to the definition in the Revenue and Taxation Code (R&TC).

Under the R&TC, this bill would create a penalty equal to 75% of the proceeds received from insurance policies that insure a risk relating to an investment in an abusive tax avoidance transaction. An abusive tax avoidance transaction is defined as one that lacks economic substance and specifically includes an abusive tax shelter.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

AB 1601 (Frommer, Ch. 654, Sts. 2003) and SB 614 (Cedillo, Ch. 656, Sts. 2003) in 2003, enacted anti-abusive tax shelters provisions and provided a voluntary compliance period.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois, Massachusetts, Michigan*, and *New York* were surveyed because their tax laws are similar to California's income tax laws. A cursory review of the websites for these states did not reveal that these states prohibit insurance companies from indemnifying tax shelters. In addition, a cursory review of these states' tax laws indicate that all the states conform to the federal treatment of insurance, with no exceptions noted for tax shelter insurance.

OTHER AGENCY IMPACTED

The Department of Insurance may be affected by the provision that prohibits insurance companies from providing insurance coverage regarding tax shelters.

FISCAL IMPACT

Fiscal Impact

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on the data and assumptions below, order of magnitude revenue effects are estimated to be in the range of $25 to $100 million annually.

Revenue Discussion:

The revenue impact for this proposal will be determined by the:

- Number of abusive tax shelters identified by the department.
- Percentage of these shelters covered by insurance policies that protect the investor against audit adjustments related to these shelters.
- Impact on self compliance of investors if they are no longer able to insure the audit risks associated with these abusive shelters.

The interaction of all of these factors will determine the impact of this proposal.

ARGUMENTS/POLICY CONCERNS

Promoters of abusive tax shelters entice taxpayers with insurance contracts to indemnify and defend the taxpayer from audit adjustments. Permitting taxpayers to use insurance proceeds to pay tax assessments removes financial risks from purchasing abusive tax shelters and promotes their proliferation.

The department and the IRS have limited resources and will be unable to locate and audit every abusive tax shelter, thus, it is likely that taxpayers will continue to engage in abusive tax shelters packaged with insurance. Permitting abusive shelter activities to be insured undermines our self-compliance tax system.

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