

**PREPARED TESTIMONY OF
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INTERNAL REVENUE SERVICE
SENATE FINANCE COMMITTEE
HEARING ON ABUSIVE CORPORATE TAX SHELTERS
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INTRODUCTION

Mr. Chairman, and distinguished members of the Committee, I thank you for this opportunity to testify on the IRS' programs and actions to address the proliferation of abusive corporate tax shelters. These transactions undermine voluntary compliance and threaten the fairness of our tax administration system.

The IRS Large & Mid-Size Division (LMSB) has made curbing abusive corporate tax shelters a top priority. We have put into place a structure and organization to implement our strategy and plans. As Secretary O'Neill recently stated, "we are going after them in a very tough-minded way." However, our task is extremely challenging and may require new tools to identify and halt the growth of abusive corporate tax shelters.

ISSUES AND CHALLENGES

These tax shelters are tax-motivated transactions designed and promoted by sophisticated tax professionals and used by both corporations and very wealthy individuals to reduce their taxes. They are highly complex transactions crafted to exploit technical loopholes in the internal revenue laws to obtain substantial and unintended tax benefits. Indeed, a better description of these devices might be "technical tax shelters."

These tax shelters pose an enormous challenge for the IRS. First and foremost, they are extremely difficult to find on tax returns. Large corporations have complex, voluminous returns, and the only clue to a shelter may be buried deep in the return.

Even if a taxpayer does not take measures to hide the shelter, finding it can be an investigative and time consuming challenge that requires the IRS to request information from a reluctant taxpayer to shed light on what underlies the return. If a corporation makes a concerted effort to hide a shelter, even an experienced IRS examiner may not find it on the return.

To complicate the issue further, technical tax shelters are factually complex. A typical transaction may involve multiple entities created solely for the purpose of investing in the shelter, as well as complex financial derivatives. Developing the facts requires an understanding of how complex transactions are structured. Because taxpayers may not provide or have all of the relevant documents, IRS examiners must the information from third parties.

Technical tax shelters are also legally complex. Tax shelter promoters carefully scrutinize the tax laws to find loopholes and then design complex transactions to exploit them. Consequently, technical tax shelters involve highly complex and very arcane areas of the tax laws. And, Mr. Chairman, they always come with the blessing of a tax opinion. This is a critical point.

For an investor, the tax opinion legitimizes the transaction, purporting to allow an investor to claim a reasonable belief that the tax benefit, no matter how outrageous, was legally justifiable. As a result of these tax opinions, technical tax shelters too frequently result in litigation. Moreover, the tax at issue is large enough, and the outcome is uncertain enough to encourage taxpayers to litigate the issue.

Although corporations already have a disclosure requirement, we believe too many are parsing words, narrowly construing the disclosure rules and broadly construing the exceptions. Taxpayers must adequately and properly disclose complex, tax-motivated transactions. The benefits are clear. With proper disclosure, we can conserve both our resources and the taxpayer's resources. With clear and adequate voluntary disclosure by taxpayers, our audits will be more focused. We will be in a better position to more quickly and effectively perform the audits. And the system would be more transparent, requiring all taxpayers to fully disclose complex, tax-motivated transactions.

Mr. Chairman, this is a two-way street. The process must be transparent from both sides. Taxpayers must disclose so that the IRS can identify and assess the propriety of the transaction. However, it is then our responsibility to use effectively the information by publishing guidance, telling the public our position on the transaction, and dealing with taxpayers who have invested in abusive ones.

In summary, if, as technical tax shelter promoters and investors claim, these transactions are proper, then they should not oppose our scrutinizing these transactions. The longer a technical tax shelter remains hidden, the longer the government is denied the tax dollars it is rightly due, the greater the resources that must be devoted to collecting those tax dollars, and the greater the number of taxpayers lulled into believing that the transaction is proper. Once again, the fairness of our voluntary compliance tax administration system is at risk and we, at the IRS, are making every effort to combat abusive tax shelter transactions.

ADMINISTRATIVE ACTIONS ADDRESSING TECHNICAL TAX SHELTERS

We have undertaken significant administrative actions to curb abusive corporate tax shelters. In February 2000, the IRS and the Department of Treasury issued the first set of tax shelter regulations. These regulations require corporate taxpayers to disclose reportable transactions, and require promoters to register confidential corporate tax shelters and maintain lists of tax shelter investors. Also, in February 2000, the IRS announced the creation of the Office of Tax Shelter Analysis (OTSA) to serve as the IRS' focal point for gathering and analyzing tax shelter information.

We continue to evaluate and improve our processes for eliciting tax shelter information and dealing with the information we obtain. As such, in December 2001, we announced a temporary disclosure initiative designed to encourage greater voluntary disclosure of questionable transactions. (I will discuss the disclosure initiative in more detail later.) We have also continued to make fundamental organizational changes to improve our overall capabilities to identify and resolve tax shelter issues. While we have made progress, we are finding that taxpayers and promoters are interpreting the current disclosure rules very narrowly and are disclosing few transactions. Consequently, it is our view that the disclosure regulations need to be revised and expanded. The set of initiatives described by Assistant Secretary Weinberger fills those needs.

Tax Shelter Registrations

One component of the February 2000 disclosure regulations are rules requiring promoters to register confidential corporate tax shelters. All registrations are now filed with the Ogden Service Center. Today, we review all promoter registrations for completeness and compliance with the tax shelter registration regulations prior to the issuance of the tax registration number. We evaluate all of the registrations to identify transactions that warrant further legal analysis or compliance attention. Over the past several years, we have initiated compliance actions on promoters based on information obtained from our evaluations of promoter registrations. For example, the Custom Adjusted Rate Debt (“CARDS”) transactions that was recently made a listed transaction was identified from promoter registrations filings and other tax shelter information in our OTSA office.

In 2001, 945 registration statements were received. Of these, 670 were confidential corporate tax shelter registrations (section 6111(d)), and 275 were ones filed under section 6111(c), which requires registration of any transaction in which total gross deductions in the first five years are projected to be more than twice the invested amount.

Promoter Contacts

A second component of the February 2000 tax shelter regulations are rules requiring promoters to maintain lists of tax shelter investors. Upon request, a promoter is required to provide its list to the IRS. The list is to be provided within 10 days of a request and the IRS is not required to issue a summons.

Using our authority under section 6112, we have been attempting to penetrate one of the most important sources of information about technical tax shelters – the persons and entities that develop and promote them. As such, we have contacted over 30 entities in connection with promoting technical tax shelters. However, we are finding that too frequently, we are not receiving the information on a timely basis, forcing us to initiate a promoter audit and issue a summons. To date, we have initiated 16 promoter audits to obtain investor information.

Through our promoter compliance actions, we have identified and are evaluating several transactions that appear to be potential abusive tax shelters and have identified other transactions that have been promoted by an individual promoter. Also, we have identified investors who have engaged in abusive tax shelter transactions and have initiated audits of those taxpayers.

Corporate Disclosures of Reportable Transactions

The third component of the February 2000 tax shelter regulations are rules requiring corporate taxpayers to disclose reportable transactions on their returns and send a copy of the disclosure statement to OTSA. Reportable transactions fall into two categories: (1) listed transactions, which are transactions the IRS has identified in published guidance as tax-avoidance transactions; and (2) other reportable transactions, which are transactions that have at least two of five characteristics common to technical tax shelters. Corporate returns that were filed during the fall 2001 filing season were the first to be fully covered by the taxpayer disclosure regulations.

However, as I have previously indicated, we believe that corporate taxpayers are narrowly construing the disclosure requirement while broadly construing the exceptions to disclosure. Last year, 99 corporations disclosed 272 transactions. Only 64 listed transactions were disclosed. The remaining 208 disclosures were other reportable transactions.

The disclosure statements received by the IRS have included both listed and unlisted transactions. All disclosure statements are reviewed by OTSA, cross-matched to other OTSA information and sent to a field office for examination action. To date, we have identified taxpayers, who should have previously made disclosure, and have identified names of promoters who have marketed tax shelter transactions.

Disclosure Initiative – Announcement 2002-2

On December 21, 2001, the IRS issued Announcement 2002-2, announcing a temporary disclosure initiative designed to encourage greater voluntary disclosure. The period of the announcement runs from December through April 23, 2002. During this period, taxpayers may disclose questionable transactions and other items that may result in an underpayment of tax. The initiative is not limited to reportable transactions. As an incentive, the IRS will waive any accuracy-related penalty that might be applicable if additional tax ultimately is due, but taxpayers must disclose all relevant information about the transactions, including the identity of any promoter.

The number of disclosures received has been both encouraging and discouraging for us. In the context of the program, the results are encouraging because over 100 taxpayers have disclosed transactions, and we expect many more. With the information we receive, we are pursuing promoters, identifying taxpayers who have not disclosed reportable transactions, and evaluating new types of transactions that are identified.

However, in the broader context of tax administration, the results are discouraging. The fact that so many taxpayers have only now disclosed these transactions illustrates our concern that these transactions are taking place frequently and without transparency on the returns.

The disclosure initiative has identified promoter participation in listed transactions not previously known. It also identified several new transactions that are currently not listed and are being evaluated with the Office of Chief Counsel.

LMSB ORGANIZATIONAL STRUCTURE

Having identified and designated abusive tax shelters as one of its strategic initiatives, LMSB has put into place an organizational structure to implement its plans and to establish coordination and oversight of the IRS' tax shelter activities. This organizational structure is designed to promote internal and external awareness and training on tax shelter issues, direct appropriate resources to tax shelter compliance activities, and greatly enhance coordination with the Department of Treasury, the Office of Chief Counsel, IRS Appeals, and other IRS operating divisions.

LMSB Tax Shelter Committee

Executive oversight of LMSB's tax shelter program lies with the LMSB Tax Shelter Committee, which is composed of the LMSB Commissioner and Deputy Commissioner, five Industry Directors, the Director of the Field Specialists, the Director of Pre-filing & Technical Guidance, the Director of International, the Director of Strategy, Research & Program Planning, and the LMSB Division Counsel. The Tax Shelter Committee sets LMSB's tax shelter compliance strategy and coordinates compliance issues with other IRS operating divisions, the Office of Chief Counsel, the Office of Appeals, and the Department of the Treasury. The Tax Shelter Committee also monitors significant tax shelter activity with the goal of improving the IRS' ability to coordinate and deal effectively with tax shelter cases.

The Tax Shelter Committee is responsible for coordination and oversight of all tax shelter activities. To enhance the IRS' compliance capabilities and efficiencies, the five LMSB Industry Directors are assigned to significant tax shelter issues for development, coordination, and resolution. By designating an issue champion for specific tax shelter issues, LMSB ensures uniform and consistent audit treatment of the tax shelter issues.

Office of Tax Shelter Analysis

A key organizational component to the IRS' tax shelter strategy, OTSA, is the IRS' focal point for gathering and analyzing tax shelter information from internal and external sources. *(Please see appendix: Announcement 2000-12, 2000-12 IRB 835)*. As the clearinghouse and information resource for all tax shelter information, OTSA obtains tax shelter information from a variety of sources, including the tax shelter hotline, corporate disclosure statements, IRS field surveys, and promoter registrations. OTSA analyzes the information to identify potential tax shelter issues and to compare corporate disclosures, tax shelter registrations, hotline information, and other information to identify taxpayers and promoters for further compliance action.

Office of Pre-filing & Technical Guidance (PFTG)

This LMSB office is responsible for providing technical assistance to field personnel in the development and resolution of shelter tax issues. PFTG has a technical advisor identified for each listed transaction. Technical advisors are issue specialists who support the examination teams with issue identification and development. The technical advisors are the focal point for information sharing and disseminating information related to a specific tax shelter transaction and provide technical training to field examiners.

LMSB Division Counsel

The Office of Division Counsel (LMSB) is an important organizational component and resource for LMSB personnel. This office provides a wide range of legal assistance and support to examination teams, technical advisors, and headquarters personnel. It also has a designated Senior Legal Counsel for Corporate Tax Shelters who participates in all tax shelter matters within LMSB.

CONCLUSION

Mr. Chairman, in spite of our multi-faceted approach and efforts to curb abusive corporate tax shelters, or technical shelters, the problem persists. Although we have a solid foundation to address the problem, we believe the Treasury recommendations will provide another important tool that could greatly assist our efforts. We look forward to working with you and the Members of the Committee on this issue that is critical to the fairness of our tax administration system. Thank you and I would be happy to answer any questions you have.