

## **Franchise Tax Board Staff Report: 2005 Income Tax Gap Symposium**

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An Income Tax Gap Symposium was held by FTB in Los Angeles on May 19, 2005. Presenters and panel participants included noted experts in the field of tax compliance, university law and tax policy professors, and IRS and FTB staff. At the June 15, 2005 meeting of the Franchise Tax Board, FTB staff presented a summary of three Symposium suggestions. The Board asked for a report describing all suggestions at the next Board meeting. Following is the requested report.

FTB has moved forward to adopt several tax gap suggestions using resources received through the 2005/06 budget augmentation. For some suggestions, more time is needed to study the feasibility of taking action. Other suggestions are very broad in scope, and will require major policy and/or legislative changes, or possibly will require additional resource augmentations. To that end, all of these suggestions will be part of a larger strategic tax gap planning effort that has begun. Our schedule is to produce a plan for review by the Board members in early 2006.

### **Major Recommendations from the 2005 Symposium**

The 2005 Income Tax Gap Symposium can be distilled into five major strategies:

1. Use more data and improve data matching
2. Make complying easier and more rewarding; create disincentives for not complying
3. Aggressively pursue abusive preparers, agents and promoters
4. Understand and attack offshore and other complex financial transactions designed to conceal tax liabilities
5. Convey positive messages about tax compliance and its societal benefits

#### **1. Use More Data and Improve Data Matching**

##### Background

Data matching is a proven method to verify the accuracy of tax data provided by taxpayers. Among other uses, data matching helps identify nonfilers, income underreporters and others who erroneously claim deductions and tax credits. Data matching has been a mainstay of FTB's compliance programs for many years. For example, a key element of FTB's nonfilers program is the automated matching of more than 120 million data records against tax returns filed to produce a list of potential nonfilers. Using this data in FY 2004/05, FTB contacted about 750,000 taxpayers and received \$471 million in new revenue.

FTB developed its 2005-06 tax gap Budget Change Proposal (BCP) to include a request for funds to expand data matching, specifically by obtaining information from five new sources:

- Day care licensing information
- Motor fuel information to identify self employed truckers
- City business tax licensing information
- Alcohol Beverage Control licensing information
- Third-party check cashing information

Using data from these new sources is expected to identify 35,000 additional nonfilers and result in additional revenue estimated at \$7 million starting in FY 2006/07.

During 2004-05, FTB also determined that some 1099S income reporting commissions for real estate sales were not properly filed by real estate brokers. An education and outreach campaign is in process and is expected to increase voluntary compliance leading to \$10 million per year in additional revenue. About \$1 million per year in enforcement revenue also is projected from this effort.

### 2005 Symposium

Presenters at the Symposium suggested that FTB should pursue more 1099 information return reporting and undertake more enforcement action against those payers already required to report. Specific recommendations included the use of licensing data (already used by FTB for many occupational licensing business segments), hedge fund reporting, gambling payout reports, records of online auction transactions and check cashing information.

Presenters also suggested that holes and inconsistencies in current 1099 reporting requirements allow some taxpayers to avoid detection by government tax agencies, or make it easy for other taxpayers to mis-report income. One example was that reporting requirements do not apply to payments made to corporations. FTB was cautioned that closing these holes could be difficult without increasing burden on taxpayers and increasing nonconformity with federal requirements.

Presenters also recommended that FTB should consider using more “indirect income indicators” such as SEC news releases, corporate 10-K filings, bank and brokerage statements, and indicators of high levels of consumption, to identify taxpayers who maintain funds offshore. These “indirect” sources can be compared to “direct income indicators” such as W-2 wage reports, 1099 interest and dividend reports, etc. While citing these indirect indicators as useful sources for detecting noncompliance, presenters also noted that using them might raise privacy and government intrusiveness concerns. As mentioned above, these issues will be reviewed more closely as part of the strategic planning process.

## **2. Make complying easier and more rewarding; create disincentives for not complying**

### Background

Consistent with its longstanding direction to improve customer service to encourage more voluntary compliance, in 2004 FTB pursued initiatives to make filing less burdensome, particularly for individuals. Most notable is the expansion of the department’s successful electronic tax filing program to include the Board-approved ReadyReturn pilot project implemented in February 2005. Electronic filing continues to grow: more than 7.9 million taxpayers e-filed in 2005 -- 57% of the State’s personal income tax filing universe.

In addition to easier and expanded filing options in FY 2004-05, FTB continued to offer a variety of online and telephone-based customer service applications to simplify tax compliance at all stages of the tax filing and compliance cycle. This resulted in increased e-payments and more use of FTB’s website and FTB’s customer service center.

In 2004-05 FTB also developed proposals that were included in its tax gap BCP, but subsequently stricken during final budget action, to create a misdemeanor program to pursue non-felony criminal cases, and to authorize reward payments to informants who provide compliance tips.

### 2005 Symposium

Participants provided several challenging suggestions that diverge from current tax administration policies and operations including:

- Allow (and provide incentives/rewards for) individuals to enroll in a system in which all accounts and all transactions are directly reported to the government
- Provide a tax discount for taxpayers who report all expenditures and payments made to others (including all cash payments)
- Allow pre-transaction settlements that take into account not only the merits of a case, but the odds of detection
- Reward taxpayers who are audited when they provide useful data
- Become involved earlier with higher-income taxpayers and those filing more complex returns to assist the taxpayer

### **3. Pursue Abusive Preparers, Agents and Promoters**

#### Background

Tax practitioners prepare nearly two of every three California income tax returns filed by individuals. While most preparers file accurate returns, some file incorrect or fraudulent returns on behalf of their clients or for their own direct benefit. FTB's Fraud Unit identifies and develops problem preparer cases for FTB's Investigations Bureau to pursue through civil or criminal avenues. These actions helped to reduce the number of fraudulent returns filed by tax preparers.

#### 2005 Symposium

Presenters noted that some promoters sell opportunities to set up sham corporations in Nevada and other "tax haven" states to help incorporating companies avoid California taxes. The suggestion was made that FTB should aggressively shut down these promoters. Participants also noted that the perceived high cost of doing business in California drives some businesses to undertake such actions. Associated recommendations were that FTB should aggressively investigate preparers who offer clearly abusive schemes to clients, and should attend seminars of promoters of "no-pay" schemes and shelters to learn how to catch promoters' clients. The suggestion was made to conduct a publicity effort to point out the potential illegality of scams.

Based on information provided at the symposium regarding sham and abusive incorporation schemes, FTB soon will roll out an education and awareness campaign targeted at preparers who have asked FTB for help to dissuade clients from falling prey to unscrupulous promoters of improper tax avoidance schemes. FTB will communicate and educate through its website and via newsletters, press releases, presentations and speeches with interested groups such as Enrolled Agents and CPAs. In addition, staff will be identifying Nevada corporations with California owners; audits will be conducted to determine appropriate California activity; and when there is

evidence of criminal activity, the California Attorney Office will be asked to assist in prosecution activity.

#### **4. Understand and Attack Financial Transactions Designed to Conceal Tax Liabilities**

##### Background

Inappropriate activity to conceal income 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 loss to government.

In September 2003, California and 48 other states signed a Memorandum of Understanding (MOU) with the IRS to share information and coordinate enforcement efforts against abusive tax avoidance schemes. The MOU enhances the exchange of information about compliance programs, litigation, types of schemes, investor and promoter lists, staff training and publicity.

In March 2004, California and 44 other states ratified a Memorandum of Agreement (MOA) to share information about abusive tax schemes. This MOA streamlines and facilitates the exchange of information among states, promotes consistency, maximizes resources and prevents duplication of effort. The MOA allows states to share names of participants in abusive tax schemes, training materials, and other related information through a national centralized database. In early 2004 FTB also conducted a Voluntary Compliance Initiative (VCI) aimed at participants in abusive tax schemes. Participants reported \$1.4 billion in additional tax liabilities.

In August 2004, FTB jointly hosted an abusive tax shelter symposium with the Multistate Tax Commission and the Federation of Tax Administrators. The symposium enhanced partnering relationships among the 29 attending states and the IRS, accelerated awareness of the national problem, and solidified the commitment of the taxing agencies to boost their curtailment efforts.

##### 2005 Symposium

Most of the offshore-related comments and suggestions at the Symposium were provided by Jack Blum, a noted expert in the field. He pointed out that there are many among the very rich, including many Californians, who keep a significant amount of their wealth offshore but use their money here in the U.S. Blum suggested that states should do a better job of tracking purchases and other financial activities of these taxpayers. He encouraged FTB to develop a database for this purpose. Blum focused on several examples that show steps FTB could take to identify offshore abuses:

- FTB should identify homeowners with mortgages from an offshore bank. Frequently, according to Blum, taxpayers using an offshore bank to obtain a mortgage really are using their own money, disguised as a loan, to buy a home. He also suggested FTB could look more closely at those who own a home in the name of an offshore trust.
- FTB should track yachts stored in California but registered in offshore locations. Blum suggested that there is a likelihood many yachts registered offshore are owned by taxpayers who hide funds in offshore bank accounts.

- FTB should follow SEC news releases and corporate 10-K filings more closely. These sources routinely reveal the names of taxpayers who sell businesses or corporations. Sometimes, taxpayers fail to report all earnings from sales and divert money offshore.
- FTB should more closely track bank and brokerage statements sent to wealthy taxpayers to more easily identify taxpayers who are keeping funds offshore.
- FTB should identify a way to track individuals who use check-cashing agencies because these agencies can serve as conduits for diverting substantial amounts of money offshore.

#### Current Status of FTB Efforts -- Abusive Tax Shelters

FTB continues to capitalize on our joint efforts with other states and the IRS. The Multistate Tax Shelter database is fully functional with more states adding new information as their tax shelter programs progress. The FTB Abusive Tax Shelter Unit continues to analyze data sources to develop tax shelter leads. The Unit has sent 50 letters to potential audit candidates giving them an opportunity to self-comply before the audit began. About 40% of those contacted agreed to amend their returns. To date, 19 taxpayers filed 36 amended returns with payments of \$4.2 million in additional tax and interest, but all are disputing the penalty amounts.

#### Current Status of FTB Efforts -- Offshore Financial Arrangements

With funding made available in the 2005-06 budget, in July 2005 FTB organized a new Tax Gap Discovery Unit to centralize our efforts to analyze data sources and develop leads on the most egregious methods of underreported income. The use of offshore financial arrangements to conceal taxable income will be a priority as well as other financial arrangements that facilitate or advocate noncompliance with income tax laws or tax evasion. We will explore opportunities to build a task force through the collaboration of state and federal tax and non-tax agencies, law enforcement, interested industry groups, and practitioner communities.

As mentioned earlier, FTB staff consulted with Jack Blum for training, and already has obtained information regarding the tactics used to divert income offshore, how to identify when a taxpayer may be using offshore arrangements for concealment, and potential training needs to develop a program to address this problem. Staff is currently developing a plan to identify and prioritize lead information, train staff on the complexities of these financial arrangements, and develop methodologies to address the noncompliance in conjunction with our criminal investigations staff. Several new audit cases already have been opened and are currently in the development stage.

Recent legislation now requires third-party check cashing companies to report data to FTB. AB 139 was chaptered as part of the 2005-06 budget package and requires such reporting. This information should be helpful in identifying offshore activities.

## **5. Effectively Convey the Social Good Message**

### Background

FTB has not researched nor employed this specific strategy extensively in the past. However, several years ago, FTB gathered anecdotal and ad hoc information from taxpayers about their needs and reactions to FTB actions. Results suggested that taxpayers perceive filing and compliance burdens imposed by government as factors that influence compliance with tax laws.

### 2005 Symposium

Opinions were offered that current approaches by tax agencies have resulted in an “us versus them” attitude toward tax compliance in which compliant taxpayers are beginning to identify with non-compliant taxpayers. Both groups now see the tax collector as a common enemy. FTB was encouraged to proactively work to change this attitude by following certain communication principles. These principles include making sure that taxes are on people’s minds, especially at tax time, and underscoring the positive effects of paying taxes. It was also suggested that perhaps FTB could feature celebrities who champion paying taxes, and then focusing a high degree of publicity on noncelebrities who are caught not paying taxes.

### **Next Steps**

The tax gap has always existed. Purposeful noncompliance with income tax laws will continue to siphon billions of dollars from the State of California each year. As described in this report, FTB is moving forward on several fronts to increase efforts to help address the tax gap. Where possible, FTB has incorporated into its action plans the suggestions and input of experts and others who have participated in Tax Gap Symposiums.

While there has been good progress lately, tactical and narrowly focused tax gap initiatives likely will result only in relatively modest increases in compliance and revenue. To identify more strategic and potentially more far-reaching solutions to the tax gap problem, as mentioned above, FTB staff is in the early stages of undertaking a strategic planning initiative. An important part of this planning process will be to continue seeking input from external stakeholders. Our schedule is to produce a plan for review by Board members in early 2006.