

## **Addressing the Tax Gap—Update on Several Initiatives**

### **PURSuing PROMOTERS OF ABUSIVE TAX SHELTERS**

The legislation that created the Voluntary Compliance Initiative (VCI) in 2004 also included registration requirements for promoters and enhanced penalties for promotion of abusive tax avoidance strategies. In response, the department began to identify possible promoters of such strategies and initiated the Promoter Audit Team. We have identified numerous cases to pursue for a promoter penalty audit and continue to identify the best methods to proceed. In addition, the department is evaluating strategies for taking other actions against abusive tax shelter promoters.

### **PURSuing UNSCRUPULOUS PREPARERS**

The department has established a Tax Gap-Tax Practitioner Team to pursue unscrupulous tax preparers. Using modeling techniques, auditors have begun looking at questionable tax return trends and patterns by tax preparers showing an overstatement of deductions or improper claiming of credits. The team has identified a number of potential cases for examination.

Publicity and education initiatives are also being undertaken to encourage voluntary compliance by tax preparers, including providing information through FTB on-line *Tax News* and professional newsletters such as the newsletter published by the California Tax Education Council (CTEC).

FTB's Fraudulent Preparer Program has identified preparers who included fraudulent claims for the Child and Dependent Care Expenses Credit on their clients' returns—sometimes without the knowledge of the clients themselves. During 2004-05, this program stopped almost \$8 million in fraud.

### **OUT-OF-STATE SHAM CORPORATIONS**

FTB staff is devoting the necessary resources to continue to gather and analyze data to better scope the severity of the out-of-state sham corporation issue and develop a detailed action plan. The IRS and a few other state agencies are also interested in joining efforts on this project. The IRS is interested in the use of the sham corporations by independent contractors to avoid self-employment taxes.

### **TAX GAP-OFFSHORE PROGRAM**

The goal of the tax gap efforts focused on offshore activities is to create a comprehensive program to address the California income taxes lost to offshore tax havens. California is an integral player in creating the tools and techniques state governments can use to address the use of offshore financial arrangements and offshore entities to underreport or simply evade income taxes.

Taxpayers have used cross-border techniques for years, knowing that strapped government resources often lacked cooperation or authority to enforce their laws in other jurisdictions. The “offshore scheme” can often be as simple as creating ownership hierarchies across the borders of a taxpayer’s state of business operations, which can hamper any pursuit or questioning. The ownerships established overseas can serve several purposes, but often they are designed to muddy-up the paper trail so as to frustrate auditors trying to trace the flow of funds. If the offshore entities actually exist, then the scheme is simply to use the offshore company to report profits, while the onshore company deducts all the expenses.

Historically, compliance has used tax return information to detect potential noncompliance. To detect those taxpayers contributing to the largest sector of the tax gap, that being underreported income, FTB’s offshore program must broaden our ability to detect off-return diversions of income. Our strategies include evaluating non-tax return data sources for potential income tax leads, developing staff knowledge on offshore techniques, and coordinating joint efforts and cooperative exchanges with other government agencies.

We’ve created a list of many different data sources to evaluate and expect this list to grow as we learn about more sources of information. A number of these sources show good potential.

The objective of our enforcement efforts is to evaluate non-traditional approaches to enforce compliance and encourage self-compliance. Our strategies include using test cases, evaluating applicability of penalties, and addressing the enablers/facilitators.

The objective of our remediation efforts is to compliment the department’s overall tax gap efforts with a focus on the most egregious types of income tax diversions. Our strategies include a publicity plan and legislative considerations, as well as partnering with practitioners.

#### **DEVELOPING A BETTER UNDERSTANDING OF THE TAX GAP**

A key component of addressing the Tax Gap is understanding its causes and learning how best to use existing and new data to address it. In order to accomplish this, the department is working on its own and with outside experts to undertake research projects and learn about new ideas for addressing the tax gap. This occurred, for example, when Jack Blum came to FTB and shared his expertise relative to offshore trusts. We will continue to call on such outside experts and will also explore the feasibility of collaborating with academic institutions to undertake a research studies using our existing and new data.