

**FRANCHISE TAX BOARD
FY 2006/07**

Budget Change Proposal

BCP No. 1

Abusive Tax Shelters - Legal Workload

Date: July 25, 2005

A. Nature of Request

The Franchise Tax Board requests an augmentation of \$1,427,000 and 10.4 PYs (11 positions) in FY 2006/07 and \$634,000 and 4.8 PYs (5 positions) in FY 2007/08 to provide our Legal Department with the necessary resources to address abusive tax shelter related workloads.

B. Background/History

On October 2, 2003, SB 614 and AB 1601 were chaptered providing FTB with enhanced enforcement tools to curtail the use of abusive tax shelters. Included in the provisions of these bills, Section 19790 (a) was added to the Revenue and Taxation Code mandating that the FTB establish a specialized tax shelter task force to coordinate all matters related to combating abusive tax shelters. The legislation also greatly increases penalties for participation in abusive tax shelters, increases the period to conduct audits, and adds registration requirements for abusive tax shelters. In addition, a Voluntary Compliance Initiative (VCI) was mandated to provide a one-time chance for taxpayers who used abusive tax shelters to amend their state tax returns voluntarily before the State pursued the harsher penalties authorized by this same legislation. This legislation was the beginning of FTB's efforts to address the economically stifling problem of abusive tax shelters.

Duties of the tax shelter task force were legislated to include, but are not limited to, collecting and analyzing information about abusive tax shelters and transactions, ensuring compliance with tax shelter registration requirements, auditing tax shelters and transactions, providing litigation support, and coordinating efforts and sharing information with tax authorities of the federal government, other states, and foreign countries.

The Legal Department of the FTB was authorized seven permanent attorney positions to carry out its support and involvement in the task force. This involvement is ongoing and includes:

- Assisting the department in determining and drafting procedures for the imposition of tax shelter penalties;
- Developing legal positions to be taken on tax shelter schemes;
- Drafting information document requests and subpoenas;
- Evaluating documents obtained from disclosure and registration information;
- Audits of investors and confidential informants;

- Determining referrals of cases to special investigations;
- Developing privilege logs and training audit staff on attorney-client privilege;
- Working with other states in drafting legislation;
- Developing a repository of information to track tax shelter issues and promoters;
- Making presentations and educating the public;
- Working with other governmental agencies to identify tax shelter transactions.

Abusive Tax Shelter Audits

The Voluntary Compliance Initiative (VCI), held from January 1, 2004 through April 15, 2004, offered penalty relief to taxpayers who participated in an abusive tax shelter if such taxpayers voluntarily amended their tax returns by April 15, 2004. This initiative resulted in 1,200 taxpayers filing amended returns. Approximately sixty percent of these taxpayers (720) elected to reserve their right to file an administrative appeal to contest the additional liability. The total amount involved in these administrative appeals is approximately \$1.1 billion.

FTB has stepped up its audit activities, as mandated, on taxpayers participating in abusive tax shelters and is working with the IRS to identify taxpayers, performing audits, and uncovering abusive tax shelter schemes. It is anticipated that 171 taxpayer audits will be completed during FY 2005/06 (independent of IRS). A high percentage of these taxpayers are expected to protest, as these are taxpayers who chose to avoid disclosure of tax shelter transactions in the VCI filing period, which would have provided for the exclusion of large penalty assessments.

FTB audits of these taxpayers are proving to be contentious at best, with minimal cooperation with FTB's requests for information. Tax shelters are now big business with vast resources of the country's largest accounting firms, law firms, investment advisory firms, and banks to draw upon.

FTB is also currently identifying promoters who may be subject to the new promoter penalties. To impose the penalty, the amount of income a promoter derived from the sale of a tax shelter transaction must be determined. In addition, it must be found that the promoter knew, or should have known, that material items on a client's tax return were false or fraudulent. The IRS is conducting promoter audits as well, however even if the IRS shares promoter information with FTB, the IRS information can only be used to establish that the promoter "knew or had reason to know." An audit of revenues derived for California purposes is still required.

Requests for Penalty Relief

California considered different components to spur the highest probability of VCI participation. In cooperative effort 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 cooperative enforcement efforts nationally.

Current law authorizes the FTB's Chief Counsel to rescind tax penalties if doing so promotes equity, compliance and effective tax administration. Taxpayers will request relief from penalties because they did not understand non-economic substance transactions (these transactions are frequently associated with tax shelter schemes.) In order to conform to the relief standard, taxpayers will generally argue they relied on opinions of legal, accounting or investment professionals. We anticipate a large workload of penalty relief requests from taxpayers who are assessed the abusive tax shelter penalties.

C. State Level Considerations

FTB Notice 99-01 communicated to the taxpayer community that FTB would evaluate the merits of a taxpayer's protest of an audit, conduct requested hearings, and issue a notice of action of FTB's protest findings within 33 months of the protest filing date. The FTB Legal Department's ability to meet this timeframe with protests of abusive tax shelter audits will not be possible without additional resources to address the extensive work that will be required.

The workloads discussed represent a significant amount of California's general fund revenue. FTB's ability to resolve the amounts disputed in these programs impact both previously collected revenues and future revenues estimated to be in excess of \$1.65 billion over the next four to five years. However, addressing these workloads with the adequate resources to successfully defend the State's position will also prove significant in preventing future abusive tax shelter schemes, thus protecting billions in future tax revenues.

D. Justification

FTB's Strategic Goal number 2 is to Promote Fair and Effective Tax Administration. One strategy used to achieve this goal is to provide targeted taxpayer education and outreach to increase self-compliance across all economic sectors. FTB's efforts in VCI and abusive tax shelters is designed to not only determine and collect the appropriate amount of tax, but to encourage and increase future compliance by the taxpayer community.

Abusive Tax Shelter Audits

FTB has identified approximately 33 tax shelter schemes. The Audit Division is planning to complete an estimated 171 tax shelter audits (independent of IRS) over the current year which Legal will begin receiving as docketed protests. The Legal Department anticipates a much higher percentage of protests filed (90%) on completed audits, since these taxpayers avoided filing during the VCI and have taken a much stronger position. FTB's historical experience is that taxpayers do not voluntarily change their positions unless they can dispute the result. This docketed protest rate results in 154 additional cases (171 X 90%) referred to Legal from audits completed in the current year for which the majority of docketed protests will be received in F/Y 2006/07. The closing of abusive tax shelter audits with resulting protests is expected to continue for several years due to the aforementioned abusive tax shelter legislation that

also extends the statute of limitations on abusive tax shelter audits to eight years from the normal four years.

A number of the docketed protests will also generate subsequent appeals and litigations. As continuing protests, subsequent appeals, and litigations begin to build in out years, FTB's strategy is to re-direct the seven attorneys currently working on the Abusive Tax Shelter Task Force to address these ongoing caseloads.

Legal is anticipating the first cycle of docketed protests from the current year completed tax shelter audits will require 20,465 hours annually over the life of these protests, beginning with FY 2006/07. This workload is not presently funded. Of the anticipated 154 new docketed cases to be received in FY 2006/07, FTB projects at least 15 will be considered principle tax shelter schemes. For each of these principle cases, we estimate 1,000 hours for multistate cases and 900 hours for personal income tax cases will be needed to bring the protest to conclusion. Ensuing volumes for subsequent years' protests will depend partially on federal actions but are expected to maintain the requested resource need.

It is apparent, as audit assessments are protested and become Legal workloads, attorney staff will spend considerably more time issuing subpoenas and/or information document requests, and expending additional time reviewing and dissecting these materials to formulate the appropriate legal position. The Legal Department's strategy to efficiently manage and effectively address tax shelter docketed protests is to focus initial efforts on complex high-profile cases. The results of these primary cases will be applied to sets of smaller, or similar cases in order to establish a legal precedence to which the remaining cases can be more easily resolved. These cases are estimated to require an average of 400 hours to complete.

Attachment 1 provides more detail on this projected unfunded workload.

Legal is requesting 12 additional Tax Counsel III positions to handle the abusive tax shelter disputes. However, the FTB acknowledges the high level of difficulty the State has with recruiting quality attorneys. Compounding the recruitment needs, the very complex aspects of abusive tax shelter cases requires even higher qualities and skills. In addition, the Legal Department stands to be impacted in the current year by several senior attorney retirements, which will diminish the strength of our attorney skill base, thereby placing an even higher demand for successful recruiting in the near future. To address these recruitment issues, we are recommending a phased augmentation, which would add 7 new attorney positions to start work in FY 2006/07 and a second augmentation of 5 additional attorneys to start work in FY 2007/08.

We also request one Senior Legal Analyst position (0.9 PY) and one Senior Legal Typist (0.9 PY). Without the essential support staff to assist with the abusive tax shelter program within the Legal Department, attorneys in these complex and voluminous workloads will be spending time on non-complex and clerical tasks that would otherwise be spent directly on the attorney level work. Current support staffing levels cannot absorb these workloads. Specific duties for each classification include:

- The Senior Legal Analyst will conduct advanced legal research, assist with hearings and meetings, prepare briefs and correspondence, maintain organization of cases, work with database administrators on legal case records, and maintain a database to track the inventory and revenue associated with tax shelter cases.
- The Senior Legal Typist will be responsible for drafting format memorandums, proofing and distributing attorney correspondence, maintaining attorney calendars for timely casework, and directing the physical flow of abusive tax shelter case materials.

Request for Chief Counsel to Relieve Penalties

Legal is anticipating 3,850 hours annually of workload from penalty relief requests. This estimate is based on 100% of taxpayers assessed the abusive tax shelter penalties will request relief from the penalties. The Legal Workload attachment provides more detail on this projected workload.

Taxpayers will most likely request penalty relief from the substantial abusive tax shelter penalties, arguing that they relied on opinions of legal, accounting or investment professionals. Legal is not funded for this workload and is requesting one Tax Counsel III and one Senior Legal Analyst position to process these requests. The Tax Counsel III will be assigned primary responsibility to handle the complex tax shelter penalty relief requests. The Senior Legal Analyst will provide paralegal assistance in these matters and will also be assigned to develop the recommendation to the Chief Counsel in instances where the disputed issue has been determined to be a non-tax shelter issue.

Case Management Support

FTB's Legal Department currently has a contract agreement with the Office of the Attorney General for access to their Litigator's Notebook case management system through an external vendor. This case management system scans, codes, and indexes litigation case files providing Legal staff instant access to litigation documents. This service has been extremely beneficial in regards to expeditious legal research and reference. It is anticipated to be equally critical by providing organization and access to documents in anticipated tax shelter litigation cases. Legal is requesting a permanent augmentation of \$200,000 in order to extend these services to tax shelter case management matters.

E. Analysis of all Feasible Alternatives

Alternative # 1 - Authorize the augmentation of \$1,427,000 and 10.4 PYs (11 positions) in FY 2006/07 to provide our Legal Department with the first phase of the necessary resources to address the abusive tax shelter related workloads.

The abusive tax shelter issues facing the State are serious and additional resources would be an appropriate investment, both short term and long term, in tax compliance and enforcement to protect billions of dollars in tax revenue. These resources would allow the Franchise Tax Board to carry out the intentions and mandates of the abusive tax shelter legislation enacted in October 2003.

Alternative # 2 - Redirect existing staff to these new workloads.

The complexity of docketed protests is greater in tax shelter cases. Redirection of resources to this complex workload would disrupt current revenue benefits produced from Legal caseloads, typically a 49% revenue sustainment rate. Without the requested resources, FTB will be faced with a backlog of tax administrative cases resulting in the inability to fully develop legal positions in docketed protest, claims, appeals and litigation.

From a policy perspective, FTB responsiveness and effective representation in these protest, claim, settlement, appeal and litigation cases serves the additional purpose to promote taxpayer compliance. The inability to represent and defend these programs could discourage taxpayer compliance and result in delays collecting disputed tax revenue or default judgments in favor of taxpayers, each having an adverse impact to the General Fund.

F. Time Table

Allocate staff as requested on July 1, 2006.

G. Recommendation

Alternative 1 provides FTB's Legal Department with the necessary resources to proceed with the effective representation in these protest, appeal, and litigation matters.

**STATE OF CALIFORNIA
BUDGET CHANGE PROPOSAL - COVER SHEET
FOR FISCAL YEAR 2006/07
DF-46 (REV 03/03)**

**Department of Finance
915 L Street
Sacramento, CA 95814
IMS Mail Code: A-15**

BCP # 1	PRIORITY NO	ORG CODE 1730-001-0001	DEPARTMENT Franchise Tax Board
PROGRAM 10 Tax Programs	ELEMENT 00 All Tax Programs	COMPONENT	

TITLE OF PROPOSED CHANGE:

Abusive Tax Shelters - Legal Workload

SUMMARY OF PROPOSED CHANGE:

The Franchise Tax Board requests an augmentation of \$1,427,000 and 10.4 PYs (11 positions) in FY 2006/07 and \$634,000 and 4.8 PYs (5 positions) in FY 2007/08 to provide our Legal Department with the necessary resources to address the abusive tax shelter related workloads.

REQUIRES LEGISLATION <input type="checkbox"/> YES <input checked="" type="checkbox"/> NO	CODE SECTION(S) TO BE AMENDED/ADDED	BUDGET IMPACT-PROVIDE LIST AND MARK IF APPLICABLE <input checked="" type="checkbox"/> ONE-TIME COST <input checked="" type="checkbox"/> FULL-YEAR COSTS <input type="checkbox"/> FACILITIES/CAPITAL COSTS <input type="checkbox"/> FUTURE SAVINGS <input checked="" type="checkbox"/> REVENUE
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PREPARED BY:	DATE	REVIEWED BY:	DATE
Pending Board Approval			
PROGRAM APPROVAL:			
DEPARTMENT DIRECTOR:			DATE

IF PROPOSAL AFFECTS ANOTHER DEPARTMENT, DOES OTHER DEPARTMENT CONCUR WITH PROPOSAL? N/A

YES NO

ATTACH COMMENTS OF AFFECTED DEPARTMENT SIGNED AND DATED BY THE DEPARTMENT DIRECTOR OR DESIGNEE.

FOR INFORMATION TECHNOLOGY REQUESTS, SPECIFY THE DATE SPECIAL PROJECT REPORT (SPR) OR FEASIBILITY STUDY REPORT (FSR) WAS APPROVED BY THE DEPARTMENT OF FINANCE.

DATE PROJECT # FSR OR SPR

**DOF ANALYST USE
(ADDITIONAL REVIEW)**

CAPITAL OUTLAY	<input type="checkbox"/>	TIRU	<input type="checkbox"/>	FSCU	<input type="checkbox"/>	OSAE	<input type="checkbox"/>	CALSTARS	<input type="checkbox"/>
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BCP # 1 DATE 07/25/2005 Title of Proposed Change:
PROGRAM Abusive Tax Shelters - Legal Workload
ELEMENT
Tax Programs All Tax Programs COMPONENT

	Personnel Years			Current Year	Budget Year	Budget Yr +1
	CY	BY	BY + 1			
Total Salaries & Wages a/	.0	11.0	16.0	\$ 0	\$ 888,000	\$ 1,351,000
Salary Savings	.0	-.6	-.8	\$ 0	-\$ 44,000	-\$ 67,000
Net Total Salaries and Wages	.0	10.4	15.2	\$ 0	\$ 844,000	\$ 1,284,000
Staff Benefits b/				\$ 0	\$ 294,000	\$ 443,000
Total Personal Services				\$ 0	\$ 1,138,000	\$ 1,727,000

	Current Year	Budget Year	Budget Yr +1
Operating Expenses and Equipment	\$ 0	\$ 45,000	\$ 24,000
General Expenses /1	0	1,000	2,000
Printing /2	0	10,000	13,000
Communications /3	0	0	0
Postage	0	16,000	26,000
Travel In-State /4	0	0	0
Travel Out-of-State	0	0	0
Training	0	0	0
Facilities Operations /5	0	4,000	6,000
Utilities	0	0	0
Cons & Prof Svs - Interdept/1	0	0	0
Cons & Prof Svs - External /6	0	207,000	210,000
Consolidated Data Center	0	0	0
California Health and Human Services Agency Data Center	()	()	()
Stephen P. Teale Data Center	()	()	()
Data Processing /7	0	6,000	3,000
Equipment	0	0	0
Other Items of Exp (Specify Below)	0	0	0
Total Operating Expense & Equipment	\$ 0	\$ 289,000	\$ 294,000

a/ Required detail on Page II-3 by classification as in Salaries and Wages Supplement.

b/ Detail provided on following pages.

- /1 General Expense for Branch @ \$225, and for Depart1 \$433 per position. Plus minor equipment @ \$1784 per position. PCs @ \$1350 per position. Dues and memberships for 8 pos @ \$445.
- /2 Departmental \$103 per position.
- /3 Departmental \$762 per position. Display phones for 8 positions @ \$200.
- /4 In State Travel, 8 positions @ \$2,000 per year - frequent trips to So. Cal
- /5 Departmental \$330 per position.
- /6 \$200,000 for contract agreement with vendor for legal research and organization. Research services at \$600 per position.
- /7 Software for PCs @ \$500 per PC.

	Current Year	Budget Year	Budget Yr +1
TOTAL OPERATING EXPENSES AND EQUIPMENT	\$ 0	\$ 289,000	\$ 294,000

	Current Year	Budget Year	Budget Yr +1
SPECIAL ITEMS OF EXPENSE d/	\$ 0	\$ 0	\$ 0

	Current Year	Budget Year	Budget Yr +1
PROGRAM ADMINISTRATION	\$ 0	\$ 0	\$ 0
Distributed Admin	\$ 0	\$ 0	\$ 0

	Current Year	Budget Year	Budget Yr +1
TOTAL STATE OPERATIONS EXPENDITURES	\$ 0	\$ 1,427,000	\$ 2,011,000

Source of Funds	Appropriation No.			Current Year	Budget Year	Budget Yr +1
	Org	Ref	Fund			
General Funds	###	##	0001	\$ 0	\$ 1,427,000	\$ 2,011,000
	---	---	---	0	0	0
	---	---	---	0	0	0
	---	---	---	0	0	0
	---	---	---	0	0	0
	---	---	---	0	0	0
Reimbursements	###	##	0996	0	0	0
Totals				\$ 0	\$ 1,427,000	\$ 2,011,000

Source of Funds	Appropriation No.			Current Year	Budget Year	Budget Yr +1
	Org	Ref	Fund			
General Fund	###	##	0001	\$ 0	\$ 0	\$ 0
	---	---	---	0	0	0
	---	---	---	0	0	0
	---	---	---	0	0	0
	---	---	---	0	0	0
Reimbursements	---	---	---	0	0	0
Totals				\$ 0	\$ 0	\$ 0

d/ Special items of expense must be titled. Please refer to the Uniform Codes Manual for a list of the standardized Special items of expense objects which may be used.

DETAIL OF STAFF BENEFITS AND PERSONAL SERVICES

Positions	CY	Positions			CY	Amount	
		BY	BY + 1	Salary Range		BY	BY + 1
Legal Division							
Tax Counsel III Spec	PERM	0.0	8.0	\$ 6,902 \$ 8,517	\$ 0	\$ 740,000	
Sr Legal Analyst	PERM	0.0	2.0	\$ 4,316 \$ 5,247	\$ 0	\$ 115,000	
Office Tech Typ	PERM	0.0	1.0	\$ 2,510 3,050	\$ 0	\$ 33,000	
Total Legal Division		.0	11.0		\$ 0	\$ 888,000	\$ 0
Adjust for Part Year Positions		.0	0				
Net Positions/ P/Ys before salary savings		.0	11.0				
Total Salaries and Wages					\$ 0	\$ 888,000	\$ 0
Part Yr Adj		.0	0				
P.Y.s		.0	11.0				

Schedule of Staff Benefits Costs FOR FISCAL YEAR 2006/07

	2005/06	2006/07	2007/08
Staff Benefits			
OASDI /1	\$ 0	\$ 52,000	\$ 0
Dental /2	0	6,000	0
Health /3	0	68,000	0
Retirement /4	0	144,000	0
Vision /5	0	1,000	0
Medicare /6	0	12,000	0
Worker's Comp /7	0	9,000	0
Industrial Disability /8	0	1,000	0
Non Industrial Disability /9	0	1,000	0
Unemployment Insurance /10	0	0	0
Total Staff Benefits	\$ 0	\$ 294,000	\$ 0

- 1/ For permanent and overtime, 6.2% of net salary.
- 2/ For permanent, \$543 per net personnel year.
- 3/ For permanent, \$6,558 per net personnel year.
- 4/ For permanent, 17.022% of net salary.
- 5/ For permanent, \$85 per net personnel year.
- 6/ 1.45% of net salary for permanent.
- 7/ 1.1% of net salary for permanent.
- 8/ 0.1% of net salary for permanent.
- 9/ 0.17% of net salary for permanent.
- 10/ 22.57% of net salary for temporary help.