**STATEMENT OF THE CALIFORNIA FRANCHISE TAX BOARD
BEFORE THE
UNITED STATES SENATE FINANCE COMMITTEE
JULY 21, 2004**

I. INTRODUCTION

Good morning, Mr. Chairman, Senator Baucus and Members of the Committee. My name is Debbie Langsea and I am testifying on behalf of California State Controller Steve Westly and the Franchise Tax Board (FTB). On their behalf, thank you for the opportunity to testify on California's efforts to combat the tax gap and tax shelters.

II. TAX GAP

The California income tax gap is approximately $6.5 billion a year.[1] Our tax gap is the difference between what taxpayers owe and what is voluntarily paid. The IRS estimates about 80 percent of the tax gap is attributable to the **underreporting** of income. The remaining 20 percent is attributable to the failure to file tax returns and underpayment of taxes.

Underreporting income includes failing to report income, hiding barter and cash transactions or minimizing taxable income through **abusive tax shelters**. My testimony will focus on abusive tax shelters and California's efforts to narrow this portion of the tax gap.

The tax gap is a chronic and inordinate challenge for tax administrators and is becoming a national epidemic. Although the tax system is fundamentally based on taxpayers voluntarily reporting the correct amount of tax, the opportunity to escape detection, underreport income, underpay taxes, and not get caught creates a behemoth challenge for federal and states governments alike.

California is increasing efforts to address the tax gap, collect additional revenues, and encourage future self-compliance by identifying unreported income, assessing or collecting owed taxes and considering other enforcement measures, such as, informant rewards patterned after federal provisions, identification of tax preparers who enable clients to underreport income and fraudulently claim tax credits, and identification of underground or suspicious activity information.

California is considering other alternatives that inhibit noncompliance, such as, increased penalties, misdemeanor program, identification of additional income sources, questionable wage withholding and other deterrent measures. Finally, we are seeking

[1] The tax gap is equivalent to about 10 percent of the California State General Fund for tax year 2002.

ways to modify public perception that help taxpayers voluntarily comply with tax laws and other educational measures.

III. TAX SHELTERS

A. California Voluntary Compliance Initiative (January 1, 2004 through April 15, 2004)

In April 2004, California reported over **$1.3 billion** in additional tax revenues from the Voluntary Compliance Initiative (VCI). These revenues were generated from about 1,200 taxpayers who filed amended returns reporting additional taxes from potentially abusive tax shelters. Of these taxpayers, 800 individuals reported approximately $900 million and 400 businesses reported close to $500 million. Based on these figures, VCI raised what was equivalent to $13 million a day or two times more money than any other amnesty program in U.S. history!

One of the authors of California's strongest tax shelter legislation, Assembly Majority Leader Dario Frommer (D-Glendale), stated, "Wealthy tax cheats have been stealing $600 million to $1 billion each year from our classrooms, public hospitals and police and fire stations. By combining the nation's toughest penalties for illegal tax shelters with an amnesty program, California has found the right carrot and stick to force rich scofflaws to pay the taxes they owe."[2]

1. **Breakdown by VCI Options**
   VCI allowed taxpayers to elect either full or limited relief of penalties under one of the following options:

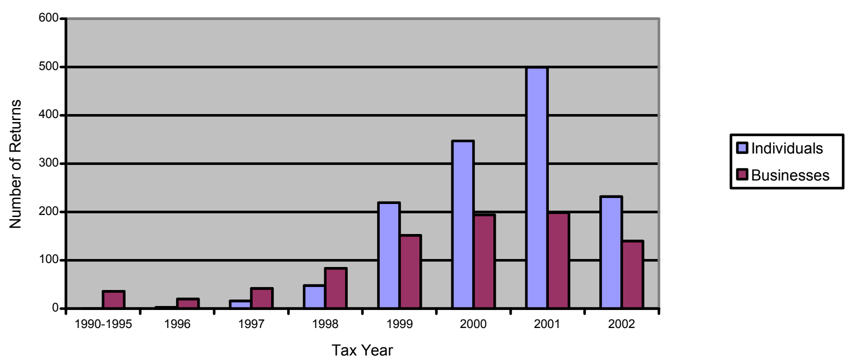
   a. ***Right to File Future Claim for Refund:*** About 65 percent of VCI revenues came from taxpayers who reported additional tax but elected to protect their right to file a claim for refund **in the future**. These taxpayers remain subject to the accuracy related penalty.[3]
   b. ***No Appeal Rights:*** About 25 percent of VCI revenues came from taxpayers who elected to forego their appeal rights and would not be subject to any tax shelter penalties including the accuracy related penalty.
   c. ***Pending Federal Activity:*** About 7 percent of VCI revenues came from taxpayers who had pending federal activity and elected to protect their right to file a claim for refund in the future.
   d. ***Filed Claim for Refund:*** The remaining 3 percent came from taxpayers who filed claims for refund and are subject to the accuracy related penalty.

[2] News Release by Assembly Majority Leader Dario Frommer (D-Glendale) on April 26, 2004.
[3] California Revenue and Taxation Code Section 19164.

2. Breakdown by VCI Tax Years

Taxpayers filed over 2,200 VCI amended returns for tax years 1990 through 2002 (see Figure 1). Ninety percent of the revenues were attributable to tax years 1999 and subsequent. Individuals filed returns for tax years 1996 and subsequent while businesses filed returns for tax years 1990 and later. Some corporate taxpayers had pending federal audits on older years and were seeking relief from California tax shelter penalties.

Figure 1 Breakdown by VCI Tax Years



B. Events Leading Up to VCI

How *did* California receive the $1.3 billion in additional tax revenues?

You have heard testimony of the many egregious, tax-engineered and artificial transactions designed to thwart and undermine the tax system. The devastating effects of these transactions should not be underestimated.

In November 1999, the Acting Assistant Secretary for Tax Policy Jonathan Talisman testified before the House Committee on Ways. In his testimony on corporate tax shelters, Mr. Talisman stated that “if unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue loss we currently are experiencing in the corporate tax base.”[4]

[4] Statement by Jonathan Talisman, Acting Assistant Secretary for Tax Policy, U.S. Dept. of the Treasury, in his Testimony Before the House Committee on Ways and Means Hearing on Corporate Tax Shelters, November 10, 1999. See also the Treasury Department’s White Paper on “The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals.”

Five years later, lost tax revenues attributable to abusive tax shelters were staggering!

- Federal government lost about $85 billion over the last decade[5],
- States lost $10 to $17 billion due to corporate income shelters in 2001.[6]
- California lost $2.4 to $4 billion over the last four years.

Just one of the 31 IRS listed transactions generated about $6 billion in tax benefits for 5,000 participants. Of the 500 tax products produced by one major accounting firm, four products were sold to 350 people and generated $124 million in fees for that firm.

More disturbing was the rate that tax shelters were proliferated and marketed. For example:

- In December 1999, the IRS issued Notice 99-59 to curtail the Bond and Option Sales Strategies (BOSS). BOSS was designed and marketed by a major accounting firm to shelter gains through a complex series of sale, loan and dividend arrangements.
- By August 2000, the IRS issued Notice 2000-44 to crack down on variations of BOSS (Son of BOSS) designed to escape provisions of the 1999 IRS Notice. These BOSS variations were marketed by other accounting or legal firms and used short sales, digital options, and loan premiums.
- Although the IRS issued new regulations to deter such abuses in 2001 and 2003, promoters designed new strategies to escape application of the IRS notices and regulations and the Grandson of BOSS (using different financial instruments, such as, market linked deposits to create artificial tax losses) was born.

These new generations of tax shelters were devised and collaborated by tax professionals, utilized variations of complex schemes, buried in many layers of transactions and multiple entities to escape detection, packaged as generic tax products with boiler-plate legal and tax opinions for mass marketing, and sold to thousands of taxpayers to generate millions of dollars in fees.

Historically, government officials have reacted to meet these challenges by enacting legislation with more penalties or curtailments, incurring increased administrative costs to challenge seemingly unending new shelters, offering initiatives, or engaging in more enforcement measures to plug the leaky dam of lost tax revenues. But at every turn, tax officials were outgunned and outmaneuvered by promoters rewarded with millions of dollars in fees and taxpayers escaping millions in taxes.

State Controller Steve Westly stated, “The transactions we are seeing are so complicated that a typical taxpayer wouldn’t dream them up. Financial experts are

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[5] U.S. General Accounting Office Report 04-104T “Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters”.

[6] Reported by the Multistate Tax Commission at the Federation of Tax Administrators Annual Meeting in June 2004.

going to great lengths to devise complex deals and push them on taxpayers through their partners and even through seminars."[7]

C. California Targets Abusive Tax Shelters

Similar to other federal and states efforts, California strategies to combat abusive tax shelters focused on the following components:

- **Voluntary Compliance** to promote taxpayer compliance and to discourage the buying or selling of abusive tax shelter products.
- **Detection** to identify taxpayers who failed to participate in our Voluntary Compliance Initiative.
- **Enforcement Measures** to engage in tougher actions with taxpayers who continue to engage in abusive tax shelter transactions.

In 2001, California identified about 40 tax shelter cases. Within two years, this number quickly grew to over 600 tax shelter cases! California needed stronger voluntary compliance, detection, and enforcement measures to more effectively combat tax shelters. Current tax shelter laws were sorely inadequate to combat tax shelters at the federal and state levels.

California pursued other compliance efforts, such as, encouraging taxpayers to file amended returns and to participate in the IRS Offshore Voluntary Compliance Initiative (OVCI). By the end of 2002, it was readily apparent more drastic measures were needed due to the escalating number of tax shelters and budgetary deficits.

1. California Legislators Crack Down on Abusive Tax Shelters

As California considered legislative solutions to more effectively combat the escalating tax shelter phenomenon, Senator Charles E. Grassley (R-IA) introduced S.476 CARE Act of 2003[8] on February 27, 2003. Its tax shelter provisions provided desperately needed tools to more effectively combat abusive tax shelters.

The creation and proliferation of abusive tax shelters were running amok and tax officials were reduced to merely chipping away at the tip of an iceberg. These shelters provided a windfall for promoters, advisors, businesses and taxpayers who could well afford and benefited from engaging in abusive tax shelters. But the windfall came at the expense of the millions of Americans who voluntary complied with the tax laws. Without the appropriate legislative and administrative tools to effectively combat abusive tax shelters, both federal and state governments were fighting a losing battle to close the tax gap.

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[7] Statement by State Controller Westly in Press Release dated November 18, 2003.
[8] S.476, the CARE (Charity Aid, Recovery, and Empowerment) Act of 2003 108th Congress, first session) introduced on February 27, 2003 by Senator Charles E. Grassley (R-IA). See Title VII Revenue Provisions. Subtitle A Provisions Designed to Curtail Tax Shelters.

Due to the overwhelming number of tax shelter investments during the late 1990's[9] and the pending expiration of our statute of limitations, California raced against the clock to quickly move forward and enact its own state legislation. On October 2, 2003, California enacted SB 614 (introduced by Senators Cedillo and Burton) and AB 1601 (introduced by Assembly Member Frommer). The bills established over a dozen new or significantly increased penalties and curtailments, adopted federal disclosure and reporting requirements, and provided the **Voluntary Compliance Initiative** provisions.

2. Publicity Efforts Ignite the California VCI Program

One key ingredient in the success of VCI was the publicity efforts with assistance from many key areas:

a. Federal, other states and individuals challenging abusive tax shelters including U.S. Senate hearings, IRS initiatives and summons, individual lawsuits and other enforcement activities.
b. News conferences conducted by State Controller Steve Westly and state legislators.
c. Over a hundred news media articles and broadcasts, California press releases and tax newsletters.
d. California Abusive Tax Schemes Symposium[10] and over 30 professional presentations.
e. California websites provided information on the unprecedented tax shelter legislative provisions, we responded to a thousand public e-mails and phone calls, and mailed over 32,000 letters and publications to taxpayers, practitioners, and promoters.
f. Staff testified at the U.S. Senate Permanent Subcommittee on Investigations Hearings on the U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals.[11]

3. California Partners with Other Agencies

Another essential ingredient was the joint information sharing agreements with the IRS and many states or cities. In September 2003, California signed the IRS Memorandum of Understanding specifically targeting abusive tax shelters.[12] California received thousands of leads from the IRS and other sources on potential

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[9] The economic growth in capital gains and option income of $93 billion, $164 billion, $200 billion in 1998, 1999 and 2000 respectively. Some investors reduced or eliminated taxes aggressively during these tax years. In comparison, capital gains and option income took a sharp decline to $94 billion and $80 billion in 2001 and 2002, respectively.

[10] Abusive Tax Schemes Symposium conducted by California officials, Professor Joseph Bankman, Former IRS Deputy Commissioner (Small Business/Self-Employed Operating Division) Dale Hart, and other participants in Sacramento, California on July 15, 2003.

[11] Statement by Debra Petersen of the California Franchise Tax Board Before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs on November 18, 2003.

[12] Memorandum of Understanding between the Internal Revenue Service Small Business/Self Employed Division (SBSE) and 45 Other States, New York and Washington D.C. Concerning Abusive Tax Avoidance Transactions.

investors or promoters. These information exchange agreements were essential to avoid duplication of government efforts and to take a united approach combating abusive tax shelters.

In February 2004, California, New York and 45 other states and cities signed a States Memorandum of Agreement specifically targeting abusive tax shelters.[13] This agreement provides for the increased exchange of abusive tax shelter information including developing information on participants and promoters.

California was active on various federal and state task forces to improve communication and other enforcement activities on abusive tax shelters and other tax related matters. "Working together is often the most efficient way to enforce tax laws, and it is frequently the best way to help honest taxpayers deal with their multiple responsibilities."[14]

4. California Detection Efforts: Identification of Abusive Tax Shelters

Since January 2004, we received over 300 boxes of information and are evaluating over 2,000 leads on tax shelters. We are currently matching this information against our databases for use in our enforcement efforts and to locate other tax shelter investors and promoters.

In April 2004, the new reporting and registration requirements generated additional leads on potentially abusive tax shelter promoters and investors. Although some filings were filed as protective measures, there are many new leads and confirmation of other leads. Our new tax shelter registration rules expanded the requirements to register any listed transaction connected to California since February 28, 2000. Over 900 organizers filed registrations reporting tax shelter transactions from 1994 and located in the United States and other countries.

Promoters must now automatically provide the name of investors for any listed transactions. This filing requirement generated information on over 7,000 investors who paid over $62 billion for listed transactions. Since California conformed to the federal disclosure requirements, taxpayers were required to disclose their participation in reportable transactions beginning on their 2003 tax return. Almost 800 taxpayers separately filed their disclosure and illuminated over 160 different possible reportable transactions.

5. California Enforcement Efforts

Of the $1 billion in tax shelters under state audit, about half of the taxpayers participated in the California VCI. We are aggressively pursuing taxpayers who

[13] Memorandum of Agreement Pertaining to Abusive Tax Avoidance Transactions between 46 states, New York City and Washington D.C. in February 2004.
[14] Statement by Harley Duncan, Executive Director, Federation of Tax Administrators in the IRS Press Release IR-2004-77 "IRS and State Partnership Moves Forward to Improve Compliance and Service" dated June 7, 2004.

failed to participate and applying the increased or new tax shelter penalties. We continue to evaluate leads for potential investors and promoters for future enforcement activities.

a. **Insurance Companies**
In April 2004, we issued subpoenas on two major insurance companies suspected of issuing insurance policies covering potential adverse rulings for tax liabilities associated with abusive tax shelters. Subpoenas may require insurance companies to provide information, such as, names of clients who requested insurance policies and all supporting documentation associated with these requests. Currently, we received about nine boxes of information, issued a third subpoena on another insurance broker and expect to receive more information.

Proposed legislation (AB 1297 introduced by Assembly Majority Leader Frommer) would prohibit insurance companies from insuring or defending losses resulting from or in connection to an abusive tax shelter. Such policies would be null and void and require return of premiums to the policyholder. This bill establishes a penalty against the policyholder equal to 75% of the proceeds received from any insurance policy or other financial protection product related to abusive tax shelters.

b. **Abusive Tax Shelter Task Force**
California continues to dedicate resources including plans to establish an Abusive Tax Shelter Task Force to coordinate increased tax shelter activities, such as, audit engagements, issuance of subpoenas, assertion of all appropriate penalties, enforce reporting requirements for promoters and investors, seek injunctions against promoters, and use consultants to provide financial products and other industry expertise.

IV. RECOMMENDATIONS

Despite the successful efforts combating abusive tax shelters obtained by federal and states government, the following are some recommendations essential if we are to effectively address the tax gap and abusive tax shelters:

A. **Congress should pass tax shelter legislation.**

The abusive nature of tax shelters is a nationwide problem that states cannot manage solely by improving state laws. There must be corresponding consequences at the federal level to make any meaningful dent in the overall effort to combat abusive tax shelters. California's passage of ideas proposed at the federal level illustrates tax administrators can influence noncompliant behavior if the right level of consequences exist.

B. **Congress should encourage the AICPA to follow the SEC's interpretation of prohibited contingency fee transactions and the states should have uniform restrictions on contingency fees consistent with the SEC's interpretation.**

The AICPA's interpretation under Rule 302 regarding contingency fees is too broad and should be more narrowly construed consistent with the SEC's interpretation of this same language. The AICPA's definition of contingency fee in its Code of Professional Conduct, Rule 302, is identical to the definition used by the SEC in its regulations discussing Qualifications of Accountants (17 CFR 210.2-01(f)(10)). Both rules state:

> Contingent fee means, except as stated in the next sentence, any fee established for the sale of a project or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered

While both regulatory agencies use the same definition, the AICPA's interpretation and examples of what constitutes a prohibited contingency fee differs significantly as explained in the letter sent from Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, to Bruce P. Webb, Chair of the Professional Ethics Executive Committee for the AICPA, dated May 21, 2004. The AICPA's interpretation states that:

> A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns.

Mr. Nicolaisen stated in his letter that the exception to the definition of contingency fee is not based on whether the accountant reasonably expects a government agency to consider issues with respect to its audit client. Rather, the exception applies only when the determination of the fee is taken out of the hands of the accounting firm and its audit client and is made by a body that will act in the public interest.

Mr. Nicolaisen's letter cites an example of a prohibited fee arrangement:

> … For example, as discussed in the Proposing Release, an auditor might undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. Fees for such services might be based on a percentage of the tax

> credits generated, a base fee plus a percentage of tax credits generated over a pre-determined base amount, or a base fee plus a "value added" amount to be added to the base fee. In that case, the accounting firm's economic benefit will be greater if the tax credits are maximized. ***Because this interest (in the economic benefit) is inconsistent with acting independently in assessing the accuracy of the impact on the income tax accounts and financial statements of the tax credits, those kinds of fee arrangements are prohibited under the final rule…***

We have often seen an accounting firm base its fee upon the tax benefits derived. When this occurs, the firm has an incentive to over inflate the tax benefits. In support, we have seen claim for refunds filed reporting aggressive tax positions claiming credits for property and other expenditures that are clearly not qualified and appear to be claimed merely as a means to increase fees for the firm. The taxpayer and the accounting firm play audit roulette in the hopes of being sustained on some or all of the highly aggressive, and, in some cases, completely erroneous positions. We have seen firms claim tax benefits for years prior to California's enactment of statutes granting those benefits. We are aware of firms that make it a policy to bypass state prohibitions on contingency fees by issuing their contingent fee engagement letters in a state that permits contingent fees. Accordingly, state uniformity in defining and interpreting contingency fees is imperative to addressing the abuses.

C. **Congress should fund the IRS's tax gap and abusive tax shelter compliance and enforcement efforts at an aggressive level in the long term to address the current level of abusive transactions and common tax gap issues, and to deter future noncompliance.**

Successfully combating abusive transactions set up by some of the most brilliant minds in the legal and accounting communities requires staff with extensive training, experience, and knowledge. If we increase the likelihood of detection and prosecution, we decrease the taxpayer's benefits of playing the audit roulette.

In determining IRS funding levels, consideration should be given to providing funds to hire industry expert witnesses and outside consultants. Combating highly technical financial transactions requires specialized skills and the flexibility to hire the best person for the worst situation.

Specific funding should be provided for increased coordination and assistance between the IRS and the states at a technical level. Overall tax enforcement is increased if state and federal activities complement each other, but these requires that joint administration be given a priority, rather than an auxiliary role.

Finally, eighty percent of the tax gap is made up of taxpayers who underreport their income. Therefore, increased funding for enhanced information reporting, increased education, and stepped up enforcement efforts are key to addressing the tax gap.

D. **The SEC rules adopted pursuant to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") have proven effective in curbing similar non-tax corporate abuses. We believe these rules should be amended as necessary to specifically address abusive tax shelters consummated by publicly traded corporations. We further believe that additional legislation should be adopted to apply similar laws to privately held companies engaging in abusive tax shelters. These recommendations are summarized below:**

Ban sale of tax shelters to financial audit clients. Section 201 of Sarbanes-Oxley enumerates certain nonaudit services auditors cannot perform at the same time as the audit under any circumstances. The SEC rules adopted pursuant to Section 201 of Sarbanes-Oxley do not give definitive guidance on how audit committees should determine whether a tax service is an allowable activity. The rules provide that CPA firms are permitted to provide tax minimization services to audit clients, except for "transactions that have no business purpose other than tax avoidance."[15] These SEC auditor independence rules have proven entirely ineffective in curbing corporate tax shelter abuses due to the lack of unambiguous guidance identifying specific indicia of transactions having no business purpose.

We believe Congress should amend Section 201 of Sarbanes-Oxley to ban the sale of tax shelters to audit clients (including listed and reportable transactions or those reasonable likely to be characterized as such in the future). U.S. Senator Carl Levin has introduced such legislation. This legislation should also prohibit audit firms from "signing off" on tax shelter transactions if the audit firm participates in the sale of the same or substantially similar tax shelters to other parties.

Financial statement disclosure of tax shelters. SEC rules adopted pursuant to Sarbanes-Oxley Section 401 require publicly traded corporations to disclose certain off-balance sheet transactions that have a material impact on financial statements. We believe that Congress should adopt similar legislation to require financial statement disclosure of certain tax shelter transactions, particularly listed and reportable transactions. Companies are reluctant to make such financial statements disclosures principally because they believe this will diminish their ability to "play the audit lottery." The IRS has the authority to obtain audit work papers relating to a company's tax accrual. In 2002, the IRS announced its intention to request such work papers as necessary to combat abusive tax shelters. SEC rules adopted pursuant to Section 802

[15] The rules the SEC originally proposed had listed "formulation of tax strategies (tax shelters) designed to minimize a company's tax obligations" as a prohibited activity. The AICPA provided comments to the proposed rules extolling the virtues of tax-minimization strategies (i.e., lower cost of capital, increased free cash flow and funds for dividend distributions, increased after tax earnings per share, and other increased value for a corporation's stockholders). The AICPA suggested that audit firms be allowed to provide tax-minimization services to audit clients, except for transactions with no business purpose other than tax avoidance (unless consistent with applicable tax laws). The rules the SEC issued as final substantially adopted the AICPA recommendation.

of Sarbanes-Oxley requires public companies to retain records relevant to the audit and review of financial statements, including information associated with the tax accrual.

CEO/CFO responsibility for tax shelters disclosures. SEC rules adopted pursuant to Sections 302 of Sarbanes-Oxley require certain CEO and CFO certifications with respect to the financial statements disclosures of publicly traded corporations. We believe that these certification rules should provide unambiguous guidance with respect to their application to tax shelters. Section 1001 of Sarbanes-Oxley provides that it is the sense of the Congress that the Federal income tax return of a publicly traded corporation should be signed by the CEO of such corporation. With respect to all corporations, public and private alike, we believe that Congress should require CEO or CFO signature or certification with respect to the disclosure of all transactions and other material facts relevant to the filing of a corporate tax return.

Expand application of obstruction provisions. Sections 802 and 1102 of Sarbanes Oxley make it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine. We believe that legislation may be required to adopt similar statutory provisions specifically applicable to the documentary evidence related to corporate tax shelters consummated by public and private companies. Application of such a provision should be reserved for the most egregious of conduct. Hopefully, the mere existence of such authority unambiguously defining the targeted conduct and associated penalties may be sufficient to increase the perceived risk of prosecution to adequately deter such misconduct.

E. **Adopt proposed changes to Circular 230.**

The proposed changes to Circular 230 enhance the effectiveness of the professional ethics provisions, include critical elements necessary to address abusive tax shelters, and establish common rules relevant to all preparers covered by Circular 230. Proposed changes include:

1. **Applies to all preparers.** Adoption of “Best Practices” including:
    - Clear communication regarding scope of advice or assistance rendered.
    - Establishing facts, *including* evaluation of reasonableness of any assumptions or representations.
    - Relating law to the facts.
    - Arriving at a supportable conclusion.
    - Advising client of all conclusions.

2. **Applies only to preparers issuing abusive tax avoidance transaction opinions** including “more likely than not” and marketed opinions.
    - Abusive tax avoidance transactions are any plan, arrangement, etc. used to avoid or evade taxes.

- Proposed changes require those who write opinion letters to be fully aware of ***ALL*** facts and circumstances surrounding the transaction rather than just a piece of the transaction. Changes require the opinion author to:
  - Identify and consider ***all*** relevant facts and not rely on any unreasonable assumptions and representations.
  - Relate applicable law to the facts.
  - Consider ***all*** federal tax issues and reach supportable conclusion.
  - Provide ***overall*** conclusion and statement as to why conclusion was reached, or if unable to provide overall conclusion, state and indicate why.
  - Disclose to the taxpayer their relationship with the promoter or other practitioners involved in the transaction including information on compensation arrangements and referral agreements.
  - Disclose that their opinion may not be sufficient for the taxpayer to rely on to avoid the accuracy related penalty.
  - State that the taxpayer should seek advise from their own tax advisor.
- If the opinion is limited in scope, the writer must disclose other issues that may exist that could effect the tax treatment discussed in the opinion.

V. CLOSING COMMENTS

We are far from completely closing the tax gap. We continue to encounter challenges thwarting our ability to effectively combat abusive tax shelters. As soon as one abusive tax shelter is identified, others are created to take its place.

State Controller Steve Westly stated, “The huge success of our amnesty program shows that government can think outside the box. We must collect the taxes already owed to California before we consider raising taxes or cutting services.”[16] But, Westly also added, “We’ve climbed out of the revenue quicksand, but we’re not out of the woods.”[17]

Thank you.

[16] Press Release by State Controller Westly on April 22, 2004.
[17] Press Release by State Controller Westly on May 6, 2004.