



Dan Bucks  
Director

# Montana Department of Revenue



Brian Schweitzer  
Governor

DOR #9

## Montana Department of Revenue Administrative Efforts to Correct Abusive Tax Shelters September 18, 2007

### Background on the Problem

Beginning in the mid-1990s, three multinational accounting firms in conjunction with large investment banks and law firms marketed abusive tax shelters to large corporations and individuals with a very high net worth. Federal congressional investigations and criminal prosecutions have established that these abusive tax shelters often constitute tax evasion and even fraud. Congress and some states have responded to this problem by enacting "dual disclosure" legislation requiring reporting, subject to substantial penalties, by 1) taxpayers concerning abusive shelters they have purchased and 2) tax shelter promoters concerning abusive shelters they have sold. The dual disclosure system and the larger than normal penalties provide an incentive for both taxpayers and shelter promoters to report abusive shelter activity.

Despite requests to the Internal Revenue Service for information on the use of abusive tax shelters by out-of-state corporations doing business in Montana, the Service has not supplied out-of-state corporate taxpayer information to the Department of Revenue. Thus, the department has relied on other federal investigative sources, information sharing from other states and self-reporting by taxpayers to identify the nature and extent of the problem affecting Montana. Information from these other sources does not typically include the level of financial detail that would be present in information from the Internal Revenue Service. The absence of both detailed IRS information and a Montana abusive tax shelter disclosure law significantly affects the Department of Revenue's ability to correct the abusive tax shelter problem.

From sources other than the IRS, the Department of Revenue has identified approximately 425 cases of corporations doing business and earning income in Montana that have engaged in abusive tax shelters. All but three of these corporations are out-of-state companies.

We identified 64 of these cases in 2005 from companies that volunteered to correct their abusive tax shelters with California. Because these 64 corporations had volunteered in another state, we consider these to be the easier cases to resolve. During 2005 and 2006, the department worked with these corporations and resolved the tax shelter issues with 47 of these companies. A total of \$465,394 was paid to Montana as a result of this work. The remaining 17 corporations in this first group remain under IRS audit and have agreed to file amended Montana returns when those audits are complete.

The department expects the remaining estimated 360 unresolved cases of corporations engaging in tax shelters to be more difficult to address because it appears that a very large majority of these companies have not chosen to voluntarily cooperate with other taxing authorities to correct their underreporting of income.

The department's existing productive corporate audit program completes approximately 18 audits per year. If one-third of this staff were diverted to conducting abusive tax shelters and only one-half or 180 of the highest priority corporations were selected for audit, it would at best take 30 years to address these cases—assuming no taxpayer resistance. Clearly more efficient and effective methods are needed to resolve these cases.

Because the tax shelter problem is almost exclusively an out-of-state corporation and non-resident taxpayer problem, the Department of Revenue joined with 22 other states in an abusive tax shelter voluntary compliance program announced by the Multistate Tax Commission (MTC) on June 11, 2007 and scheduled to run until October 1, 2007. Under this program, the 24 states offer taxpayers various incentives—typically penalty or interest waivers—to reverse voluntarily their use of abusive shelters. These incentives, however, are for most of these states based on ordinary late payment and underreporting penalties and interest—modest sanctions that have already failed to deter abusive tax shelters. Nonetheless, because the MTC program is aimed at a national audience, the department judged it to be suited to Montana's need to reach the estimated 360 unresolved cases of out-of-state corporations doing business in Montana that have engaged in abusive tax shelters.

The MTC program is contacting taxpayers that have volunteered in states that have enacted their own abusive tax shelter legislation. As noted earlier, Montana has already worked with 64 corporations comprising the "easier cases" of taxpayers that have volunteered in California. So to a degree the MTC program is focusing on some of the relevant taxpayers whose cases Montana has already resolved.

The hope was that having multiple states offer combined incentives would attract some significant participation—even though the incentives were based for most states on ordinary late payment or underreporting penalties and interest that do not appear to have a significant impact on tax shelter behavior. However, the MTC program has only attracted three volunteering taxpayers at this point out of 7,500 taxpayers the program contacted, and none of the three volunteering taxpayers earn income in Montana. Two weeks remain in the MTC program. However, if there is no significant change, the lessons are clear: taxpayers using abusive tax shelters are unlikely to voluntarily correct their improper reporting of income unless faced with state laws that require dual disclosure by taxpayers using shelters and promoters selling them and that impose substantial penalties for failing to disclose.

The Department of Revenue will do what it can with available resources available to resolve as many of the several hundred abusive tax cases as possible. However, traditional audit tools are inadequate to produce any rapid resolution of any significant number of cases. New tools comparable to the dual disclosure laws enacted by Congress and some states are needed to make additional progress in correcting this problem that adversely affects honest Montana taxpayers.

As a part of our continuing efforts in this area, the Department of Revenue issued on Monday, September 17, 2007, a summons to a significant tax shelter promoter asking for the disclosure of abusive tax shelters aimed primarily at understating only state taxable income.