PREPARED TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
MARK W. EVERSON
BEFORE THE
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COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
HEARING ON ABUSIVE TAX SHELTERS
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INTRODUCTION AND OVERVIEW

Mr. Chairman, Senator Levin and Members of the Subcommittee, thank you for inviting me to discuss the subject of abusive tax avoidance transactions. We appreciate the interest the Subcommittee has shown in this issue, particularly in examining the proliferation of these transactions. The work of the Subcommittee has highlighted the need for greater transparency with respect to potentially abusive tax avoidance transactions and the need for increased penalties on participants and promoters.

The focus of the Subcommittee's first day of hearings was the mass marketing of tax shelters by some professional advisors. Beginning in the mid-1990s, some professional firms shifted their focus from their historic role of trusted advisors to that of professional salesmen.

According to the witnesses that appeared before you on the first day of the hearing, the biggest accounting firms no longer engage in mass marketing. If this is true, we believe that IRS efforts may have played a significant role in this development. We believe some promoters and taxpayers may have recognized the increased risk of detection of tax returns claiming tax benefits from abusive tax avoidance transactions. In any event, it is my view that this problem is significant, and we need to increase our diligence and effort in this area.

The Treasury Department and the IRS have responded by taking aggressive actions against participants in and promoters of abusive tax avoidance transactions. As a core element of these efforts, the Treasury Department and the IRS proposed in March 2002 to create a web of disclosure through a series of administrative and legislative initiatives.

The Treasury Department and the IRS didn't wait for the enactment of the legislative proposals, but moved forward with all of the administrative actions described in the March 2002 proposals, and almost all have been completed. These actions have been important steps in creating the transparency and certainty needed to combat abusive transactions. The legislative proposals would complete and reinforce these actions by simplifying the disclosure rules and imposing meaningful penalties on taxpayers and promoters who fail to provide the IRS with requested information.

One of the top priorities of the President's 2004 Budget Request for the Treasury Department was to strengthen the integrity of the nation's tax system by deterring inappropriate tax avoidance and evasion (especially among high income taxpayers).

As was made clear at the first day of the Subcommittee's hearing, issues of professional practice must be a priority. Tax professionals are vital to our system of voluntary compliance. They advise taxpayers on sophisticated legal transactions that involve complex rules and fine legal judgments. The tax laws are complex and taxpayers are permitted to take aggressive positions within the bounds of the law. Tax professionals should assist taxpayers in navigating through this challenging landscape to determine their fair share of taxes. Instead, we have seen far too many instances in which tax professionals have helped taxpayers avoid paying the taxes rightfully owed.

We are looking for ways to encourage best practices and ethical professional behavior by tax professionals, as well as discourage participation in abusive tax avoidance transactions. A key thrust in this effort is transparency, that is, the rules that the Treasury Department and the IRS have put in place to require the disclosure to the IRS of transactions that constitute abusive tax avoidance transactions or potentially abusive tax avoidance transactions.

The IRS and the Treasury Department are committed to ensuring compliance with the rules governing the promotion of tax avoidance transactions by tax professionals. The IRS is currently conducting well over 100 examinations of promoters. As part of the examinations, we are requesting investor lists and other information, and, if necessary, issuing summonses for those lists and other information. As a consequence of the examinations, we are reviewing numerous transactions to determine whether they should have been registered under section 6111 of the Internal Revenue Code, and whether investor lists should have been maintained under section 6112 of the Code.

Tax professionals, including lawyers and accountants, must comply with the law requiring registration of tax shelters and the keeping of investor lists. Many entities have provided us with the information we have sought pursuant to our requests. Others have been less forthcoming. We will continue our efforts to assure adherence to the law by promoters of potentially abusive tax avoidance transactions, including the use of summons and summons enforcement actions where necessary to obtain the information to which we are entitled. We will not hesitate to use the tools at our disposal to gather information about transactions, the taxpayers who invest in them, and the promoters who sell them.

QUESTIONS POSED BY THE SUBCOMMITTEE

In your letter of invitation, you asked the IRS to address four specific questions at this hearing. To the extent possible, I will address those questions in order.

(1) The scope of the potentially abusive and illegal tax shelter problem including the role played by professional firms, the estimated overall cost to the U.S. Treasury from these tax shelters, and the IRS' efforts to combat these tax shelters.

Estimates vary on the size of this problem. Unfortunately, it is very difficult to make a precise determination based on the many different interpretations and definitions of abusive tax shelters. The October 2003 GAO report on abusive tax shelters also acknowledged this difficulty. Whatever the actual volume of abusive tax shelters, we recognize that there is a significant compliance problem and we are taking aggressive action to address it, utilizing existing regulatory, administrative, and enforcement tools. For example, in our Large and Mid-Size Business Division (LMSB), we currently have 118 promoter cases open for investigation. In addition, in our Small Business/Self Employed Operating Division (SBSE) there are 41 technical tax shelter promoter investigations open. The audits began in LMSB in 2001, with 22 entities under investigation. As is apparent, we have increased the number of audits significantly. This includes large accounting firms and major law firms, as well as banks and a number of boutique and mid size promoters.

There are three ways the IRS finds out about questionable transactions. One, taxpayers and promoters are required to disclose or register questionable transactions and maintain investor lists under sections 6011, 6111 and 6112 of the Code. Two, the IRS identifies questionable transactions through its examination process. Three, the IRS and the Treasury Department learn about transactions through tips, some of which are anonymous tips through the Office of Tax Shelter Analysis ("OTSA") Hotline.

As I have indicated, disclosure is critical to our ability to identify and address abusive transactions early on. In February 2003, the IRS issued final regulations under Code Sections 6011, 6111 and 6112 to improve and enhance the disclosure of potentially abusive transactions by taxpayers, the registration of those transactions by "material advisors" (which would include "promoters"), and the maintenance of customer lists by those advisors. These regulations are designed to improve our information about potentially abusive transactions, promoters who market abusive transactions and those taxpayers who invest in abusive transactions. The regulations require taxpayers to disclose "reportable transactions" on their returns and to the IRS' Office of Tax Shelter Analysis, or OTSA. In addition the regulations require promoters to register their tax shelters with the IRS, and promoters and other persons to maintain lists of investors in their tax shelters and furnish those lists to the IRS upon its request.

A reportable transaction may not necessarily be an abusive transaction. But by subjecting a broad range of transactions to disclosure, we increase the likelihood of the IRS detecting the most abusive transactions. The increased likelihood of detection by the IRS alters the risk/reward calculus for potential investors entering into abusive transactions.

The number of disclosures received from taxpayers has increased significantly since 2001. We expect to receive more taxpayer disclosures pertaining to calendar year 2003 than with respect to any previous year.

Coordination with the States

Another way in which we are combating abusive transactions is through our work with the States. The IRS and state tax officials announced a new nationwide partnership to combat abusive transactions in September 2003. Under agreements with individual states, known as Memoranda of Understanding, the IRS and states will share information on abusive transactions and those taxpayers who participate in them. The agreements creating this partnership are designed to enable both state and federal governments to move more aggressively in the fight to ensure all taxpayers pay their fair share of tax. As of November 12, 2003, forty-two states, the District of Columbia, and the New York City Department of Finance have agreed to partner with the IRS on this initiative.

Under the initiative, the IRS and states will exchange information about a range of abusive tax avoidance transactions. This will allow the IRS and state agencies to avoid duplication and to piggyback on the results of each other's work. The states and the IRS will then share information on any resulting tax adjustments, reducing the need for duplicating lengthy taxpayer examinations by both a state and the IRS.

In addition to greater cooperation in sharing leads in the area of abusive transactions, the partnership with the states includes joint outreach and education activities to more effectively counter the claims of those marketing tax schemes and scams.

Initial data provided by the California Franchise Tax Board in response to an IRS request for state information relative to a high profile transaction the IRS currently is examining resulted in the identification of additional participants the IRS had not yet identified. As a result, the IRS will be able to protect statutes of limitations and bring additional participants into compliance.

Over the recent past, the IRS has taken a number of other noteworthy actions to combat abusive transactions. You are probably familiar to varying degrees with most or all of these actions. They center on greater transparency and developing and using a web of information to curb these transactions at the front end.

(2) With respect to BLIPS, OPIS, FLIP, SC2, COBRA, BOSS, and Son of BOSS, since 1995, the approximate total number of persons who have used each tax product and total amount of tax revenues lost as the result of each tax product.

It is difficult for us to identify the total number of persons who have used each tax product. We are, however, using examinations of promoters to secure investor lists to identify the participants. We have received a number of disclosures and, as the changes in the disclosure regulations take full effect and the number of listed transactions increases, we anticipate receiving more. There will be those who do not disclose, however, which will make it more difficult for us to get a complete picture. That some may choose not to disclose is why it is important for Congress to enact the change to the registration rules proposed by Treasury and IRS that will complete the information web on which the IRS relies to assist in finding non-disclosing taxpayers. That is also why it is important that the IRS maintain and strengthen its examination program so it continues to be capable of detecting undisclosed transactions.

Within our Operating Divisions, we have management information systems that track the activity on cases of known investors. Within our Office of Tax Shelter Analysis (OTSA), we can track the activity on cases of known investors through all sources.

We can provide the following data on specific transactions:

Notice 99-59 —The OTSA database contains transactions totaling $356 million in potential tax dollars.

Notice 2000-44— The OTSA database contains 2,208 transactions totaling $5.4 billion in potential tax dollars.

Notice 2001-45 — The OTSA database contains 322 transactions totaling $631 million in potential tax dollars.

(3) Whether, to your knowledge, professional firms are now routinely developing and marketing complex tax products for sale to multiple clients and, if so, the impact and implications of mass marketing these tax products, including whether professional firms may be, at times, misleading taxpayers regarding the legal validity of the products they are selling, and whether IRS oversight of tax professionals selling generic tax products poses new and different enforcement issues than reviewing the tax returns reflecting individualized tax planning advice.

Our promoter investigations have established that organized and comprehensive marketing strategies have been utilized by professional firms to sell abusive tax products that have been developed. These include transactions that were structured for the use of, and were marketed to, multiple investors, rather than a single investor. We have also seen indications that abusive transactions have moved "down market" through more widely-marketed promotions by lesser known professional firms to less affluent taxpayers. Such a development increases the likelihood that taxpayers may be misled or may be inadequately equipped to assess the tax avoidance proposals presented to them.

While circumstances differ from transaction to transaction, information received from investors suggests that some of these transactions, which are complex, may not have been fully understood by taxpayers, who consequently may have relied on the representations of the promoter.

A significant priority in the Service's efforts to curb abusive transactions is our focus on promoters.

Initiatives focused on promoters can provide a number of benefits. Promoters are required to maintain investor lists that identify taxpayers who participate in or purchase potentially abusive tax avoidance transactions that are "reportable" or "listed" under the Service's rules. By auditing the promoters and obtaining investor lists and following up with audits of those investors, we can deter the promotion of as well as the interest in such products. That is, these activities alter the risk/reward ratio for potential investors.

The IRS has included accounting and law firms in its investigations of tax shelters and related promoters. The IRS has included these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers.

Where the IRS believes a firm has failed to comply with the registration or list-keeping rules, the Service will not hesitate to audit.

The IRS conducts promoter examinations to determine whether a promoter has complied with regulations requiring identification of potentially abusive transactions by registering such transactions and maintaining and providing investor lists to the IRS upon request.

Through the promoter audits, we have shown that we are willing to use the tools at our disposal to obtain the information promoters are obligated to provide to us. Through the disclosure regime, including transactions and investor identities, generated by these efforts, we are demonstrating that the risk of detection and audit is serious and must be factored into the risk-reward calculus by promoters and investors alike. Mr. Chairman, we believe we can do more in this area and you can expect us to continue our efforts.

In regard to this question, I further want to point out several noteworthy actions we have taken in connection with our promoter efforts.

KPMG/BDO Seidman

In July 2002, the Justice Department, on behalf of the IRS, filed suit in federal court in Washington, D.C. against KPMG LLP, asking the court to compel the firm to disclose information to the IRS about tax shelters it had marketed since 1998.

In a similar suit filed in Chicago, the Department asked the federal court there to enforce summonses issued to another firm, BDO Seidman, LLP, for information related to its marketing of tax shelters since 1995.

Jenkens & Gilchrist

Earlier this year, the Department of Justice on behalf of the IRS petitioned the United States District Court, Northern District of Illinois, for enforcement of five administrative summonses and a John Doe summons served on Jenkens & Gilchrist. The summonses ask the law firm to provide information on certain listed transactions or other potentially abusive transactions organized or sold by the firm's Chicago office and to identify taxpayers who may have invested in them.

This was the first case of its kind involving a law firm.

Sidley Austin Brown & Wood LLP

In October, the IRS received approval from the United States District Court, Northern District of Illinois to serve a John Doe summons on Sidley Austin Brown & Wood, asking the law firm to identify taxpayers who may have invested in listed transactions or other potentially abusive transactions organized or sold by the firm.

Grant Thornton

On September 17, 2003, the Department of Justice, on behalf of the IRS, filed a petition in the U.S. District Court, District of Columbia, to enforce nine administrative summonses issued to the accounting firm, Grant Thornton LLP.

The summonses were issued as part of an IRS examination to determine Grant Thornton's compliance with tax shelter registration and list maintenance requirements, including identifying taxpayers who may have invested in potentially abusive transactions organized and sold by the firm.

Finally, the IRS has entered into closing agreements with professional service firms resolving issues related to those firms' compliance with the registration and list maintenance requirements that apply to the marketing of tax shelters. The agreements required payments to the IRS to resolve the issues. More important, however, the agreements require procedures that will prevent the future occurrence of the kind of practices that led to the IRS's audits and to the payments to the IRS to resolve the issues. In particular, the agreements ensure ongoing compliance with the registration and list maintenance provisions of the Internal Revenue Code and regulations. One of the agreements provides for the firm to implement a Quality and Integrity Program to ensure the highest standards of practice and ongoing compliance with the law and regulations. The IRS may, upon its request, review documents prepared as part of this program.

We are pleased with the full cooperation the IRS has been afforded by the firms that have entered into closing agreements in resolving these matters. This represents a real breakthrough and is a good working model for future agreements with practitioners.

Disclosure Initiative

In December 2001, the IRS announced a 120-day disclosure initiative that ended on April 23, 2002. The initiative provided taxpayers an opportunity to disclose questionable transactions to the IRS. Under the terms of the initiative, if taxpayers provided all relevant information about the disclosed transactions or items, including the identity of the promoter of the transaction, the IRS would waive certain accuracy-related penalties that might apply to those transactions and other questionable items that resulted in an underpayment of tax.

The IRS has used the disclosures to identify tax shelter promoters and to connect promoters to particular listed transactions. We are examining the activities of these promoters to determine whether they complied with their legal obligations to register certain transactions and maintain investor lists. Upon receipt of the investor lists from promoters, the IRS will be able to identify other taxpayers who participated in abusive transactions and failed to disclose them.

(4) Any recommendations you may have to ensure that professional firms develop and market generic tax products that comply with the law, the IRS learns of potentially abusive tax products marketed by professional firms to multiple clients, potential buyers are fully informed of risks associated with such tax products, or to address other tax shelter development, marketing, or implementation concerns.

As I indicated previously, we believe transparency is a key element in addressing abusive tax transactions. Transparency includes the disclosure of information *by* taxpayers and promoters and the disclosure of information *to* taxpayers and promoters.

In terms of disclosure of information by taxpayers and promoters, we will continue to rely on regulatory requirements for registration, disclosure, and maintenance of investor lists to provide the information we need to identify and monitor potentially abusive transactions. Transparency is critical to our early identification and would be significantly enhanced by the legislative change proposed by the Treasury Department that would expand the scope of the registration rules. We need to ensure that questionable transactions are registered and subject to IRS review. This is critical to our ability to identify and address abusive tax practices early on. The majority of taxpayers are honest and want to comply with the tax laws. By providing quicker guidance on tax transactions, we can enhance voluntary compliance.

I believe that tax professionals are an integral part of our effort to ensure that the Internal Revenue Code is administered fairly and appropriately. The majority of tax professionals recognize their obligations to the system as well as their obligations to their clients, and they have expressed dismay about the inappropriate behavior of some of their colleagues. I have asked the Deputy Commissioner for Services and Enforcement to develop and coordinate a unified strategy for improving confidence in the integrity of tax professionals, a strategy that will encourage best practices and deter improper and unethical practices.

The Treasury Department and the IRS intend to make changes to Circular 230, which governs professional conduct. Among the subjects we are closely examining in this regard are the standards employed in legal opinions regarding tax shelter transactions. I have asked the new Deputy Commissioner for Services and Enforcement, to make the strengthening of Circular 230 one of his priorities.

Moreover, the Treasury Department has solicited support for a number of legislative proposals intended to curb abusive transactions. We appreciate that these proposals have been included in several Senate bills. If the IRS or Treasury Department identify the need for additional legislation, we will bring those areas to the attention of Congress. We appreciate this Subcommittee's efforts to secure passage of that legislation.

In terms of disclosure of information to taxpayers and promoters, the Service intends to continue to emphasize its provision of published guidance. The published guidance program is an important tool that the IRS can use to increase disclosure and compliance. The IRS has in recent years made significant progress in accelerating and increasing its issuance of published guidance and our intention is to continue to improve our performance in this area.

Informing taxpayers through published guidance of abusive transactions will discourage participation in them. And there is another side to the coin – a very positive one that is sometimes forgotten. Some transactions that are worthy of IRS scrutiny may nevertheless prove to be sound under the law. Our willingness to indicate transactions that the Service believes are permitted under the tax law should encourage promoters and taxpayers to come to us with transactions that they believe are technically sound. In addition, through published guidance in non-shelter areas, we can save audit resources that we can then devote to areas with higher risk of noncompliance.

CONCLUSION

Mr. Chairman, we are firmly committed to curbing abusive tax transactions. They are an affront to honest taxpayers and practitioners and undermine confidence in the fairness of our tax system. The Congress and our taxpayers have every right to expect diligence, care and professionalism from the IRS in this effort, and I will do my utmost to see that those qualities are applied to our effort, and that there is no compromise of taxpayer rights.

Abusive transactions can and will continue to pose a threat to the integrity of our tax administration system. We cannot tolerate the promotion of or participation in abusive transactions. The stakes are too high and the effects of an insufficient response are too corrosive. We have put in place the foundation and structure to begin to attack these transactions in a systematic way. Certainly we will need to do more and we will need to do it better.

If professional service firms have in fact curtailed their marketing activities, as indicated in the testimony on the first day of the Subcommittee's hearing, we think it likely that IRS efforts played a significant role in this development. Some promoters and some taxpayers may be recognizing the increased risk of detection and audit of tax returns claiming tax benefits from abusive tax avoidance transactions. In any event, we must continue to be diligent.

Senate Finance Committee Chairman Grassley recently said, "The IRS should be able to enforce the tax code and respect taxpayers' rights at the same time. We can't have people abusing the tax code, and we can't have the IRS abusing taxpayers. It's as simple as that." I heartily agree. The IRS must demonstrate and execute a balanced approach if taxpayers are to remain faithful to our system of self-assessment. I believe the IRS has made progress in meeting these concerns.

I would be very pleased to answer any questions Members of the Subcommittee might have.