TAX EXECUTIVES INSTITUTE, INC.

August 4, 2010

The Honorable Lois Wolk
Chair, Committee on Revenue and Taxation
California State Senate
State Capitol, Room 4032
Sacramento, CA 95814

The Honorable Mimi Walters
Vice Chair, Committee on Revenue and Taxation
California State Senate
State Capitol, Room 3082
Sacramento, CA 95814

Via Facsimile 916.327.9234

Re: Comments on A.B. 2498

Dear Ms. Chairwoman:

Tax Executives Institute urges the California Legislature to reject the proposals in Assembly Bill 2498 including those that would (1) impose strict liability penalties on taxpayers participating in so-called abusive tax avoidance transactions, (2) adopt the recent federal codification of the economic substance doctrine, (3) establish a "tax amnesty" program with heavy-handed penalties and no appeal rights, and (4) unjustifiably put the professional licenses of both certified public accountants and lawyers at risk by encouraging state licensing boards to consider punitive measures for professionals only marginally associated with abusive tax avoidance transactions. These provisions would impose substantial taxpayer burdens without improving tax compliance or administration. They would also undermine the fairness of California's tax system, which is essential more broadly to a functioning self-reporting tax system.

Tax Executives Institute was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including five in California. Our 7,000 members represent 3,200 of the largest companies in the world, many of which are either resident or doing business in California. As the pre-eminent association of business tax professionals worldwide, TEI has a significant interest in promoting sound tax policy, encouraging the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. The Institute is committed to maintaining a system that works — one that builds upon the principle of voluntary compliance and is consistent with sound tax policy. We, along with federal, state, and local governments, have the most at stake in crafting a tax system that is administrable and efficient.

The Need for Transparency

There have been no public hearings on this bill, and none appear to be scheduled. This lack of transparency cannot help but undermine taxpayers' perception of the proposals – and the tax system generally. TEI believes that if A.B. 2498 goes forward, hearings should be held and stakeholders should be invited to provide comments on the proposals.

Expanding the Definition of "Abusive Tax Avoidance Transaction"

Existing California law imposes numerous penalties and reporting requirements designed to discourage over-aggressive tax positions. For example, taxpayers contacted by the Franchise Tax Board (FTB) regarding reportable transactions, listed transactions, or gross misstatements (terms defined in the federal Internal Revenue Code) may be assessed a penalty of 100-percent of the interest attributable to the related understatement – in addition to other applicable sanctions. A.B. 2498 would significantly increase penalties, remove the reasonable cause defense, and grossly expand the list of transactions to which these penalties apply.

Specifically, section 21 of A.B. 2498 would broadly define the term "abusive tax avoidance transaction" to include, among other things, "noneconomic substance transactions" and transactions involving financial arrangements that in any manner rely on offshore financial arrangements. This expansive definition would subject common business transactions to unwarranted penalties. For multinational companies, transactions inevitably involve foreign parties, including foreign financial institutions. For example, a business headquartered in California seeking to expand its business to China would likely enter into agreements with local Chinese banks. Likewise, a U.K. manufacturer with a branch in California may also engage the services of a Mexican financial institution to assist with its Mexican operations. The bill would penalize these common and necessary transactions notwithstanding the lack of any tax avoidance motive.

The bill would also fold "noneconomic substance transactions" into this expanded definition; this change would be *in addition to* the formal adoption of the federally codified economic substance doctrine in section 20 of A.B. 2498.[1] Precious little guidance exists, however, on what constitutes a "noneconomic substance transaction" other than the language in California Revenue & Tax Code § 19774(c)(2), which provides that "[a] transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California

[1] I.R.C. § 7701(o).

business purpose for entering into the transaction." Accordingly, the provision would far exceed even the broad boundaries of the federally codified economic substance doctrine.[2]

A provision that does not provide clear guidance on its scope and application cannot deter taxpayer misconduct without unduly impeding legitimate business transactions. Section 21 is such a provision, and its subjective definition of "abusive tax avoidance transaction" deprives taxpayers and their advisers of meaningful guidance on what transactions fall within its scope. That same vagueness means that the provision could ensnare routine business transactions whenever a company considers the after-tax consequences of a transaction. Subjecting these routine transactions to a significant penalty, moreover, could prompt more litigation, which would delay receipt of revenue from the provision. TEI urges the legislature to refrain from expanding the definition of "abusive tax avoidance transactions" as contemplated in A.B. 2498.

Codification of Economic Substance

Sections 6 and 20 of A.B. 2498 would (1) codify the federal statutory economic substance doctrine and (2) impose a 20-percent penalty for underpayments of tax attributable to transactions lacking economic substance that are disclosed to the FTB. The penalty would increase to 40-percent for undisclosed noneconomic substance transactions. In addition, none of the current law exceptions to the imposition of underpayment penalties (whether substantial authority, reasonable basis plus disclosure, or reasonable cause and good faith) would apply to transactions lacking economic substance.

The courts developed the economic substance doctrine as a common law "backstop" to the Internal Revenue Code's substantive provisions more than 70 years ago.[3] The doctrine empowers courts to step in to prevent abuses of the Code's substantive provisions, and history confirms the courts' willingness to exercise that authority, with the IRS winning myriad cases in recent years.

To date, there has been little evidence that codification of the doctrine is necessary at either the federal or state level. Indeed, in our view statutorily "clarifying" the doctrine would do nothing to curb illegitimate transactions *because there are no illegitimate transactions currently beyond the judicial doctrine's reach*. Historically, the Treasury Department and IRS voiced concerns about the need for and the possible unintended consequences of codifying the doctrine,[4]

---

[2] "The [federal] provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," Joint Committee on Taxation, JCX-18-10, at 152 (March 12, 2010).

[3] *See Gregory v. Helvering*, 293 U.S. 465 (1935).

[4] *See, e.g., Solomon Says Rule Not Enough to Fix Tax Patent Problem; Other Issues Discussed*, BNA DAILY TAX REPORT, G-6 (October 15, 2007).

and these concerns are shared by taxpayers and taxpayer organizations. Codification would complicate the system, confuse taxpayers and auditors, raise significant issues of statutory construction, impede the courts' ability to rely on existing precedent, and interfere with legitimate commercial transactions.[5] This is especially true in California where state revenue personnel and state judges would need to apply a federal doctrine with wide-ranging judicial precedent in a state tax context. Because application of an additional complex, subjective anti-abuse rule would divert valuable department resources, enactment of the provision would likely frustrate FTB efforts to combat abusive transactions.

Moreover, California Revenue & Tax Code § 19774 already imposes strict penalties on transactions lacking economic substance. Layering in this additional federal definition of economic substance would create unnecessary confusion without benefit to tax administration generally. As a result, TEI urges rejection of the state's adoption of section 7701(o) of the Internal Revenue Code.

The Imposition of Strict Liability Penalties Is Contrary to Sound Tax Policy

A.B. 2498 would eliminate the reasonable cause defense to penalties imposed on taxpayers that have engaged in transactions falling under an overbroad definition of an "abusive tax avoidance transaction" and transactions lacking economic substance as that term is defined statutorily under section 7701(o) of the Internal Revenue Code.

A rational penalty system must recognize that taxpayers who act in good faith to comply with California's amorphous body of tax laws should not be penalized. Civil tax penalties should be imposed only for volitional deviations from standards of conduct that are clearly defined by the California Legislature, the State Board of Equalization, or the FTB. Indeed, the IRS Commissioner's Executive Task Force on Civil Penalties discussed in 1989 that "[c]ivil tax penalties *should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as the raising of revenue*."[6]

Recent experience demonstrates that imposing stiff penalties without according taxpayers an opportunity to demonstrate why an exception or waiver of the penalty might apply can have unintended consequences. A reasonable cause exception is an important safety valve in the tax system because it enhances fairness and reduces disputes over penalties where the taxpayer acted

[5] The Joint Committee on Taxation's explanation of the federal codification states that these basic transactions include (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction. *See* TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN H.R. 3962, *supra* note 2 at 90. California's adoption of the federal rule would create further uncertainty given that Joint Committee on Taxation explanations may be given less weight in the state than is the case with the federal government.

[6] Commissioner's Executive Task Force on Civil Penalties, Internal Revenue Service, *Report on Civil Tax Penalties*, at 1 (February 21, 1989), available at 89 TNT 45-36, Doc. 89-1586 (emphasis supplied).

reasonably and in good faith, even where the FTB and courts ultimately disagree with the taxpayer's judgment about a particular transaction. Finally, a strict liability penalty could embolden FTB auditors to threaten assertion of the economic substance doctrine or "abusive tax avoidance transaction" merely to extract settlement concessions during examinations.

TEI submits that the current California penalty regime provides sufficient incentives for taxpayers to steer clear of over-aggressive tax positions. Indeed, less than two years ago, the legislature enacted a large corporate understatement penalty subjecting corporate taxpayers to a 20-percent strict liability penalty for understatements resulting in an increase in California tax in excess of $1 million. TEI firmly believes that the key to stopping the use of over-aggressive schemes is not layering on another penalty, but rather the strong, but fair, enforcement of existing law. For these reasons, the strict liability penalty should be rejected.

Amnesty Program

Section 11 of A.B. 2498 would establish a limited amnesty program permitting taxpayers an opportunity to disclose "abusive tax avoidance transactions" in return for an abatement of penalties that could be otherwise imposed. That program would run from January 1, 2011 to April 15, 2011. Unfortunately, the opaqueness of the expanded "abusive tax avoidance transaction" definition would leave taxpayers at a loss for knowing with any level of certainty whether they have engaged in such a transaction.

The bill would also force taxpayers to relinquish their rights to file refund claims for amounts paid as part of the amnesty program, eliminating the ability for taxpayers to challenge the characterization of suspect transactions. This could violate taxpayers' procedural due process guarantees under the United States and California Constitutions because neither A.B. 2498 nor any other California statute affords taxpayers with any pre- or post-payment opportunity to challenge an imposition of the amnesty penalty. Lastly, the bill would unfairly extend the statute of limitations for the FTB to assess undisclosed amounts from 8 to 12 years.

In its current form, this amnesty program would force taxpayers to treat everyday business transactions as "abusive tax avoidance transactions" in order to avoid the threat of excessive penalties. TEI urges that the amnesty program contemplated in this bill be removed.

Jeopardizing the Professional Licenses of In-House Tax Professionals

Sections 1 and 2 of A.B. 2498 would authorize the suspension, disbarment or censure of any certified public accountant or attorney licensed in California who has aided and abetted the understatement of a tax liability. California has long imposed a penalty for aiding and abetting the understatement of a tax liability adopting the definitions used in the federal penalty contained in section 6701 of the Internal Revenue Code. That penalty applies where a practitioner knows that her advice will be used in connection with a material matter and that the advice would result in the understatement of tax for another person. The amendments to existing law included in Section 8 of A.B. 2498 would expand the penalty to situations where the practitioner "should have known" that her advice would be used in a material matter that would result in the understatement of another person's tax liability. The bill would also increase the amount of the penalty tenfold from $10,000 to $100,000 for understatements relating to corporations.

In view of the staggering complexity of California's corporate income tax, and the federal tax code that provides many of the rules upon which a taxpayer's California liability is based, TEI is highly concerned that even the slightest misstep – a mere foot fault – by an in-house lawyer or certified public accountant licensed in California could lead to Draconian personal penalties including large fines and disciplinary action by the state. Employees involved in tax planning transactions that must be reported on company tax returns would be exposed to an enormous penalty if the FTB determines that they "should have known" the position would be used and would result in an tax understatement. This standard and its application to myriad situations would create uncertainty, disrupt routine business processes, exacerbate the degree and magnitude of tax controversies, and increase the costs of tax compliance and administration. For the foregoing reasons, TEI strongly urges the withdrawal of these sections from A.B. 2498.

Conclusion

For the aforementioned reasons, TEI strongly opposes A.B. 2498 and urges the withdrawal of the bill. It is filled with provisions that will inhibit the efficient collection of legitimate taxes, and would cause taxpayers to lose faith in the fairness of the California tax system.

TEI appreciates this opportunity to comment on A.B. 2498. If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Cathleen Stevens, Chair of TEI's State and Local Tax Committee, at 847.735.4672 (cathleen.stevens@brunswick.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Respectfully submitted,

Tax Executives Institute, Inc.

N. Traubenberg

Neil Traubenberg
International President

cc: Ms. Nancy Skinner, Assemblywoman
Senate Budget and Fiscal Review Committee
Assembly Committee on Budget