Legislative Fiscal Bureau

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Tax Shelter Compliance Initiative (General Fund Taxes -- Tax Administration)

Bill Agency

[LFB 2007-09 Budget Summary: Page 210, #1]

CURRENT LAW

Under current law, the Secretary of Revenue has statutory authority, if he or she determines that it is necessary to prevent evasion of taxes, or to clearly reflect the income of any trade, business, or organization, to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses, that are incorporated or unincorporated, affiliated or not affiliated, or organized in the U.S. or another country.

GOVERNOR

Create disclosure requirements for taxpayers and material advisors for reporting certain transactions and establish penalties for failure to disclose the required information. Taxpayers would be subject to penalties for understating tax liability due to the transactions. Material advisors would be required to maintain a list of client taxpayers and would be subject to a penalty for promotion of tax shelters. A tax avoidance voluntary compliance program would be established under which the Department of Revenue (DOR) would waive or abate penalties for underreporting or underpayment of taxes due to tax avoidance transactions.

DISCUSSION POINTS

1. Historically, the Internal Revenue Service (IRS) has attempted to curb the use of tax shelters to reduce or avoid taxation. During the period from the 1950s through the late 1970s,

individual cases were litigated in court to disallow tax benefits. The first legislative response was included in the Tax Reform Act of 1976, which enacted "at-risk" rules that limited individuals from claiming losses for certain investments that involved limited economic risk for the taxpayer. The "at-risk" rules were extended in 1978, and again in 1981. The federal Deficit Reduction Act of 1984 contained a number of provisions designed to restrict the use of "abusive" tax shelters including: (a) a requirement for tax shelter organizers and sellers to register tax shelters with the IRS; (b) organizers and sellers of "potentially abusive tax shelters" were required to maintain a list of investors; and (c) certain penalties were strengthened. Many of the tax shelters during this era were similar and involved the creation of artificial (non-economic) losses for passive investors through the combination of tax preferences (often accelerated depreciation) and interest expense deductions. The federal Tax Reform Act of 1986 effectively stopped these type of shelters by enacting the rule that a taxpayer cannot deduct losses from an activity in which he or she does not "materially participate" against income from other sources.

During the 1990s, a strong stock market that generated large capital gains, and the increased use of stock option compensation, contributed to the growth of a tax-avoidance industry that marketed tax shelters to individual taxpayers and corporations. During this period the IRS issued a series of tax regulations, and took administrative actions that expanded disclosure requirements, attempted to eliminate certain practices, and publicized "abusive" transactions. Federal "abusive tax shelter" provisions were most recently expanded by the American Jobs Creation Act of 2004. The Act included increased penalties related to disclosure, understatement of tax, false statement, and reporting for taxpayers, material advisors, and tax shelter promoters. The Act also extended the statute of limitations for taxpayers' failure to disclose certain transactions, and enhanced IRS enforcement powers.

2. Since tax shelters take many forms and are structured in different ways, there is no uniform definition of the term. As used by the IRS, "abusive tax shelters" refers to certain investments or transactions in which the tax benefits derived by investors go beyond those intended by the tax law. According to the IRS, abusive tax shelters arise when deductions come from investments that produce little or no economic benefit, or when the tax benefits are exaggerated beyond those intended by Congress. The IRS offers the following questions to be asked by an investor to indicate a potentially abusive plan:

a. Do the tax benefits far outweigh the economic benefits?

b. Is this a transaction you would seriously consider, apart from the tax benefits, if you hoped to make a profit?

c. Do shelter assets really exist and, if so, are they insured for less than their purchase price?

d. Is there a non-tax justification for the way profits and losses are allocated to partners?

e. Do the facts and supporting documents make economic sense? Are there sales and resales of the tax shelter property at ever increasing prices?

f. Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?

g. Does the promoter offer to backdate documents after the close of the year? Are you instructed to backdate checks covering your investment?

h. Is your debt a real debt or are you assured by the promoter that you will never have to pay it?

i. Does this transaction involve laundering U.S.-source income through foreign corporations incorporated in a tax haven and owned by United States shareholders?

The Department of Revenue indicates that tax shelters are transactions that do one or more of the following: (a) create artificial losses or deductions; (b) shift income to "tax-indifferent entities" (experience no tax consequences for certain transactions), such as foreign corporations; (c) defer income recognition; and/or (d) convert taxable income into tax-free income. Tax shelters often include the presence of non-taxable entities and the role of financial intermediaries (such as accounting firms or tax attorneys). In a typical shelter, a revenue stream is bifurcated for tax purposes, with items of income allocated to the non-taxable entity, and items of expense allocated to the shelter purchaser (Bankman, 2004).

3. A wide variety of abusive tax shelters, including high-basis, low-value shelters, Roth IRA expansion kits, and partnership tax straddles, have been identified by the IRS. One of the more common class of shelters was the Bond and Option Sales Strategy (BOSS) marketed by PriceWaterhouseCoopers and the Son-of-Boss shelter marketed by Ernst & Young. The later shelter is also referred to as Currency Options Bring Rewards (COBRA). An example would be where the taxpayer contributes a purchased stock option with a strike price (value of shares when option is exercised) of $20 million and a "sold" stock option (a contract to sell a share of stock at a given price) with a strike price of $19.8 million to a partnership. Both options have the same expiration date. Although the net economic worth of the two options is $200,000 ($20 million minus $19.8 million), the taxpayer reports his or her basis in the partnership as $20 million. The taxpayer then withdraws from the partnership and accepts shares of stock with a fair market value of $100,000 in exchange for the taxpayer's partnership interest. The taxpayer sells the shares immediately and claims a loss of $19.9 million ($20 million minus $100,000) because the basis of the stock received for the partnership interest carries over from the partnership.

An example of this transaction was reported on an October, 2003, episode of "60 Minutes" which told the story of Henry Camferdam who was sold a COBRA shelter by Ernst & Young. To participate in the shelter, he paid $7.0 million in fees. The accounting firm arranged for Camferdam to buy two offsetting foreign currency options. One a $50 million option on the euro declining, and one a $50 million option on the euro increasing. Ernst & Young then moved the offsetting options through a series of hard-to-trace shell companies and partnerships, a process called basis bouncing.

Ultimately, only one of the $50 million currency options was included, and it resulted in creating a corporation with an artificial $50 million tax loss, that offset $50 million Camferdam had made selling his computer business. However, the IRS assessed Mr. Camferdam for $13 million in taxes plus interest, based on an IRS required listing of tax shelters. In turn, Mr. Camferdam sued Ernst & Young.

4. A second type of tax shelter, corporate-owned life insurance (COLI), is based on the favorable treatment of life insurance. A primary attraction of whole life insurance is that investment return on the policy is not subject to tax. In a simplified example, a business taxpayer borrows $100 million at 11% from an insurance company and uses the proceeds to purchase whole life insurance policies on its employees with the taxpayer as beneficiary and a predicted return (assuming employees live to life expectancy) on the policies of 10.5%. Consequently, the value of the policies would increase by $10.5 million in the first year. The taxpayer borrows this increased value, adds $500,000 of its own funds, and pays the insurer $11 million on the loan used to purchase the policies. This is repeated almost every year. On a pre-tax basis, the taxpayer would lose money each year ($500,000), and borrow virtually all of the equity in the insurance policies. The shelter is attractive because the interest paid on the loan is deductible, while the appreciation of the value of the policies, which provided the basis for most of the interest payment, was tax-free. In this example, the taxpayer would have an out-of-pocket expense of $500,000 but receive a tax deduction of $11 million each year.

The COLI shelters produced huge tax deductions for about 100 taxpayers. For example, Winn-Dixie supermarkets purchased life insurance policies on 36,000 employees with itself as the beneficiary. The purchase plan had an estimated pre-tax cost (over 60 years) of approximately $700 million, but an after-tax savings of $2.7 billion. The IRS denied COLI tax benefits, and won some court cases, but resolved many other cases through negotiated settlements.

5. Tax shelters significantly reduce tax revenues. Through 2003, the IRS estimated that the potential tax loss from tax avoidance transactions was $33 billion, with the majority of that amount concentrated between tax years 1993 and 2003. The California Legislative Analyst's Office estimated that, before the state adopted tax shelter disclosure and enforcement laws, the annual revenue decrease due to abusive tax shelter transactions was between $600 million and $1 billion. Tax shelters also redistribute the tax burden. For any level of taxation, the tax rate paid by shelter purchasers is lowered, while the rate on all other taxpayers is increased. The federal and state income tax systems rely heavily on voluntary compliance by taxpayers. To the extent tax shelters are viewed as mechanisms solely used by wealthy individuals and corporations to avoid taxes, other taxpayers could be motivated to reduce their own tax payments through measures such as overstated deductions, understated income, and non-filing. Economic inefficiencies are created if the marginal private and social costs of replacing the revenues lost due to shelters exceed the cost of raising revenues where no shelters were involved. Finally, the shelter industry takes resources away from more productive economic activities. Shelters are expensive to develop, market, and set up.

Anti-tax shelter legislation can create uncertainty for businesses and other taxpayers about the type of investment activities that are legal and the types that are illegal. In many cases, the distinction between what constitutes legitimate tax planning and what is illegal can rely on relatively small and apparently minor distinctions. As a result, businesses could be influenced not to engage in allowable tax planning activities. On a more general level, very restrictive laws and overly aggressive enforcement could depress business investment in the state.

6. Contemporary tax shelters are varied in design and in the IRC provisions that they exploit. The shelters are complex, difficult to discover, and most proposed legislative changes address single shelter activities prospectively. In these circumstances, from the taxpayer's perspective, there is little to lose, other than promoter fees, by investing in a tax-shelter scheme if the only consequence if the scheme unravels is payment of taxes that would have to be paid anyway. Frequently, the tax shelter promoter (at the taxpayer's expense) obtains and furnishes an independent tax counsel opinion that the tax shelter is legal in order to help the taxpayer avoid civil fraud penalties.

Theoretically, an economically motivated taxpayer will purchase a tax shelter only if the benefits outweigh the costs. In a simple formula, the taxes saved must exceed the costs, which would include the fixed costs, such as promoters' fees, of participating in the shelter, the probability that the shelter would be detected, the probability that the shelter would be upheld in court, and the penalty that would be levied on the shelter if it was discovered and lost in court. Current federal and state laws are designed to increase the cost to the taxpayer of participating in abusive tax shelters by increasing the likelihood of discovery and the penalties imposed on illegal shelters.

7. The American Jobs Creation Act of 2004 established most of the provisions of current federal law governing abusive tax shelters. The federal law includes disclosure requirements for material advisors and taxpayers with regard to certain tax shelter (reportable) transactions. Penalties are provided for: (a) failure of material advisors to disclose reportable transactions or maintain a list of such transactions; (b) failure of taxpayers to register reportable transactions; and (c) taxpayer understatement of income due to a reportable transaction.

Federal law requires material advisors to disclose on a return (federal Form 8264) information identifying and describing reportable transactions, including tax benefits, investment base, and financing methods. In addition, a material advisor is required to maintain a list that identifies each taxpayer the material advisor counseled about each reportable transaction, and to provide the list to the IRS within 20 days of an IRS request. Information on the list must be maintained for 10 years.

Corporations, individuals, trusts, partnerships, and S corporations are required to disclose their participation, direct or indirect, in reportable transactions by filing an information statement (federal Form 8886, or M-3) with their tax returns. In general, a separate statement is required for each reportable transaction for each tax year in which the taxpayer's federal income tax liability is affected by the taxpayer's participation in such a transaction.

A reportable transaction is defined as a transaction that satisfies any one of the following five categories of transactions:

a. Listed Transactions. A transaction specifically identified by the IRS as a tax avoidance transaction in Notice 2004-67 and subsequent modifications. There are currently 31 listed transactions, including the Son-of-BOSS/COBRA shelter (Notice 2000-44) and the COLI shelter (Notice 2004-20).

b. Confidential Transactions. A transaction offered to a taxpayer under conditions of confidentiality, for which the taxpayer paid a tax advisor a minimum fee ($50,000 for individuals; $250,000 for corporations), where the advisor limits the taxpayer's ability to disclose the advisor's tax strategies.

c. Transaction with Contractual Protection. A transaction for which the taxpayer has a right to a refund of tax advisor fees if all or part of the intended tax consequences from the transaction are not realized.

d. Loss Transaction. A transaction that results in the taxpayer claiming a loss greater than a certain threshold amount for a single transaction. Generally, the threshold amount is $2 million for individuals and $10 million for corporations.

e. Transaction with a Brief Asset Holding Period. A transaction that results in the taxpayer claiming a federal tax credit of more than $250,000, if the asset giving rise to the tax credit was held for 45 days or less.

A material advisor is any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out a reportable transaction. The material advisor must, directly or indirectly, derive gross income from the advice or assistance, in excess of $50,000 for transactions benefiting natural persons, and $250,000 in other cases.

Federal law imposes the following penalties on taxpayers and material advisors:

a. Taxpayer Failure to Disclose a Reportable Transaction. If a taxpayer fails to file Form 8886 or a similar statement, the taxpayer is subject to penalties of $10,000 for individuals and $50,000 for corporations for reportable transactions that are not listed transactions; and penalties of $100,000 for individuals and $200,000 for listed transactions.

b. Taxpayer Understatement of Income Due to Reportable Transaction. Taxpayers that are found to have reduced taxes as a result of a reportable transaction are subject to a penalty of 20% of the tax deficiency caused by the reportable transaction, and 30% if the reportable transaction was not disclosed.

c. Material Advisor Failure to Register a Reportable Transaction. In cases where a material advisor fails to disclose a reportable transaction, the advisor is subject to a penalty of $50,000 for reportable transactions that are not listed transactions; and penalties of the greater of $200,000 or 50% of the material advisor's fee if the transaction was a listed transaction. The penalty increases to 75% of the fee if there was intentional disregard of the disclosure requirement.

d. Material Advisor Penalty for Failure to Provide Investor Lists. If a material advisor fails to make an investor list available within 20 days after the date of an IRS request, the material advisor is subject to a penalty of $10,000 for each day of such failure after 20 days.

e. Material Advisor Penalty for Promoting Tax Shelters. In cases where a tax shelter promoter or organizer furnishes or causes another person to furnish a statement about the allowability of any tax benefit obtained through participation in a tax shelter the person knows or has reason to know is false or fraudulent, or about a gross valuation overstatement concerning any matter that is material to the tax shelter, the person is subject to a penalty of 50% of the promoter's or organizer's fee.

Since 2000, the IRS has offered disclosure and settlement initiatives to taxpayers for various transactions during specified time periods. The IRS pursued such activities from December, 2001, to April, 2002, for certain types of transactions. Between October, 2002, and March, 2003, in a targeted approach, the agency allowed taxpayers involved in certain life insurance, basis shifting, and contingent liability transactions to resolve the associated tax penalties. In 2003, it also allowed certain taxpayers involved in specified off-shore abusive tax shelter transactions to reconcile their tax accounts and avoid some penalties The IRS conducted a Son-of-BOSS settlement initiative in 2004 that permitted taxpayers who settled Son-of-BOSS related liabilities to deduct promoter and professional fees. Most recently, from October, 2005, through January, 2006, the IRS allowed taxpayers participating in 21 specified transactions to pay the associated taxes and avoid most penalties.

8. The SB 40 provisions are very similar to current federal tax law regarding abusive tax shelters. Disclosure requirements would be established for taxpayers and material advisors, and penalties would be imposed on taxpayers for failure to disclose reportable transactions and for related understatement of income. Penalties would be imposed on material advisors for failure to disclose reportable transactions and for promoting tax shelters. Finally, the bill would initiate a tax avoidance compliance program to allow taxpayers to settle shelter-related tax liabilities and avoid penalties.

The specific statutory provisions recommended by the Governor are described in the following sections:

Definitions

"Listed transaction" would mean any reportable transaction that was the same as, or substantially similar to, a transaction, plan, or arrangement specifically identified by the U.S. Secretary of the Treasury as a listed transaction, for the purposes of section 6011 of the IRC (relating to tax shelter transactions), that occurred on or after January 1, 2002, and that was specifically identified by the U.S. Secretary of the Treasury as a listed transaction on or after the date the transaction occurred.

"Material advisor" would be defined as any person who provided any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction and who, directly or indirectly, derived gross income from providing such aid, assistance, or advice in an amount that exceeded the following thresholds:

a. $50,000, in the case of a reportable transaction, not including a listed transaction, from which a substantial part of the tax benefits are provided to an individual.

b. $10,000, in the case of a listed transaction, from which a substantial part of the tax benefits are provided to an individual.

c. $250,000, in the case of a reportable transaction, not including a listed transaction, from which a substantial part of the tax benefits are provided to an entity, and not an individual.

d. $25,000 in the case of a listed transaction, from which a substantial part of the tax benefits are provided to an entity and not an individual.

"Reportable transaction" would be defined as any transaction, plan, or arrangement, including a listed transaction for which a taxpayer was required to submit information to DOR because the taxpayer was required to disclose the transaction, plan, or arrangement for federal income tax purposes, as provided under U.S. Department of Treasury regulations.

"Tax avoidance transaction" would be defined as a transaction, plan, or arrangement devised for the principal purpose of avoiding federal or Wisconsin income or franchise tax and that was a reportable transaction as provided under U.S. Department of the Treasury regulations, as of the effective date of the bill.

"Tax shelter" would mean any entity, plan, or arrangement, if avoiding or evading federal income tax or Wisconsin income or franchise tax is a significant purpose of the entity, plan, or arrangement.

"Taxpayer" would mean a person who was subject to the state individual income or corporate income and franchise taxes, and who has a tax liability attributable to using a tax avoidance transaction for any tax year beginning before January 1, 2007.

Taxpayers

Disclosure Requirement. Taxpayers would be required to file with DOR a copy of the form prescribed by the Internal Revenue Service for disclosing a reportable transaction, for each tax year that the taxpayer participates in a reportable transaction. The filing requirement would apply to any reportable transaction entered into on or after January 1, 2002, for any tax year for which the transaction remains undisclosed, and for which the statute of limitations on an assessment, including any extension under the provisions of the bill, has not expired as of 60 days after the effective date of the bill. The form would have to be filed no later than 60 days after the date for which the taxpayer was required to file the form for federal tax purposes, except that if the taxpayer filed a form with the IRS on or before the effective date of the bill, the taxpayer would have to file a copy of the form with the Department by December 31, 2007. DOR could require that the disclosure form be filed separately from the taxpayer's state income and franchise tax return.

Penalty for Failure to Disclose. Any taxpayer who fails to file a required disclosure form would be subject to a penalty equal to: (a) the lesser of $15,000 or 10% of the tax benefit obtained from a reportable transaction, if the taxpayer participated in such a transaction that is not a listed transaction; or (b) $30,000 if the taxpayer participated in a listed transaction. The penalties would apply to: (a) any failure to disclose a listed transaction that was entered into on or after January 1, 2002, including transactions that were not listed transactions when entered into but became such before the effective date of the bill, or (b) any other reportable transaction entered into before the effective date of the bill, for any tax year for which the statute of limitations on assessment, including any extension under the bill, has not expired as of the effective date of the bill. The Secretary of Revenue would be authorized to waive or abate these penalties, or a portion of them, that were related to a reportable transaction that is not a listed transaction, if the waiver or abatement promoted compliance with these provisions and effective tax administration.

Understatement Penalties. Taxpayers would also be subject to penalties for understatements of tax liability due to reportable transactions. In addition to any tax owed, the taxpayer would be subject to a penalty of either 20% of the reportable transaction understatement, or 30% of the reportable transaction understatement in cases where the reportable transaction was not disclosed. A taxpayer would have a reportable transaction understatement if the following calculation resulted in a positive number:

a. Multiply the taxpayer's highest applicable state individual income or corporate income and franchise tax rate by the amount of any increase in Wisconsin taxable income that results from the difference between the proper tax treatment of the reportable transaction and the taxpayer's treatment of the transaction on the taxpayer's return. This calculation would also apply to any amended return the taxpayer filed before the date on which the Department first contacted the taxpayer regarding an examination of the tax year for which the amended return was filed. The amount of any increase in Wisconsin taxable income for a tax year would include any reduction in the amount of loss available for carry-forward to the subsequent year.

b. Add the amount determined under "a" to the amount of any decrease in the aggregate amount of Wisconsin income or franchise tax credits that resulted from the difference between the proper tax treatment of a reportable transaction and the taxpayer's treatment of the transaction as shown on the taxpayer's return.

The reportable transaction understatement penalties would apply to any understatement from a reportable transaction, including a listed transaction, that was entered into on or after January 1, 2002, for any tax year for which the statute of limitations on the assessment, including any extension, had not expired on the effective date of the bill.

Additional penalties could be imposed for reportable transaction understatements. A taxpayer that filed an amended return after December 31, 2007, and before the taxpayer was contacted by the IRS or DOR regarding a reportable transaction, would be subject to a penalty equal to 50% of the interest assessed on tax due for any reportable transaction understatement for the tax period for which the IRS or DOR contacted the taxpayer. If the IRS or DOR contacted the taxpayer after December 31, 2007, regarding a reportable transaction, and before the taxpayer filed an amended return with respect to the reportable transaction, the taxpayer would be subject to a penalty equal to the interest assessed on taxes due for any reportable transaction understatement for the tax period for which the IRS or DOR contacted the taxpayer.

These penalties would apply to any reportable transaction understatement that resulted from a reportable transaction, including a listed transaction, entered into on or after January 1, 2002, for any tax year for which the statute of limitations on assessment, including any extension, had not expired by the effective date of the bill.

The Secretary of Revenue would be authorized to waive or abate the understatement penalties, or any portion of the penalties, if the taxpayer demonstrated to the Department that the taxpayer had reasonable cause to act the way the taxpayer acted, and in good faith, in regard to the tax treatment for which a penalty would be imposed, and all the facts relevant to such tax treatment were adequately included in the disclosure statement. If the taxpayer did not fully disclose such facts in the statement, the Secretary could waive the penalty if the taxpayer demonstrated to the Department that the tax treatment for which the penalty was imposed was more likely than not the proper treatment, and that substantial authority exists or existed for such tax treatment.

Statute of Limitations. A statute of limitations would be established for assessing taxes related to reportable transactions. In cases where a taxpayer failed to provide any information regarding a reportable transaction, but not including listed transactions, the time for assessing the state income or franchise tax with respect to that transaction would expire on the date that was six years after the date on which the return for the tax year in which the reportable transaction occurred was filed. In cases where the taxpayer failed to provide any information regarding a listed transaction, the time for assessing the state income or franchise tax with respect to that transaction would expire on the latest of the following dates:

a. The date that was six years after the date on which the return for the tax year in which the listed transaction occurred was filed.

b. The date that was 12 months after the date on which the taxpayer provided disclosure information regarding the listed transaction.

c. The date that was 12 months after the date on which the taxpayer's material advisor provided, at the Department's request, the required list of Wisconsin taxpayers served (described below).

d. The date that was four years after the date on which the Department discovered a listed transaction that was a listed transaction on the date the transaction occurred for which the taxpayer did not provide the required disclosure information, or for which the taxpayer's material advisor did not provide the required list of taxpayers served.

The limitation dates for reportable transactions and listed transactions could be extended by a written agreement between the taxpayer and DOR

Material Advisors

Disclosure Requirements. Material advisors to taxpayers would be required to file disclosure statements. Each material advisor who is required to disclose a reportable transaction under the Internal Revenue Code would be required to file a copy of the disclosure with DOR within 60 days after the date for which the material adviser is required to file the disclosure with the IRS. However, if the material advisor filed the disclosure with the IRS on or before the effective date of the bill, the material advisor would be required to file a copy of the disclosure statement with DOR by December 31, 2007.

Each material advisor would be required to maintain a list that identified each Wisconsin taxpayer for whom the material advisor provided services with respect to a reportable transaction, regardless of whether the taxpayer was required to file a disclosure form with DOR. A material advisor who was required to maintain such a list would have to provide the list to the Department, after receiving a written request to provide the list. The material advisor would also have to retain the information contained in the list for seven years or for a period determined by the Department by rule. If two or more material advisors were required to maintain identical lists, DOR could authorize only one material advisor to maintain the list. The material advisor reporting provisions would apply to reportable transactions, not including listed transactions, for which the material advisor provided services after the effective date of the bill. The reporting provisions would apply for listed transactions for which the material advisor provided services, and that were entered into, on or after January 1, 2002, regardless of when the transactions became listed transactions.

Material Advisor Penalties. Penalties would be imposed on material advisors for failing to file or maintain required information, or filing false or incomplete information. Specifically, any person who failed to file a required disclosure form or filed a disclosure containing false or incomplete information would be subject to the following penalties: (a) $15,000 if the disclosure related to a reportable transaction that was not a listed transaction; or (b) $100,000 if the disclosure related to a listed transaction.

Any material advisor who failed to provide the required list of taxpayers to DOR no later than 20 business days after the date on which the person received the request to provide the list, would be required to pay a penalty to DOR that equaled $10,000 per day for each day that the person did not provide the list, beginning with the day that was 21 business days after the date on which the person received the Department's request.

The Secretary of Revenue would be authorized to waive or abate the material advisor penalties, or any portion of such penalties, that were related to a reportable transaction that was not a listed transaction, if the waiver or abatement promoted compliance with the material advisor reporting provisions and effective tax administration. In cases where a penalty was imposed for failure to maintain or provide the list of taxpayers served, the Secretary could waive or abate the penalties if, on each day after the time for providing the list without incurring a penalty had expired, the person demonstrated that the failure to provide the list was due to a reasonable cause.

Tax Shelter Promotion. The bill includes provisions that would impose a penalty on persons for promotion of tax shelters. Beginning on the effective date of the bill, any person who organized or assisted in organizing a tax shelter, or directly or indirectly participated in the sale of any interest in a tax shelter, and who made or provided, or caused another person to make or provide, in connection with the organization or sale of a tax shelter, a statement that the person knew, or had reason to know, was false or fraudulent as to any material matter regarding the allowability of any tax deduction or credit, the excludability of any income, the manipulation of any allocation or apportionment rule, or the securing of any other tax benefit resulting from holding an interest in the entity or participating in the plan or arrangement, would be required to pay a penalty to DOR, for each such sale or act of organization. The amount of penalty would equal 50% of the person's gross income derived from the sale or act of organization.

The bill also includes statutory language that would provide that, for the purpose of administering the tax shelter compliance provisions, beginning on the effective date of the bill, a written communication between a tax practitioner and any person, director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person, regarding the promotion of the person's direct or indirect participation in any tax shelter would not be considered a confidential or privileged communication.

Injunction. DOR would be authorized to commence an action in the circuit court of Dane County to enjoin a person from taking any action, or failing to take any action that would be subject to the tax shelter compliance penalties or would be in violation of the tax shelter compliance provisions included in the bill, or any related rules promulgated by DOR.

Tax Avoidance Voluntary Compliance Program

The bill would create a voluntary compliance program under which DOR would waive or abate all penalties imposed for tax avoidance transactions, if the taxpayer filed amended returns and paid amounts due. DOR would be required to waive or abate all penalties that were applicable to the underreporting or underpayment of Wisconsin income or franchise taxes attributable to using a tax avoidance transaction for any tax year for which the taxpayer met certain conditions (described below). Similarly, DOR could not seek criminal prosecution against a taxpayer for using a tax avoidance transaction for any tax year for which the taxpayer satisfied those conditions.

Specifically, a taxpayer would be eligible for penalty waiver and abatement, and not be subject to criminal prosecution for underreporting or underpayment of income or franchise taxes if, during the period beginning on October 1, 2007, and ending on December 31, 2007, the taxpayer did the following:

a. Filed an amended Wisconsin tax return for each tax year for which the taxpayer had previously filed a state tax return that used a tax avoidance transaction to underreport the taxpayer's Wisconsin income or franchise tax liability, and the amended return reported the total Wisconsin net income and tax for the tax year, computed without regard to any tax avoidance transaction, and without regard to any other adjustment that was unrelated to any tax avoidance transaction.

b. Paid, in full, for each year for which an amended return was filed, the entire amount of Wisconsin income or franchise tax and interest due that was attributable to using a tax avoidance transaction.

A taxpayer who participated in this program could not file an appeal or a claim for credit or refund with respect to the tax avoidance transactions for the tax years for which the taxpayer filed amended returns for penalty waiver or abatement and no criminal prosecution. However, a taxpayer who filed an amended return under the program could file a separate amended return with respect to adjustments that were unrelated to any tax avoidance transaction.

DOR could not waive or abate a penalty if it related to an amount of Wisconsin income and franchise tax that was attributable to a tax avoidance transaction and was assessed or paid prior to October 1, 2007, or after December 31, 2007. DOR would be required to promulgate rules, publish forms, and take any other action necessary to implement and administer the compliance program.

A transaction would not have to be a reportable transaction as provided under U.S. Department of the Treasury regulations in order for DOR to examine the transaction with regard to its principal purpose.

9. The estimated fiscal effect of the proposal was developed by the Department of Revenue based on revenues generated under similar disclosure and penalty provisions and a related voluntary compliance program enacted in Minnesota. Based on the revenue generated in Minnesota, adjusted to reflect differences in population, per-capita tax liability, personal income levels, and the difference in the structure of the penalties that would be imposed on taxpayers and advisors, the Department estimates that there would be an increase of $9.4 million in individual income and corporate income and franchise taxes in 2007-08. Most of this amount would come from the voluntary compliance program. The estimated ongoing increase in income and franchise tax revenues related to continued enforcement of the new law would be $800,000 in 2008-09, and annually thereafter.

10. The Department of Revenue indicates that seven states, California, Connecticut, Illinois, Minnesota, New York, Utah, and West Virginia have adopted tax shelter disclosure and related penalty provisions. Each state imposes somewhat different penalties. Five of the states adopted voluntary compliance initiatives. Voluntary compliance programs generated $1.4 billion in California, $342 million in New York, and $133 million in Illinois. Minnesota reported one-time revenues of $22 million and increased ongoing revenue of $1.7 million annually. Attachment 1, prepared by the Department of Revenue, provides a comparison of the various state disclosure and penalty provisions. Attachment 2, also prepared by DOR, provides a comparison of the proposed

Wisconsin provisions with federal law. Also, Attachment 2 shows which other states' provisions are similar to those proposed in the bill.

11. The IRS and most states included voluntary compliance programs as components of programs designed to limit abusive tax shelters. Through these programs, taxpayers pay taxes that might otherwise not be collected. Tax shelter transactions can be identified that enhance abusive tax shelter enforcement activities. In addition, substantial additional revenues are generated. However, providing preferential treatment to taxpayers who have attempted to avoid paying legitimate liabilities could be viewed as furthering the inequality of the tax system. Other taxpayers could be encouraged to engage in tax avoidance activities. As a result, the Committee may wish to delete the voluntary compliance program. This would reduce income and franchise tax revenues by an estimated $8.6 million in 2007-08.

12. DOR has submitted a number of modifications to the statutory tax shelter provisions that the Department indicates would be necessary to reflect the intent of the administration. The proposed modifications include:

a. The voluntary compliance program ending date would be extended from December 31, 2007, to February 29, 2008, and taxpayers could enter into installment payment agreements with DOR to pay taxes.

b. The definition of tax avoidance transaction would be expanded to include any transaction that provides tax benefits for Wisconsin income and franchise tax purposes, even if there is no federal tax benefit.

c. The definition of listed transaction would be modified to eliminate the effective date of transactions occurring after January 1, 2002.

d. The definition of reportable transaction would be clarified to specify the disclosure is for the tax year in which the reportable transaction occurred.

e. The definition of threshold amount for transactions as they apply to material advisors would be modified to specify that that the tax benefits are provided primarily to a certain individual or entity, rather than a substantial amount being provided.

f. Disclosure provisions would be modified to provide that a taxpayer file, with DOR, a form required, rather than prescribed by the IRS, that the copy be filed by February 29, 2008, rather than December 31, 2007, that the disclosure requirement applies to any reportable transaction entered into on or after January 1, 2001 (rather than 2002), or any such transaction entered into before January 1, 2001, which reduced the taxpayer's liability for tax years beginning on or after January 1, 2001.

g. The Secretary of DOR's authority to waive taxpayer disclosure, understatement, and additional penalties would be final.

h. Taxpayer penalties that apply to failure to disclose a listed transaction or to underreporting due to a reportable transaction would apply to such transactions entered into on or after January 1, 2001 (rather than 2002), or any such transaction entered into before January 1, 2001, which reduced the taxpayer's liability for tax years beginning on or after January 1, 2001.

i. Additional penalties for reportable transaction understatements by taxpayers would apply in cases where taxpayers that file amended returns or where the IRS contacts the taxpayer after February 29, 2008, rather than after December 31, 2007. In addition, additional understatement penalties would apply to understatements from reportable transactions entered into on or after January 1, 2001 (rather than 2002), or any such transaction entered into before January 1, 2001, which reduced the taxpayer's liability for tax years beginning on or after January 1, 2001.

j. The statute of limitations for assessing taxes related to reportable transactions would apply to transactions entered into on or after January 1, 2001 (rather than 2002), or any such transaction entered into before January 1, 2001, which reduced the taxpayer's liability for tax years beginning on or after January 1, 2001.

k. Material advisors would be required to file a copy of a disclosure form with DOR by February 29, 2008, rather than by December 31, 2007. The reporting requirements would apply to transactions for which services are provided and that were entered into on or after January 1, 2001, (rather than 2002), or any such transaction entered into before January 1, 2001, which reduced the taxpayer's liability for tax years beginning on or after January 1, 2001.

l. The Secretary of DOR's decision to waive material advisor disclosure penalties would be final.

m. Reference to tax practitioner would be deleted, and advice regarding participation in a tax shelter would not be confidential or privileged information.

The requested change to the retroactive disclosure period is intended to be consistent with the six-year statute of limitations under the bill and to include tax year 2001, when tax shelter transactions were more prevalent.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to implement a system to require taxpayers and tax advisors to report certain types of transactions that may indicate the existence of tax shelters. Impose specified penalties for engaging in, and failure to report on such activities, and for underreporting for tax purposes. Initiate a voluntary compliance program under which DOR could waive or abate penalties.

ALT 1	**Change to Bill** Revenue	**Change to Base** Revenue
GPR	$0	$10,200,000

2. Amend the Governor's proposal to include the statutory modifications submitted by DOR.

ALT 2	Change to Bill Revenue	Change to Base Revenue
GPR	$0	$10,200,000

3. Modify the Governor's recommendation to eliminate the voluntary compliance program.

ALT 3	Change to Bill Revenue	Change to Base Revenue
GPR	- $8,600,000	$1,600,000

4. Delete provision.

ALT 4	Change to Bill Revenue	Change to Base Revenue
GPR	- $10,200,000	$0

Prepared by: Ron Shanovich
Attachments

ATTACHMENT 1

States Which Enacted Legislation for Tax Shelter Initiatives

Retro-active to	Voluntary Compliance Initiative (VCI)?	Taxpayer Penalty: Failure to Disclose	Taxpayer Penalty: Income Understatement	Taxpayer Penalty: Failure to Self-Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
California								
2/28/00	Yes. By statute. Went from 1/1/2004 - 4/15/2004 in conjunction with the new penalties.	$15,000. Increases to $30,000 if the reportable transaction is also a listed transaction. Applies only to large entities or individuals of high net worth.	20% of understatement from reportable transaction if disclosed. Increases to 30% if not disclosed and 40% if not disclosed, and also a "noneconomic substance transaction" (a type of listed transaction)	50% of interest assessed prior to time taxpayer is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after taxpayer is contacted by State.	$15,000. Increases to the greater of $100,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, $10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to eight years for listed transactions
Connecticut								
1/1/05	Yes, but not by statute. Went from 6/16/2004 - 9/30/2004. Took place before the Connecticut "tax shelter" penalties became law.	None	75% of understatement from listed transaction, if not disclosed	None	None	None	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to six years for failure to disclose a listed transaction

Retro-active to	Voluntary Compliance Initiative (VCI)?	Taxpayer Penalty: Failure to Disclose	Taxpayer Penalty: Income Understatement	Taxpayer Penalty: Failure to Self-Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
Illinois								
2/28/00	Yes. By statute. Went from 10/15/2004 - 1/31/2005 in conjunction with the new penalties.	$15,000. Increases to $30,000 if the reportable transaction is also a listed transaction. Limited to 10% of the tax benefit of the reportable transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	50% of interest assessed prior to time taxpayer is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after taxpayer is contacted by State.	$15,000. Increases to $100,000 if the reportable transaction is also a listed transaction.	$15,000. Increases to $100,000 if the reportable transaction is also a listed transaction.	The greater of $10,000 or 50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to six years for failure to disclose a reportable transaction
Minnesota								
1/1/02	Yes. By statute. Went from 8/1/2005 - 1/31/2006 in conjunction with the new penalties.	$10,000 for individuals and $50,000 for corporations. Increases to $100,000 and $200,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	None	$50,000. Increases to the greater of $200,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, $10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to later of six years for failure to disclose, or (if listed), one year following the date taxpayer or advisor makes info available to State.

Retro-active to	Voluntary Compliance Initiative (VCI)?	Taxpayer Penalty: Failure to Disclose	Taxpayer Penalty: Income Understatement	Taxpayer Penalty: Failure to Self-Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
New York								
9/9/05	Yes. By statute. Went from 10/1/2005 - 3/1/2006 in conjunction with the new penalties.	$10,000 for individuals and $20,000 for corporations. Increases to $25,000 and $50,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	100% of total accrued interest after taxpayer is contacted by State about a reportable transaction.	$20,000. Increases to the greater of $50,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, $10,000 per day until lists are provided	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to six years for listed transactions. If failure to disclose, extended to 1 year following the date taxpayer or advisor makes info available to State.
Utah								
1/1/04	No	$15,000. Increases to $30,000 if the reportable transaction is also a listed transaction.	10% of the understatement from reportable transaction	None	$20,000	If lists are not provided within 20 days of State's request, $10,000 per day until lists are provided	None	None
West Virginia								
2/28/00	Yes. By statute. Went from 8/1/2006 - 11/1/2006 in conjunction with the new penalties.	None unless there's an understatement or deficiency	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed. If not disclosed and discovered in audit, appears to be an additional penalty of 70% for listed transactions and 35% for other reportable transactions.	100% of total accrued interest after taxpayer is contacted by State about a listed transaction.	$10,000. Increases to $100,000 if the reportable transaction is also a listed transaction.	$10,000. Increases to $100,000 if the reportable transaction is also a listed transaction.	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false	Extended to six years, or three years after the filing of an amended return (whichever is later), for failure to disclose a listed transaction

Source: Department of Revenue.

ATTACHMENT 2

Recommended Wisconsin Legislation/Federal Law Comparison

Retro-active to	Voluntary Compliance Initiative (VCI)?	Taxpayer Penalty: Failure to Disclose	Taxpayer Penalty: Income Understatement	Taxpayer Penalty: Failure to Self-Report in VCI Program	Advisor Penalty: Failure to Register	Advisor Penalty: Failure to Provide Investor Lists	Advisor Penalty: Promoting Tax Shelters	Extension of Statute of Limitations
Wisconsin								
1/1/02	Yes. By statute. Recommended for 10/1/2007 - 12/31/2007	$15,000. Increases to $30,000 if the reportable transaction is also a listed transaction. Limited to 10% of the tax benefit of the reportable transaction.	20% of understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	50% of interest assessed prior to time taxpayer is contacted by State about a reportable transaction. Increases to 100% of total accrued interest after taxpayer is contacted by State.	$15,000. Increases to $100,000 if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of State's request, $10,000 per day until lists are provided.	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false.	Extended to later of six years for failure to disclose, or (if listed), one year following the date or advisor makes info available to State.
State Modeled After (see Attachment 1)								
	Minnesota	Illinois	Minnesota	Illinois	Illinois	Minnesota	Minnesota	Minnesota
Federal Penalties								
		$10,000 for individuals and $50,000 for corporations. Increases to $100,000 and $200,000 if the reportable transaction is also a listed transaction.	20% of the understatement from reportable transaction if disclosed. Increases to 30% if not disclosed.	None	$50,000. Increases to the greater of $200,000 or 50% (75% for intentional disregard) of the advisor's fee if the reportable transaction is also a listed transaction.	If lists are not provided within 20 days of IRS request, $10,000 per day until lists are provided.	50% of advisor's fee, if advisor has reason to know a statement about deductibility, exemption, etc. is false.	

TP = Taxpayer

Source: Department of Revenue.