

ANALYSIS OF AMENDED BILL

Author: Machado Analyst: Jeff Garnier Bill Number: SB 747
 Related Bills: See Legislative History Telephone: 845-5322 Amended Date: 4/21/05 & 5/25/05
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT:

Tax Representative Suspension & Penalty For Promoting Abusive Tax Shelters Or Aiding & Abetting Understatement Of Tax Liabilities

SUMMARY

This bill would provide substantial disincentives to promoting abusive tax shelters and aiding and abetting taxpayers in understating their income.

SUMMARY OF AMENDMENTS

The April 21, 2005, amendments removed all the existing provisions relating to the railroad car tax and replaced it with the provisions discussed in this analysis.

The May 25, 2005, amendments removed a legislative finding in the Business and Professions Code that stated it was in the public interest to sanction an attorney or a CPA for promoting an abusive tax shelter or aiding or abetting taxpayers in understating their income.

The May 25, 2005, amendments also removed the provision requiring the California State Bar to conduct a study to determine if attorneys employed by accounting firms are engaged in actions that violate the attorney's rules of ethics.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to stop persons from promoting and accommodating abusive tax shelters. Thus the bill would remove the infrastructure and support necessary to market and execute abusive tax shelters to otherwise law-abiding taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2006, and operative as of that date.

POSITION

Pending.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Will Bush

6/22/05

ANALYSIS

Background – The Tax Shelter Promoter

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. The report recommends increasing various promoter type penalties and that the IRS should work together with other organizations, such as the American Bar and American Bankers Associations, to re-instill integrity into the professions.

In October 2003, California enacted companion abusive tax shelter curtailment acts: SB 614 (Stats. 2003, Ch. 656) and AB 1601 (Stats. 2003, Ch 654). These acts provided substantial incentives through new and enhanced penalties and a voluntary compliance initiative (VCI) that ended April 15, 2004, for investors to file amended returns with respect to abusive tax shelters entered into in the past. The department received \$1.4 billion from the VCI from approximately 1,000 taxpayers.

These acts also provide incentives for not investing in abusive tax shelters in the future. The acts contain some enhanced penalties for abusive tax shelter organizers, promoters, and material advisors (hereafter "promoters"). The "Introduction" to the U.S. Senate Report states:

Some members of the U.S. tax profession are apparently claiming that the worst tax shelter abuses are already over, so there is no need for investigations, reforms, or stronger laws. The subcommittee investigation, however, indicates just the opposite: while a few tax shelter promoters have ended their activities, the tax shelter industry as a whole remains active, developing new products, marketing dubious tax shelters to numerous individuals and corporations, and continuing to wrongfully deny the U.S. Treasury billions of dollars in revenues, leaving average U.S. taxpayers to make up the difference¹.

Additionally, in the "Executive Summary" the report states:

Secondly, the investigation has found that numerous respected members of the American business community are now heavily involved in the development, marketing, and implementation of generic tax products whose objective is not to achieve a business or economic purpose, but to reduce or eliminate a client's U.S. tax liability. Dubious tax shelter sales are no longer the province of shady, fly-by-night companies with limited resources. They are now big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks².

¹ U.S. Senate Permanent Subcommittee On Investigations, Committee on Governmental Affairs - U.S. Tax Shelter Industry: The Role Of Accountants, Lawyers, and Financial Professionals, Senate print number "S. Prt. 108-34" (November 18, 2003), at page 3.

² Supra, The Role of Accountants, Lawyers, and Financial Professionals, at page 5.

And finally, under "Findings" the report states:

The sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, and some professional firms, such as accounting firms, banks, investment advisory firms, and law firms, are major participants in the mass marketing of generic "tax products" to multiple clients³.

During the past ten years, professional firms active in the tax shelter industry have expanded their role, moving from selling individualized tax shelters to specific clients, to developing generic tax products and mass marketing them to existing and potential clients. No longer content with responding to client inquiries, these firms are employing the same tactics employed by disreputable, tax shelter hucksters: churning out a continuing supply of new and abusive tax products, marketing them with hard sell techniques and telemarketer cold calls; and taking deliberate measures to hide their activities from the IRS⁴.

The federal American Jobs Creation Act (AJCA) (P.L. 108-357) was passed in 2004. The AJCA has numerous anti-tax shelter provisions. The AJCA anti-shelter provisions adopted several SB 614/AB 1601 anti-shelter provisions. The AJCA also adopted anti-shelter provisions not contained in SB 614/AB 1601. Both the federal and state anti-shelter legislation was primarily directed at the tax shelter investor (taxpayer), not the promoter or accommodator⁵. Both the federal and state legislation modified the penalty for promoting and failure to maintain a list and broadened the criteria for the courts to enjoin the selling of tax shelters. The federal legislation allows the U.S. Treasury to assess an unspecified monetary penalty for certain acts outlined in Circular 230 for persons practicing before the Internal Revenue Service. The state legislation increased the tax preparer penalty as discussed below.

Tax professionals can be assessed penalties by the IRS or the Franchise Tax Board (FTB) for specific conduct. The agencies regulating the tax professionals penalized by the IRS or FTB are not required to take action with respect to the tax professional's behavior because it is not specifically prohibited.

Current Federal/State Law

Federal law imposes a \$250 penalty on tax preparers for understating a taxpayer's tax liability. If the understatement is due to a willful or reckless act or intentional disregard of the rules or regulations, the penalty is increased to \$1,000. California conforms to this penalty with one modification: SB 614/AB1601 increased the penalty amounts to \$1,000 and \$5,000, respectively.

Additionally, current federal and state law imposes a penalty for promoting an abusive tax shelter. The penalty is either:

1. the lesser of \$1,000 or 100% of the income earned from the promotion of the tax shelter, or
2. 50% of the income earned from promoting the abusive tax shelter where the promoter issued a tax opinion regarding the legality of the tax shelter.

³ Supra, The Role of Accountants, Lawyers, and Financial Professionals, at page 20.

⁴ Supra, The Role of Accountants, Lawyers, and Financial Professionals, at page 22.

⁵ "Accommodator" means a person that helps facilitate the execution of the abusive tax shelter transactions for a profit, including for this purpose a bank, a trust fund, lessor or other entity seemingly unrelated to the investor.

Item 2 above was added by SB 614/AB1601 in 2003 for state purposes, and by the American Jobs Creation Act for federal purposes.

Federal and state law provides for a \$1,000 (\$10,000 in the case of corporations) penalty for aiding or abetting a taxpayer in understating its tax liability. The penalty can be assessed if the person knows, or has reason to know, that the information being provided to the taxpayer would result in an understatement of the tax liability of the taxpayer.

This bill would amend the Revenue and Taxation Code to:

- Prohibit persons who offer to sell abusive tax shelters to taxpayers from preparing the return for the taxpayer. Failure to comply with the law would result in a penalty equal to the greater of \$10,000 or 75% of the compensation received.
- Prohibit any person who performs a service related to financial information on a tax return, such as CPAs or attorneys, from receiving compensation from clients for tax work based upon the amount of taxes saved (a contingent fee). Failure to comply with the law would result in a penalty equal to the greater of \$10,000 or 75% of the compensation received.
- Prohibit any person assessed the penalty for promoting an abusive tax shelter or the penalty for aiding and abetting an understatement from preparing tax returns and practicing before the Franchise Tax Board and Board of Equalization regarding parts of the Revenue & Taxation Code administered by the Franchise Tax Board. The prohibition is for five years, and the penalty must be collectible before the prohibition takes effect.
- Modify the penalty for aiding and abetting. The threshold application of the penalty would be change to “known or should have known” from “known or reason to believe.” The penalty would be increased to \$25,000 from \$1,000 for non-corporate taxpayers affected and to \$100,000 from \$10,000 for corporate taxpayers affected by the information provided by the person on whom the penalty is assessed.
- Require the department to notify all appropriate state agencies and departments overseeing the person when the penalty for promoting an abusive tax shelter or the penalty for aiding and abetting of an understatement was assessed with respect to that person.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

SB 614 (Cedillo) (Stats. 2003, Ch. 656) and AB 1601 (Frommer) (Stats. 2003, Ch 654) enacted anti-tax shelter provisions primarily affecting tax shelter investors/taxpayers.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

A cursory review showed that *Illinois, Massachusetts, and Michigan* generally prohibit CPAs from preparing tax returns on a contingent fee basis. Information on contingent fees for *Florida, Minnesota, and New York* was not readily available.

Florida, Illinois, and Michigan do not have preparer or promoter penalties comparable to federal or California law. *Massachusetts* has a criminal penalty of up to \$500,000 and up to three years imprisonment for the willful aiding in the preparation of a fraudulent tax return. *New York* has a civil preparer penalty of \$1,000 for individual and \$10,000 for corporate returns for aiding in the preparation of a fraudulent return. *New York* also has a misdemeanor and a felony penalty for the preparer assisting or advising in the preparation of a fraudulent tax return.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on discussion below, the revenue gain from this bill is as follows:

Estimated Revenue Impact of SB 747 As Amended 4/21/05 Assumed Effective Date 1/1/2006 Assumed Enactment Date After 6/30/05 (Millions)		
2005/06	2006/07	2007/08
\$50	\$50	\$50

Revenue Discussion

These provisions are intended to deter third parties from promoting tax shelter activity. The revenue depends on the extent to which taxpayers are dissuaded by these provisions. Revenue gains from this proposal could be on the order of \$50 million annually.

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