Bill Analysis

Peter A. Cooper *Legislative Service Commission*

H.B. 124

126th General Assembly
(As Introduced)

Reps. Skindell, Sykes, Miller

BILL SUMMARY

- Requires taxpayers and planners of abusive tax shelters to disclose their participation in such shelters to the Tax Commissioner.
- Creates a permanent voluntary disclosure program permitting taxpayers participating in abusive tax shelters to disclose and pay outstanding tax liabilities in exchange for partial penalty waiver.
- Imposes an additional understatement penalty on persons for substantially understating taxes due from a transaction that is a "reportable transaction."
- Requires the Tax Commissioner to conduct a temporary, 12-month voluntary disclosure initiative permitting taxpayers participating in abusive tax shelters to disclose and pay outstanding tax liabilities in exchange for partial penalty waiver.

CONTENT AND OPERATION

Permanent tax shelter disclosure requirements

(R.C. 5703.61(A) and (B))

The bill institutes tax shelter disclosure requirements for corporations, other entities, trusts, estates, and individuals subject to the corporation franchise tax, the personal income tax, and the withholding tax on pass-through entities with nonresident investors. The disclosure requirements apply to any such taxpayer required to file a "reportable transaction disclosure statement" for federal income tax purposes (IRS Form 8886). The bill's disclosure requirement is that any taxpayer required to file that statement for federal tax purposes for a given year, or for any of the preceding three years, must file a copy of the statement along with the applicable Ohio tax return.

The reportable transactions covered by the bill's disclosure requirements are the same as those covered by the federal reporting requirements. The Internal Revenue Service maintains a list of tax shelter transactions that promoters and participants (i.e., taxpayers) must report to the IRS because the IRS considers the transactions to have the potential for tax avoidance or evasion. These "reportable" transactions fall into six general categories (summarized below).

Categories of IRS Reportable Transactions

Listed transactions. Specific kinds of transactions determined by the IRS to be tax avoidance transactions. The IRS identifies them by notice, regulation, or some other form of published
guidance. Currently, there are about 30 such transactions. (See www.irs.gov/businesses/corporations, "Abusive Tax Shelters and Transactions" for the updated list.)

Confidential transactions. Transactions offered under the condition that the participant is limited in disclosure of the transaction's tax treatment or tax structure, and the limitation protects the promoter's tax strategies. The participant also is charged a fee of $50,000 (or $250,000 for corporations and corporate-held entities).

Transactions with contractual protections. Transactions under which the participant is guaranteed the intended tax benefits or under which payment of the participation fee is contingent on realization of the tax benefit.

Loss transactions. Transactions resulting in a tax-deductible (gross) loss exceeding $2 million in any year or $4 million in any number of years for individuals, partnerships, trusts, and S corporations; and $10 million in any one year or $20 million in any number of years for C corporations and corporate-held entities.

Book-tax difference transactions. Transactions resulting in book-tax differences in any one year of $10 million or more. The category applies only to SEC-filing companies and to businesses with at least $250 million in gross assets. (The book-tax difference is the excess of (i) the income, gain, expense, or loss item resulting from the transaction for federal income tax purposes over (ii) the income recorded in the participant's books according to standard accounting practices.)

Transactions with brief asset holding period. Transactions resulting in the participant claiming a tax credit of more than $250,000 for holding an asset for 45 days or less.

Penalties

Penalties are imposed for failing to file a copy of the reportable transaction disclosure statement as required by the bill. If a listed transaction is not involved, the penalty is $15,000. If a listed transaction is involved, the penalty is $30,000, and the statute of limitations on assessments is unlimited.

Tax shelter registration disclosure

(R.C. 5703.61(A) and (C))

The bill requires taxpayers participating in registered tax shelters and required to file an "investor reporting of tax shelter registration number form" for federal income tax purposes (IRS Form 8264) to file a copy of that form, disclosing their participation, with the Tax Commissioner. The copy of the form must be filed for any year for which the federal form was required, or for any year within three years after the year a federal form had to have been filed. The copy of the form must be filed in a manner to be prescribed by the Tax Commissioner.

Under federal law, persons organizing certain shelters or providing material assistance in organizing shelters are required to register the shelters and to maintain a list of participating taxpayers. (I.R.C. §§ 6111 and 6112.) Persons selling certain shelters must provide the purchaser with the registration number the IRS assigns to the shelter. Participants in a registered shelter must file Form 8264 with the Internal Revenue Service showing the number assigned to the shelter.

Tax shelter registration requirements

(R.C. 5703.62)

General registration requirement

The bill requires organizers of a tax shelter that must be registered under federal law to also register the shelter with the Tax Commissioner if the shelter has an Ohio connection--i.e., if it is organized in Ohio, does business in Ohio, derives income from within Ohio, or has at least one Ohio-based participant that is subject to the corporation franchise tax, the personal income tax, or the withholding tax on pass-through entities with nonresident investors.[1] The registration is accomplished by filing a copy of the federal "application for registration of a tax shelter" form (IRS Form 8264) with the Tax Commissioner on or before the first day the tax shelter is offered for sale. Registration is not required if the shelter has no such Ohio connection when it is first offered for sale, but if an Ohio connection is later established, a copy of Form 8264 must be filed within 60 days after the Ohio

[1] For tax shelter registration purposes, "tax shelter" has a specific meaning defined by the ratio of associated tax benefits to the investment in the shelter. Specifically, a tax shelter is an investment where the value of the associated tax deductions, plus 350% of the associated tax credits, is twice the investment in any of the first five years.

connection is established. The copies of the form must be filed in a manner to be prescribed by the Tax Commissioner.

A penalty of $15,000 must be imposed on any person who fails to file a copy of the form as required by the bill.

Organizers of such tax shelters having an Ohio connection when the federal Form 8264 must be filed for federal purposes must provide the IRS-assigned tax shelter registration number to the Tax Commissioner within 60 days.

A penalty of $15,000 must be imposed on any person who fails to provide the registration number as required by the bill.

Listed transactions registration

The bill prescribes reporting requirements specifically for tax shelters involving listed transactions that are organized in Ohio, doing business in Ohio, or deriving income from Ohio sources, or having at least one investor that is subject to the corporation franchise tax, the personal income tax, or the withholding tax on pass-through entities. Organizers of such shelters must file a copy of Form 8264 with the Tax Commissioner if the form was required to be filed for federal tax purposes. The requirement applies to shelters that become listed transactions at any time after January 1, 2005. If a federal form was not required, the organizer must file any other form prescribed by the Tax Commissioner for the purpose of registering the transaction. The filing must be made within 60 days after the transaction becomes a listed transaction and has an Ohio connection.

The filing must be made by organizers of listed transactions, which includes any person that discovers, creates, investigates, or initiates investment in a listed transaction, devises the business or financial plans for the investment, or carries out such plans through negotiations or transactions with others, or any other person who participates in the organization or management of the listed transaction.

A penalty must be imposed on any person who fails to file a copy of the form, or any form required by the Tax Commissioner, as required by the bill. The penalty is $100,000 or 50% of the gross income from the transaction, whichever is greater.

Potentially abusive tax shelters

Federal law requires organizers or other persons selling "potentially abusive tax shelters" to maintain a list of investors in those shelters. A potentially abusive tax shelter is one that has to be registered with the IRS under federal law and that also falls within regulations prescribed by the Secretary of the Treasury. (I.R.C. § 6112.)

The bill requires organizers and sellers subject to the federal law to also maintain a list of investors if the shelter has an Ohio connection--i.e., organized in Ohio, doing business in Ohio, deriving income from within Ohio, or having at least one Ohio-based participant that is subject to the corporation franchise tax, the personal income tax, or the withholding tax on pass-through entities. The list must be provided to the Tax Commissioner upon the Commissioner's request.

The penalty for not providing the list as required by the bill is $10,000 per day.

Reportable transaction understatements of income

(R.C. 5703.66)

The bill imposes an additional penalty on any person subject to the corporation franchise tax, personal income tax, or pass-through entity withholding tax that engages in a reportable transaction to avoid or evade the tax, or that engages in a listed transaction, with the result that there is a difference between their proper tax amount and their reported tax amount. The penalty equals 20% of the understated tax resulting from the transaction. It is in addition to any other applicable penalties. The penalty cannot be avoided by the taxpayer filing an amended return if the amended return is filed after the Internal Revenue Service or Tax Commissioner contacts the taxpayer regarding an examination.

Voluntary disclosure agreements

(R.C. 5703.63 to 5703.65)

The bill institutes a permanent voluntary disclosure program whereby certain kinds of taxpayers may anonymously approach the Tax Commissioner and apply for a waiver of penalties on previously unreported or unpaid personal income or corporation franchise tax liabilities. The liabilities may be from any of the six prior years. Taxpayers remain anonymous until the Tax Commissioner accepts the taxpayer's application and executes an agreement with the taxpayer. The Tax Commissioner does not have to accept an application, but the taxpayer may remain anonymous even if the application is rejected. The agreement commits the state to waiving various applicable penalties for the six-year period and to waive its right to assess taxes, interest, and penalties for periods before the six-year period. The agreement commits the taxpayer to fully disclose and pay its liabilities for the six-year period and to pay its future liabilities.

Agreement terms

The bill prescribes the terms of a voluntary disclosure agreement which are binding on both the Tax Commissioner and the taxpayer entering into the agreement.

The terms binding on the Tax Commissioner are as follows:

(1) The Tax Commissioner waives authority to make an assessment for taxes, additions to tax, fees, or penalties with respect to each taxable year ending before six years from the signing date;

(2) With respect to each of those six taxable years, all or some of the following are waived, as specified in the agreement:

(a) Any penalty related to a failure to make and file a report or return;

(b) Any penalty related to a failure to pay any amount due by the date prescribed for payment;

(c) Any penalty or addition to tax related to an underpayment of estimated tax;

(d) The $100 per-day penalty for doing business in Ohio after the privilege to do so has been revoked for noncompliance with the tax laws.

The terms binding on the taxpayer are as follows:

(1) The taxpayer voluntarily and fully discloses on the application all material facts pertinent to the taxpayer's tax liability;

(2) The taxpayer files all returns or reports required by law and pays in full any tax, interest, fee, and penalties imposed other than penalties specifically waived under the terms of the voluntary disclosure agreement within 30 days after the agreement is signed. The payments may be made in installments if permitted by the Tax Commissioner.

(3) The taxpayer agrees to comply with all provisions of the applicable tax law in subsequent taxable years by filing all returns required and paying all amounts due.

Eligible applicants

Voluntary disclosure agreements are available to "qualified persons," which are defined as "qualified entities," "qualified shareholders," "qualified members," and "qualified beneficiaries."

A ***qualified entity*** is an entity satisfying all of the following:

(1) It is a corporation, limited liability company, or qualified trust;

(2) Neither it nor its predecessors have filed a return for income, corporation franchise, or pass-through entity withholding tax;

(3) Neither it nor its predecessors have been the subject of an inquiry by the Tax Commissioner with respect to liability for any of those taxes;

(4) It has voluntarily come forward without any prior unilateral contact from the Tax Commissioner, the Department of Taxation, or an agent or employee thereof, completes an application for a disclosure agreement, and makes a full and accurate statement of its activities in Ohio for the six immediately preceding taxable years.

Even if an entity meets all of the above criteria, it is not eligible for the voluntary disclosure program if it is organized under Ohio law, holds a license to do business in Ohio, or maintains and staffs a permanent facility in Ohio (excluding holding property in a public warehouse).

A ***qualified shareholder*** is an individual who is a nonresident at the time the disclosure agreement is signed, who is a shareholder in an S corporation that applied for the disclosure agreement, and all the material facts pertinent to the shareholder's liability would be disclosed on that S corporation's voluntary disclosure agreement.

A ***qualified member*** is an individual, corporation, or limited liability company that, in the case of an individual, is a nonresident at the time the disclosure agreement is signed and, in the case of a corporation or limited liability company, is not organized under Ohio law or does not hold a license to do business in Ohio, and that is a member of a limited liability company that applied for a disclosure agreement and all the material facts pertinent to the member's liability would be disclosed on the limited liability company's voluntary disclosure agreement.

A ***qualified trust*** is a trust satisfying both of the following:

(1) Administration of the trust, other than administration activities that are inconsequential to the overall administration of the trust, has never been performed in Ohio.

(2) For the six taxable years ending immediately before the signing date of the voluntary disclosure agreement, the trust has had no resident beneficiary other than a beneficiary whose interest in that trust is contingent. (A beneficiary's

interest is not considered to be contingent if the trust has made any distribution to the resident beneficiary at any time during the six taxable years ending immediately before the signing date of the agreement.)

A ***qualified beneficiary*** is an individual who is a nonresident when the disclosure agreement is signed, is a beneficiary of a qualified trust that applied for a voluntary disclosure agreement, and all the material facts pertinent to the beneficiary's liability would be disclosed on the trust's voluntary disclosure agreement.

Approval of applicants

The bill prescribes considerations the Tax Commissioner must take into account in considering whether to approve applicants for voluntary disclosure, as follows:

(1) The nature and magnitude of the applicant's previous presence and activity in Ohio and the facts and circumstances by which the nexus of the applicant with this state was established;

(2) The extent to which the weight of the factual circumstances demonstrates that a prudent business person exercising reasonable care would conclude that the previous activities and presence in this state were or were not immune from taxation by this state by reason of federal law prohibiting state taxation of the net income of nondomiciliary persons whose only activity in the state is soliciting orders for sales of tangible personal property, which orders are approved or rejected outside the state and, if approved, are shipped to the state from outside the state (Pub. L. No. 86-272, 15 U.S.C. 381);

(3) Reasonable reliance on the advice of a person in a fiduciary position or other competent advice that the activities of the applicant were immune from taxation by this state;

(4) Lack of evidence of willful disregard or neglect of the tax laws;

(5) Demonstrations of good faith on the part of the applicant; and

(6) Benefits that will accrue to the state by entering into a voluntary disclosure agreement with the applicant.

Nullification

Voluntary disclosure agreements become null and void if the Tax Commissioner finds any of the following:

(1) The taxpayer has misrepresented any material fact in applying for or in entering into the agreement.

(2) The taxpayer fails to file any report or return for any taxable year covered by the agreement on or before the due date prescribed by the agreement.

(3) The taxpayer fails to pay in full any tax, fee, penalty, or interest due within the time prescribed under the agreement.

(4) The tax shown by the taxpayer on its report or return filed for any taxable year covered by the agreement understates by 10% or more the tax imposed, and the taxpayer entity cannot demonstrate that a good-faith effort was made to accurately compute the tax.

(5) The taxpayer fails to begin to prospectively comply with applicable tax law according to the terms of the agreement.

If the Tax Commissioner finds that a taxpayer has failed to comply under any of the circumstances that render the voluntary disclosure agreement null and void, the limitation on the Tax Commissioner issuing an assessment for any taxable year covered by the agreement, and the waiver of any penalties under the agreement, are not binding on the Tax Commissioner.

Administration

The bill requires the Tax Commissioner to prescribe application procedures, to accept applications on an anonymous basis, and to provide procedures through the Multistate Tax Commission's National Nexus Program.

Temporary voluntary compliance initiative

(Sections 3 and 4)

The bill provides for a temporary, three-month period during which persons subject to the corporation franchise tax or personal income tax that have engaged in "abusive tax avoidance transactions"--that is, in some plan or arrangement devised for the principal purpose of avoiding either or both of the taxes, including listed transactions. The initiative permits these taxpayers to enter into an agreement with the Tax Commissioner providing for the waiver of all penalties and criminal prosecution. The initiative requires taxpayers to file an amended report for the period in which income was underreported by use of an abusive transaction, including income from all sources without regard to the transaction, and to pay the full amount of tax and associated interest due. The payment may be made in installments if the Commissioner approves. The Tax Commissioner is permitted to inquire into the circumstances and facts related to taxpayer's use of abusive transactions.

Failure by a taxpayer to comply with the agreement voids the agreement and reinstitutes the penalties and the possibility of criminal prosecution.

The Tax Commissioner is required to establish and administer the initiative. The three-month period begins on the first day of the month beginning at least 60 days after the bill's effective date.

HISTORY

ACTION	DATE	JOURNAL ENTRY
Introduced	03-10-05	p. 304

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