

**STATEMENT OF THE CALIFORNIA FRANCHISE TAX BOARD BEFORE THE U.S.  
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE  
COMMITTEE ON GOVERNMENTAL AFFAIRS  
NOVEMBER 18, 2003**

Mr. Chairman and members of the Subcommittee,

I am Debra Petersen and I am testifying on behalf of Controller Steve Westly and the California Franchise Tax Board (FTB). On their behalf, I would like to thank you for this opportunity to give testimony on some of the most egregious tax scams we have ever seen.

In recent years, the FTB has seen a gross proliferation of abusive tax schemes and tax shelters that have been aggressively marketed to taxpayers. These transactions and schemes run afoul of the basic intent of the tax laws. We have been appalled at the positions taken to justify these transactions and schemes. These are designed and sold as tax savings strategies and are veiled with a limited technical reading of the tax law and a flimsy excuse for a valid business purpose. The transactions are designed to create artificial losses and to make use of losses and deductions a second time.

Tax Shelters in General

Generally, an abusive tax scheme is a transaction that is promoted with the promise of tax benefits, has predictable tax losses or tax consequences and/or has no true or correlating economic loss experienced with respect to the taxpayer's income or assets. Typically, an abusive tax scheme follows the literal reading of the tax statute, but applies the meaning in a manner that is inconsistent with the purpose or intent of the tax statute.

Some of the characteristics of abusive tax schemes are:

- the separation of income and expenses (one taxpayer reports the income and a different taxpayer reports the expenses related to the same transaction);
- the use of pass-through entities that have no other purposes than to accommodate the desired tax results (they may not conduct an operating business);
- the use of third-party accommodators;
- the use of offshore foreign account or accommodator;
- a double benefit for the same tax loss or deduction; and/or
- conducted over a short period of time (transitory in nature).

These schemes lack economic substance meaning that there are no economic advantages other than tax savings, that the tax benefits outweigh the economic risks and profit potential or that there is no business purpose separate from the tax

consequences. Usually there is no justifiable business purpose for the transaction other than to reduce taxes and the transaction lacks the potential to generate a profit.

We have seen the major accounting firms and other professional firms actively engage in the sale and promotion of these tax shelters and schemes in return for hefty fees. These shelters are marketed and purchased by reputable firms, not by fly-by-night or underground companies, which makes it all the more shocking that these tax avoidance transactions exist. These types of transactions are not isolated, but pervasive and are used by large and small taxpayers alike. A tax advisor told a taxpayer that "everyone is doing this," pressuring the taxpayer to think that one would be foolish not to engage in tax shelter transactions.

The professional firm that promotes the abusive tax shelter will issue tax opinions. Often, these tax opinions are not properly prepared and lull the taxpayer/investor into a false sense of security. These opinions are written to only address potential problem areas based upon specifically cited published tax law but they fail to address the overall ramifications of the transactions. The opinions generally fail to discuss all the risks of the transaction including application of tax doctrines such as step transaction, lack of economic substance and assignment of income. The opinions often assume facts that are critical to making a proper assessment of the risks of the transactions and often are not complete in addressing all relevant tax code provisions.

Frequently, the fees obtained by the promoters are directly related to the amount of tax benefits to be delivered and are enormous. The fees do not represent the actual costs to put together the deal and are very often contingent in nature.

For the most part, these transactions and schemes are not disclosed on the tax returns and very often the tax preparers and promoters, who may be one and the same, will go to great lengths to hide the transactions from taxing authorities. They will set up elaborate multi-tiered entity structures using pass-through entities or tax-exempt entities to hide the transactions. It is very resource intensive to identify the entire transaction as one part will appear on one taxpayer's return and the rest on other returns, including exempt organization returns which may not be examined by tax agencies.

We are aware that professional firms sold abusive tax products from 1999 through 2001. We have not examined tax returns for the 2002 taxable year yet and do not have a feel for the extent to which such activity is continuing or has taken place after 2001. We did find some abusive tax transactions before 1999, but in some cases we were not aware of the entire transaction so that we were unable to identify them as abusive tax shelters.

When we conduct our audits, we usually deal with a representative who typically is also the tax shelter promoter. In some cases, however, we did speak directly to taxpayers who invested in abusive tax shelters. These individuals typically had substantial gains from a one-time event or large, constant streams of income amounts. When speaking with their tax advisor about their gain or income for the year, their tax

advisor made them aware of the availability of certain tax shelters; they did not seek out the tax shelter investment on their own.

The transactions we have seen are so complicated and convoluted, that an investor would not have put together such a transaction on their own. The investors rely upon and are at the mercy of their "trusted business advisor" who clearly can no longer be trusted with giving valid tax advice. Our auditors and legal staff have difficulties understanding the transaction because of the insertion of steps that have no business purpose except to complicate the nature of the transaction. Often, we are not aware of all the facts and cannot always reach the right conclusion the first time we see the transaction or a piece of the transaction.

We have observed the direct marketing of shelters to clients of the promoter, to smaller tax preparation firms and to the public through direct mailing. We estimate that roughly eighty percent of the tax shelter cases are marketed by firms to their own client, about ten to fifteen percent are the result of literature mailed to potential investors and five to ten percent based upon referrals.

These tax shelters and tax avoidance schemes are a horrific threat to the tax compliance system and to state revenues. State tax revenues in California have declined over the past few years and we think that a good portion of that decline is attributable to tax shelter activities.

### Specific Shelter Transactions

We have identified several hundred cases involving California taxpayers for the 1999 through 2001 tax years that may involve tax shelters. These cases include tax shelter transactions involving contingent liabilities,<sup>1</sup> loan premiums, basis shifting, short sales, loss shifting, notional principal contracts, loan assumptions, abusive use of registered investment companies and real estate investment trusts, and digital or binary options. Some of these were marketed by professional firms under names such as FLIP, OPIS, BLIPS, COBRA, BOSS, Son of BOSS, TRACT, SC<sup>2</sup>, PICO, CARDS and COINS. In our opinion, none of these transactions comply with federal and state income tax laws.<sup>2</sup>

The transactions used in FLIP (Foreign Leveraged Investment Program) and OPIS (Offshore Portfolio Investment Strategy) are extremely complex and involve the use of offshore accounts, warrants, options and stock redemption to accomplish a shifting of basis and creation of artificial losses. The transactions require the cooperation of offshore accommodators such as Union Bank of Switzerland. Generally, the transactions make use of Internal Revenue Code section 318 attribution rules and

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<sup>1</sup> In response to the abuses involving contingent liabilities, Congress enacted, on December 21, 2002, Internal Revenue Code section 358(h) which applies retroactively to October 18, 1999 and the Internal Revenue Service issued, on June 23, 2003, temporary and proposed regulations which are also retroactive to October 18, 1999.

<sup>2</sup> The Internal Revenue Service has listed many of these as potentially abusive tax shelters. The Franchise Tax Board will likewise be listing these transactions.

Treasury Regulations section 1.302-2(c) basis adjustments to increase the basis of stock and subsequent loss on the sale of that stock. The Internal Revenue Service issued Notice 2001-45, 2001-C.B. 129 to alert taxpayers and their representatives that the purported tax benefits from these transactions are not properly allowable for federal income tax purposes. It also alerted taxpayers, their representatives and promoters of these transactions that they may be subject to penalties and reporting requirements. The notice concludes that "the Service intends to disallow losses claimed (or to increase taxable income or gains) in the transaction described in this Notice to the extent a taxpayer derives a tax benefit that is attributable to stock basis purportedly shifted from the redeemed shares." The reasons for the disallowance, depending upon the specific facts of a given case, may include that the redemption does not result in a dividend and therefore there is no basis shift, the basis shift is not a proper adjustment as contemplated by Treasury Regulations section 1.302-2(c), and there is no attribution of stock ownership or basis shift because the steps taken to achieve those results are transitory and serve no purpose other than tax avoidance. The Franchise Tax Board agrees with and will follow the Internal Revenue's position on these transactions.

I have examined materials collected by the Permanent Subcommittee on Investigations pertaining to the promotion of BLIPS and SC<sup>2</sup>. With respect to BLIPS, the transaction lacks economic substance. It is designed to create a non-economic paper loss through the use of basis inflation. When we look through the surface of the transaction to the true substance, there is no economic tax loss. The loss to be generated is determined up front and the transaction is structured to produce the desired amount of tax loss. Use of foreign currency transactions is a clever attempt to make the transaction appear to have some element of risk, but in reality, the foreign currency actually selected is not subject to large market fluctuations in the short term. The cases we have seen during our audits are completed in a short period of time, within sixty to ninety days, thus minimizing the potential for market fluctuations. There is no valid business purpose for the formation of the pass-through entity. The sole purpose of this entity is to create tax basis that will give rise to an alleged tax loss. This transaction requires the orchestration of each step by a sophisticated tax advisor and a cooperative investment firm such as Presidio. It also requires the accommodation by a bank such as Deutsche Bank AG.

The Internal Revenue Service issued Notice 2000-44, 2000-2 C.B. 255, to address transactions that purport to generate tax losses for taxpayers. One of the transactions described in that notice is similar to BLIPS. The notice discusses a taxpayer that borrows funds at a premium that is subsequently assumed by a partnership. The taxpayer claims a basis in the partnership equal to cash contributed and reduced by only the stated principal amount of the loan (ignoring the premium). When the partnership interest is disposed of, the taxpayer claims a loss for the basis even though the taxpayer has incurred no corresponding economic loss. The notice states that the "purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of section 165. The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal

income tax purposes." The notice states that the purported tax benefits claimed from these transactions may be disallowed under Internal Revenue Code section 752, Treasury Regulations section 1.701-2 or other anti-abuse rules. With respect to individuals, the transactions may be subject to challenge under Internal Revenue Code section 165(c)(2) as transactions not entered into for profit. The notice alerts taxpayers, their representatives and promoters of these transactions that they may be subject to penalties and reporting requirements. The Franchise Tax Board agrees with and will follow the Internal Revenue's position on these transactions.

With respect to the SC<sup>2</sup> transactions, I see several problems with the way this transaction is structured. The tax opinion rendered by Seyfarth, Shaw, Fairweather & Geraldson, dated December 30, 1999, states that the "plan will be required to execute a redemption agreement which will provide, in effect, that the Plan will have the right to 'put' the stock back to the corporation (or one of its shareholders) at some point in the future (which we are advised will be in approximately two years)." These facts, combined with the issuance of warrants to the S corporation shareholder leads me to conclude that there was not a completed gift in the year that the preferred stock was transferred to the pension plan. This means that a charitable contribution deduction cannot be claimed until the year that the gift is completed. Under this transaction, the gift is not complete until the redemption occurs and the plan receives the cash from the S corporation. In addition, since there is no valid gift until the time of the redemption, the plan is not the owner of the shares and no allocation of income can properly be made to the pension fund. Given the fact that the stock is nonvoting, that there is a plan for the stock to be redeemed or for the warrants to be exercised, no or minimal cash distributions are made and no income tax is being paid on the income earned in connection with those shares, the pension plan is not the beneficial owner of the shares and income should not be allocated to the pension fund. There is no valid purpose for the issuance of nonvoting preferred stock followed by redemption of that stock other than for the avoidance of income tax. The donor could have transferred cash to the pension fund and taken a charitable contribution. There was no need to donate and then redeem the stock other than for the purpose of attempting to assign income of the S corporation to an organization exempt from tax thus reducing the tax liability of the shareholders who owned the voting common stock.

The tax opinion letters obtained by the Permanent Subcommittee on Investigations that I reviewed used by KPMG in connection with the SC<sup>2</sup> transactions are grossly deficient. The letters fail to discuss the impact of the warrants, whether there was a completed gift, assignment of income doctrine and the step transaction doctrine. The tax opinion rendered by Seyfarth, Shaw, Fairweather & Geraldson, dated December 30, 1999, recognizes that this is "a very unusual transaction, and there is almost no statutory, regulatory or other authority addressing the issue . . . ." This is an example of how the opinion letters are written to address specific legal authority that may cast doubt on the transaction, but fail to examine all the potential risks to the investor. Rather than present clear legal authority for the transaction on an overall basis, the opinions attempt to clear the roadblocks for individual steps in isolation.

The Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 678) added Internal Revenue Code section 6111 regarding the registration of tax shelters. The FLIP, OPIS and BLIPS cases that we have seen meet the registration requirements of that section. In the cases that we have looked at during our audits, the investor received at least two dollars in tax savings for every dollar invested in the transaction. These shelters were marketed to multiple investors such that the aggregate amount of investment in these shelters exceeded \$250,000 and there were five or more investors. With regards to SC<sup>2</sup> transactions, based upon the materials provided by the Permanent Subcommittee on Investigations which I have reviewed, it met the registration requirements of Internal Revenue Code section 6111 for the same reasons as the other shelters mentioned above.

### Impact of Tax Shelters on California

Based upon a U.S. General Accounting Office (GAO) study presented in testimony to the Senate Finance Committee, we estimate lost revenue to the state of approximately \$3.5 billion from abusive tax shelters. According to the GAO study, potential tax losses covering a multiyear period are estimated to be approximately \$85 billion as of September 30, 2003, with \$33 billion attributable to listed transactions and \$52 billion for nonlisted transactions. Based upon a comparison of state-to-nation tax effect, it is projected that California's potential losses from abusive tax shelters is \$1.5 billion for listed transactions and \$2 billion for non nonlisted transactions, for a total of \$3.5 billion. Our recently enacted tax legislation estimates that as a result of the legislation, the state of California will have increased revenue in each of the next two fiscal years of approximately \$90 million and \$50 million in the following fiscal year.

The State of California is dedicated to cracking down on tax cheats and abusive tax shelters. In the words of Controller Steve Westly, "California loses hundreds of millions of state tax dollars each year as a result of these sophisticated tax schemes. This is legitimate tax money owed to the state of California that funds our schools, helps our elderly and fuels our emergency and transportation services. With a record deficit currently plaguing our state, we are very motivated to pursue these cases." We have already taken a number of steps to curb the promotion and use of these tax avoidance schemes, including the following:

1. In 1998 we rolled out a computer software program that allows us to track information better so we can trace income from pass through entities to the ultimate taxpayer that should report the income. We were concerned in the early 1990s about abusive transactions involving pass through entities and found that it was very time consuming to manually examine each return and trace the income to other returns. The program has increased compliance and allowed for more efficient auditing of tax returns and tracing of income.
2. On September 13, 2003, California, along with 33 other states, signed a Memorandum of Understanding with the Small Business-Self-Employed Operating Division of the IRS. We have been and will continue to cooperate with the Internal Revenue Service (IRS) in the identification and audit of tax shelters.

We will share information at an earlier stage in the audit process and we will assist each other whenever possible with the audit of tax shelters and tax avoidance schemes. We are coordinating our audit efforts to maximize efficiency.

3. In October of 2003, the governor of California signed into legislation a bill that provides for reporting requirements, increases existing penalties and imposes new penalties for tax shelters. Our bill was modeled after the Tax Shelter Transparency Act bill and we hope that Congress will pass this legislation at the federal level in the near future.

With regards to the enhanced penalties, we have increased the penalty for promoters to fifty percent of the gross income derived or to be derived from the tax shelter activity. We lowered the threshold for the imposition of the accuracy related penalty for corporations. We quadrupled the accuracy related penalty and raised the standard necessary to avoid the penalty.

We added a frivolous return penalty, penalties for failure to disclose reportable and listed transactions and a noneconomic substance transaction understatement penalty. We also added a penalty equal to one hundred percent of the interest due on a deficiency related to a tax shelter. The new and increased penalties generally apply to all open years regardless of when the shelter is "listed."

The new law extends the statute of limitations for issuing notices of proposed assessment on tax shelter transactions to eight years, thus doubling the regular California statute of limitations for tax cases. It creates an exception for confidential communications for written communications between a tax practitioner and the taxpayer/investor. It also makes it easier for the FTB to issue subpoenas.

Another part of our new law provides for a Voluntary Compliance Initiative wherein taxpayers who voluntarily file amended returns and pay the full amount of tax and interest related to tax shelter benefits claimed on their return can avoid the new and increased penalties. We have been and will continue to publicize this program in order to encourage taxpayers to voluntarily comply with the law and to educate the public on the tax shelters that they should not engage in and the consequences of doing so. Our policy is not to settle any tax shelter issues. If taxpayers fail to come in under the voluntary compliance initiative, they will face the higher penalties.

4. We also passed legislation that shut down one of the most egregious tax avoidance scams we have seen. It involved banks that formed solely owned subsidiaries which they registered as investment companies under the Investment Act of 1940 for the purpose of avoiding California taxes. The registration is clearly improper under the Investment Act of 1940. By 2003, all of the banks involved with this shelter withdrew their registration after examination

by and discussions with the Securities and Exchange Commission. Rather than pay tax at one level, which is what the law provides for, they combined unrelated code sections and attempted to pay no state tax whatsoever on the interest income earned on the bank's loan portfolio.

5. We have worked in cooperation with the Securities and Exchange Commission (SEC) on the bank issue noted above.

6. The Executive Director of the FTB, Mr. Gerald Goldberg, chairs the Corporate Income Tax Shelter Working Group of the Multistate Tax Commission (the MTC). Some of the goals of the working group is to share information among the states regarding tax shelters and abusive tax transactions and develop anti-abuse legislative tools. Thirteen states are members of the working group: California, Massachusetts, Alabama, North Carolina, Arizona, Kentucky, Oregon, North Dakota, Montana, New Hampshire, Arkansas, Idaho, Maryland, Illinois and Florida.

7. Apart from the MTC, we have communicated directly with several states and share information concerning the state-level shelters that we have encountered. This has been very useful and we plan to expand those contacts. These states include New York, New Jersey, Massachusetts, Indiana, Ohio, Illinois, Minnesota, Wisconsin, and Texas.

### Recommendations

While we are pleased with the progress we have made to identify and close down tax shelters, we think that more needs to be done in order to prevent creative minds from formulating new shelters and schemes that circumvent the new laws. Listed below are some of these recommendations.

1. Extend Sarbanes-Oxley to tax return preparers. If a return preparer or related party has marketed, sold or recommended a tax shelter, the firm and related parties should not be allowed to sign the return for that year or any year in which the taxpayer benefited from the shelter. Another return preparer would be required to prepare and sign the return. The other preparer would then need to independently review the transaction to determine if the position is appropriate under the tax laws and to include disclosure statements in order to avoid liabilities. Mere disgorgement of the profit made on the transaction is not enough to discourage these practices because the taxpayers and their advisors play the audit roulette. If the promoter is caught 1 in 10 times, then 9 out of 10 times they win. Thus, even if they have to pay back \$1 million out the \$10 million that they earned, they still come out \$9 million ahead. In addition, the firm may have insurance to cover these penalties or may self-insure by setting aside funds in the event that penalties are imposed. Requiring an independent firm to sign the return would provide checks and balances within the private sector.

2. Remove registration exemptions for these types of investments. Requiring registration under the 1933 act and other acts will provide disclosure of more information about the transaction and will cost the promoter more. Registration is an expensive undertaking and failure to comply with SEC rules are very costly. Until there is a risk that one may not be able to continue in the business of selling these investments, they will continue to be marketed in new ways. The fact that the tax laws require registration under the Investment Act of 1940 in order to take advantage of the single level of tax provision for registered investment companies is one of the prime reasons we were able to identify and shut down this tax shelter.

3. The AICPA should prohibit all contingency fees and fixed fees not based upon actual hours incurred for tax services. We have seen contingency fees not only in the area of abusive tax shelters but for services in connection with claiming tax credits. Use of contingency fees results in aggressive positions being taken and over inflation of the benefits. This works to the detriment of the taxpayer who not only pays for the advice but also for someone to defend the position taken. Contingency fees are like opium to the accounting firms. Once they start accepting contingency fees, it's very difficult to go back to hourly billing rates because the amounts are very lucrative.

4. Enact whistle blower statutes that would allow people to receive compensation for reporting of tax shelters and abusive transactions. Without the assistance of honest people willing to come forward and disclose information concerning abusive transactions, it is very difficult to uncover them. The information they provide is extremely valuable.

5. Require licensing or registration of tax return preparers. Require educational standards including ethics training. Then, if the preparer files tax returns with abusive transactions that are not properly disclosed, suspend or revoke their right to prepare tax returns. Again, imposing penalties (including disgorgement of revenue) may have some deterrent effect, but nothing is more effective than shutting down the ability to earn a living from one's profession.

6. Raise the ethical standards for tax preparers and advisors. Require a duty to uphold the spirit of the tax laws. Currently, many tax preparation firms take the position that if something is not specifically disallowed or illegal under the tax law, then it is allowable, even if it violates the purpose and spirit of the law.

7. Beef up enforcement agencies. A prominent California tax litigator who defends high-net-worth taxpayers in tax shelter cases commented that the thought part of the reason we are seeing so many abusive tax shelters is that the enforcer backed off. A gentler, kinder Internal Revenue Service has contributed to the perception that tax professionals can get away with just about anything because the watch dog is asleep. The odds of their getting caught have diminished. We have learned the hard way that self-compliance only comes with regular enforcement activities. The IRS and other tax enforcement agencies

need more resources to audit taxpayers who engage in abusive tax transactions. The transactions are highly complex and require smart technicians to unravel the convoluted steps taken in these types of transactions.

8. Publish a list of firms that issue tax opinions that fail to properly analyze the tax consequences of the transactions so that the public can be put on notice that they cannot rely on opinions of that firm. The firm would remain on the list for a certain period of time (say one year) and would be added and remain on the list for that period of time each time it is determined that an improper opinion has been issued. A taxpayer should not be able to rely upon an opinion that fails to analyze all of the steps in a given transaction.

9. Tax laws should be amended to provide an entity level tax on the amount of income that is passed through to a tax-exempt entity that does not pay the unrelated business income tax on that income. As seen in the SC<sup>2</sup> shelter, tax advisors will manipulate the laws to their advantage. They used the tax provisions that allow pension funds to be S corporation shareholders to attempt to escape income tax on a large portion of income, while not actually distributing all the income allocated to the pension fund. The pass through entity should be required to make cash distributions of the amount allocated to the exempt organization.

10. Tax laws should be amended to clearly state that any reimbursement from the tax preparer or promoter to the taxpayer/investor, whether for tax, interest or penalties, constitutes income to the taxpayer/investor and is not deductible by the payor. Any amounts received by the promoter from an insurer should be taxable to the promoter.

The sale of tax shelter and tax avoidance products is clearly wrong. These abusive tax transactions manipulate the tax laws for the purpose of creating phony losses. They have cost the federal and state governments billions of dollars of tax revenues. The investors pay not only to get into these schemes, but they face large penalties when they are caught. The only ones who come out ahead are the promoters and accommodators who obtained exorbitant fees for selling these tax schemes. As Controller Steve Westly said, "Abusive tax shelters victimize honest citizens who pay their fair share of taxes while the tax cheats profit."

Thank you.