

**SCHEMES, SCAMS AND CONS:
THE IRS STRIKES BACK**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED SEVENTH CONGRESS
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CONTENTS

OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance	1
Grassley, Hon. Charles E., a U.S. Senator from Iowa	3

AGENCY WITNESSES

Cimino, Ronald A., Chief, Western Criminal Enforcement Section, Tax Division, Department of Justice, Washington, DC	15
Rossotti, Hon. Charles O., Commissioner, Internal Revenue Service, Washington, DC accompanied by Mark Matthews, Chief, Criminal Investigation, Internal Revenue Service, and Dale Hart, Deputy Chief, Small Business and Self-Employed, Internal Revenue Service	31
Brostek, Michael, Director of Tax Issues, General Accounting Office, Washington, DC	33
Williams, David, Inspector General, Treasury Inspector General for Tax Administration, Washington, DC	34

PUBLIC WITNESSES

Bullock, Dr. Daniel, former orthopedic surgeon, Atwater, CA	6
Sodaro, Jennifer, defense attorney for Daniel Bullock, Scottsdale, AZ	9
Blum, Jack A., Lobel, Novins & Lamont, Washington, DC	10
Stone, Kelly, Bozeman, MT	13
Spears, Robert L., retired insurance salesman, Traverse City, MI	16
Spears, Mary Elaine, Traverse City, MI	19
Daniels, Donald, executive counsel, U.S. Attorney's Office, Western District of Michigan, Grand Rapids, MI	21

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max: Opening statement	1
Blum, Jack T.: Testimony	10
Prepared statement	41
Brostek, Michael: Testimony	33
Prepared statement	45
Bullock, Dr. Daniel: Testimony	6
Prepared statement	55
Cimino, Ronald A.: Testimony	15
Prepared statement	56
Daniels, Donald: Testimony	21
Prepared statement	59
Grassley, Hon. Charles E.: Opening statement	3

IV

	Page
Rossotti, Hon. Charles O.:	
Testimony	31
Prepared statement w/attachment	61
Response to a question from Senator Torricelli	77
Sodaro, Jennifer:	
Testimony	9
Prepared statement	80
Spears, Mary Elaine:	
Testimony	19
Prepared statement	78
Spears, Robert L.:	
Testimony	16
Prepared statement	79
Stone, Kelly:	
Testimony	13
Prepared statement	82
Williams, David C.:	
Testimony	34
Prepared statement	83

SCHEMES, SCAMS AND CONS: THE IRS STRIKES BACK

THURSDAY, APRIL 11, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

As the April 15th tax filing deadline approaches, Americans will sit down at the kitchen table or home computer and try to figure out their income taxes.

Sure, they will grumble. We all think taxes are too high. We all think the forms and calculations are too complex. But, by and large, with quiet patriotism, average Americans will step up and pay their fair share of taxes.

As a result, our government will have the resources to defend our shores, educate our children, provide a clean environment, improve highways, and help provide for seniors and for those suffering through hard times.

In return, the American people expect two things. First, they expect the IRS to treat them decently. They want their privacy to be respected. They want forms and instructions that they can understand.

They want to be able to call the local IRS office and get a quick and courteous answer to a simple question. When there is a disagreement about how much they owe, they want a fair opportunity to explain their point of view.

Make no mistake about it, there have been serious problems in this area. There is a lot more to do, especially to make the Tax Code more simple.

But under the leadership of this committee, we have made some progress. We protected taxpayers rights and we have reformed the IRS. Americans also want something else. At the same time that they pay their own fair share, they expect everyone else who enjoys the benefits of this great country to also pay their fair share.

Everyone should help pull the wagon, from the richest corporations in New York or Houston to the guy down the street. Otherwise, we will reach the point where honest taxpayers will feel like

chumps, and the whole system of voluntary compliance will break down. That is where today's hearing comes in.

A few weeks ago, we heard about sophisticated techniques that some corporations are using to avoid taxes. We have heard about aggressive tax shelters that have no economic substance.

We even heard how one tax advisor told her corporate clients that, "Maybe the patriotism issue needs to take a back seat" so that they can abandon their U.S. citizenship and move to a foreign tax haven. In these cases, a solution may require some changes in law. I worked with Senator Grassley on two bills that would do just that.

Today's hearing will focus on another part of the problem which is just as important. We may be seeing a dramatic rise in flagrant, flat-out cheating. We are not talking about gray areas here, about close calls, about honest people making honest mistakes.

We are not talking about people fudging a little on the margin. No, we are talking about thousands—and maybe even millions—of people remaining right here in this country, but shifting their income to Bermuda, the Cayman Islands, or some other tax haven and then hiding their income from the IRS.

We are also talking about slick promoters who trick people into thinking that they do not have to pay taxes because of some bogus exemption, deduction, or credit.

They prey on formerly law-abiding taxpayers, doctors, lawyers, small business owners, ordinary people. The only good thing to say about these promoters is that they do not discriminate. They perpetuate equal opportunity frauds.

Their targets are people across all economic, social, and racial lines. When the trap is set, promoters charge their fee, skip town, leaving their unsuspecting victims holding the bag when the IRS finally comes around to collect. In these cases, we do not need new laws. We need better enforcement of the laws that are already on the books.

Let me say more about what is probably the most troubling issue. That is, offshore accounts. A year ago, under the leadership of Chairman Grassley, we had an initial hearing. Commissioner Rossotti testified, along with several private sector witnesses.

We heard alarming news about wealthy taxpayers using foreign trusts to hide their income. The IRS estimates that there are one to two million offshore accounts held by Americans in tax haven countries but only about 170,000 of these accounts are reported on their income tax returns.

The clear implication is that in many cases the accounts are being used to evade taxes. The total amount of revenue lost could be as high as \$70 billion, and that, of course, has to be made up by honest taxpayers.

At least year's hearing, we asked the IRS to take a closer look at this problem. Today, we will get a progress report and we will hear what steps the IRS is taking.

We will also hear from witnesses who sought, listened to, and took the wrong advice. These witnesses are presently paying the price, a couple of them with their liberty.

Now, while we do not condone what they did, we appreciate their willingness to appear before the committee and explain to us what happened, and why.

This is not an easy time for any of them. They are appearing because they want to warn others that tax cheating is risky and can have significant real-life consequences. Hopefully, their stories can serve as a warning to others.

One final point. Some have suggested that this committee swings like a pendulum. A few years ago, we said that the IRS was being too tough. Now the pendulum is swinging in the other direction and we are saying that the IRS is not tough enough.

I do not see it that way. Not at all. This is not an either/or situation. We do not have to choose between protecting the rights of taxpayers and properly enforcing the laws. These concepts are not mutually exclusive. They are different sides of the same coin.

So let me go back to the average American citizen sitting at the kitchen table as she fills out her tax return and pays the taxes that support the government. That citizen has a perfect right to hold her government to a standard of basic competence.

The IRS should be able to take a fair and respectful approach to honest taxpayers, and at the same time, take a hard line with con artists who are engaged in flagrant violations of the law. In fact, the American taxpayer expects nothing less.

I would now like to turn to the Ranking Member of our committee, Senator Grassley, for any statement he may want to make.

**OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S.
SENATOR FROM IOWA**

Senator GRASSLEY. I thank you very much. Just to make things clear, I associate myself with your remarks. I may repeat a little bit, but will say other things as well.

First of all, it is very necessary to hold this hearing on tax schemes and scams, and I am very glad that you are doing it. We have worked closely on this important matter that Congress needs to address.

The Finance Committee first looked into the issue a year ago when it became apparent, after a bipartisan investigation, that, thanks in part to the Internet, hundreds of thousands of Americans were hearing the snake oil salesman's pitch to get involved in all of these tax scams.

It is important that the American people be made aware of these tax hucksters and that the IRS take strong effort to put them out of business. The numbers are staggering.

We will hear testimony that approximately 740,000 Americans used abusive tax schemes in tax year 2000, costing billions. They say you cannot avoid death and taxes, but it looks like a lot of people are avoiding at least one of them.

Behind those staggering numbers are the stories of people's lives broken and ruined. We will hear from prisoners and their family members, all of whom have been devastated by falling for these schemes.

The testimony of these people should make one thing clear for Americans now as we approach April 15. If the sales pitch sounds too good to be true, it probably is not true. It is not that good.

In addition, we will hear about the latest growing scheme, the establishment of offshore accounts in tax haven countries with credit cards and debit cards being used to draw down money from that account.

The IRS, thank God, has started taking aggressive steps to find out about these offshore credit card accounts, going as far as subpoenaing records of Mastercard, Visa, and others.

So, I say to Americans everywhere, particularly those who are engaged in these offshore tax schemes, listen up. It is time to come clean, because the IRS is going to know whether you have got dirty hands.

Mr. Chairman, I would like to take just a few minutes to touch upon a matter that you addressed in your comments about some of the questioning of the Senate Finance Committee by others on these actions that we are taking.

I know that informing taxpayers about tax schemes and encouraging the IRS to do its important law enforcement duties would seem like mother's milk. But it does not seem so. One or two folks out there have attacked the Finance Committee for even holding this hearing.

These few individuals attacking the committee are a part of kind of an "amen corner" that I find at every agency that I investigate. These members of the "amen corner" are the agencies' lap dogs.

They usually never ask the difficult questions of the agency, and they inevitably find the answer to every problem in the simple answer that all you have got to do is give more money and hire more staff. The lap dogs are barking because they think the Senate Finance Committee is demanding too much of the Internal Revenue Service.

So what is the Finance Committee demanding? We are asking the IRS to do its job of one, providing taxpayer service, and two, enforcing the law. Unlike the lap dogs, I am confident that the IRS can walk and can chew gum, and do it all at the same time.

Why do some take the Finance Committee to task for asking the IRS to do these two things, or to chew and walk at the same time? A few years ago, under then-Chairman Roth, this committee held very important hearings that exposed the fact that some managers and employees at the IRS were out of control and were abusing the rights of taxpayers.

Last year, and today, the Finance Committee raises the issues of tax scams to, one, inform the public, and two, spotlight the IRS's enforcement activity. This is too much for this handful of folks who seem to believe that protecting taxpayers' rights and law enforcement at the same time are mutually exclusive.

It seems that they have a very myopic view that the Senate Finance Committee can only be for either taxpayers' rights on the one hand, or law enforcement on the other, but you can't be for both.

Well, that is obviously sheer nonsense. It is, as always, a question of balancing the protection of taxpayers and of law enforcement. This position, on my part, is nothing new.

In the first few lines of my opening statement to the 1997 IRS hearings, I used the word "balance" four times to emphasize the point that we need balance between taxpayers' rights and enforce-

ment. This goes unmentioned by those who want to tell a tale instead of telling the truth.

The lap dogs have been taught a few other tricks by the IRS Press Office. My favorite, is when they howl that the IRS barely has two pennies to squeeze. Well, the reality is that the IRS has had budget increases 29 of the last 30 years, and the Congress has fully funded the IRS budget requests the last 4 years.

They also ignore the fact that the IRS has been wasting millions of dollars of taxpayers' money. I would just give you three quick examples. IRS managers have wasted millions of taxpayers dollars constantly moving executives around the country.

The IRS moved one manager twice in 2 years for \$300,000. By contrast, the Commerce Department moved someone from Connecticut to South Africa for \$8,200.

The Tax Inspector General's investigation found that IRS employees on the Internet spend half their time looking at pornography, shopping, and gambling instead of working.

Three of my own investigations showed that dozens of IRS employees are placed on paid administrative leave for months at a time. In fact, one individual who committed several felonies was on paid administrative leave for 3 years, even after he was indicted, convicted, and sentenced. He was not fired until I raised questions about this waste of taxpayers' money.

Now, I know this may shock some who think that the only answers can be found in ever more dollars for the IRS or any other agency, but clearly, more money is not going to solve these problems any more than it has in the past.

Finally, Mr. Chairman—and I am done about now—let me assure everyone that even though this hearing focuses on enforcement, the Finance Committee also continues to be strongly concerned about the rights of taxpayers.

Chairman Baucus and I recently released a report on the offers in compromise program, and will soon, I believe, release a General Accounting Office study on the innocent spouse program. Both of these programs are critical to helping taxpayers. Again, it gets to the point of trying to achieve a proper balance between rights and enforcement.

So, thank you, Mr. Chairman, for allowing me to make these comments, particularly about the lap dogs, for a minute. Thank you for holding this hearing, once again.

The CHAIRMAN. Thank you very much, Mr. Grassley.

This hearing actually has two panels. The first panel is now before us. The second panel will consist of Commissioner Rossotti, as well as Mr. Michael Brostek, who is with the General Accounting Office, and Mr. Williams, who is Inspector General at Treasury.

So the point of the first panel, just for everyone's information, is to hear from people who know about these schemes, these arrangements, both from the point of view of being an actual participant who tried to evade taxes, and then from the lawyers who defended people in this area and who have an understanding of how these schemes are put together. They have some pretty deep knowledge, I might say, based upon the statements that I have read from a good number of you already.

The second panel will get more into enforcement. How well are we enforcing or not enforcing the law to bring these people to justice?

Starting at my far left on our first panel is Dr. Bullock. Dr. Bullock is a former orthopedic surgeon from Atwater, California. Next to him is Jennifer Sodaro, who is a defense attorney for Mr. Bullock. She hails from Scottsdale, Arizona.

Jack Blum is an attorney here in Washington, DC. Mrs. Stone is from Belgrade, Montana, my home State.

Next, is Mr. Cimino, who is the chief of Western Criminal Enforcement Section, Tax Division, of the Department of Justice.

Robert Spears, retired insurance salesman from Traverse City, Michigan. He is accompanied by his wife, Mary Elaine Spears, who is also from Traverse City.

And Donald Daniels, executive counsel, U.S. Attorney's Office, Western District of Michigan, of Grand Rapids, Michigan.

Thank you all for coming. I know that some of you come under great stress and you are here to give your side of the story, how you have been victimized or why you did what you did. You are here to warn others not to do the same thing, because it is not a good thing to do.

Dr. Bullock, will you not begin?

STATEMENT OF DR. DANIEL BULLOCK, FORMER ORTHOPEDIC SURGEON, ATWATER, CALIFORNIA

Dr. BULLOCK. Thank you, Mr. Chairman, Senator Grassley, members of the committee for an opportunity to tell my story.

My name is Daniel Bullock, M.D. In 1974, at age 23, I graduated from medical school. By 1981, just seven years later, I had served my country in the U.S. Public Health Service for a year and I had spent 4 years in specialty training as an orthopedic surgeon.

Between 1981 and 2001, I was in private practice in orthopedic surgery and sports medicine, and became board certified in 1985. In 1991 and 1992, I served my country again as a senior team physician for the U.S. Cycling Team.

Today, I am before you as an inmate of the Federal Correctional Facility, a satellite prison camp in Atwater, California. My home in Mt. Shasta, California is where my wife and two daughters live. I have 18 months to serve. I work as a janitor.

Here is how an elder and Bible teacher in his church, a happily married husband and father of two beautiful daughters, a medical missionary to Honduras and Nicaragua, and an orthopedic surgeon got in this situation.

The problem has not changed in 2,000 years. Paul wrote to Timothy, "People who want to get rich fall into temptation, and a trap, and into many foolish and harmful desires that plunge men into ruin and destruction." I Timothy 5:19.

In the mid-1980's, orthopedics was not enough. I was new in practice, but I had friends who were entrepreneurs and it sounded good. So, I started a business with some friends selling computers. A couple of years went by and, as is often the case, the business failed and there were some trust fund taxes unpaid by one of my associates.

The IRS felt that I was a responsible person and they wanted \$100,000 for the \$23,000 in taxes unpaid. After several years, several attorneys, the taxes were still unpaid and I was trying to reach a solution as I continued to work as a doctor, faced personal bankruptcy, and went through personal bankruptcy.

Several years later, in 1991, one of my attorneys finally got a hearing. I went to the hearing and, after several hours before the IRS, we offered \$45,000 to settle it and that was rejected.

I discovered that three evenings later when, at my private phone at home, the IRS hearing officer called me and told me, "Doctor, we really don't care what the facts are. We think you're a rich doctor, so we're going to stick it to you."

I was pretty upset. I called my attorney. He used some colorful swear words and said, "We'll sue them." Nothing happened. I was very naive. I did not realize that these things took a long time. Month after month went by. I did not know what to do.

Finally, my anger and fear combined together to make me a little bit rebellious. I began to look for some other kind of solutions. There is always a friend somewhere that knows somebody with the "silver bullet" or the inside scoop on a solution.

I talked to tax protestors. I went to some seminars and ultimately rejected their theories and strategies. I tried some administrative procedures and got no favorable responses or help.

The IRS threatened to levy my insurance company payments and my bank accounts, and in desperation, because I did not know how I could pay the by then \$200,000-plus, I sought a solution and found some information about starting a business trust, which supposedly offered extra protection against the government, possible tax savings, and increased privacy.

The first promoter, I now call him, seemed to know what he was doing. He had a relatively professional office and a professional staff, and he said that he could help me with my situation.

It was a bumpy start. Within 6 months, that man had stolen some of my money and was rated by the FBI as a money launderer. I related my stolen money to the money laundering, and since it was the FBI, I figured it was not a tax situation and looked for a solution.

Once again, I did not feel I had another alternative. My attorney still had not done anything. I found a man by the name of Lonnie Crockett. He was pointed out as an expert by another physician, after reading an article in a national magazine.

I attended a Crockett seminar. He was professional, believable, appeared to be law abiding, and he was very knowledgeable of trusts and tax laws, much more so than other attorneys or CPAs that I had encountered.

He had legal opinions and letters from several attorneys. These were all testimonials. So, I went to his offices with my wife. She also had attended the seminar, and her first question was, is this all legal? His answer was, yes, this is the way the wealthy do it.

After seeing his offices and consulting privately with him, I decided to go ahead and let him reorganize the complicated trust arrangements. For \$15,000, he filed tax returns, set up new bank accounts personally, and advised me that I was now an employee of the business trust.

The Orthopedic Trust was now a business operated and under his control. I was merely an employee and had access to special tax laws that could be used in combination with tax haven countries to save me money, as well as protect me in some ways.

Within a year or two, though, some funny things started happening. When payments from the Orthopedic Trust were sent to him in Utah to go off to the Isle of Man, and then to Austria, and subsequently 90 percent of the funds coming back to me here in the U.S. to my family trust, he began sending receipts after a payment was sent to him in the amount of the receipt, but for services that his business claimed to have provided.

I knew that not to be true and did not know quite what to do. By early 1999, I decided I had had enough, sought another legal opinion, got another attorney, and I stopped sending money offshore to Mr. Crockett.

But it was too late. Five months later, 13 armed, Kevlar-vested agents raided my offices and my home, forced the door open on my 16-year-old daughter, and went through all my belongings, seizing books, records and papers, when I thought I had nothing to hide. I thought it was all there on the tax returns. I thought it was legal.

I was indicted in July of 2000. In the summer of 2001, I met Ms. Sodaro. She advised me that I should probably settle this because I had 10 charges, 10 counts filed against me for tax evasion, fraud, and false returns.

I had thought the case was defensible, or so attorneys had advised me, because using tax haven countries was legal in certain special situations. I found out that was not true.

I plead guilty to two counts in October of last year. I was sentenced in January and presented, self-surrender, at Atwater to spend my first night ever in jail in "the hole." That is solitary confinement inside the maximum security Federal penitentiary in Atwater, California.

Fortunately, God taught me, in November of last year, what it was I had really done. And as I came to that understanding, I realized that the IRS did not have to be my enemy, they could be a help.

I thank the Federal agents, I thank the Department of Justice, for helping me get through this. I am sorry for putting them to the trouble. I realize now that there is a price to be paid for being an American. It is called filling out a tax return, making sure it is right, and sending it in.

I will never have a chance to be what I was before. Being a felon for life means that, in California, I have lost my medical license. Though I may regain it, I will never be able to bill managed care companies again.

I have substantial fines and penalties to pay. I have not yet settled with the IRS, and do not really know how I will do that if I cannot work as a physician for a while, especially with time being served.

That is my story. I am thankful that, for me, there is hope. With God, there are 1,000 ways.

The CHAIRMAN. Thank you, Dr. Bullock, very, very much.

[The prepared statement of Dr. Bullock appears in the appendix.]

The CHAIRMAN. Ms. Sodaro.

**STATEMENT OF JENNIFER SODARO, DEFENSE ATTORNEY FOR
DANIEL BULLOCK, SCOTTSDALE, AZ**

Ms. SODARO. Good morning. Thank you for the opportunity to be here and to represent to you some of the views of taxpayers like Dr. Bullock.

You are probably almost as upset about hearing his story as I was, and I encounter many taxpayers like Dr. Bullock. The people that I represent are middle class, small business owners, farmers, professionals, many physicians. They are not the wealthy that engage in large corporate tax shelters, but they are the middle class Americans that I would argue to you are the backbone of this country.

The only similarity between the devices that they get involved in and the corporate tax shelters, are that those devices, these abusive tax avoidance devices, are very complex and they rely on the uncertainty and lack of clarity in the law which exists.

They exploit the loopholes. In doing so, they are able to be rather persuasive for these very intelligent and otherwise responsible members of society.

What these promoters do. Who are these promoters that are so successful? I find that judges, other lawyers, people in the IRS wonder, how can you fall for these promotions? Are there not red flags?

These individuals often misrepresent themselves as lawyers. Lonnie Crockett, for one, said, well, I want to law school but I did not take the bar. They have recommendation letters from attorneys. They present very complex, what appears to be current legal authority. But it is not current. It is out of date. It has been overruled. But the client really does not have any way of knowing that.

Now, I want to make a caveat. In no way do I excuse tax cheating at any level, wealthy, middle class, anyone. But I also need to say that there are legitimate asset protection devices that are not tax evasion. So, there are legitimate people out there that can help structure an individual's affairs to protect their assets.

So because some are legitimate and some are not, the water is a bit muddy out there. It is very difficult for a taxpayer to know really what is legitimate. There are too many gray areas in the law. There are too many professionals, whether they be CPAs or attorneys, whose knowledge is not detailed enough to specifically refute what they are being told by these promoters.

So if the IRS can promote more clarity of information and make this available to the public, this will go a long way toward avoiding susceptibility to the scams. The scam artists rely on the fact that it is difficult to know exactly what is legal and what is not legal. There are gray areas. That is exactly why they are able to be so successful.

So if the Service can eliminate those gray areas and make the information readily available to the public—and I emphasize the public because, as I pointed out, there are not many attorneys and CPAs that are conversant in these details, so they are not able to specifically refute what the promoters are saying.

Now, another feature that would be a great benefit to the taxpayers and would make our job easier, is to provide liberal am-

nesty. The IRS has proposed extending amnesty through the 23rd of April for tax shelters and so forth.

I have had cases with individuals finally realize that they have committed a tax crime, but if they come forward they will be prosecuted criminally. Now, this is counterproductive to what should be the goals of the IRS. They are to collect revenue and not make criminals out of taxpayers.

Any time an individual comes forward prior to being investigated or prosecuted, they should be welcomed by the IRS. If penalties apply, fine. Charge them interest. But do not make this a criminal offense for ordinary people who were just perhaps naive, perhaps they were misguided. The emphasis is often on criminal prosecution. This keeps people away from coming forward and paying their taxes. So if you want to get the taxes, if you want to get the revenue, make the amnesty more available to ordinary taxpayers.

Now, to effectively deal with this problem, I think you need to increase the enforcement against the promoters, not the taxpayers. They are the root of the problem. Because the current enforcement seems to be directed to criminal prosecution, it takes a long to prosecute them.

So in that intervening time, they use that to their benefit. They say, if we were doing something wrong, they would be able to close us down. The fact that they have not done so shows that we are exposing a conspiracy and they just cannot stop us. So, they use that to their own benefit. The Service can use more effectively injunctive relief under 6700 of the Code and, going to court on restraining orders, and stop these people.

When you can put them in jail for contempt and you can stop their activities, this would then also put the taxpayers on notice that something is wrong. But they continue to think there is a conspiracy of privilege.

So if I could wrap up, I would say that it is really important, and I am very gratified to see your efforts, this committee, and how it is approaching the IRS. The Commissioner has enacted many reforms which are quite beneficial in terms of enforcement. We do not see the unreasonable and harassing tactics that were used in the past. We do not see that so much anymore, and that goes very far in producing respect for the IRS.

But we need to see that the big guys are not going to get away with the tax havens and the tax loopholes. This will inspire respect for the Service and the tax system, and people will be more compliant.

Thank you.

The CHAIRMAN. Thank you very much, Ms. Sodaro. Is that how you pronounce your name?

Ms. SODARO. Sodaro.

The CHAIRMAN. Sodaro. Thank you very, very much.

[The prepared statement of Ms. Sodaro appears in the appendix.]

The CHAIRMAN. Mr. Blum.

STATEMENT OF JACK T. BLUM, ATTORNEY, WASHINGTON, DC

Mr. BLUM. Good morning, Mr. Chairman, Senator Grassley. It is a pleasure to be here this morning. I appreciate the opportunity to share some of my experiences.

I have been working on offshore tax problems since 1974, when I visited the Cayman Islands for the Senate Foreign Relations Committee. Subsequently, I have had involvement in many cases, both with the government and with taxpayers, involving offshore tax evasion.

What I would like to do, is briefly sketch the different levels of offshore tax evasion. There is what I call the very high end, and this is where sophisticated lawyers, frequently in Wall Street firms, set up vehicles for the hiding of profits from things like hedge funds.

I was amazed to discover that most hedge funds are incorporated outside of the United States, and these are investments that typically the wealthiest people in society go into. These are the investments that the very, very rich go into.

These vehicles permit them not to report what are essentially partnership earnings on a current basis and allow them to allow profits to accumulate, later to be taken as capital gains. Then the holdings are in vehicles that are reported in a way on the tax return that IRS does not even know enough to ask questions about. So that is the very high end.

The new, sophisticated lawyers and law firms do these opinion letters routinely, and as far as I know, IRS has never really seen the layout to be able to challenge the way these hedge funds are held.

The next tier down is the asset protection game, which is an extraordinary game that I think is illegitimate on many fronts. We have bankruptcy laws in the United States. People have the right to protect themselves to a certain degree. If they fail in business, we do not send people to debtor's prison.

On the other hand, let me describe one case which I think tells a story. I was brought into the case as a consulting lawyer when an attorney in the Mid-Atlantic region had a client in a divorce case, a wife. The husband beat the wife.

The wife got an order throwing the husband out of the house. The wife drilled the husband's safe in the bedroom. What they found, were a set of papers that described how the husband was hiding all of his money from the wife and from the IRS.

Now, what troubled me most about this was, to do it, the husband went to a major Philadelphia law firm. The Philadelphia law firm referred the husband to their London office, where there was an "asset protection specialist." It occurred to me that the Philadelphia law firm understood what it was doing.

The asset protection specialist set out a Cook Islands trust, which is a kind of walking trust, so that if a court inquires, the trust dissolves and moves somewhere else. It is state-of-the-art. All of the assets were put offshore through that trust.

As a matter of fact, the wife had to settle for pennies on the dollar, even though we tried to explain to the court what was going on. Of course, we were in a terrible situation because we well understood that the man was evading taxes, yet to report it to IRS was against the interests of our client, who would then be caught with no support at all.

But that, I think, is one example of the kind of asset protection that is grossly illegitimate, where people are trying to duck ali-

mony payments, where they are trying to duck legitimate debts, and they just decided they are going to be beyond the system. In Latin America, they refer to it as "impunity."

Now, there is a middle range for this sort of thing. This is the stuff that is marketed by supposedly sophisticated members of the tax bar. They will hold conferences and regularly try to convince doctors and dentists who frequent those conventions, and they tell them there are all kinds of wonderful ways to beat the system. In 9 cases out of 10, the fees they charge are exorbitant, and every one of the cases involves a requirement of evasion.

Then at the low end, there are the characters who advertise in the airline magazines, like Jerome Schneider. There, I have plenty of comment on that in my statement, so I will not go into it any further.

But suffice it to say that when ABC taped Schneider under cover, it was very clear that what he was selling was evasion. When the producer asked Schneider, "What are my chances of getting caught," his answer was, "How big is your mouth?" Because he could figure that nobody at IRS was going to find out about those accounts.

There are a lot of problems here. The problems are, the cases are complicated. They are difficult. I have worked with IRS agents who were amazingly good, and determined, and really worked their hearts out. But they need much more. They need much more support and help and they need to be allowed to run with the cases.

We have some very specific problems. Delaware corporations. Delaware corporations are formed by both people in the United States and outside who are cheating on taxes. Delaware requires no disclosure of beneficial ownership.

The IRS has no system for matching the existence of the Delaware corporation with a corporate return, so they don't even know if all the LLCs and other corporations that have been set up in Delaware are actually filing American returns.

Lest you think that this is stuff that is stopping because of news of enforcement, I call your attention to a case today which I have been involved in because a client of mine was the complaining witness who brought it to the attention of government.

The case was Evergreen Securities, a Bahamian mutual fund where lawyers and accountants were encouraged, for a 10 percent commission, to tell their clients to take second mortgages on their home, get a deduction on the second mortgage, invest in a Bahamas offshore mutual fund which would pay a guaranteed 12 percent, and come out ahead on the system. The truth was, it was a huge bomby scheme, and in the end I think about \$300 million has gone missing.

What I was amazed about, was the number of lawyers and accountants who took commissions for putting their clients into this kind of operation, which they had to know was illegal and wrong.

I am happy to say that, at the moment, most of the people in this will be prosecuted by the New York District Attorney, by the U.S. Attorney in Orlando, Florida, and I am hoping that some of the lawyers will be disbarred for their involvement in the scheme.

I see that my time is up. I appreciate your attention.

The CHAIRMAN. Thank you very much, Mr. Blum. That is very informative.

[The prepared statement of Mr. Blum appears in the appendix.]

The CHAIRMAN. Mrs. Stone, you are next.

STATEMENT OF KELLY STONE, BOZEMAN, MONTANA

Mrs. STONE. Good morning.

The CHAIRMAN. Good morning.

Mrs. STONE. My name is Kelly Stone, and my husband Jeff and I have been married for 23 years. We have six children, ranging in age from 20 years to 2 years. We run a small appliance business in Bozeman, Montana and have worked that business since 1985.

In November of 1994, I received a phone call from my sister. She had heard from one of her church friends about a tax and insurance seminar being held at an insurance agency in Billings, Montana.

The man running the seminar was supposedly a Christian man with solid morals and an uncanny knowledge of American history. He ran a profound business that helped small business owners with tax reduction.

Even though we had to travel 336 round trip miles to this seminar and find someone to watch our four children, we decided to go. We had been without health insurance for 6 years, and with the amount of self-employment tax we were paying per year, we were beginning to wonder whether our small business venture was going to succeed or not.

We walked into this seminar with great expectations and we were not disappointed. This man was not only knowledgeable, he was confident and strongly approved of home school and raising your children with a solid, godly foundation.

He had a captivated audience and held our attention with stories of our country's founding fathers and how America was established. His plan for our future was compelling. The money we saved on our taxes we would use to buy medical insurance for our family.

We would even have enough to invest in a universal annuity life insurance policy for both Jeff and myself. We often talked about what would happen to the kids if we died. Who would be able to afford to raise my four children?

Not only did it take care of that problem, but at the age of 65 we could draw on the policy for retirement. This man resolved all of our problems with one easy payment a month.

This plan of action was not simple, but was easy to understand. We brought in our three most recent tax returns. His plan was to amend the prior three returns, and with the money that the government sent us, we would establish two trusts: a personal trust for \$3,500 and a business trust for \$3,500.

This \$7,000 would make us untouchable. No one could sue us for any of our hard-earned dollars and the IRS could not take any of our assets to cover taxes they might claim we owed.

He would prepare our tax returns from now on. With the money we saved, we would be able to pay for our insurance policies. We got all of this for a mere \$180 a month that was automatically drafted from our checking account.

We signed up for his services in November of 1994 and we were audited the following year. The mode of operation for our tax preparer was to appeal at every turn. He was confident that the IRS would not spend the money to pursue our case. The amount was surely insignificant, and he kept assuring us that they would soon give up.

By the time we had run the gamut of appeals, almost 5 years had passed. We were told to prepare for audit on the remaining years.

The story does not end there, but I was only given 5 to 10 minutes to share 8 years of my life. The bottom line is, my tax preparer was sentenced to 6 years in prison. My fear is that my sentence will be longer.

I may not go to prison, but the effects may be everlasting. I have paid my lawyer and my new accountant thousands of dollars to help us out of this mess. The State is waiting to hear from the IRS before assessing back taxes, penalties, and interest.

The IRS put a \$32,000 lien on our home. We filed an offer and compromise with them in July of 1999, and it was denied. We appealed and just received our first letter from them in January, 2002. They want me to re-file all the paperwork they required the first time because so much time has passed.

In the meantime, I cannot apply for any loans. I cannot supply my family with a safe vehicle to ride in. We went an entire winter with no heat source in our house because our pellet stove broke and we had no money to buy a new one.

We hold no hope for the future for us or our children. We have no ability to grow or succeed without the forgiveness of our tax debt. There will always be predators out there that prey on people like me. There is no way to prevent it and there is no way to change it. But I do feel we have a responsibility to try.

If victims such as myself could share their stories with the public, that would be the first step. That you are even listening to my story, is another step.

My story may be compelling, but you are the ones that hold the key. You have the ability to educate the public and you have the backing to initiate an advertising campaign that could forewarn the very people that voted you into office.

In my eyes, it is a solid investment. The people who fall victim to this kind of crime will end up costing the government money that could have been used to prevent the crime in the first place.

Even if there was a reward offered for information leading to arrests and convictions, it would still save you money. These criminals destroy lives. Any action you take will not be too soon.

The CHAIRMAN. Thank you very much, Mrs. Stone. I appreciate your coming this great distance and sharing your experience with us.

[The prepared statement of Mrs. Stone appears in the appendix.]

The CHAIRMAN. Mr. Cimino.

STATEMENT OF RONALD A. CIMINO, CHIEF, WESTERN CRIMINAL ENFORCEMENT SECTION, TAX DIVISION, DEPARTMENT OF JUSTICE, WASHINGTON, DC

Mr. CIMINO. Chairman Baucus, Senator Grassley, I am pleased to appear before this committee as you continue to investigate the devastating impact that criminals who market and promote these tax schemes cause to the American public.

As the section chief of the Tax Division, I have seen an increasing number of cases of these unscrupulous promoters who market so-called tax programs in which they claim not only that they can reduce Federal income taxes prospectively, but they can arrange for a refund of taxes already paid.

Many people who join these schemes willingly become co-conspirators in tax evasion. Their greed leads them to risk their future liberty. Let there be little mistake. Those who knowingly and willingly file false tax returns under these programs are criminals, just like the promoters.

But sometimes, however, there are those who are negligent or foolishly lured into these schemes. They follow a promise of a tax-free world. They become the victims of the modern-day equivalent of the alchemists of old, who promised to turn base metal into gold.

However, when the schemes are uncovered, even the participants who are not criminally prosecuted face substantial tax bills, interest, and penalties. There are many kinds of tax fraud scams that are widely marketed today.

Some claim that our tax laws are unconstitutional and no one need pay taxes. Others claim a secret understanding of our tax laws that converts ordinary personal daily living expenses into business deductions.

Despite the differences in these types of scams, criminals who promote them generally share one thing in common: for a fee, they promise to eliminate taxes without any real change in the manner in which a person lives or earns his income.

One way for this committee to better understand this growing problem, its impact on those who participate and join in these schemes, and the manner in which the government investigates them, is to have more discussion about the matter which Mrs. Stone found herself caught in.

That scheme first came to the government's attention in 1994 when a confidential informant brought to the attention of the IRS in Billings, Montana that he had attended a seminar in which information was being distributed that trusts and other means could eliminate and reduce all taxes.

That information given to the IRS caused it to open an investigation. An undercover agent was sent into that seminar to learn more about the program, how it was being marketed, and what the reality of this program was.

The undercover agent represented himself to be a businessman from a different State. In the opening meeting, one of the three perpetrators of that fraud suggested that since he was a private pilot, he could deduct his flying expenses as a manner of stress release.

After the agent learned more about this program, he was able to produce enough evidence so that the government could secure a

search warrant. Only then did we see the scope and dimensions of this one tax crime.

The particular case that I am referring to had tentacles both in Billings, Montana and in Little Rock, Arkansas. More than 50 individuals in Billings, Montana fell under the program.

The program, in its very essence, said that these individuals, Donald Fletcher, who was its principal, knew secret ways and had secret information. They offered to prepare amended tax returns, as Mrs. Stone has indicated, in order to secure refunds.

They also offered and counseled the filing of trust returns to create what otherwise would be personal living expenses, and convert them into deductible business expenses.

The particular case that I am referring to ultimately led to indictments, both in Little Rock, Arkansas and in Billings, Montana. The three defendants have either plead guilty or have been convicted. Judge Cebull recently sentenced Donald Fletcher, the lead defendant, as Mrs. Stone has indicated, to more than six-and-a-half years incarceration. The other two defendants have plead guilty, and one will be sentenced on April 17.

These types of case, though, are not unique. The government has seen more of them in recent days and is trying to address them.

But there is a side of the criminal prosecution that does not tell the whole story. That is, the cost to people such as Mrs. Stone and other taxpayers. Judge Cebull found tax loss in this case exceeded \$861,000.

There were tax penalties assessed against these individuals who had joined in these programs and filed amended returns. There was interest. Not one of those clients, though, was criminally prosecuted.

In addition, for the fee that Mrs. Stone related that was taken out of anyone who participated and sent to bank accounts in another State, \$400,000 was taken from these individuals.

Following the completion of the government's investigation, these back taxes were assessed and interest and penalties are being collected. But the pain to individuals who joined in these programs, as you just heard, is immeasurable.

But I start off with one thought that I think the committee has to understand. The criminal side to the prosecution against these promoters is a part of our solution. We are trying to bring other methods of concurrent civil and criminal proceedings to stop them.

I believe that is all of my time.

The CHAIRMAN. All right. Thank you very much. Thank you, Mr. Cimino.

[The prepared statement of Mr. Cimino appears in the appendix.]

The CHAIRMAN. Mr. Spears.

**STATEMENT OF ROBERT L. SPEARS, RETIRED INSURANCE
SALESMAN, TRAVERSE CITY, MI**

Mr. SPEARS. Thank you, Mr. Chairman and Senator Grassley. I thank you, truly, for the opportunity to appear before you today.

I would like to, if I may, address Dr. Bullock and express to him that my heart goes out to you, sir. I know where you are and where you have been. I have not been treated as harshly as you, but I do know where you are.

I became a minister and a teacher of God's word about 4 years ago, and I praise God, likewise, for the strength and the peace that He gives us. Mrs. Stone, likewise for you. Praise God for the strength He gives you.

I want to begin by saying that I am preparing a paper. I have titled it, "The Odyssey of a Tax Protestor." I mention this to shed light on my motive for appearing before this committee. Nothing I have done since I plead guilty to tax evasion has been done to affect the outcome of that decision. I have already been sentenced, so my motive is only to inform others who might be deceived into going where I have been. Many of my remarks today will appear in the paper I am preparing.

A strong—very strong—alluring call continues to blow across this great land, telling us that the income tax is unconstitutional, therefore, illegal and unenforceable.

The very nature of a tax that requires us to expose every facet of our lives brings converts to the cause. Anti-tax gurus and pied pipers send their patriotic calls to ears ready to hear how to get our country back. They appeal to our patriotism, desire for more freedom and privacy, and love of God to encourage us to join their crusade.

They quote the founding fathers, as was mentioned earlier, and cite court cases. But most of what they provide are, at best, half-truths and sometimes outright lies meant to enhance our zeal.

Tragically, they reach out with both hands for money in exchange for these great truths. The real truth is, when the law comes knocking—and the gurus know it will—these gurus disappear over the horizon and you are left on your own to find an attorney able to help you. Believe me, they are a lot harder to find than the gurus.

The message you really need to hear, is that all the gurus know this day of reckoning will come, but they encourage you anyway. Many encourage you to represent yourself in court while following their directions. Believe me, things happen in court that you do not expect and it moves far too fast to be dealt with by a novice.

I challenge anyone anywhere to find me anyone that has challenged this tax, with or without an attorney, and had the tax declared unconstitutional or was found not subject to the tax for any of the myriad of reasons declared by the gurus.

My journey began in the spring of 1993, shortly after I retired. I had formed a foundation for the purpose of teaching our Christian heritage and the Constitution, with emphasis on the first and second amendments.

I met a realtor who shared my zeal and he loaned me a video made by one of these gurus, and I was on my way. I have that video and one other made by this particular guru that I am going to leave with the Senate. You might find it very informative to view that and see the types of material that is being spread by not only this guru, but many others. And I have read them all.

I contacted this guru and purchased all that he had to offer, as well as books and tapes made by others. This culminated in my purchasing his "untaxing kit" for only \$1,500. I filed a series of letters which he provided at very precise times. It all seemed very well thought out and very impressive.

I filed my status as a non-taxpayer with the county registrar of records, and I was now an ex-taxpayer. Funny thing, though. The IRS responded a short time later, informing me that I must file and referencing some sections of the Internal Revenue Code.

I contacted my guru and he told me the letter had no legal merit and was therefore a non-response. This seemed true, because the IRS had not responded to the specific allegations in my untaxing letters.

I continued to research for the next year, and I filed claims with the IRS demanding a return of the taxes I had paid in the last 2 years which I had filed. I was a believer. This was the advice of yet another guru.

On April 18, 1996, an IRS criminal investigator left his card in my door. I called the first guru and he advised me to ask them to put in writing exactly what they expected of me. So, I sent a copy of my untaxing letters to the criminal investigator and requested he advise me, in writing, exactly what the IRS expected. I presumed this would end the matter.

The response, however, was a bevy of summonses to every bank and stockbroker I had dealt with in recent years requesting all my financial records. They responded. They must have not believed they were legal.

Meanwhile, the IRS had deemed my request for return of my taxes as frivolous filings, fined me \$500 for each of the 2 years, and slapped a lien on my home. Again, I called my faithful guru and he informed me that the liens were always illegal. I went to the county courthouse and found they were not illegal. I did pay the fines.

I was concerned that the IRS might tie up my assets and I would be unable to defend myself if they pursued me. The guru had the answer for this, too. He advised me to send him all my cash and he would invest it offshore. He said it would be safe, and an 8 percent interest rate was guaranteed, but I could expect my money to double. Kind of sounds too good to be true? Sure was.

I sent him over \$100,000. Part of it was returned, but the rest is gone. In February of 1999, I was indicted on three counts of income tax evasion, 1993, 1994, and 1995, the result of my first guru's advice, and two counts of fraud, demanding return of my taxes for 1991 and 1992, the result of advice from another guru.

I want to emphasize the fact that I had the materials of many, many other gurus, not just these two. They all have very similar messages.

This is when my gurus headed for the hills. No advice on what attorney to get to represent me. Would you not think they would know of a number of attorneys that could plead their cause for me? No attorneys were named. No, not one.

In panic mode, I searched for an attorney and found one that believed in my cause. He was, however, new to the movement and was not aware that all the arguments he was advancing in my case had been dealt with by appellate or the Supreme Courts.

I learned all of this later, after spending \$70,000 on my first attorney, and 2 years in appeal. By the way, I got a new attorney, well-versed in these laws and cases. After being enlightened by him

and a very merciful judge, I plead guilty to one count of tax evasion.

The one point I want to continue to emphasize to those who would consider going where I went, is to do your homework before you proceed. Having done that, you will not proceed because you will find that not one of these gurus can show you a single case won on their arguments.

In summation, I would make six observations. Number one, do not refuse to pay taxes as a means of opposing the tax. Remember, no court ever ruled anyone exempt.

Number two, get competent legal advice before doing anything. You will undoubtedly learn that the gurus beliefs have been ruled on by the courts.

Number three, the IRS is not the enemy, whatever they do. They simply administer the Tax Code. Number four, the courts are not the enemy. They simply enforce the tax code. Number five, Congress, even though they passed these laws, is not the enemy.

Number six, if there is an enemy, it is apathy and complacency. One of this country's framers said that the cost of liberty is eternal vigilance. If America really wants the income tax terminated, simplified, or even declared unconstitutional, it is within the power of the people to do it. Your going to jail will not change a thing. May God bless America.

Senator GRASSLEY. Thank you, Mr. Spears.

Now, Mrs. Spears.

**STATEMENT OF MARY ELAINE SPEARS, WIFE OF ROBERT
SPEARS, TRAVERSE CITY, MI**

Mrs. Spears. Thank you for allowing me to bring testimony here before this committee.

What I met Bob back in 1988, I had been widowed for 8 years. I had raised three teenaged boys while working as a sales representative covering the Eastern half of the United States. I was independent and I was not interested in marriage. That is, until Bob came charging into my life.

What a breath of fresh air! A man full of confidence, moral, honest, and with love for his children, his friends, and his country. Bob pursued me like he did everything else in life, full speed ahead, and does not let anything stand in the way of the goal.

On top of that, he had a boyish, sincere innocence. He wanted to believe that people were honest and good. I had never met anyone like him. He did not know how to play games, especially when it came to love and commitment. He was so blatantly honest about his feelings, I feared for his naivety. Commitment was his middle name, and he was not one bit shy about it.

Little did I know that the very things I admired about him would cause a wall between us several years later. It was one thing to be fearlessly committed to God, family, friends, business, and country. To have that same perseverance to writing our country's ills was another story.

The trouble began when Bob had come in contact with information that our income tax that he had dutifully paid for 40 years had been put in place without legal due course.

This sent Bob on a diligent quest to verify the information, and verify it he did. Information flowed in from all parts of the country that convinced him without a shadow of a doubt that he was not liable to pay income tax.

He believed that the facts spoke for themselves and felt morally obligated to share this information with others. He was willing to stand in defense of his fellow Americans. As he shared the information with others, Bob quickly came to understand that even though they believed the same information that Bob believed, they were afraid to confront the issue.

No wonder. All one has to do is read, watch TV, listen to radio, or attend movies where time and time again the abuses of government are documented to understand why fear and helplessness had permeated our society.

On top of that, his own wife was frightened. There was no way I could go along with his wild dream of being able to confront the system. Many dark days followed. I contacted attorneys, CPAs, government representatives, and even a political journalist, trying to find information to show my husband another perspective.

Unfortunately, no such help was forthcoming. I struggled with my own alternatives. The easy thing to do would be to seek divorce, but I knew I did not want to end my marriage. I made a vow, for richer, for poorer, for better, for worse, in sickness and in health, 'till death do us part. What I decided to do, was to file a separate tax return, even though I had no income and I owed no tax.

I was reprimanded by the IRS for filing a frivolous return and fined \$500. I was able to get that straightened out by telling them that I was attempted to separate my actions from that of my husband.

My filing separately caused Bob to feel betrayed by me. I was able to convince him that I was neither betraying him or issuing an ultimatum, but rather I was just unable to partner in his actions. I also told him I was not going to do anything to prevent him from pursuing what he felt was right.

Marriage did not give me license to be in charge of my husband's convictions, or he mine. I had done all I knew how to bring information to the table for Bob to consider. I had no solid evidence and very little information. It was time for me to let go and continue to love him through this process.

Nothing was solved, but an uneasy peace returned to our relationship. It was during this time that Bob and I became heavily involved in Bible study, and it was in the context of God's understanding that Bob realized the error of his zeal.

Our zeal for righteousness needs to start within our own hearts. We cannot change others, only ourselves. Each individual will have the opportunity to change. As we change or do not change, our entire environment will change or not change.

Thank you for the opportunity today to give some understanding and hope to others that have become involved in the fruitlessness of the lies within the tax protest movement. Our world can change, but first it must change within you.

God bless you and bring you peace.

Senator GRASSLEY. As one who appreciates the redeeming sacrifice of Jesus Christ, I appreciate all of your statements along those lines.

[The prepared statement of Mrs. Spears appears in the appendix.]

Senator GRASSLEY. Mr. Daniels.

STATEMENT OF DONALD DANIELS, EXECUTIVE COUNSEL, U.S. ATTORNEY'S OFFICE, WESTERN DISTRICT OF MICHIGAN, GRAND RAPIDS, MI

Mr. DANIELS. Mr. Grassley and members of the committee, my name is Donald Daniels. I am an assistant U.S. Attorney in the Western District of Michigan. I appreciate the opportunity to appear today to discuss the efforts of the Department of Justice to combat unlawful tax schemes.

One such scheme is that involving Robert Louis Spears. It was our district that was responsible for bringing the charges to the grand jury which indicted Mr. Spears. I will try to limit my comments to things that he has not already commented on involving his case.

As he said, he was a lawful tax filer until 1992. Beginning in 1993, he ceased filing income tax returns. He also at that time began to send the Internal Revenue Service correspondence expressing his philosophical opposition to the taxation system of the United States.

Mr. Spears embraced this tax protestor philosophy when he was about to retire and would no longer have business expenses to claim as deductions for his returns. He has also alluded to the fact that he founded a corporation known as the Spears Foundation.

He applied to the Internal Revenue Service to have this foundation declared tax-exempt, pursuant to Section 501(c)(3) of the Internal Revenue Code. The Internal Revenue Service denied this request. Nevertheless, he twice filed frivolous tax returns on behalf of the foundation, claiming the corporation's income tax was exempt from taxation.

Mr. Spears also prepared what is called an IRS Form WA to Certificate of Foreign Status and sent it to the person to whom he was selling his insurance business. He advised that person that he was a "non-resident alien who was exempt from reporting income from the sale of his insurance business on an IRS Form 1099."

During the course of his correspondence, Mr. Spears sent a number of letters to the Internal Revenue Service, claiming that he was not subject to the laws of the United States, that the Internal Revenue Code was unconstitutional, and that he was a "sovereign non-taxpayer."

He also sent tax protestor literature, notifying the Service that he no longer considered himself subject to the Tax Code because his status had changed to one of a nontaxpayer. He challenge the authority of the Internal Revenue Service because of the purported non-delegation of authority by the Secretary of Treasury to the Service.

He returned IRS correspondence with notations denying that he lived in any Federal district, and he sent letters to the IRS threat-

ening to file suit if the IRS failed to return monies he claimed the Service had illegally collected.

This conduct is typical of that of tax protestors. Affirmative acts common to tax protestor prosecutions include the filing of false IRS forms, the filing of protest documents, the filing of amended returns for prior years in an attempt to receive a refund, the transfer of assets to spouses, relatives, or third parties, and the creation of so-called nonprofit organizations to conceal ownership of assets from the Internal Revenue Service.

How did he learn these practices? As stated, he viewed a videotape entitled, "American Institute for Republic," which instructed its viewers to contact a man named Al Carter concerning questions.

As he further testified, he purchased an untaxing kit from Mr. Carter and used this as a basis for many of the statements that he made and letters that he sent to the Internal Revenue Service.

When he looked for advice with respect to the criminal prosecution that was imminent, he was referred to a group called Family Advocates in Texas, which gave him the name of an attorney named Robert Elsey. Mr. Spears, at considerable expense, retained Mr. Elsey to represent him. Mr. Elsey did represent him at a trial held in Lansing in September of 1999.

However, the trial was terminated after 3 days when the judge, on his own motion, declared a mistrial and stated on the record that Mr. Elsey was providing ineffective assistance. After an appeal and obtaining new counsel, Mr. Spears did elect to plead guilty.

It should be noted that Mr. Spears has complied with his obligation to pay past due tax returns and he has paid tax liabilities totaling approximately \$97,000.

That concludes my remarks at this time. Thank you.

[The prepared statement of Mr. Daniels appears in the appendix.]

The CHAIRMAN. Well, thank you very much, Mr. Daniels. Thank you all.

I have several questions here, and we do not have a lot of time in which to ask them. But we will do the best we can. I would like you, please, to give fairly short answers.

One first question that comes to my mind, is you, Dr. Bullock, and Mrs. Stone, and Mr. Spears, the degree to which you had some idea that something was not quite right here when the promoters came to you, or when people came to you and said, hey, here is a way to hide your assets or not pay taxes and increase your income, et cetera. Did you have some inkling or were you just totally taken in by con artists?

Dr. Bullock?

Dr. BULLOCK. My initial experience was somewhat like Mr. Spears'. I began studying some of the tax protestor literature and sent some of those same letters to the IRS initially. But it was not right. I very shortly concluded it was not right. That is when I proceeded along what I thought to be more legal avenues of administrative procedure, and subsequently the business trust procedure.

The CHAIRMAN. All right.

Mrs. Stone?

Mrs. STONE. One thing that I found with my tax preparer, is whenever I asked a question he always told me a half-truth which

sounded really good. It was not an out-and-out lie. There was always some truth to it. So, it was real easy to believe.

The CHAIRMAN. Did you have some sense that maybe it was not entirely true?

Mrs. STONE. Probably. Probably some suspicion.

The CHAIRMAN. But yet, you were in a situation where you wanted to believe it.

Mrs. STONE. Absolutely.

The CHAIRMAN. All right.

Mr. Spears?

Mr. SPEARS. I stood totally steadfast in my beliefs until I was faced with my second trial. Judge David McKeague, who I have great admiration for, by the way, in a hearing that he held called a motion hearing, addressed every single motion made by my then-attorney Mr. Elsey, and did not just deny them, but he named appellate cases and Supreme Court cases in his denial of all the motions. I stood there for the first time naked, really, of any defense.

That is when I realized I needed a new attorney, and thank God I found a really good one. After great research on his part in my case on all the factors, he likewise showed me case, after case, after case that destroyed all of my arguments.

Had I known that the day before, or 10 years before, I would not have gone where I went. When I finally saw the truth, it was simply over.

The CHAIRMAN. Mr. Blum, you seem to have a fairly extensive knowledge of this area. I appreciate the way in which you broke down the scams, basically, into four categories.

How did you arrive at your conclusion? I think it was you said that you think that the lost taxes collected is close to \$70 billion. How did you arrive at that?

Mr. BLUM. The way I put that together, is taking a look at the size of the offshore industry, its geometric growth, the huge number of banking institutions, the offshore incorporations which now are in excess of two million worldwide, and that number is probably an under estimate.

Then take a look at the amounts of money that are placed in various kinds of offshore vehicles for special financing where there is no way to trace the profitability.

I will tell you that the number is an estimate, a rank estimate. The truth of the matter is, no one who commits a crime reports that fact to the government so that you can come up with a neat tabulation of the number. You just have to take a guess at it.

The CHAIRMAN. Do you think the IRS knows the extent, the magnitude of this problem?

Mr. BLUM. I think at this point the IRS has a pretty good idea of the magnitude of the problem. I have been working with IRS as a consultant on the credit card initiative. We have looked at the FBAR filings, the Foreign Bank Account Report filings, and it is just unbelievable, the degree to which that law has simply not been complied with.

The CHAIRMAN. That is, taxpayers do not check the box.

Mr. BLUM. They do not check the box, they do not file a report about the return. And we are talking about something that is a violation of the money laundering laws, Title 28, a 5-year felony. And

all you have to do is have control of one of those accounts and not report it, and it is a felony. So, there is a real problem.

The CHAIRMAN. Now, I was stunned by your statement that law firms, reputable law firms—accounting firms do not stun me quite so much—and others are advising people to participate in these scams. I mean, it is incredible that major American law firms, maybe investment banking companies, big names in America, are participating and are, as you are saying, essentially co-conspirators.

Mr. BLUM. For years there has been very little offshore enforcement. There was a period in the 1970's when IRS made some efforts in that direction. The cases were dismissed. The agents who were involved had their careers ruined and there was a 10-year hiatus in the 1980's when offshore cases were simply not touched within IRS.

The CHAIRMAN. Why?

Mr. BLUM. It was a career killer, is the way it was described to me.

The CHAIRMAN. Why was it a career killer?

Mr. BLUM. Because the cases were complicated and the cases always involved people who had access to the political system in a way that made the case not have a good future. So what happened was, not very much was done. IRS got back into the game in the 1990's and began to realize the complexity of the cases.

You had a few very dedicated agents, and I think some of them are here in this room today, who were willing to take these cases. And even though they involved 10, 12, and 15 years of work, put the case together and get the guy who put the money offshore, people who set up offshore trusts in the Bahamas, people who set up trusts in the Cook Islands, people who had fake insurance annuities, and it was gradually, out of those cases, that people in IRS began to understand, this is not just an occasional one-off problem, it is an industry. It is an industry that has to be dealt with.

I think the last straw has been the Internet, because all you have to do is go to the Internet, type in in any search engine the words "offshore," "tax haven," or whatever, and you will get hundreds and hundreds of hits, which give you endless opportunities.

They began to realize that if you did not bring some of these cases and begin to show that this whole arrangement of offshore trusts and other annuity arrangements were wrong, we would have wide open, flagrant violation of the tax laws by everyone who was not withheld.

The CHAIRMAN. Well, this sounds like we have got a problem.

Mr. BLUM. I want to say you have a very serious problem.

The CHAIRMAN. You are quite knowledgeable in this area. What is the solution, or what are the beginnings of a solution?

Mr. BLUM. I will start with one solution that I think is very important. You have heard several people this morning talk about how the promoters advertise to them.

The problem has been that IRS's tools are the wrong kinds of tools. They can prosecute criminally. They prosecute the promoters criminally, and that is good and that works, but it takes years.

What we really need is the Federal Trade Commission to come down hard on the advertising of the schemes. IRS should be working cooperatively with Federal trade to prevent it.

There is one promotor who particularly irks me. His name is Jerome Schneider. He advertised again and again in the American Airlines magazines. He was saying you do not have to pay taxes. Buy a bank in Vanawantu. The bank in Vanawantu will—

The CHAIRMAN. Where?

Mr. BLUM. Vanawantu.

The CHAIRMAN. Where is Vanawantu?

Mr. BLUM. The Pacific Islands. They used to be called the Solomons. You can get a bank there without ever having a building. You just buy the piece of paper. You open a correspondent account in a bank in Canada, and then you use it as your personal checking account.

His idea was that if you combined that with certain other trust arrangements offshore, you could hide all your money, pay no income tax. He was selling this stuff at conferences. He had a conference in Cancun that I encouraged ABC TV to do an undercover taping at, where 400 people showed up bragging to the ABC producers about how they were able to evade taxes.

The CHAIRMAN. I apologize to my colleagues here for the time I am taking but, in addition to the FTC regulations or laws with respect to representations, what else? How else do we start getting at this?

Mr. BLUM. You have to support the people who are trying to do the offshore initiative with the access to the tools they need, and they can describe it. But I think it is the computer tools they need to do the analysis of the data they are going to get, and there have to be the resources to make the cases that come out of the credit card initiative. There will be thousands and thousands of cases, and there has to be a system set up to deal with those cases.

I think the tool that they really do have is that there is a 5-year felony involved in the non-reporting of control of an offshore account.

If IRS works and coordinates properly with the Department of Justice, I believe that those taxpayers can be encouraged to come forward, pay their taxes, pay their penalties, and some arrangement can be worked out on the felony failure to inform about the offshore account.

The CHAIRMAN. It is my understanding that there is so much individual work required here. That is, somebody has got to manually put in the names of people on the credit cards, along with banks, to get a match. It is just terribly labor intensive, a new computer program or some other system is needed.

I think they are going to be able to do it if they have the resources, and I think there are very good ways of doing it.

Now, just one other point on this. I think it is absolutely essential that some of the very high-end offshore sophisticated systems be taken on. The notion that you can somehow invest in a hedge fund offshore in the Cayman Islands and not pay current tax the way I would if I was in an investment partnership, is stunning to me. I think that really has to be looked at by the committee to see if there is a legal problem, and looked at by IRS.

Because when people come to me and they say, how can I get out of paying taxes, can I go offshore, I say, you cannot. They say, but what about all these other people? My problem is, I look quite the fool, because he goes down the street and somebody will say, well, here is how they do it, and such and such law firm gave an opinion letter. That has to be undone.

The CHAIRMAN. Thank you, Mr. Blum. Again, I apologize to my colleagues here. But you make an excellent point. Most people, the corner grocer, the average employee that works at a construction outfit, or someone who has a small business, or even a moderate-sized business cannot do what some of these other people are doing, and it is an outrage. I thank you very much for your help here.

Senator Grassley?

Senator GRASSLEY. Following up, Mr. Blum, on your comment about the FTC. Senator Baucus and I held a hearing about a year ago right now, and we did have the FTC before us.

I will have to go back and review what they said, but they were trying to tell us, I believe, that they were involved and had some concern about this. Maybe it is a lack of resources more than not having a desire on their part.

I am struck by your written comments about the very rich getting away with it, and the hucksters pointing to that to sucker everyone else in. My question is, what are the very rich doing, and what do we need to be doing to make sure that the very rich are not getting away with cheating on their taxes?

Mr. BLUM. Well, what you are going to have to look at, is this system of fake insurance annuities. There are companies in offshore jurisdictions that will offer what appear to be annuity policies, only you control the insurance company, the assets in the annuity, and you control everything about it.

Of course, in the jurisdiction involved there is no insurance regulation, there is no supervision. So what appears to be a real insurance product, which is then unreported as income to IRS, winds up being accepted as an insurance product and, therefore, no one pays tax on it. That is one of the devices.

Then there are devices that involve the tying together of trusts and annuities and moving all the businesses to the control of an offshore company, which is then in turn controlled by a trust which is owned by an annuity.

You get into a tangle like that, and all of the assets are tangled up in bank secrecy jurisdictions. There is very little way of unraveling it. Unless something happens to put it to the attention of IRS, IRS does not get the opportunity to go after it.

One more thing. I have heard a lot about asset protection. There is a section of the American Bar Association that talks about itself as an asset protection section.

I would argue that asset protection is a concept that has to be looked at very carefully by the Congress, because to successfully protect your assets, for example, in the divorce case that I described, the taxpayer has to perjure himself and he has to, at the same time, not file a proper tax return, because the tax return would be discoverable.

So, in effect, if you are setting somebody up in a situation where they are offshore, first, the guy is going to have to lie about the offshore structure when he comes in to be questioned under oath about his assets, and then you almost know in advance he is going to have to cheat on his taxes because the returns will be discoverable. So, I think the entire proposition of asset protection is a very dubious proposition.

Senator GRASSLEY. There seem to be some very reputable accounting firms or their subsidiaries mentioned as promoters of these offshore schemes. I have KPMG Corporation as an example that was involved in a San Francisco, Northern District of California affidavit filing.

Are the promoters of these offshore credit card accounts also companies that are mainstream?

Mr. BLUM. Well, for all of the major accounting firms there are systems of affiliates offshore. So the accounting firms are collections of partnerships, some of which are here in the United States, but then the parent company has affiliates which operate in various other places. So, virtually every major accounting firm has an offshore affiliate somewhere and they advertise services of putting together offshore structures.

Now, the problem is, although the accounting firms, in their own internal security operations, try to control the fact of, is it a U.S. person who is coming there to ask for things that might be illegal, they cannot always control the activities of the offshore entity which bears their name.

So, you are probably looking at KPMG, which is sort of the franchise KPMG in the jurisdiction that offers the services. I think it has to be made clear to the U.S. accounting firms that they are not to do this for U.S. persons, period, if their name is on the franchise, period.

Senator GRASSLEY. Mrs. Stone and Dr. Bullock, you have mentioned the need to improve the offers in compromise program at the IRS as a way of giving people real help in addressing these tax problems. In addition, by helping people with their tax problems through an offer in compromise, they will be less likely to buy into tax schemes. Too often, a simplistic view by some here in D.C. is that the only answer to stopping people engaging in tax schemes is through more enforcement.

Is it your view that proper treatment of taxpayers and improvement in programs such as offers in compromise can also help people from getting sucked into these sort of scams?

Mrs. STONE. I do not know if it will eliminate people getting involved, but the offer and compromise program, I know, has the potential to aid victims. The system is not working at this time. It is taking way too long. In the process, people are accumulating years of back taxes and it is devastating. Something needs to be done with the program. I think it could work, but it needs some work.

Senator GRASSLEY. Dr. Bullock?

Dr. BULLOCK. I think the number-one thing, is there needs to be readily available education that is reliable. As was mentioned earlier, I believe, by Mr. Blum, the Internet is rampant with all these tax protestor schemes, tax avoidance schemes, offshore invest-

ments, but there is very little reliable information. The information you get from the IRS is in quasi-legalese that is not understandable, if you can even get it.

Mrs. Stone had extreme difficulty in finding reliable help. Mrs. Spears also had extreme difficulty in finding reliable help. I, too, experienced that problem.

I think the solution of offers and compromise helps victims. I think offering some kind of help solution of information, maybe a panel of attorneys or something like that that is available to give counsel to people, something on the Internet by the IRS that offers information would be real helpful. Offers and compromise.

For me, one of the things that I hope for is to be able to get back on my feet again some day. Now that I know it is going to be two, three, or maybe 4 years before I can resolve that, who knows how many hundreds of thousands of dollars I will have to be faced with paying without a career to do it with. That is what I am facing.

Senator GRASSLEY. Ms. Sodaro, I understand that while your business is based in Arizona, you represent taxpayers throughout the country. In your opinion, are crooked promoters becoming more prevalent and more sophisticated?

Second, does the taxpayer have to make inquiries to hunt down these promoters or do they aggressively self-promote? Last, do promoters target similar demographics?

Ms. SODARO. The promoters target the demographics I described, middle class small business owners. They are prolific on the Internet and they are very, very effective.

Whether they are more prolific than they were several years ago, I could not tell you. But I do know that the problem is, even if their activities stayed even, people are involved in these schemes, and they have been for several years.

So let us say, as of today you stopped all new schemes. It is the people that are already in these systems, and have been in the systems for five, six years, that do not know how to get out of them. They do not know how to find competent advice. As all these taxpayers told you, it is hard to find attorneys and CPAs that can answer the questions.

So there will continue to be a problem, even if their numbers do not increase, because there are so many thousands of people already in the system.

Senator GRASSLEY. Let me ask just one more question. This would be for Ms. Sodaro and Dr. Bullock. We held a hearing in this committee just a few weeks ago. This committee heard about U.S. corporations creating artificial corporate headquarters and tax havens in order to avoid millions of dollars in taxes. Companies are making a decision of whether to stay in this country and pay their tax bills or to dash to some other country and stash away their money.

Companies like Stanley, that receive millions of dollars of government contracts, are choosing to create corporate headquarters that are basically nothing more than a piece of paper in a foreign filing cabinet.

Chairman Baucus and I are committed to reigning in this activity and, as Senator Baucus said in his opening statement, will be announcing some legislation.

But I want to ask you whether the actions of corporations seeking to avoid taxes might have a ripple effect, whether the little guy hears all about these tax shelters and then gets suckered by some pitch of a con man that the big guys are avoiding taxes and running off to havens, so the taxpayer ought to be able to. Do you hear that? Did that thought go through your mind?

Ms. SODARO. It is not just the thought goes through my mind. It has a huge effect on the taxpayer. I hear that more often than any other reason for attracting the interest.

It almost counteracts any common sense that Senator Baucus referred to. Did a voice in your head not say this was not right? It is counteracted by the fact that it appears that the big guys are getting away with murder, so the little people, the middle class people, feel that there is this conspiracy of privilege and that is why the Tax Code is obscure.

Now, the difficulty I think that you are going to have with stopping these companies from going offshore, is I am skeptical that these offshore nations will cooperate. I have visited many of them. I go on vacation and I check out what they are doing, and try to discover what kind of operations exist there. The offshore banking business is such a substantial part of these economies, that I think these people would be very reluctant to give them up.

I do not know what incentive the U.S. can offer these people, because if we only have a tax treaty we are not giving these countries any economic aid. They really do not have a reason to give up such a huge part of their economy.

So, that is what I think is one of the greatest difficulties in getting cooperation from these offshore countries. As long as they will continue to offer these services to Americans and other people around the world, there will continue to be a problem.

Dr. BULLOCK. Sir, as I was beginning in my experience in the mid-1990's, I remember very well a little article in Newsweek Magazine where the former IRS Commissioner was asked to comment on the millions of dollars saved by the Forbes family in taxes. His comment was, "Many of the wealthy use complicated trust arrangements to lawfully avoid taxes."

That was confirming information to me that, yes, the wealthy use these kinds of mechanisms. We have heard testimony about that today. That is something that is very powerful in people's minds. They have got it, I want it. People do not realize that the only successful tax avoidance scheme is the one that keeps you out of leg irons, handcuffs, and a waist chain.

The CHAIRMAN. Thank you very much.

Senator Hatch?

Senator HATCH. Well, I will only ask one question of Ms. Sodaro, Mr. Cimino, and Mr. Daniels. If you had one thing you could change in the system that might alleviate some of these problems, what would you choose?

Ms. SODARO. The most important thing is to stop the promoters. If the promoters were stopped by injunctions under 6700 of the Code, you would get at the root of the problem. Then, if those promoters are enjoined from further statements, from promotion, their offices are cleaned out, you can then conduct the long, involved criminal prosecution. But it puts the taxpayer on notice, and the

taxpayer finally starts to believe, gee, maybe there is something wrong. Then you offer the amnesty program so they could come forward.

That would bring about so much more revenue and it would solve the problem of people's lives being ruined, like Dr. Bullock. So if you do that, that is the root of the problem. You get more respect for the law when you do that.

But you may not have heard earlier, we said that many times when there is a long, involved criminal prosecution going on, the promoter has been under suspicion, but because the process is so long, they continue to operate with impunity. They tell their clients that, well, it is a big conspiracy. That is why they cannot stop us. We are telling the truth and they are just rattling their chains, so it almost helps them to get more victims.

So, the promoters are the key.

Senator HATCH. Mr. Cimino?

Mr. CIMINO. I agree. I think that we need to act more quickly. The Department of Justice and the Internal Revenue Service is working on a plan to bring both civil and criminal enforcement actions, including injunctions. I would also add, Senator, that I think education to our citizens as a whole, to that one important thing that if these ideas sound too good to be true, you need to talk to an independent professional.

What has happened in a lot of the situations, including the ones that you have heard, people who had been previously going to ethical and professional return preparers stopped following and using their services and went to these promoters.

If our citizens would take time and when they receive something that sounds too good to be true, to check it out, to go to a professional, I think that would go a long way in helping these situations to be stopped.

Senator HATCH. Thank you.

Mr. Daniels?

Mr. DANIELS. I will echo Mr. Cimino's comments. I believe the problem has been appropriately identified and I think that he has given the committee a number of considerations.

Senator HATCH. Thank you.

The CHAIRMAN. But the question I have is, what kind of education? How do you educate people?

Mr. CIMINO. Senator, I think the very fact that these hearings are going on and that there will be publicity, I think the IRS, through its media outreach, I think professionals, bringing the message to citizens, is all part of a program that we must do.

The CHAIRMAN. Thank you. You all have provided a great service here, and we thank you very, very much. Dr. Bullock, Mrs. Stone, Mr. Daniels, Mr. and Mrs. Spears, all of you. Also, Mr. Blum, Mr. Cimino, Ms. Sodaro. Thank you very, very much.

You have come great distances, some of you, at great expense, but you are doing it because you believe in our country, you believe that there are solutions here. We thank you very much and we are going to do our level best to honor your expectations and to try to find some answer to these questions, and the right answers so this is stopped in its tracks. Thank you very much, all of you. We appreciate your time and effort here. Thank you.

Our next panel consist of Hon. Charles Rossotti, Commissioner of the IRS. He will be accompanied by Mark Matthews, who is the Chief of the Criminal Investigation section of the IRS, as well as by Dale Hart, who is Deputy Chief of the Small Business and Self-Employed section of the IRS.

Next, is Michael Brostek, who is Director of Tax Issues at the GAO; and third, David Williams, who is the Treasury Inspector General for Tax Administration.

Thank you, everyone, for attending. I would like each of you to be extremely brief. We have votes beginning at 12:00 noon. I know there is another engagement which Senator Grassley and I are scheduled to attend about that same time.

I would ask each of you, please, to shorten your statements to as short a time as you possibly could so we can get in some questions here.

Mr. Rossotti, why do you not begin?

STATEMENT OF HON. CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC; ACCOMPANIED BY MARK MATTHEWS, CHIEF, CRIMINAL INVESTIGATION, IRS; AND DALE HART, DEPUTY CHIEF, SMALL BUSINESS AND SELF-EMPLOYMENT, IRS

Mr. ROSSOTTI. Thank you very much, Mr. Chairman.

We appreciate your holding this hearing. We think the hearing itself is part of the strategy to inform taxpayers not to get sucked in by some of these promoted schemes.

I do want to say that, as far as the IRS is concerned, that combatting these promoted schemes is our highest compliance priority. One of the reasons, of course, is the substantial amount of money which is lost to the Treasury, but the other reason is that these promoted schemes are very unfair and corrosive to the health of the tax system.

My belief is that nothing undermines the confidence in the tax system more than the impression of an honest taxpayer that has to pay his or her taxes having the impression that wealthy or unscrupulous taxpayers are allowed to get out of paying.

The CHAIRMAN. You do not have extra handouts of these charts here, do you?

Mr. ROSSOTTI. Yes, we do have handouts. We will provide the charts.

The CHAIRMAN. Thank you. Thank you.

[The charts appear in the appendix.]

Mr. ROSSOTTI. The purpose of these charts is just to kind of lay out a little bit some of the complexity of this to try to put them into some categories.

The first chart shows really the four categories, the four basic categories, of promoted schemes. The first one is characterized by false descriptions of the law in order to claim exemption from tax, or improper deductions and credits. These include such schemes as the slavery reparations, the so-called Section 861 employment tax abatement, and other schemes which justify not filing taxes at all.

The second major category, is misrepresentation of facts in order to claim improper deductions and credits. This includes schemes such as preparers who file EITC claims using false information

about qualifying children, as well as such things as false deductions for home-based businesses.

The third category which we are finding probably the largest one, is use of devices such as trusts and offshore bank accounts to hide income. These are used mostly by upper income individuals.

Then the fourth category is the abusive tax avoidance transactions, which you discussed at the hearing you held several weeks ago. Those are outlined on that chart.

Then on the second chart, it really lays out the strategies that we use, the tools that we use to combat each of these kinds of schemes. Of course, the tools are tailored to the nature of the scheme.

But the first task is to identify the promoters, identify the schemes, and identify the participating taxpayers. We do that through summonses of records, audits of promoter records, systematic analysis of leads from a number of sources, screening of tax returns, and matching of documents.

Recently, one of our initiatives which involved obtaining records of credit cards issued by banks in tax haven countries has been particularly productive and, of course, has received coverage in the press and in your prior witnesses.

We also believe that educating and warning taxpayers about the nature of these schemes and of the dangers in participating in them is very important. We have extensive efforts which have increased over the last year. These include issuance of official notices and press releases, active media efforts, use of our Web site, and working through an increasingly deep network of relationships with business groups and practitioners.

As I mentioned, this hearing itself is a good example of an activity that I think will help to educate taxpayers not to succumb to promoters who make these promises which are designed to be too good to be true.

In the enforcement area, our top priority is the promoters. We are using civil audits, injunctions, and criminal investigations aggressively against promoters. In the last 18 months, we have obtained four injunctions and have 18 more pending in the courts and at Department of Justice against promoters.

In the criminal area, in the same period, we have obtained convictions of 118 promoters and have 287 more under investigation. Then in just the last 6 months, we have opened up 104 new investigations, civil examinations against promoters.

One initiative that we have taken as a result, in part, of last year's hearing was to work with our colleagues at the Justice Department to see if we could establish a parallel approach where we could seek civil injunctions without waiting until criminal proceedings might be completed, because that would delay the use of injunctions for a considerable period of time. We have, I believe, come up with some solutions that will allow us to do that, and that can be a significant breakthrough.

You also mentioned, Mr. Chairman, at the last hearing that we needed to do a better job of measuring the impact of these problems. While we do not have these measurement projects completed yet, we have initiated them.

The National Research Program will give us data, we think reliably, on underpayment of taxes by individuals. We are also working on a project to determine the prevalence of these tax avoidance strategies among corporations.

So we are, I believe, making progress. But, of course, it is a big area. We are learning more every week about these things. We are learning that there are new techniques, more sophisticated techniques. The Internet, obviously, is used to promote these schemes. We ourselves are trying to be creative in coming up with new and innovative approaches to stop them.

I do think I should mention, and I will stop here, the importance of the support we are receiving from the highest levels of government to combat these schemes. I think the visible commitment of leaders in the government has a big impact in deterring these kinds of activities, and also encouraging the prosecutors and our front-line employees to be effective.

I would like to thank Secretary O'Neal for his support, and especially for you, Mr. Chairman and Ranking Member Senator Grassley, for holding these hearings and for the support you have given us in this initiative.

The CHAIRMAN. Thank you, Mr. Rossotti.

[The prepared statement of Mr. Rossotti appears in the appendix.]

Mr. MATTHEWS. Mr. Hart and I do not have opening statements.

The CHAIRMAN. All right. Fine.

Mr. Brostek.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR OF TAX ISSUES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. BROSTEK. Yes. Thank you for inviting us today to talk to you about abusive tax schemes. I will be very brief.

First, there is limited and evolving evidence about the size of this problem, but suffice it to say there is evidence that it is a significant problem.

Second, we have found exactly what Mr. Rossotti has said. They have stepped up their efforts to address these schemes. They are concentrating on abusive promoters. They are doing it both on the civil side and on the criminal side.

They have assigned more staff to this effort and they have begun training them to work these cases. They are working with Justice on different techniques for using the injunctive process that we have heard about with the first panel.

They are beginning to have some success. They have had an increasing number of promoters that they have investigated, tried, and have had convictions on over the last 3 years.

They will face some continuing challenges, particularly for these very complex offshore schemes. The technique to unveil the amount of money that has been hidden and the tax that is owed may often be a personnel-intensive audit technique.

IRS has had a decrease over the last 3 years of about half in the number of face-to-face audits that they have been doing, and now they have this increased demand for their limited resources to do those audits. So, they will have a challenge in doing the audits.

Last, the IRS has asked for some additional resources in its budget for next year to deal with compliance issues. We think you might need to get a little more specificity about the measures and goals that IRS will use to assess its progress and allow you to assess their progress in addressing these schemes.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Mr. Williams.

**STATEMENT OF DAVID WILLIAMS, INSPECTOR GENERAL,
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION,
WASHINGTON, DC**

Mr. WILLIAMS. Mr. Chairman and Senator Grassley, I appreciate the opportunity to appear here today to discuss this topic.

In general, it is the responsibility of the IRS to identify and investigate violations of tax laws. TIGTA's responsibility is to investigate allegations that IRS employees have participated in tax fraud, or that individuals have impersonated IRS agents in illegal schemes.

TIGTA is also responsible for assessing systemic controls that ensure tax returns are processed without allowing questionable deductions or credits.

To complement the IRS's enforcement efforts, TIGTA conducts various projects to investigate tax schemes and analyze their impact, and make systemic and prosecutorial recommendations.

Over the past few years, we have identified systemic control weaknesses that have allowed questionable activities and conducted investigations involving reparations credits, disabled access credit, misuse of employer identification numbers, advanced fee schemes, and impersonation schemes.

Since the early 1990's, thousands of false claims have been filed with the IRS for reparations credits. Promoters use a variety of techniques to market the promise of a special tax credit to African American taxpayers who are descendants of slaves. There is no such tax credit in the Internal Revenue Code.

It is estimated that, in 2001, the IRS received over 77,000 returns with an estimated \$2.7 billion in claims. Generally, each claim asks for approximately \$43,000.

A second scheme involves the disabled access credit, whereby dishonest promoters promise individual taxpayers a tax credit of up to \$5,000. The disabled access credit is reserved for taxpayers who incur expenses to bring their businesses into compliance with the Americans With Disabilities Act.

In this scheme, the promoter offers to sell taxpayers expensive coin-operated telephone equipment, with a promise that the taxpayer can claim the disabled access credit because the telephones have volume controls. My office worked with the IRS on this issue and provided recommendations to detect more of these returns and to educate taxpayers.

In regard to the misuse of EINs, my office has founded that promoters charge a fee to advise individuals with poor credit on how to create a new credit file. Once the fee is paid, promoters provide the taxpayer with instructions on how to obtain an EIN. The tax-

payer is then instructed to use the EIN as a Social Security number. Many of these Social Security numbers are already assigned to individuals and their credit record quickly becomes marred.

Improper use of the EINs as Social Security numbers also lead to problems with erroneous postings to taxpayer accounts. In the past year, TIGTA has initiated 37 investigations involving the fraudulent use of EINs.

The last area TIGTA has focused on relates to the so-called advanced fee scheme. As with the disabled access credit, the primary victims are elderly. In these situations, the telemarketer misleads the victims by convincing them that they have won large cash prizes.

The individuals are advised that they must prepay Federal taxes before they can collect the money. The amounts requested range from \$2,000 to \$20,000, and are remitted to the promotor, not to the IRS.

In many cases, taxpayers believe this story because the telemarketer has invoked the name of the IRS. Some victims have lost more than \$100,000.

TIGTA is dedicated to ensuring the integrity of the IRS and assisting the IRS to better serve taxpayers and maintain confidence in the tax system.

I would be happy to answer any questions that you have.

The CHAIRMAN. Thank you very much, Mr. Williams.

[The prepared statement of Mr. Williams appears in the appendix.]

The CHAIRMAN. Mr. Rossotti, as you well know, about 80 percent of American taxpayers try to do the right thing. It is up to the Service to be very user-friendly with them. That is, if they have got a question, that the question is answered on a timely basis, courteously. After all, we are all public servants and we all are, in a sense, employees of all Americans, the taxpayers.

I understand that the Service has moved significantly in that direction, or at least tried, to be courteous and to be helpful to the 80 percent of American taxpayers who are law abiding folks who want to do the right thing.

Some of the measurements I have seen, is they are a little soft. You are not doing as good a job—not you personally, but the Service—as they could, and I would encourage you to keep going in that direction.

As I mentioned earlier, that is not to be to the exclusion of the other 20 percent. That is, stepping up your enforcement and making sure the other 20 percent who are not law-abiding taxpayers are, in effect, discovered and prosecuted, and so forth. Both parts of your job are necessary.

I would like you now to focus a little bit on that 20 percent. That is, how large a problem is it in terms of number of taxpayers, in terms of dollars not collected? If you could just give us a sense. And there are lots of different areas here. Mr. Blum divided it into four areas; your charts divide it in various areas.

But if you could just give us a sense, honestly, of the magnitude of the problem here so we can know what we are dealing with, so that together we can work to try to solve it.

Mr. ROSSOTTI. I will try to do the best I can, recognizing, as Mr. Blum said, that one of the key things that makes this difficult is that inherently you have people who are violating the law.

The CHAIRMAN. Right. But you are the Commissioner.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. You have some sense of this. What is it?

Mr. ROSSOTTI. Yes. I think that my sense is that if you want to just take the tax loss that has been associated with the kinds of promoted schemes that are defined there on that chart, that while we certainly do not have a precise number at all, having looked at all the data, it is my belief that we are into the several tens of billions of dollars of loss per year, whether that be \$20, \$30, \$40 billion per year, we really do not have a precise number. But it is a big enough number in those tens of billions that it is certainly worthy of a very serious focus.

The CHAIRMAN. Now, what obstacles does the Service have in finding out the degree to which its people are violating the law and prosecuting the violators and collecting revenue?

There are all kinds of potential obstacles here. There are the tax treaties, the secrecy provisions offshore, legitimate privacy concerns. Someone in an earlier panel mentioned Delaware law, which is a problem because most companies incorporate in Delaware. There is a reason why most companies incorporate in Delaware. It is more favorable to corporations.

Maybe it is lack of sufficient coordination among Federal agencies or with State agencies, maybe the SEC, Treasury, et cetera or maybe it is lack of personnel and resources? So if you could just kind of give us a sense.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. So what is it? How are we going to get from here to there?

Mr. ROSSOTTI. Well, first of all, I think that the key item, as you noted, is to identify the people who are participating, identify the promoters and identify the people that are participating in these schemes.

The people that are doing this are doing it in order to make money for themselves, the promoters, and are quite ingenious in using every device that they can to hide what they are doing from the IRS.

So, I mean underlying all of this, we have to realize that we are dealing with a group of people who are in business, if you will, to be effective at hiding things. So right off the bat, it is the ingenuity factor of people to use whatever device they can that underlies this.

Now, what are the devices that they can use? Well, as we can see in just this chart, some of the devices involve layering multiple layers of entities so that it becomes very complex to untangle what is really happening.

They use trusts, they use partnerships, they use various kinds of corporations, corporate structures that are layered on top of each other domestically and internationally. Simply untangling the ownership and untangling the flow of funds between those different entities is one of the key techniques. The other key technique is moving the funds offshore into jurisdictions that are tax havens.

The CHAIRMAN. No, no, no. Mr. Commissioner, with all due respect, I do not think you are answering the question, I tried to ask.

Mr. ROSSOTTI. All right.

The CHAIRMAN. Not a description of the problem.

Mr. ROSSOTTI. All right.

The CHAIRMAN. I am trying to ask, what are the obstacles that prevent you from going after these characters more quickly? That is what I am asking. Is it State law? Is it insufficient coordination? What is it? We know the complexity of these arrangements. We know that. We are just trying to figure out how we are going to solve this.

Mr. ROSSOTTI. What are some of the problems that we have?

The CHAIRMAN. Yes. Right. Yes.

Mr. ROSSOTTI. Well, I think that with respect to one dimension of it, with respect to the issue of the information that is held offshore—let us just focus on that one because that seems to be one of the most driving things.

Up until now, the inability to get information, especially related to civil tax issues from tax haven jurisdictions, was probably one of the greatest obstacles. That actually remains a considerable obstacle.

The initiative we took with the credit card was a way of getting around that obstacle, because what we were able to do was to issue summonses to the credit card companies who are operating in the United States and get the records from them. So, that was a way of cracking those obstacles.

The CHAIRMAN. Now, is that working?

Mr. ROSSOTTI. Well, I think that it appears to be. It is at an early stage. It appears to be a significant breakthrough.

Now, of course, not everyone that has money offshore is using the credit cards, but it appears that many have been using them because it is a very convenient way to repatriate the money that is held offshore. So, that is a breakthrough that we have found, we think, in identifying people who have put money offshore and are using credit cards to repatriate it.

But the basic underlying problem, to get back to your question, of the inability of the IRS to get information from tax haven countries, still remains. There is some effort under way to negotiate treaties that will give us access to some information, although that may be some years off.

The CHAIRMAN. Mr. Matthews, I see you kind of nodding your head a little bit.

Did you want to add to that in any way?

Mr. MATTHEWS. I agree, we have had some progress. But every new country, every new treaty, every MLAT, helps us. The problem of going offshore is exacerbated by the involvement of the Internet here as well. It brings those offshore vehicles to a larger group of citizens in this country.

It poses challenges in the area of injunctions. An injunction, as has been talked about here today, is a great device. It is something we are really using, over the last year, much more aggressively with the help of the Justice Department.

But when we start talking about enjoining people who are using the Internet, you see the phenomenon of how easy it is for them

to set up a new site under a different name, switch the ownership of that name, switch the server to an offshore location. So, we are still learning and putting resources into solving that problem.

The CHAIRMAN. Let us just focus for a moment on the offshore entities, havens, Bermuda, the Cayman Islands, et cetera. What would you like those countries, if you will, to do?

Mr. MATTHEWS. Well, I do not want to step on Treasury's toes here. They are the experts. But obviously, we are seeing gains. I believe there have been several new tax treaties and MLAT agreements this year.

But every time we can achieve an agreement whereupon, with an appropriate summons from this country, we can obtain bank records from that country—and obviously it is reciprocal, we have to the same in exchange—to the degree that we can agree that tax violations are worthy of international cooperation and are appropriate for exchange of information, each new country we unpeel increases the problems for the promoters.

The CHAIRMAN. I understand. Now, you heard someone on the prior panel say that it is her judgment that these countries are not going to deal, it is so much revenue for them. Why are they going to want to enter a treaty, the result of which means they have lost a lot of revenue?

Mr. ROSSOTTI. I think this is why it is a Treasury issue. It has to be dealt with internationally.

The CHAIRMAN. Mr. Williams, you are the closest Treasury guy here. [Laughter.]

Mr. WILLIAMS. Well, it is not completely my fault, but I have some ideas regarding the question.

The CHAIRMAN. I know it is not, but you are as close as we can get at this point.

Mr. WILLIAMS. One very powerful thing that is coming to us is an expanded capacity to work in an automated environment. You can do so much. I mentioned some examples here where we were able to use the database and mine them with search engines to find the people responsible for false claims.

There are some powerful tools coming at us we could use. 6103 is always a good thing to look at. It is a hurdle in working with other law enforcement and other entities that could help and could exchange information.

The IRS has a legacy of a very weak and poor research capacity. The Commissioner is committed to embarking on strengthening that. That will help us a great deal. It has been so bad, we are not able to answer some of the questions, even in a gross way, like the amount of tax cheating that is going on.

So, research and automation. There just needs to be that constant balance that you talked about with regard to 6103, and making sure that it always allows law enforcement agencies to work together where possible. I know you need to balance privacy against that. That is the other anchor.

The CHAIRMAN. What about these big-name firms, the law firms, accounting firms, investment banking firms that seem to be aiding and abetting a lot of this?

Mr. ROSSOTTI. Well, let me just say that when we talk about the examinations that we have under way with promoters, we are not

excluding anyone from that. We are not only talking about the Internet fly-by-night promoters, we are talking about anyone that has promoted schemes that fall within our disclosure issues.

The CHAIRMAN. But you agree, as one of the prior witnesses said, that this is part of the problem?

Mr. ROSSOTTI. That what is part of the problem?

The CHAIRMAN. That some big-name companies are——

Mr. ROSSOTTI. Yes, I do.

The CHAIRMAN. And what do we do about that?

Mr. ROSSOTTI. We are issuing summonses and we are issuing audits to some of those firms to get their investor lists, and potentially they could be subject to penalties as well. We are not limiting our promoter activity to, if you want to call it that, downscale or low-end promoters.

We are looking at all four of those categories of schemes and the promoters that are associated with them. That does include some, if you want to call them, more established larger firms that are promoting various kinds of transactions and schemes. We are auditing and investigating on all fronts. So, we are not excluding them at all.

The CHAIRMAN. What is the best way we can sort of benchmark or determine what progress we are making here? That is, do you have some suggestions as to what the criteria should be, like the number of people prosecuted, and over what period of time? It just seems to me we need some kind of business-like accounting here so that maybe 6 months from now we can revisit this question and determine what progress we have made.

Mr. ROSSOTTI. I think in terms of progress we are making in terms of getting at the problem, I think that there are some measures that we are starting to track. These include how many promoters we were getting injunctions against, how many promoters we are getting prosecutions against, and how well we are getting information from those promoters on the list of investors or taxpayers that they have promoted to.

We are starting to track those numbers, and I think we are starting to make some serious headway. I think, really, the breakthrough on the credit cards has potential to be a very significant one.

The CHAIRMAN. Mr. Brostek, your suggestion on how we benchmark progress, or lack of it. What is a good way to do this?

Mr. BROSTEK. The ideal way is to get an accurate actual measure of overall compliance so that you can determine whether compliance is going up or down. The IRS is working on a study that should begin this fall that should give us the first measure in over a decade of level of compliance with the tax system.

Until that measurement is available, measures as Mr. Rossotti is talking about, activity measures that you can use to hold IRS accountable for specific achievements, are probably the best fall-back that you could have.

The CHAIRMAN. Why do we not have more compliance assessments? It takes 10 years.

Mr. ROSSOTTI. No, no. It does not take 10 years.

The CHAIRMAN. I am sorry.

Mr. ROSSOTTI. It is just that it has not been done in 10 years.

The CHAIRMAN. Why?

Mr. ROSSOTTI. Well, because there were ill-fated attempts. Remember when we spoke about this, I talked to you about the so-called TCMP program that was tried and did not go over too well with the public and with the Congress because it was viewed as overly intrusive. We have come up with the National Research Program to achieve the same purpose, but in a way that we think will be far more acceptable. We are very gratified with the response we have gotten from you and others, and that is the study that Mr. Brostek mentioned that we are initiating this year. It will produce results towards the end of 2003.

The point is, it is not that it would take 10 years to do it again, it is just that it has been actually more than 10 years. It will actually be 14 years since the last time it was done. That is not acceptable.

The CHAIRMAN. Yes, that is not acceptable.

Mr. ROSSOTTI. It is not acceptable. I think the important point is, we are launched and we will have this information available. We are starting this, but it will be about a year after.

The CHAIRMAN. Why are we starting so late? Why not start now?

Mr. ROSSOTTI. Well, because we have to wait until people file their returns. What we are doing, is we are actually starting right now to identify the returns that will be selected for the study. Then we have got a period of analyzing those returns to gather the data that we can internally, and then we will begin actually contacting the taxpayers in the fall.

The CHAIRMAN. You could start now on the 2000 returns. That is something.

Mr. ROSSOTTI. Yes, but we would rather have the more current data.

The CHAIRMAN. Well, I just urge you to go quickly.

Mr. ROSSOTTI. Yes. Yes.

The CHAIRMAN. We have to leave. There are votes, and all that kind of thing. I would like you, though, Mr. Commissioner, to come up with some benchmarks, some criteria, that you think are fair.

Mr. ROSSOTTI. All right.

The CHAIRMAN. Maybe working with Mr. Brostek, we can somehow get this so that, at an appropriate future date, we can have this discussion again and see what is needed to solve this problem.

Mr. ROSSOTTI. Sure. Sure.

The CHAIRMAN. I would appreciate that very much.

Thank you all very much for taking your time. We appreciate it.

The hearing is adjourned.

[Whereupon, at 12:15 p.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF JACK A. BLUM, ESQ.

My name is Jack A. Blum. I am a partner in the Washington, D.C. law firm of Lobel, Novins & Lamont. For much of my legal career I have worked on the issues of money laundering, offshore tax evasion, and financial crime in a variety of capacities—as a member of the Senate staff, as a private practitioner, and as an expert consultant for executive branch agencies.

Although I am currently on contract to both the Department of Justice and the Internal Revenue Service, I appear here this morning a private citizen. The views I share with you this morning are my own and have not been cleared by any government agency.

The problem of the use of offshore accounts and trusts to evade taxes is not a new one. What is new is that the internet has provided average citizens access to the offshore world and credit and debit cards have made it possible to easily access money held offshore. As a result, offshore tax evasion has grown geometrically as has the threat to the U.S. system of voluntary taxation.

What makes matters worse is that a few of the wealthiest Americans have used highly sophisticated methods backed by opinion letters from top flight law firms to avoid paying current taxes on offshore hedge fund earnings. The success of the very rich in beating the system has allowed low end promoters to tell their clients that all they are doing is offering a version of the same product for the common man.

While the credit card enforcement initiative will go a long way toward controlling the offshore evasion trend, I urge this committee to examine the entire offshore avoidance/evasion problem. I am especially concerned about the use of the offshore world by sophisticated tax lawyers who are offering highly questionable tax avoidance products. These products go unchallenged by the IRS because no trace of the offshore structure appears on the tax returns.

These products include:

- Offshore “charitable trust” arrangements in jurisdictions which do not define charity or regulate the trusts.
- Insurance products in which the insured is the owner of the insurance company and its only client.
- Offshore trusts which use insurance policies as the beneficiaries.
- U.S. holding companies which cover holdings in offshore assets.

This committee must understand that, because the Internal Revenue Service has been starved for money and manpower, a sector of the tax bar has become so “aggressive” in its use of offshore products that the entire tax system is in jeopardy.

Much of what has been done masquerades as “asset protection.” The lawyers who do it say asset protection is legitimate and that it is up to the clients to file proper tax returns. In my opinion, there is very little that is legitimate in the asset protection field. It is a form of what people in Latin America call impunity. By that they mean that the rich escape the consequences of their actions by stepping out of the legal system. As officers of the court, lawyers have no business helping client hide money for clients faced with alimony and child support payments, judgments in civil cases, and fines and penalties in criminal cases. Every lawyer who knows why his client is “protecting assets” knows that for the protection to work, the client will have to commit perjury. Lawyers cannot and should not suborn perjury.

A second point which is essential is what the offshore mess means for people whose income is subject to withholding. They get to make up the lost revenue by paying higher taxes or by having important benefits cut. Middle America gets to pay

for the social benefits of the offshore evaders. The offshore evaders enjoy our schools, hospitals, courts, and our national defense. They should pay their share.

The offshore tax evasion problem is an old one. I first became aware of its seriousness on my first visit to the Cayman Islands in 1974. I was working for the Senate Foreign Relations Committee at the time. I was investigating the methods Robert Vesco used to hide the money he stole from Investors Overseas Services. There were three or four hotels, the most important of which was the Holiday Inn. On the morning after I arrived, the phone system in the hotel failed. The only way to make a phone call was through a pay phone in the hotel lobby. As I came into the lobby that morning I saw a line of well dressed men, mainly Americans, waiting to use the pay phone. Eavesdropping was not difficult, and it did not take long to discover that the men were American lawyers and accountants trying to make appointments with Cayman bankers.

The lawyers and accountants were there to set up bank accounts and trusts for their U.S. clients who did not want to pay taxes. The bankers I met with at the time were quite frank about the source of their business. The American bankers in the Caymans told me they refused business from U.S. persons but referred the U.S. business to their Canadian colleagues. Likewise, the Canadians referred Canadians to American bankers.

At that time there were approximately 25 banks in Cayman. Most of those had moved from the Bahamas to Cayman because the depositors feared the consequences of Bahamian independence and wanted to have the security of operating from British territory. Today there are 590 banks in Cayman and the Islands have gone from being a sleepy backwater to a major world financial center. The flow of American lawyers and accountants continues, and the problem this represents for the American tax system continues.

To give you a sense of how the offshore tax evasion system works let me share several case histories. In cases I worked on for the government I will disguise the facts, but if the committee wishes, I can identify the cases in closed session so that you can obtain the records from the Internal Revenue Service using your oversight authority.

Several years ago I was asked to help a lawyer who represented the wife in a divorce case understand some papers his client had obtained. The wife had been the subject of physical abuse. She got a court order barring the husband from the family home, and soon thereafter had a locksmith drill a safe she found in the bedroom. The safe contained all the documents relating to her husband's plans to hide assets from the wife and their two young children. At the same time the plan allowed, indeed required, that the husband fail to report his offshore income.

The papers showed that the husband had gone to a large Philadelphia law firm which referred the client to an "asset protection" specialist in the firm's London office. The London lawyer suggested forming a Cook Islands trust which in turn would control an offshore corporation which would hold the client's assets. The client would have a power of attorney for the corporation's accounts and would thus be able to trade stock and manage the money. The client could also use the corporate credit card for his day to day expenses.

Tax evasion was an essential part of the program because tax returns would be discoverable in the divorce proceeding. If the husband had been truthful on his returns, both the wife and the divorce court would have known about the offshore trust arrangements.

I was especially disgusted by the role of the Philadelphia law firm in this affair. No American law firm, even one with a British office, should be in the situation of suborning perjury and assisting in outright tax evasion. Because I learned the facts in a privileged setting, there was little I could do.

In another recent case, the taxpayer was sued by the government for civil fraud. The lawsuit and the resulting appeals went on for years. The taxpayer hired a well known asset protection lawyer who set up state of the art asset protection trusts in the Cook Islands, and a fake insurance annuity program in an offshore haven. The trust beneficiary was the annuity. The trusts in turn controlled all of the taxpayer's business and personal assets. The taxpayer took a modest salary from the offshore companies and charged all of his expenses to the offshore company's credit cards. The taxpayer is resisting the government's efforts to collect taxes on the offshore earnings, but he knows that, even if he loses, the government will have nothing to levy against. The offshore credit cards are an essential part of the scheme because they allow the taxpayer instant, and virtually unlimited, access to the money that is beyond the reach of the Internal Revenue Service.

In 1998, I suggested to Brian Ross, ABC's Chief Investigative Correspondent, that ABC send an undercover team to a conference in Cancun, Mexico, run by Jerome Schneider. Schneider is a well known proponent of offshore tax evasion. He ran reg-

ular ads in airline magazines featuring pictures of a couple on a beach and inviting the reader to cut his tax bill by going offshore “the way the wealthy do.”

Two ABC producers went to Cancun and taped private meetings they had with Schneider and several lawyers who Schneider had on the program. In the taping, Schneider proposed that the would be tax evaders purchase banks in Vanuatu. The banks would then open a correspondent account with a Canadian bank which could be controlled by the taxpayer as his personal checking account. The identity of the taxpayer, he argued, would be completely protected. The bank would also be in a position to authorize the issuance of credit cards.

When one of the producers asked a lawyer Schneider had invited to his conference what the chances of being caught by IRS were, the lawyer answered, “How big is your mouth?”

There were more than 400 people who attended the Cancun conference. Many of the attendees bragged to the producers that they had been evading taxes for years and were at the conference to learn the latest evasion and avoidance techniques. I am please to report that the ABC taping led to aggressive action against Schneider by IRS and as a result the airline magazine ads and the conferences have stopped.

Even though the Patriot act has controls on offshore “shell banks” and correspondent accounts, Europe does not yet have similar controls and European banks are offering to step into the breach. It is essential that the European Union’s Commissioners adopt a directive which controls shell banking.

In 1994 I went to the Cayman Islands with a film crew from BBC and did an undercover taping of John Mathewson, the “Chairman” and proprietor of the Guardian Bank and Trust. Mathewson’s bank was selected because he advertised heavily in airline and hotel magazines. The ads suggested that, if one used his services, paying taxes became an optional matter.

In the meeting, Mathewson told me that his bank would set up a corporation for me. The corporation would then open bank and brokerage accounts that I could trade in by using a power of attorney so that all of the records would remain offshore. To access the money, he offered me a gold Mastercard on which he said I could have a spending limit as high as \$1 million a month. Of course, he said, I would have to have that amount on deposit with him.

Since that time, Mathewson has been arrested and charged, and has turned his customers over to the IRS. But Mathewson’s bank was only one of dozens throughout the Caribbean, Panama, the Pacific Islands, and the Channel Islands advertising the same services. A quick search of the internet using the terms offshore banking, or tax haven will show you how easy it is to evade our the tax system.

These cases represent a small sampling of the offshore issues I have encountered. All of the cases have one or another of these themes:

- A desire to hide money from a spouse, a judgment creditor, or a law enforcement agency in which tax evasion is a necessary corollary.
- A sophisticated plan using a thin veneer of legality to place assets out of reach of the income and estate taxes.
- A naive taxpayer who falls for the schemes advance by a sleazy promoter.
- A criminal con-man, stock fraud artist, or drug dealer who is using the offshore system to launder money and who will never consider paying taxes of the ill gotten gains.

The schemes are aimed at different market levels. At the high end, tax planners, lawyers and accountants alike devise complex “structures” through which their clients invest in offshore hedge funds and partnerships. These structures show no current income and as a result the client pays no taxes until the funds are repatriated. The structures are rarely challenged because they appear to be plain vanilla investments on the 1040. The structures are designed so that, if the taxpayer dies, the assets will not appear to be part of the estate.

At another level, the lawyers who make up the “asset protection bar” devise plans that would be completely legal if they were fully reported to the Internal Revenue Service. The plans are designed to keep assets away from judgment creditors. The lawyers tell their clients that for the schemes to work there should be no paper trail. They take no responsibility for insuring that the tax reporting is complete and the tax payments are made. Inasmuch as the offshore financial institutions do not report to IRS, the taxpayers know the risk of being caught is very low. I would guess that 95% of the “asset protection” clients would have to pay substantial additional tax if IRS had access to all of their records.

Then there are the promoters who target professionals including doctors, dentists, and lawyers. They offer a range of schemes, most of which are blatantly illegal. To give one example, two years ago I was approached by a dentist who wanted to buy a bank in the Caribbean. He told me that he had heard that, as the owner of the

bank, he would not have to pay taxes and he could keep his money there without being questioned about it.

When I questioned him, it became clear that he was being offered a “shell” bank which was merely a piece of paper. The bank would have one customer—the dentist who owned it. I tried to explain to him that, unless the business was a real business with a real offshore operation, he would pay higher taxes than if he invested in the U.S. stock market. The more I explained, the angrier he got. Finally, he told me my advice was useless, and that I did not know what I was talking about.

At the very bottom of the offshore business are web sites which offer access to “offshore” bank accounts and services. These run the gamut from the outright criminal to the merely abusive. In one notorious case I dealt with, that of the European Union Bank of Antigua, the owners of the bank advertised that they would not report income to the IRS and solicited deposits and accounts through their web site. The bank immediately “lent” all the deposits to its owner, a Bahamas bearer share company. Needless to say, all the money disappeared and the depositors were left holding the bag.

The Internal Revenue Service has a very difficult time dealing with taxpayers who use complex offshore schemes. If the schemes are uncovered because of diligent work by a revenue agent, the follow up work is exceedingly complex. The evasion schemes involve many tax years and many returns. The revenue agent must decide which years to focus on. To make the case the agent must make repeated document requests, most of which are not met or are the subject of repeated delays and appeals. The agents are under pressure to close the cases and produce results. There are few rewards in the system for sticking with a complex offshore case.

Making matters worse is the fact that obtaining a final judgment in the tax court is just the beginning of the process. The IRS must then collect the money. If the funds are tied up in offshore trusts and the assets are securities held by offshore holding companies, there is little the government can do to get the money. US tax judgments will not be enforced by the courts of foreign countries. The irony of this is that unless the taxpayer is stupid—and there are quite a few in that category—the government will have litigated for years to produce no concrete result.

I have worked with IRS revenue agents and lawyers who have pressed these offshore cases. They are among the country’s most dedicated, hard working, and abused employees. I am amazed at their willingness to persevere against impossible odds. They need to be given support, rewards within the system, and tougher tools to insure compliance with subpoenas.

Offshore tax evasion usually involves other crimes. I am currently representing a witness in a criminal case in New York. The case involves a Bahamas mutual fund which called itself Evergreen Securities. The mutual fund was sold through lawyers and accountants who told their clients to take second mortgages on their homes and invest the money in the “tax free” offshore fund which guaranteed a 12% return. They were told that the interest on the second mortgage could be deducted. In fact the money was stolen by the fund promoters who paid themselves extravagant commissions and used the money from new investors to pay off the old ones. As the investigation progressed, it became clear that the operation of the fund was a carnival of criminality. Tax evasion was only one part of the problem.

In another case, a taxpayer siphoned money from his privately held corporation by submitting false invoices from an offshore shell for equipment that was never delivered. The other family members were clearly the victims of fraud. The taxpayer could have been charged with wire fraud and mail fraud. Given the way the system works, if the revenue agents had referred the case for criminal prosecution, it would have kicked around in the system until it died.

The IRS needs a better way to work with the criminal investigators as information is developed about criminal behavior. As matters now stand, civil tax information cannot be shared with criminal investigative agencies. If the civil side of IRS makes a referral to the criminal side of IRS, the cases take so long to process that they push the statute of limitations. Before a taxpayer can be indicted for a tax crime, the indictment must be subjected to repeated reviews within both the IRS and the Department of Justice.

There are enforcement tools which will work. I believe that every one of the taxpayers who knowingly failed to file the required foreign bank account report on an offshore financial account should be notified that he or she can be charged with a five year felony. The taxpayers should then be given the chance to plead out in exchange for a complete disclosure and payment of back taxes and interest. The Foreign Bank Account Report is required by the anti-money laundering laws. Until now enforcement has been in the hands of Fincen, the financial intelligence arm of Treasury. Fincen’s failure to enforce the FBAR requirement is a national scandal.

The enforcement should be turned over to IRS and should be placed in the hands of a joint civil criminal task force.

Finally, we need to support, not oppose, the OECD's efforts to close these offshore tax havens, even though the Administration and some very powerful banks and corporations try to keep them open.

The offshore issue is central to the issue of a tax system based on voluntary compliance. If a large number of taxpayers can escape the system this way, we will lose an important component of or national life, the notion of equality under law and equal justice without regard to social status.

I commend the committee for its work in this area and I hope this hearing will be the beginning of a serious review of the issue.

PREPARED STATEMENT OF MICHAEL BROSTEK

Mr. Chairman and members of the committee:

I appreciate the opportunity to testify on the Internal Revenue Service's (IRS) efforts to identify and deal with abusive tax schemes that primarily are used by individual taxpayers.¹ My statement today, based on work we have done at the committee's request, focuses on what is known about the extent of abusive tax schemes involving individual taxpayers, the status of IRS's efforts to combat such schemes, and challenges IRS faces in moving forward.

During hearings before this committee last April, several witnesses testified about the increased promotion and use of various types of abusive tax schemes and scams, including constitutional trusts, offshore trusts, and tax credits for slave descendants. Not all of these schemes were new, but in part due to the ease of marketing schemes cheaply through the Internet, schemes were flourishing. Use of such schemes can pose a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance if honest taxpayers believe that significant numbers of individuals are not paying their fair share of the tax burden. Thus, IRS's efforts to pursue abusive tax schemes are key to ensuring that such schemes do not undermine the federal tax system.

My statement today will make the following points:

- Estimating the extent of abusive tax schemes used by individual taxpayers is at best an inexact process because these schemes are often hidden. Nevertheless, IRS officials believe that the number and dollar consequence of schemes has grown in recent years. As of February 2002, IRS estimated that in tax year 2000 about 740,000 taxpayers had used abusive schemes. IRS caught about \$5 billion in improper tax avoidance or tax credit and refund claims, but estimated that another \$20 billion to \$40 billion had not been identified and addressed. Recent developments suggest that the number of individuals involved in one type of abusive tax scheme involving offshore accounts may be greater than what IRS estimated just 2 months ago, and thus, potential lost revenues may be higher.
- In part because no one individual or office could provide an agency-wide perspective on IRS's strategy, goals, objectives, performance measures, or program results, it is difficult to provide a clear picture of all that is underway and being accomplished in IRS's efforts to address abusive tax schemes. Available information suggests, however, that IRS has created new offices, reemphasized and reorganized certain prior efforts, and planned to assign or already assigned at least 200 additional staff to its efforts. Limited data also suggest that IRS's enhanced focus has led to some increased success in convicting those promoting and taking advantage of abusive schemes, "in publicizing these results, and in uncovering previously hidden major offshore compliance problems.
- The sheer number of possible abusive tax schemes that likely will require face-to-face audits could outstrip IRS's available resources. Furthermore, identifying and handling these cases will require a better coordinated effort on IRS's part. IRS has recognized these challenges and is beginning to work on solutions and options. To date, however, IRS has not developed a means to track the resources, in particular staffing, devoted to combating abusive schemes or developed goals and measures that Congress and IRS can use to assess its progress.

¹Although overlap may exist between the types of abusive tax schemes used by individuals and other tax paying entities, like corporations, our work focused on those schemes generally used by individuals to inappropriately reduce the taxes they owe, or to generate refunds to which they are not properly entitled.

BACKGROUND

According to IRS, during the mid to late 1990's, abusive tax schemes reemerged across the country. The use of abusive tax shelters, anti taxation arguments, abusive tax schemes, and frivolous returns last peaked in the 1980's. IRS characterizes an abusive tax scheme as any plan or arrangement created and used to obtain tax benefits not allowable by law. Schemes run from simple to very complex, from clearly illegal to those carefully constructed to disguise the illegality of the scheme. Furthermore, users of schemes can range from those believing their position is correct to those who knowingly but willfully file incorrect tax returns. Schemes can be based on improper use of domestic and foreign trusts, inflated business expenses and deductions, falsely claimed tax credits and refunds, and various anti-tax arguments. Some schemes are created by tax professionals such as accountants, lawyers, and paid tax preparers, or by groups and individuals. Tax schemes are offered to taxpayers using various means, including conferences or seminars, publications, advertisements, and the Internet. Others are promoted by word-of-mouth.

Abusive tax schemes that are generally used by individuals fall into four major categories. For the first two of these, frivolous returns and frivolous refunds, taxpayers submit a tax return that either states an argument that IRS can readily identify as frivolous, or a return with characteristics IRS has identified as reflecting a frivolous argument. For the other two types of schemes, abusive trusts and offshore compliance strategies, taxpayers' returns are less likely to reveal use of a clearly abusive tax scheme.

FRIVOLOUS RETURNS

These schemes generally use any number of anti-tax arguments to incorrectly claim that income is exempt from taxation or that IRS otherwise lacks authority needed to tax income. These arguments have been well litigated in the courts and consistently ruled to be without merit. Examples include the following:

- Form 2555 Scheme: In this scheme, individuals file an IRS Form 2555, Foreign Earned Income, and claim that their income was not earned within the United States. This is also known as the "not a citizen" argument in which taxpayers file returns stating they are citizens of the "Republic of [any state]" and not citizens of the United States, and thus, their income is not taxable.
- Section 861: Individuals using this scheme claim that under Internal Revenue Code section 861 income tax must only be paid on foreign income and, therefore, their income is not subject to tax or withholding. In these cases, taxpayers file a tax return and show a zero amount for wages. According to IRS, this argument has spread to some employers who are using it to avoid withholding and paying payroll type taxes on their employees.

FRIVOLOUS REFUNDS

According to IRS, credit and refund abusive tax schemes are designed to substantially reduce taxes or create a refund for the taxpayer, generally by claiming eligibility for a credit that does not exist or to which the taxpayer is not properly entitled. One such scheme that has received much attention is the Slavery Reparation Refund scheme. According to IRS, promoters circulate or publish information claiming African Americans are eligible for slavery reparations. Taxpayers claiming this credit generally enter a significant amount on their tax return as a credit that results in a taxpayer realizing a refund if not detected by IRS.

ABUSIVE DOMESTIC TRUSTS

A trust is a legitimate form of ownership, which completely separates asset responsibility and control from the benefits of ownership. As such, trusts are commonly used in matters such as estate planning. An abusive domestic trust scheme usually involves a taxpayer creating a trust that does not meet the Internal Revenue Code requirements that the assets and income of the trust not be subject to the control of the taxpayer. Once such an improper trust is established and the taxpayer has transferred business or personal assets to it, the scheme may involve further abuses, such as offsetting income of the trust by overstating its business expenses or including the taxpayer's personal expenses—like a home mortgage—as an expense of the trust. The taxpayer will often use multiple entities such as partnerships, limited liability companies, or secondary level trusts that can be tiered or layered to mask the taxpayer's continued ownership or control of the trust's income or assets.

OFFSHORE SCHEMES

Abuses that involve foreign locations can take a wide array of forms and attempt to use a number of techniques to improperly avoid paying taxes. One common technique is simply to use foreign locations to add another level of complexity in obscuring the true ownership of assets or income and thus obfuscating whether taxes are owed and by whom. Use of foreign locations, for instance, can be combined with use of trusts to make unraveling the true ownership of assets and income more difficult for IRS. According to IRS, criminals long have used offshore schemes to disguise the true nature of their enterprise and the resulting income. Promoters of abusive tax schemes have, according to IRS, increasingly devised schemes that in some fashion involve transferring income or title to assets to foreign locations. Often foreign locations are selected because they are tax havens with little or no taxation on income in their jurisdiction, have privacy rules that help schemers hide what they are doing, or have other characteristics favorable to carrying out the schemes. According to IRS, once such transfers are established, income is often repatriated back to the U.S. owners through loans, credit cards, or debit cards. By using complex transactions and multiple entities, the individuals using these schemes attempt to hide their income and avoid potential tax liabilities.

EVIDENCE OF RAPID TAX SCHEME GROWTH

According to IRS's fiscal year 2003–2004 Small Business and Self-Employed (SB/SE) Division Strategic Assessment Report,² abusive tax schemes represent a rapidly growing risk to the tax base. IRS estimates the potential revenue loss from these schemes to be in the tens of billions of dollars annually. According to an IRS official, to make accurate estimates in this area of noncompliance is difficult. For one reason, the nuances and types of schemes are constantly changing and evolving, particularly in the areas of abusive trusts and offshore compliance. Also, IRS's detection of schemes is challenging. Trust schemes, in particular, often involve multiple entities that are vertically layered or tiered in an attempt to disguise the true ownership of the income or assets of the trust. The difficulty in determining the significance of offshore compliance is also exacerbated because these types of schemes generally use tax haven countries to disguise the transactions and prevent IRS from routinely collecting tax-related information on transactions.

Despite the difficulties in accurately estimating the significance of abusive tax schemes, IRS provided us with estimates in four major scheme areas: Frivolous Returns, Frivolous Refunds, Abusive Domestic Trusts, and Offshore Schemes. According to IRS, its estimates were made in February of 2002 and were derived from information gathered during tax return processing and examination activities and from the work of IRS's Criminal Investigation, the law enforcement arm of IRS. According to an IRS official, these estimates were derived from tax year 2000 information, the last full year for which data were available. IRS's estimates are as follows:

- Frivolous returns: about 62,000 taxpayers with associated tax amounts approximating \$1.8 billion.
- Frivolous refunds: about 105,000 taxpayers with associated tax amounts approximating \$3.1 billion.
- Abusive domestic trusts: about 65,000 taxpayers with tax losses approximating \$2.9 billion.
- Offshore schemes: about 505,000 taxpayers with tax losses ranging from \$20 billion to \$40 billion.

IRS's estimates for the numbers of taxpayers and taxes in connection with frivolous returns and refunds, although not precise, likely have less uncertainty than its estimates of the numbers of taxpayers and taxes at risk in connection with abusive domestic trusts and offshore schemes. IRS's estimates for frivolous returns and refunds are based in large part on returns and refund claims that IRS has identified while processing tax returns and has addressed by pulling the associated returns and notifying the taxpayers that their returns contained errors that need to be corrected.

Thus, in these cases, IRS has a fairly direct basis for counting the number of taxpayers involved and the amount of tax involved. Furthermore, because IRS has pulled these returns from processing, in general, improper refund claims have not

²The FY 2003–2004 SB/SE Strategic Assessment Report (Mar. 1, 2002) provides IRS assessment of critical trends, issues, and problems facing the Small Business and Self-Employed taxpayer customer segment.

been paid out, and IRS is pursuing collection of the proper amount of tax when taxpayers have failed to pay the full amount owed.³

In contrast, although taxpayers using domestic trusts and offshore schemes may file tax returns, those returns alone seldom provide enough information for IRS to determine whether an abusive scheme was used. Therefore, IRS's estimates of the numbers of taxpayers and the taxes at risk for the domestic trust and offshore scheme categories generally rely on limited numbers of cases that have been examined or investigated, on intelligence obtained in the course of normal tax administration and Criminal Investigation activities, and on IRS officials' professional judgments.

Recognizing that offshore transactions are a significant factor in offshore schemes, IRS has been taking steps concerning the use of credit/debit cards issued by offshore banks to U.S. taxpayers. Although having an offshore credit card is not illegal, IRS believes that some U.S. taxpayers are using such cards to evade U.S. taxes. In October 2000, a federal judge authorized IRS to serve "John Doe" summonses on American Express and MasterCard to obtain limited information on U.S. taxpayers holding credit cards issued by banks in several tax haven countries.

On the basis of information received from MasterCard, IRS identified about 235,000 accounts issued through 28 banks located in 3 countries. IRS's ongoing analysis of these data leads it to estimate that between 60,000 and 130,000 U.S. customers are associated with these 235,000 accounts. In part because MasterCard is estimated to have about 30 percent of this market, IRS estimates that there could be 1 to 2 million U.S. citizens with credit/debit cards issued by offshore banks. However, this is a very preliminary estimate. IRS officials believe this estimate may be reduced because, among other things, a portion of these accounts may not be associated with abusive tax schemes. By comparison, only about 117,000 individual taxpayers indicated that they had offshore bank accounts in tax year 1999. On March 25, 2002, IRS petitioned for permission to serve a summons on VISA International, seeking records on transactions using cards issued by banks in over 20 tax-haven countries.

The estimates of the number of individuals and dollar consequences associated with offshore credit/debit card schemes are very uncertain at this time. Nevertheless, IRS's February 2002 estimate of \$20 billion to \$40 billion in tax dollars at risk from offshore schemes may grow as IRS learns more about the extent of the problem.

EXPANDED IRS EFFORTS TO IDENTIFY AND CONTROL TAX SCHEMES

No one individual or office could provide an agencywide perspective on IRS's strategy, goals, objectives, performance measures, or program results, for its efforts to address abusive tax schemes. Consequently, a clear and consistent picture of IRS's efforts was difficult to obtain. Available information indicates that IRS began increasing its efforts to combat abusive schemes over the past 2 or 3 years, continued to do so in 2001, and plans further future efforts. Limited data also suggest that these enhanced efforts have helped IRS convict more promoters and users of abusive schemes over the past 3 years, which IRS has publicized through enhanced communication strategies.

Organizationally, IRS identifies and deals with schemes in two primary ways—during its processing and examination of tax returns (compliance and enforcement) and through the work of Criminal Investigation (CI). However, most of IRS's programs to address abusive schemes are the responsibility of SB/SE and CI. IRS also works with various federal agencies in its efforts to identify and deal with abusive tax schemes.

COMPLIANCE AND ENFORCEMENT EFFORTS

IRS has taken a number of steps to enhance its compliance and enforcement efforts—its audit and other civil enforcement activities—that focus on abusive tax schemes. In the past year, for example, IRS has increased staff years devoted to examining abusive tax scheme promoters, decided to assign about 50 more agents to promoter examinations and train them, and laid plans for assigning 200 or more additional staff to reviewing abusive tax schemes and offshore compliance schemes. Furthermore, IRS has created an organization that initially will focus on developing leads and cases related to abusive scheme promoters and that will monitor promoter web sites.

³IRS is not able to detect and stop every frivolous refund scheme. For example, IRS reported that in tax year 2000 about \$13 million in refunds was sent to taxpayers due to reparations filings. IRS has subsequently taken action to recover the funds.

IRS identifies many abusive tax schemes during its normal tax return processing and examination activities. For example, when tax returns initially are processed either manually or by computers, processes are in place to detect apparent frivolous returns or returns reflecting improper refunds. In these cases, the returns are pulled from processing to be forwarded elsewhere for follow-up action. Both the Wage and Investment (W&I) and SB/SE divisions in IRS process taxpayers' tax returns and both have responsibilities for identifying tax returns that may involve abusive tax schemes.

Three principal SB/SE efforts focusing on or related to abusive tax schemes are

- the Frivolous Return Program,
- the Office of Flow-Through Entities and Abusive Tax Schemes, and
- the National Fraud Program.

FRIVOLOUS RETURN PROGRAM

The Frivolous Return Program identifies the tax returns of individuals who assert unfounded legal or constitutional arguments and refuse to pay their taxes or to file a proper tax return. The program also identifies returns claiming frivolous refunds, such as those involving slavery reparations. Generally, IRS provides guidance to those who process tax returns to identify the characteristics of returns claiming such frivolous arguments or refunds. IRS also has programmed its computers to do so. The Treasury Inspector General for Tax Administration helped IRS develop software programs to identify slavery reparation schemes. Since both W&I and SB/SE staff process tax returns, both divisions are involved in identifying such returns.

Once identified, the returns are pulled out of the tax return processing stream and forwarded to the Frivolous Return Program unit where they are to be resolved with the taxpayer. The program was consolidated in January 2001, at the Ogden, Utah, Compliance Services Center. The compliance center staff enters information about each case into a database and assigns 1 of 31 different codes identifying the frivolous argument or refund being claimed by the taxpayer. Then, a notice requesting taxpayers to file a proper tax return is to be sent advising them that IRS has judged their tax return to include an argument that is without legal merit or a credit or tax refund to which they are not entitled.

IRS officials indicate that the number of staff assigned to the Frivolous Return Program unit in Ogden grew from 18 employees in September 2000 to 45 employees in September 2001. Some of this increase may not reflect a net IRS-wide increase in full-time equivalents (FTE) for frivolous returns since the increase has, in part, been due to centralizing efforts in Ogden from other IRS locations. IRS officials expect to assign more employees to this program in fiscal year 2003.

OFFICE OF FLOW-THROUGH ENTITIES AND ABUSIVE TAX SCHEMES

The Office of Flow-Through Entities and Abusive Tax Schemes became operational in January 2000.⁴ The office was created to organize IRS's efforts in addressing abusive tax schemes, particularly trusts, and to identify their promoters and sellers. The unit's goals are (1) to catalogue and profile schemes and trends, (2) direct compliance resources to examine schemes and promoters or refer tax scheme promoters and participants for criminal prosecution, (3) increase employee knowledge and skills related to abusive tax scheme issues, and (4) enhance coordination within IRS on issues related to abusive tax schemes.

IRS expects to assign and train about 50 revenue agents this fiscal year to focus mainly on promoters of abusive tax schemes. The agents are to undergo training during the summer of 2002 and to begin examining cases by the fall of 2002. According to IRS, the number of abusive promoter leads increased from 25 in March 2001 to 155 in February 2002. In addition, the number of abusive promoter cases approved for further examinations has increased from 17 cases to 94 cases during the same period. The time spent on these cases is also increasing. IRS also reports that time spent on promoter examinations for fiscal year 2002 is expected to be 12.1 staff years, which is up from 4.4 and 1.2 staff years in fiscal 2001 and fiscal year 2000, respectively.

Furthermore, IRS plans additional expansion of its abusive tax scheme compliance efforts. For example, IRS expects to develop units that will include 8 to 10 agents in each of 15 locations. These units will address abusive tax schemes and flowthrough entities. In addition, given the growing significance of the offshore credit/debit card schemes, IRS plans to create four special enforcement groups. Each

⁴As part of a reorganization within SB/SE, the responsibilities of the Flow-Through Entities and Abusive Tax Schemes office were undergoing change in April 2002. We discuss these changes later in the testimony.

group will be staffed by approximately 8 agents and will concentrate on these off-shore schemes. This growth in staffing reflects IRS's increased priority for these schemes. IRS officials expect that the agents assigned to these units will be redirected largely from other compliance areas.

Schedule K-1 Transcription and Matching. In the spring of 2001, the transcription of Schedule K-1 information became a major responsibility of the Office of Flow-Through Entities and Abusive Tax Schemes.⁵ According to IRS, information provided on Schedule K-1 is important for determining whether recipients of flow-through income have properly reported that income on their tax returns. IRS can use transcribed data for information-matching to determine whether proper reporting of income occurred.

IRS believes that flow-through entities such as trusts and partnerships are increasingly being used in abusive tax schemes. IRS can also use these K-1 data in its return examination and tax collection activities to help identify abusive tax schemes.

Tax year 1995 marked the last year that Schedule K-1 information was transcribed by IRS. From 1990 through 1995, IRS transcribed approximately 5 percent to 12 percent of the Schedule K-1 is received. After 1995, IRS did not transcribe Schedule K-1 information submitted with paper returns nor did it match the income information contained on the schedules with the information presented on individual beneficiaries' or partners' tax returns. IRS again started to transcribe tax year 2000 K-1 information during the spring of 2001 and completed the process in December 2001. IRS officials told us that the matching of the K-1 information against individual tax returns was to begin in March 2002.

IRS cites several reasons for reinstating its transcription and matching of Schedule K-1s. First, IRS has observed a significant increase in flow-through entities. The number of tax returns filed by Trusts, Partnerships, and S-Corporations has increased by 12 percent, 33 percent, and 35 percent, respectively, over the 6-year period from fiscal years 1995 through 2000. IRS also estimates an overall increase of nearly 2 million such returns by 2009. Second, based on a small study, in January 2002, IRS estimated that between 6 percent and 15 percent of total flow-through income would not be reported on tax year 2001 returns. Although data available to us at the time of this testimony were not clear, IRS estimates that income of about \$1 trillion was distributed to taxpayers from flow-through entities for tax year 2000. Third, IRS expects its Schedule K-1 matching program not only to identify under-reporting or nonreporting of income but also to improve taxpayer compliance. Transcription and matching of Schedule K-1 data are expected to increase accurate reporting of trust income on future tax returns just as matching of wage, interest, and other types of income has increased the accuracy of taxpayers' tax returns. As a result, the Schedule K-1 program places taxpayers who receive flow-through income on a more equal footing with taxpayers who are wage earners.

Lead Development Center. IRS has adopted a strategy of identifying promoters of tax schemes as a key to halting their promotion and identifying those who have taken advantage of the scheme and thus likely owe taxes. By early April 2002, SB/SE is to initiate a Lead Development Center. The center's primary functions are to develop case leads and assemble case information for distribution to compliance field offices for further investigation. Initially the center will focus on abusive tax scheme promoters, and over time, it will expand to perform similar functions for fraud and anti-money laundering cases. Also, the center will operate a computer laboratory that, among other things, is expected to monitor possible abusive promoter sites on the Internet. In addition, the center is to serve as a coordinating link among various IRS groups that deal with abusive tax scheme issues and with outside stakeholders such as the Department of Justice, the Federal Trade Commission (FTC), and others.

NATIONAL FRAUD PROGRAM

The National Fraud Program, which operates at IRS's campuses and field offices, coordinates efforts and provides oversight to IRS's compliance efforts to identify potential tax fraud. In addition, the program helps identify trends and disseminates the information within IRS and acts as a liaison on fraud cases involving bankruptcy and employment and excise taxes among other types of tax fraud. A National Fraud Program manager sets overall policy and program direction. Fraud managers are located in five area offices, and they oversee the activities of about 65 fraud re-

⁵The schedule K-1 is an information return that a flow-through entity sends to partners and beneficiaries with a copy to IRS. The schedule K-1 provides information on income distributed to partners and beneficiaries.

ferral specialists. These specialists assist other IRS revenue compliance staff in identifying cases with fraud potential, determining when indications of fraud are present, and developing potential cases. They also review fraud cases for technical accuracy and adequacy of supporting documentation to ensure appropriate and consistent application of fraud program guidelines and requirements. In cases where there is evidence of criminal activity, those cases are to be referred to criminal investigation within IRS.

CRIMINAL INVESTIGATION

IRS's Criminal Investigation investigates and pursues promoters and sellers of abusive schemes and the individuals using such schemes. CI's role is the enforcement of the tax laws for individuals who willfully fail to comply with their obligation to file and pay taxes and who ignore IRS's collection and compliance efforts. The most flagrant cases are recommended for criminal prosecution.

Criminal Investigation also administers the Questionable Refund Program that focuses on stopping the payment of various false tax refunds and, if warranted, on prosecuting the taxpayers involved. Furthermore, CI develops education and publicity activities warning taxpayers about abusive tax schemes and placed public information officers (PIO) in the field to specifically generate publicity regarding IRS's law enforcement efforts.

CI ENFORCEMENT STRATEGY

CI's enforcement strategy as it relates to fraudulent tax schemes is to focus primarily on the promoters of these schemes and on taxpayers who willfully use these schemes to evade taxes. For example, during a tax scheme investigation, CI generally attempts to gain access to a fraudulent promoter's list of clients to whom the promoter sold the scheme. In addition to pursuing the promoter, CI can then use the list of clients to determine who may have used the abusive scheme. CI determines which users of the abusive scheme merit investigation for possible prosecution and which users merit referral to IRS operating divisions for possible compliance and civil enforcement action.

Although CI has data on enforcement activity related to several types of tax scams (e.g., related to employment tax, refunds, return preparers, nonfilers, and domestic and foreign trusts), CI only separately tracked its promoter efforts for domestic and foreign trusts. (See table 1.) CI officials said that the number of full-time equivalent staff working on domestic and foreign trusts increased from 55 in fiscal year 1999 to 69 in fiscal year 2001.

Table 1: Summary of Domestic and Foreign Trust Cases from Fiscal Year 1999 through Fiscal Year 2001.

Cases	FY 1999	FY 2000	FY 2001
Indictments	35	53	32
(Promoters)	13	14	15
Convictions	24	31	45
(Promoters)	3	9	23
Active Investigations	131	126	165
(Promoters)	49	54	66
Prosecutions Recommended	57	44	30
(Promoters)	18	14	13

Note: Statistics in this table refer to individuals, such as indictments brought against 35 individuals in FY 1999.

Source: IRS Criminal Investigation.

Although no consistent pattern exists across all of the categories in table 1, CI has had increases in the number of convictions obtained over the 3-year period. Furthermore, looking only at promoter-related cases, indictments, convictions, and active investigations increased over the period while the number of prosecutions recommended declined. For purposes of deterring individuals from engaging in abusive trusts, the pattern of increasing convictions has provided IRS an opportunity to publicize more cases in which individuals have been found guilty. Further, the increases

in indictments and convictions of promoters may help deter promoter activity in particular.

Because the investigative and legal processes can span several years, data like those in the table do not show whether the cases investigated lead to prosecutions, convictions, and indictments in that same year. Further, the data do not account for differences in the importance of cases, such as whether major fraudulent efforts are being successfully investigated and closed. IRS data do show that the average length of sentence for the abusive domestic and foreign trust program rose substantially from 35 months in 1999 to 64 months in 2001. To the extent that average length of sentence relates to the severity of the crime, IRS may be making headway in pursuing key abusive trust cases.

QUESTIONABLE REFUND PROGRAM

The Questionable Refund Program (QRP), administered by CI, was established in 1977. The QRP was designed to identify false returns, stop the payment of false refunds, and prosecute scheme perpetrators. Various false refund schemes are pursued under this program, including ones involving the earned income tax credit, the fuel tax credit, social security refund schemes, and slavery reparations. Tax returns and return information are subject to manual processing or computerized information matching. IRS's compliance staff identifies those returns claiming a possible false refund generally during these various return examination processes and referred to Questionable Refund Detection Teams (QRDT). The QRDT staff within CI determines which returns should be pursued within CI or civilly. Schemes with criminal potential are referred to CI field offices for investigation while schemes lacking criminal potential are referred to the appropriate IRS compliance or collection group.

CI'S EDUCATION AND PUBLICITY EFFORTS

CI's efforts to inform and educate the public about abusive tax schemes and to publicize the results of its enforcement activities related to such schemes take many forms and involve several types of media. CI has been particularly active in trying to disseminate information to the public to make them aware of IRS's activities and accomplishments in combating abusive tax schemes.⁶ In addition, CI has PIOs located across the country who work with local media to publicize IRS's efforts and results.

CI Education and Publicity Activities. CI's education and publicity activities focus on warning taxpayers about fraudulent tax schemes so that they will not be tempted to use such schemes. CI hopes that increasing media coverage of successful tax scheme prosecutions will deter the public from participating in tax schemes because the perceived risk of detection, prosecution, and resulting penalties and sanctions will be too high. In addition, CI officials believe that publicizing the prosecutions of promoters and users of tax schemes helps assure the public that people are paying their fair share of taxes.

CI posted its web page (www.ustreas.gov/irs/ci) on the Internet in September 1997. According to CI officials, over the past 2 years the Internet site has evolved into an important tool for educating and alerting the public about tax schemes and about CI's efforts to detect and deal with those who promote and use tax schemes. The Internet site provides

- fraud alerts warning the public of schemes where promoters are targeting unsuspecting taxpayers;
- information on topics including tax filing responsibilities, nonfilers, and abusive tax return preparers;
- summaries of cases and successful prosecutions of promoters and users of fraudulent schemes; and
- press releases and other IRS publications to generate a wide public distribution.

Tax practitioners are also targets of CI's publicity strategy. According to CI officials, some tax practitioners are using IRS's materials directly from the Internet site to inform those clients who may believe that a given tax scheme is legal. For example, clients may ask the tax practitioner to set up a fraudulent trust to reduce their taxes, and the tax practitioner can simply print the brochure about "Too Good to be True?—Trusts" from CI's Internet site to discourage the taxpayers from using such a trust.

In conjunction with using the Internet site as an informational tool to educate and warn the public of frivolous schemes, CI has taken steps to increase IRS's visibility

⁶Other divisions within IRS also work to publicize IRS's activities related to abusive tax schemes. For example, SB/SE devotes part of its Internet site to fraud alerts and press releases.

and presence on the Internet. According to CI, it has recently intensified its efforts to improve the ranking of IRS's web page through the use of "metatags" or keyword tags. By doing so, IRS seeks to have Internet users who enter various terms in available Internet search engines find IRS's web page listed near the top of displayed search results. For example, CI is planning to add tags such as "pay no tax," and "form 1040" so that entering these terms will result in CI's Internet site being listed in the displayed search results.

CI is pursuing other possible strategies to ensure that CI's site rises to the top of Internet search responses. For example, CI staff has occasionally visited known promoter Internet sites to gather information on keywords used by those sites. IRS plans to incorporate those keyword tags into its Internet site. As a result, IRS expects to increase the odds that the CI Internet site would be included alongside Internet sites that promote questionable tax avoidance strategies. In addition, CI is working to create a web content manager position with responsibilities that include designing a strategy to maximize the potential of CI's Internet site. The manager would be responsible for helping to integrate CI data into the pages in IRS's Internet site that provide information to specific types of taxpayers.

CI Public Information Officers. In October 2000, CI established PIOs in each of IRS's 35 field offices. The PIOs serve as points of contact for all internal and external CI communications initiatives, including the issuing of press releases and the coordination of important law enforcement media events. Although IRS has other media relations specialists located in its field offices, their duties tend to focus on publicizing tax filing season information, including the benefits of electronic filing. CI PIOs generate publicity regarding IRS's law enforcement activities including the detection and prosecution of abusive tax schemes.

PRIMARY FUNCTIONS OF THE PIOs INCLUDE

- establishing contacts with editors, reporters, and news directors to educate them on tax issues and provide information about IRS and CI to enable them to write in-depth articles.
- encouraging media to include more stories on the detection and prosecution of abusive tax schemes.
- getting articles included in trade and professional journals and magazines that are read frequently by professionals such as doctors, lawyers, and accountants to make them aware of abusive tax schemes.
- developing a local media strategy. Part of CI's local strategy involves generating a "hook" to get the stories focused more on communities. In addition, CI has employed a strategy of "bundling" news stories. For example, CI has been working cases on fraud involved in the restaurant industry. Once several such cases have been put together, CI will bundle these stories together into a single news story for possible publication in magazines and journals read by people in the restaurant industry.
- giving speeches and participating in a wide variety of presentations, panel discussions, and conferences with professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the American Medical Association, to create public awareness of CI's activities and to provide information about fraudulent tax schemes.

IRS COORDINATION EFFORTS

IRS works with various federal agencies in its efforts to identify and deal with fraudulent tax schemes. These include the Federal Trade Commission (FTC), the Securities and Exchange Commission (SEC), the Financial Crimes Enforcement Network (FinCen), the Department of Justice (DOJ), the Federal Bureau of Investigation (FBI), and the United States Attorneys Offices (USAO).

In some cases, IRS's coordination is on an informal basis, as it is with the FTC and the SEC, and involves the sharing of certain information and detection techniques. In other cases, the relationship is more formal, as in the case with DOJ or USAOs, which prosecute fraud and other tax-related cases with the assistance of IRS staff.

IRS officials participate in various federal agency working groups, including a multiagency task force to share information, skills, and procedures for combating fraud on the Internet; an IRS and DOJ working group created to examine the use of civil injunctions against abusive promoters currently under criminal investigation; and a money-laundering experts working group. According to the officials we interviewed, these working groups are invaluable for developing networking relationships between agencies which facilitate information-sharing among staff.

IRS staff also attends quarterly meetings with staff from the FTC, SEC, and DOJ to develop joint initiatives to combat Internet fraud. These meetings have spawned other activities for IRS staff, including FTC-sponsored training seminars and periodic visits to FTC's Internet laboratory to keep current with FTC efforts to combat Internet fraud.

IRS FACES SUBSTANTIAL CHALLENGES; LACKS MEANS TO ASSESS PROGRESS

IRS has tried to develop a better understanding of the potential breadth of the problem of abusive tax schemes involving individual taxpayers and the steps needed to coordinate and manage numerous efforts to combat abusive tax schemes. In some cases, these steps have been recently implemented, and in other cases, IRS is working to implement them. These expanded efforts have not been accompanied, however, by performance goals or measures that Congress and IRS can use to assess IRS's progress.

The increased scope of the abusive tax scheme problem, and perhaps especially the offshore compliance schemes, could strain IRS's audit resources. IRS is now beginning to gather data that will better enable it to estimate the magnitude and nature of the offshore credit and debit card schemes. Improved data will help IRS identify how many and what types of resources it may need to address the schemes. However, the evasive nature of these schemes may necessitate face-to-face audits in a significant portion of cases to determine whether taxes are owed and the amount owed. Even if the number of individuals involved in these schemes is a fraction of the reported estimate of 1 to 2 million, IRS's staff may be challenged to audit them and maintain its current audit coverage as well. IRS's face-to-face audits have been declining, decreasing from nearly 400,000 in fiscal year 1999 to nearly 200,000 in fiscal year 2001.

Accordingly, IRS has begun considering whether other techniques than audits could be used to resolve these cases. For example, IRS is considering options such as disclosure initiatives, settlement initiatives, and self-correction programs. These techniques will need to be tested and refined to determine which, if any, are effective.

The increased scope of abusive tax schemes has also led IRS to

- develop an improved process for selecting the best cases to pursue among the many that it identifies,
- develop a new policy to govern simultaneous criminal and civil enforcement investigations of taxpayers,
- consider how to ensure that increased volumes of scheme-related tax assessments are followed up by IRS's collection function when taxpayers are unable to pay in full, and
- use its internal research group and a contractor to develop better models for identifying indicators that taxpayers may be participating in abusive tax schemes.

In addition, a significant organizational change has just been implemented in SB/SE that is intended to increase program oversight and coordinate programs and units dealing with abusive schemes and related tax fraud activities. To that end, in the past few weeks SB/SE has divided its Office of Flow-Through Entities and Abusive Tax Schemes. Now, its efforts to ensure accurate reporting of income connected to flow-through entities will fall under a director for reporting compliance. IRS separated the flow-through entity effort from other abusive tax scheme efforts because it judged that the flow-through effort is more related to its traditional information-matching and examination programs than to its abusive scheme efforts. The flow-through effort will, however, also provide useful information for IRS to use elsewhere in investigations of abusive schemes.

The rest of SB/SE's major programs and efforts that are more directly focused on abusive tax schemes—the National Fraud program, the Abusive Tax Schemes program, the Lead Development Center, and the Anti-Money Laundering program have been placed under a single executive for reporting enforcement. Monitoring the Internet and other media outlets where abusive tax schemes often are advertised will also be part of this centralized effort.

To date, however, IRS has not provided information on its staff year investments in combating abusive tax schemes and has not established performance goals and measures that IRS and Congress can use to gauge whether these efforts are achieving desired results. We testified recently that the IRS commissioner identified four major areas of systematic noncompliance. These areas not only focus heavily on abusive tax schemes involving individuals, but also include corporate tax shelter activity. The fiscal year 2003 budget request includes increased resources for compliance efforts, but, excluding the Earned Income Credit program, it is unclear from IRS's

congressional budget justification how many resources IRS intends to devote to major areas of noncompliance or what performance measures will be available to Congress and IRS to assess progress.

CONCLUSIONS

IRS has long-standing programs and related efforts aimed at detecting and dealing with abusive tax schemes, particularly those related to frivolous tax returns and fraudulent tax refund claims. Recently, IRS has begun to take a more assertive and coordinated approach to detecting and dealing with an ever-changing array of schemes, including those involving the use of domestic and offshore trusts. In the past year, IRS has added more resources to these efforts, created new programs, and improved others, and it is reorganizing its operations. Furthermore, based on the limited data available, IRS appears to be realizing some increased success in convicting those involved in schemes, publicizing these results, and uncovering previously hidden major offshore compliance problems.

Nevertheless, it is difficult to get a clear picture of all that is underway in IRS—how much is new as opposed to reemphasized or reorganized, and how the pieces combine to form a planned, coordinated effort with specific, defined outcomes. One of the difficulties we encountered in gathering information was that no central office, group, or executive could provide us with an agencywide focus or perspective on IRS's strategy, goals, objectives, performance measures, or program results. Responsibility for the efforts was spread across various functions and groups within IRS. To some extent this lack of clarity is not surprising given the fairly rapid and ongoing change in IRS's efforts, the expanding scope of the problem, and the difficulty in determining the difference between what is legitimate, aggressive tax planning and an abusive tax scheme.

IRS has recognized that its multiple, enhanced efforts need to be better integrated. In an attempt to bring this integration to fruition, SB/SE is reorganizing to place key efforts to combat abusive schemes under one executive. A centralized focal point should enhance IRS's ability to manage its efforts to reduce the prevalence or magnitude of abusive tax schemes.

To date, IRS has not provided information on its staff year investment in combating abusive schemes and has not established goals and measures for its efforts that it and Congress can use to assess its progress. We recently suggested that another committee consider asking IRS to provide more specifics on the level of resources it plans to devote to areas identified by the commissioner, such as abusive tax schemes, and on performance goals and measures for those efforts. This committee might want to consider requesting similar information from IRS.

Mr. Chairman, that concludes my statement. I would be pleased to respond to questions that you or other members of the committee may have at this time.

PREPARED STATEMENT OF DANIEL BULLOCK

Thank you for the privilege of speaking to you about tax scams. Speaking as both a convicted tax cheater and a loyal American citizen, this is my perspective.

I hadn't planned on cheating and had a rationalized my behavior as "legal" until I decided to plead guilty last year. It was quite a shock to apply that phrase "tax cheater" to myself as I prayerfully reviewed my actions. I was a spiritual man—a leader in my church and community. I was a successful husband, father and Board-Certified Orthopedic surgeon. I had served my country in the U.S. Public Health Service and as Senior Team physician for the United States Cycling Team. I had traveled to Honduras and Nicaragua to provide medical relief and to build churches. Non the less, the enemy of all that is good had crept into my heart and slipped a tentacle around my soul. This happened largely unrecognized and by the time I saw what I was really involved in, it was too late to avoid considerable pain for my patients, colleagues, employees, friends and family.

Praise Jesus' name I was able to acknowledge my mistake and am proceeding to pay for it as best I can. I know he has forgiven and grown me through this experience. I am content.

My story is not that unusual. Angry at the Internal Revenue Service for the way an agent that treated me, I had a rebellious attitude. When I encountered someone with "inside information" on how the very wealthy avoid taxes, I was all ears. He had a good story, a well used and "successful" strategy, hundreds of clients and legal opinion in support of his program.

This strategy involved complicated trust arrangements and tax haven countries. I rearranged my life and business and it was several years before I finally sought another legal opinion and stopped using his plan. By then it was too late.

All it takes is a simple phone call from an employee to the IRS about your unusual activities and your name can be put at the top of the list for investigation by their criminal investigations. A year goes by and kevlar-vested agents raid your house. Not long after that the U.S. Attorney takes the case. The U.S. Attorney virtually always prevails.

If you agreed with someone else on one act which the government believes interfered with the IRS and its ability to properly collect taxes on one dollar—it's called "conspiracy to defraud." There are mandatory minimum prison sentences for this activity.

Common rationalizations such as "Everybody does it," or "The tax laws are too complex," or "But John Doe was doing a lot worse than us and nothing happened to him," carry no weight with either the prosecutor or the judge.

So here I am before you, an inmate of the Satellite Prison Camp at Atwater, California. I've lost my medical license and this Board-Certified Orthopedic surgeon is restricted to janitorial work for the next 17 months. Yes, it's a heavy price.

Some of you might be tempted to conclude that I am really stupid man and at times would have agreed with you. But, tax scams are very deceptive and I believe there to be many more all-too-naive people out there.

Who is the tax cheater? They come in all shapes and sizes and in numbers now "out of control" according to the Internal Revenue Service as quoted in the New York Times recently. For example, USA Today cited U.S. government claims that nearly 2 million Americans may be using VISA cards from bank accounts based in tax haven countries to spend unreported income.

"Bending the rules" has become standard practice for many. People pay thousands of dollars to attend seminars and learn how to structure their business and family affairs to take advantage of the tax laws.

Privacy, asset protection, "tax avoidance" are all buzzwords used by "experts" touting their strategies. Attorneys, accountants and others explain systems to outwit and outflank the tax man. It is virtually impossible for "everyman" who attends to tell legal avoidance from illegal evasion.

With "everyman" a potential client of the tax scam promoter I don't believe fear of the IRS to be an adequate motivator. "Everyman" is already afraid of the IRS. After 50 years of obeying the tax laws from fear, "everyman" rebels in the easiest manner available to him,—he bends the rules a little. When he gets away with it, he bends them more.

The problem with fear is that obedience produced from fear produces the character of a rebel. Increased tax cheating and tax scam promoters are indicators of this spirit of rebellion. I know it was that spirit that allowed me to rationalized my behavior.

There is enough fear in the world today. I encourage you to help our country and "everyman." I've spent many hours pondering what would have saved me:

(1) Ask the Internal Revenue Service to identify and describe the principles and characteristics of the most problematic tax scams and tax cheats present in our country today,

(2) Insist on a program educating Americans about these scams/cheats by explaining them in laymen's terms—so "everyman" can understand.

(3) Take advantage of the internet to provide audio-visual presentations which explain these problems in a media-enhanced way for those who learn best in that manner.

(4) One of the biggest problems for those who find themselves victims of a "scam promoter" is discovering, and praying for a way out. Consider a tax amnesty program to help citizens return to their full status as taxpayers.

(5) The Offer Compromise program is failing. Act now to save the crucial avenue of recovery needed now by tens of thousands of Americans.

It's too late for me to learn other than the hard way. It is not too late for our materialistic society. As Paul wrote to Timothy 2,000 years ago: "People who want to get rich fall into temptation and a trap and into many foolish and harmful desires that plunge men into ruin and destruction." (1 Timothy 5:19).

Please act now to help keep other citizens from ruin and destruction.

Thank You

PREPARED STATEMENT OF RONALD A. CIMINO

INTRODUCTION

Chairman Baucus, Ranking Minority Senator Grassley, members of the Committee, I am pleased to appear before the Committee on Finance as you investigate

the problem created by criminals who promote and market tax evasion schemes that defraud the United States Treasury. The cases that the Internal Revenue Service forwards to the Tax Division of the United States Department of Justice for criminal investigation or prosecution represent a growing challenge to federal tax enforcement. Tax fraud schemes cheat all American taxpayers. The Tax Division of the United States Department of Justice is responsible for ensuring that people who commit tax crimes are prosecuted to the fullest extent of the law.

As a Section Chief of one of the three regional criminal trial sections of the Tax Division, I have seen an increasing number of cases in which unscrupulous promoters claim not only that they can eliminate all federal income taxes prospectively, but also that they can arrange for the refund of taxes already paid. Many people who join these schemes willingly become co-conspirators in tax evasion. Their greed leads them to risk their future liberty. Sometimes, people who negligently or foolishly listen to these tax scam artists and follow their promises of a tax free world become the latest victims of the modern day equivalent of the alchemist who promises to turn base metal into gold. When these schemes are uncovered, even participants who are not criminally prosecuted often face substantial tax bills, interest and penalties.

There are many types of tax fraud scams. Some claim that all tax laws are unconstitutional and no one need pay taxes. Others claim a secret understanding of our tax laws that converts ordinary personal daily living expenses into fully deductible business expenses. Some claim that people can avoid taxes by pretending to transfer all of their assets to a series of trusts.

Criminals who promote tax fraud schemes generally share one thing in common. For a fee, they promise to eliminate almost all taxes without any real change in the manner a person lives or earns income. They accomplish that by concealing critical facts from the Internal Revenue Service. Sometimes accountants and lawyers are also criminally involved in marketing these illegal scams.

One way to better understand this growing problem, its impact on those who join in the schemes and the manner in which the Internal Revenue Service and the Department of Justice investigate and prosecute these schemes, is to discuss a case recently prosecuted in the District of Montana against Donald Fletcher, William Webber and Steven Heimbichner.

THE SCHEME

This scheme first came to the government's attention when a confidential informant notified the IRS in Billings, Montana, that individuals were holding suspicious seminars about the use of trusts to eliminate the need to pay taxes. The presenters at the seminars reportedly were spouting anti-government rhetoric. After the seminars, Fletcher, Webber or Heimbichner met with people to review their previously filed tax returns. During the meetings, the defendants told the taxpayers that non-deductible personal items actually could be deducted. The defendants claimed that there were legitimate deductions that were not known to most CPAs and attorneys because the IRS did not publicly disclose this supposed secret information to tax professionals.

If a taxpayer agreed to become a client of the defendants, the taxpayer was then told to amend prior year tax returns in order to obtain refunds of most, if not all, taxes paid. These amended returns contained "additional business expenses" that the defendants claimed were legitimate, but actually had no basis in law or fact. For example, the defendants advised a taxpayer that he could deduct expenses for his cat, such as veterinarian bills and pet food, on the ground that a cat was a "rodent control device." In another instance, the defendants advised a separate client that he could deduct personal expenses for his family dog as a mobile security device. The defendants also regularly claimed that deductions could be taken for meals and entertainment so long as the taxpayer's business was discussed, no matter how insignificant the discussion.

The defendants arranged for the amended returns to be signed by the clients and filed with the Internal Revenue Service. The amended tax returns did not contain the signature of the paid preparer, as required by law. When some taxpayers asked the defendants why they did not sign the returns, the defendants stated that it was not necessary. These amended returns claimed refunds as high as \$38,877.

In exchange for their "work," the Defendants charged a fee of approximately 5.5% of the client's gross income for the year. One-half of this fee was to be paid when the return was prepared and the other half was to be paid upon receipt of the tax refund. In addition to amending returns for prior years, the defendants advised taxpayers to purchase two trusts at a cost of approximately \$3,500 each. The stated purpose of the trusts was to protect assets from loss due to frivolous lawsuits, inher-

itance taxes and unnecessary income taxes. During and after the seminars, however, the defendants claimed that the trusts would allow taxpayers to legally deduct all of their personal expenses. Essentially, they claimed that the "trust entities" could take deductions which individuals could not take. The defendants also implied during their seminars that members of Congress use the very same trusts and don't pay any taxes.

In addition to the trust scheme, the defendants also offered to prepare current years tax returns and charged a monthly fee that ranged from \$100 to \$1,300 a month for this service. These fees were electronically transferred to them from the clients' checking accounts. For this fee, the defendants also promised to represent the clients at any IRS audit.

The defendants continued to prepare annual returns for clients who paid these monthly fees and, in some cases, the false returns understated the taxpayer's true tax liability by as much as \$30,000 per year. On those tax returns, the defendants did not provide accurate information about the preparer of the tax return, which made it difficult for the IRS to determine who was involved in the scheme.

The defendants secured clients to attend their seminars in many ways. We have provided the Committee with an example of a brochure or advertising flyer that the defendants used to market their program and charts that help explain the manner in which the scheme functioned.

INVESTIGATIVE TECHNIQUES

The IRS began its investigation by auditing amended returns filed by Montana taxpayers. After the IRS received information about the trust promoters from a confidential informant, the IRS requested and received permission to conduct undercover surveillance. Based on evidence gathered during the undercover operation, the IRS secured a search warrant for the defendants' offices in Montana. After executing the search warrant the IRS identified additional clients of the defendants and began to appreciate the full extent of this scheme, in terms of the number of people involved and the revenue loss to the United States Treasury.

Based on the information obtained from the search warrant, the IRS conducted a financial investigation and identified the perpetrators. The IRS then referred the matter to the Department of Justice and requested that the Tax Division authorize prosecution. The Tax Division authorized prosecution of Donald Fletcher, William Webber and Steven Heimbichner in Montana. The Tax Division referred the matter to the United States Attorney for the District of Montana, but continued to provide assistance as needed.

PROSECUTION

In June of 1999, a federal grand jury in the District of Montana returned an indictment charging Donald Fletcher, William Webber and Steven Heimbichner with Conspiring to Defraud the United States, in violation of Title 18 U.S.C. § 371; Mail Fraud, in violation of Title 18 U.S.C. § 1341; and numerous counts of Aiding and Assisting in the Preparation of False Tax Returns, in violation of Title 26 U.S.C. § 7206(2).

After prolonged pre-trial motions and several hearings, the trial was scheduled to begin in August of 2001. On July 5, 2001, William Webber agreed to plead guilty and cooperate with the United States in this case and another pending criminal case in another jurisdiction. Mr. Webber's case was then severed and transferred to another jurisdiction for disposition. On July 20, 2001, Steven Heimbichner pleaded guilty to Conspiring to Defraud the United States. Finally, on August 7, 2001, on the eve of trial, Donald S. Fletcher pleaded guilty to mail fraud and conspiracy to defraud the United States.

Donald Fletcher was sentenced in the District of Montana on January 3, 2002. United States District Judge Richard F. Cebull found that the demonstrable tax loss to the United States was \$861,402. That is, had this scheme succeeded, the defendants would have prevented the United States from collecting \$861,402 in taxes. Judge Cebull also found that the Montana clients, numbering close to fifty, had paid in excess of \$440,000 to the defendants for their alleged tax and trust services. The clients may never be able to recover their money from the defendants. In addition, the clients were audited by the Internal Revenue Service and many were required to pay back taxes and interest.

At Mr. Fletcher's sentencing, Judge Cebull found that the facts warranted an upward departure from the sentencing guidelines, because the defendant's criminal history did not adequately represent the scope of his criminal conduct. The judge also noted that the defendant had been previously found liable in civil cases for fraud and civil RICO involving similar schemes with false tax returns and various

insurance companies. Judge Cebull also found that the defendant engaged in activities to conceal his involvement and role in these crimes by using fictitious entities and nominees. Finally, the judge determined that Fletcher was a leader of the conspiracy. Based on those findings, Judge Cebull imposed a sentence of 78 months imprisonment, three years of supervised release, a \$100,000 fine and restitution of \$10,000.

Steven Heimbichner was sentenced on February 12, 2002, and is cooperating with the United States in ongoing aspects of this and a related investigation.

William Webber has not yet been sentenced.

This investigation and prosecution were successful because of the joint efforts and close cooperation of prosecutors in the Office of United States Attorney William W. Mercer and the Justice Department's Tax Division, as well as the invaluable assistance of the IRS Special Agents assigned to the criminal investigation.

CONCLUSION

The Fletcher case demonstrates the considerable investigative effort and time required to successfully prosecute complex tax fraud schemes. This case is just one of many similar cases that involve promoters who make a living offering the illusory promise of a tax free world.

Hearings such as this one, combined with the publicity generated by successful criminal prosecutions and civil enforcement actions, should help deter taxpayers from participating in fraudulent tax schemes. As stated recently by Eileen J. O'Connor, Assistant Attorney General for the Tax Division, "Taxpayers should be extremely wary of promoters who market schemes they claim eliminate the obligation to file tax returns and pay taxes. The Department of Justice will prosecute the promoters of fraudulent tax schemes and their clients, and the person who claims to be liberating you from your taxes might in fact be leading you to prison."

The Department of Justice is committed to working with the Treasury Department to ensure that everyone complies with the tax laws and to stop unscrupulous schemers from defrauding honest taxpayers. The Justice Department greatly appreciates this Committee's support in our important work.

I would welcome any questions you may have at this time.

PREPARED STATEMENT OF DONALD DANIELS

Mr. Chairman, Ranking Member Grassley, and Members of the Committee, I am Donald Daniels, an Assistant United States Attorney in the Western District of Michigan. I appreciate the opportunity to appear before you today to discuss the efforts of the Department of Justice to combat unlawful tax schemes. One such scheme is discussed below.

On February 10, 1999, a federal grand jury in the Western District of Michigan returned an indictment against Robert Lewis Spears charging him with three counts of income tax evasion, in violation of Title 26, United States Code, Section 7201, and with two counts of making false claims against the United States, in violation of Title 18, United States Code, Section 287. According to the indictment, Mr. Spears failed to file income tax returns for the 1993, 1994 and 1995 tax years, notwithstanding the fact that he had taxable income for 1993 of almost \$200,000, with a tax due and owing of approximately \$53,500, that he had a taxable income for 1994 of approximately \$154,000, with a tax due and owing of approximately \$40,600, and that he had a taxable income for 1995 of over \$60,000, with a tax due and owing of approximately \$11,300. Mr. Spears was also charged with making false claims against the United States in that, on or about October 24, 1994, he filed false income tax returns for 1991 and 1992, claiming he was entitled to income tax refunds totaling \$49,924 for 1991 and \$44,129 for 1992.

Mr. Spears was born on July 9, 1936. While Mr. Spears does not have a college degree, the record indicates that he successfully ran his own insurance company for twenty-five years. Mr. Spears obtained insurance licenses in general, property, casualty, life and health insurance. He also held a certified insurance counselor license. Mr. Spears maintained eight separate insurance licenses and represented more than one hundred twenty insurance companies since 1981.

The record of the criminal proceeding reflects the following:

1. Internal Revenue Service (IRS) records for 1986 through 1992 indicate that Mr. Spears filed income tax returns for all of those years. He failed to file returns beginning with the 1993 return. In October 1994, Mr. Spears filed amended 1040X returns for 1991 and 1992 attempting to get a full refund of the taxes paid for those years. Beginning in 1993, he began to send the IRS correspondence expressing his philosophical opposition to the taxation system of the United States. His failure to

file returns, attempt to get refunds of prior tax payments and philosophical correspondence began as he approached retirement and sold his insurance business. At least one witness who knows Mr. Spears stated that he did not express any anti-government or anti-tax philosophies prior to the sale of his business.

2. In fact, the evidence in the record indicates that Mr. Spears conveniently embraced tax protestor philosophies when he was about to retire and would no longer have business expenses to claim as deductions for his returns. He received advice from his prior accountant that his failure to file was ill advised.

3. In addition to failing to file returns and filing false returns, Mr. Spears took affirmative actions in an attempt to hide information about his income and to portray himself as a "non-citizen" and "non-taxpayer." In January 1993, he formed a non-profit corporation called "The Spears Foundation," and in June 1993, he filed an Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code in an attempt to get tax-exempt status for that corporation. The IRS denied this request in August 1993. Mr. Spears apparently created the Spears Foundation in an attempt to hide personal assets. In April 1994, and again in February 1995, he filed frivolous tax returns (Form 1120A, U.S. Corporation Short-Form Income Tax Return) on behalf of the Spears Foundation, claiming that the corporation's income was exempt from taxation.

4. In March 1995, Mr. Spears prepared an IRS Form W-8, Certificate of Foreign Status, and sent it to the person who was buying his insurance business. Attached to the W-8 was a note to the buyer in which Mr. Spears advised the buyer that he (Spears) was a "non-resident alien," and was exempt from reporting income from the sale of the insurance business. The purpose of IRS Form W-8 is to inform the party paying money to the person in question that there is no need to report the money being paid on an IRS Form 1099, because the payee is not subject to the taxation laws of the United States.

5. Mr. Spears compounded his willful failure to file tax returns by sending various letters to the Internal Revenue Service claiming he was not subject to the laws of the United States, that the Internal Revenue Code was "unconstitutional," and that he was a "sovereign non-taxpayer." He also sent the IRS tax protestor literature notifying the Service that he no longer considered himself subject to the tax code because his "status" had changed to a "non-taxpayer." Mr. Spears asserted that, as a "non-taxpayer," he was not subject to the Internal Revenue Code. He also denied the authority of the IRS to act under Title 26 of the United States Code, because the Secretary of the Treasury had (allegedly) not properly delegated that authority to the Service. In January 1995, Mr. Spears returned correspondence from the IRS, in which the Service advised him that his 1992 amended return was "frivolous" and cautioned him of the potential consequences of filing frivolous returns, on which he hand wrote the following: "Our house is not in any federal district or territory, it is in the sovereign state of Michigan." Mr. Spears also sent letters to the IRS threatening to file suit if the IRS failed to return monies he claimed the Service illegally collected.

Mr. Spears' conduct in this case was typical of tax protestor cases. Affirmative acts common to tax protestor prosecutions include the filing of false IRS forms, the filing of protest documents, the filing of amended returns for prior years in an attempt to receive a refund of all taxes paid in prior years, the transfer of assets to spouses, relatives, or third parties, and the creation of "non-profit" organizations to conceal ownership of assets from the IRS.

On October 17, 2001, Mr. Spears pled guilty to Count One of the Indictment pursuant to a plea agreement with the government. Count One charged him with income tax evasion for the 1993 tax year. This was the most serious of the charge in the indictment. Pursuant to the plea agreement, Mr. Spears was required to have tax returns prepared by a certified public accountant for each calendar year from 1993 through 2000 prior to the sentencing hearing, and he agreed to enter into a good faith repayment plan with the IRS. The plea agreement stipulated the tax liability for the tax years 1993, 1994 and 1995 at \$105,577.

Prior to sentencing, Mr. Spears advised the probation department that, while on a 1993 trip to California, he obtained a video titled, "American Institute for Republic," which instructed viewers to contact a man named Al Carter if they had questions or wanted to join the organization. Mr. Spears said he later purchased an "un-taxing kit" from Mr. Carter. In May 1996, after he had been contacted by an IRS criminal investigator, Mr. Spears contacted Mr. Carter for advice. According to Mr. Spears, Mr. Carter advised him to contact a group in Texas called "Family Advocates," which gave Mr. Spears the name of Robert Elsey, who was represented to be an attorney knowledgeable regarding tax matters. Mr. Spears retained Mr. Elsey, who represented Mr. Spears during his September 1999 trial of the charges in the indictment, which ended on September 22, 1999, when the Court declared a mis-

trial, sua sponte, finding that Mr. Elsey was providing “ineffective assistance of counsel.” After obtaining different counsel, Mr. Spears elected to plead guilty.

On January 22, 2002, Mr. Spears was sentenced to two years’ probation, with six months of home detention (with electronic monitoring, bearing the cost of \$4.25 per day), 100 hours of community service (to be determined by the Probation Officer), and a fine of \$2,000. As a term of his probation, Mr. Spears is required to cooperate with the IRS in recovering moneys owed relative to his criminal conduct in this case. Additional terms of his probation require Mr. Spears to meet with his current attorney and bear the expense of filing a grievance with the Michigan Attorney Grievance Commission against Mr. Elsey for the erroneous legal advice he provided Mr. Spears in this case, and to file a motion with the United States District Court for the Western District of Michigan seeking to preclude Mr. Elsey from practicing before that court, based on that erroneous legal advice, as well as his former counsel’s conduct during the truncated trial in September 1999.

It should be noted that Mr. Spears has complied with his obligation to file past due tax returns. On December 6, 2001, he filed his tax returns for years 1993 through 1995, and on December 11, 2001, he filed his tax returns for years 1996 through 2000. These tax returns disclosed tax liabilities totaling approximately \$97,000.

Mr. Chairman, that concludes my prepared remarks. I would be pleased at this time to attempt to answer any questions you or other Members of the Committee may have.

PREPARED STATEMENT OF CHARLES O. ROSSOTTI

INTRODUCTION AND SUMMARY

Mr. Chairman, thank you for this opportunity to discuss the IRS’ efforts to identify and combat actively promoted tax schemes. As I testified at last year’s Finance Committee hearing, they are organized, actively promoted and geared to almost every pocketbook. The broad spectrum of promoted schemes runs from the patently frivolous, such as “Untax Yourself for \$49.95” packages sold over the Internet, to the most sophisticated and complex abusive tax avoidance transactions that are promoted by tax advisors to large corporations and very wealthy individuals.

Identifying and combating actively promoted tax schemes is our highest compliance priority. One reason is the money lost to the Treasury, which is clearly substantial. But, even more important, these promoted schemes are unfair and corrosive to the health of our tax system. Nothing undermines confidence in the tax system more than the impression that the average honest taxpayer has to pay his or her taxes while more wealthy or unscrupulous taxpayers are allowed to get away with not paying.

In addition, these illegal tax schemes place a major demand on IRS resources. A complex illegal offshore trust case could require several times as many hours as a typical exam, and thousands of these cases are emerging. At the same time, we cannot abandon our traditional compliance activities to focus solely on these schemes. No taxpayer should ever believe that he or she could ignore the tax law and get away with it.

As can be seen in the attached chart, there are a variety of schemes that are promoted to a wide range of taxpayers. Combating each scheme requires an approach tailored to the nature of the scheme. However, as shown in the second chart, our strategy includes the use of a full range of tools and techniques. These include:

- *Identifying the promoters and the schemes* through summonses of records, audits of promoters, disclosure regulations, and active analysis of leads from all sources;
- *Identifying participating taxpayers* through audits of promoter records, screening of tax returns, and matching of documents;
- *Providing specific warnings* to the public and to potential promoters through issuance of official notices well as through the media, partnerships with practitioner and business groups, and letters to potentially affected taxpayers;
- *Taking enforcement action against promoters*, including civil injunctions, civil penalties, and criminal investigations. In this regard, since last year, we are working closely with our colleagues at the Justice Department to establish a parallel approach where we can seek civil injunctions while criminal actions are proceeding. This will be a major breakthrough as these promoters often continue to operate while criminal investigations are taking place.
- *Taking enforcement action against participating taxpayers*, including audits, civil penalties and criminal investigations.

- *Taking action to measure the size of the problem* and improve identification methods for the future.

Mr. Chairman, although we are making substantial progress on rooting out and shutting down promoters and schemes, a number of challenges remain. We are grappling with a widespread and growing problem made more difficult by new sophisticated techniques and modern technology. Indeed, the Ranking Member, Senator Grassley, was correct in his recent comment made to the *Los Angeles Times*: “Since tax cheats are endlessly creative, the IRS has to be just as creative to catch the crooks.”

However, our limited resources also force us to focus on only the most egregious and highest priority cases. Given these facts, we are continually seeking innovative ways to stop these promoted schemes. Our initiatives to measure and identify the impact of this and other forms of non-compliance are an important step in this regard.

Let me also stress the importance of the support we are receiving from the highest levels of our government to combat the promoters and schemes. This visible commitment to find the people who promote and engage in these schemes and hold them accountable has a big impact in deterring the activities just described. It also encourages the prosecutors, courts and front-line employees to be more effective in their important work. In this regard, I want to thank Secretary O’Neill both for his support of the IRS and for the initiatives he has proposed on behalf of the Administration. In addition, Mr. Chairman, let me thank you and the Committee for holding this hearing which demonstrates both the gravity of the situation and the united front we are putting together to address it.

TYPES OF SCHEMES

Mr. Chairman, I will now attempt to describe the largest and most prevalent tax schemes and the actions the IRS is taking to combat them. Again, to aid in understanding this complex area, we prepared two charts.

The first describes and provides examples of the four broad categories of promoted schemes: (1) false descriptions of the law to claim exemption from tax, or improper deductions and credits; (2) misrepresentations of the facts to claim improper deductions and credits; (3) use of trusts and/or offshore bank accounts to hide income; and (4) abusive tax avoidance transactions.

I would also note that the IRS continues to identify new abusive tax schemes, tax refund schemes, and frivolous return filing schemes. There is no geographical pattern to them. These schemes are located throughout the country and some of the schemes are marketed nationally.

As previously described, the second chart summarizes each category of tools that the IRS is using to combat these scams and schemes. Indeed, the following statistics demonstrate that the IRS has made enforcement in this area a top priority.

In FY 2002, we had 104 promoter cases approved for examination (audits). We also had three injunctions (1 preliminary and 2 permanent); injunction suits pending in district court against 14 promoters and injunction suit referrals pending with DOJ against 4 more promoters. And over the past 17 months in the criminal area, 21 promoters of abusive trusts have been indicted, 26 have been convicted, and 70 are under active investigation.

FALSE DESCRIPTIONS OF THE LAW INCLUDING SECTION 861 AND EMPLOYMENT TAX FRAUD

What They Are

Since shortly after the federal income tax was enacted in 1913, some individuals and groups have encouraged others not to comply with the law. Using a variety of arguments, unsuccessful challenges have been made about the applicability of tax laws. There have been assertions that the 16th Amendment was not properly ratified; the tax law is unconstitutional; and the income tax only applies to certain individuals, or violates one or more constitutional rights.

Some individuals falsely claim that pursuant to Section 861 of the Internal Revenue Code, Americans are exempt from taxation on income earned within the United States. They argue, instead, that federal income taxes are excise taxes imposed only on nonresident aliens and foreign corporations for the privilege of receiving income from sources within the United States. These scams frequently, referred to here as “Section 861” schemes go under the names of “Zero Tax” or “Employer Abatement” promotions.

One of these Section 861 schemes, which has been actively promoted in recent years, instructs employers not to withhold federal income tax or employment taxes from wages paid to their employees. Unfortunately, in these cases, the employees

can be left holding the bag. They still have the responsibility to pay income taxes and are ultimately responsible for their share of FICA tax.

Another scam lures taxpayers into believing that they can get a refund of the Social Security taxes paid during their lifetime. The victim often pays the promoter and accomplice a "paperwork" fee of \$100, plus a percentage of any refund received, to file a refund claim (Form 1041) with the IRS. Of course, this is nothing more than a hoax designed to fleece the victims for the up-front fee. The law does not allow such a refund of Social Security taxes paid.

There is also no provision in the tax law that allows African-Americans to receive tax credits or refunds related to slavery reparations. However, unscrupulous promoters are shamelessly deceiving people into paying money for advice on how to file these false claims, in which they generally seek \$40,000 to \$80,000, but in some cases up to \$500,000.

All of these patently false arguments have no legal basis whatsoever, and despite the courts having consistently rejected them, their promoters continue to expound and market them, particularly to unsuspecting taxpayers and small businesses. These taxpayers may even incur penalties for bringing frivolous cases into court or for filing frivolous tax returns. In the 1980s, Congress, concerned about taxpayers misusing the court, enacted a law allowing the courts to impose a penalty of up to \$25,000 when they deem a taxpayer's argument frivolous.

Mr. Chairman, I would also note that in the Administration's FY 2003 Revenue Proposals, the President proposes to increase from the current \$500 to \$5,000 the penalty for frivolous returns and to extend this penalty to other frivolous submissions that are designed to delay the collection of tax. On March 20, 2002, the House Ways and Means Committee reported out legislation containing this provision.

Identifying Promoters and Taxpayers

Mr. Chairman, we have a number of tools at our disposal to identify scam promoters and participants. There are the traditional ones, such as audits, where we uncover schemes during the routine examination process. We also encourage and receive tips from taxpayers about all types of tax fraud. Anyone can report suspected tax fraud to the IRS by calling 1-800-829-0433. They can also contact the IRS by sending an e-mail to irs.tax.shelter.hotline@irs.gov.

Over the past few years, we crafted programs and tools to deal specifically with the problem. In FY 2000, we created the Frivolous Return Unit (FRU) at the Ogden IRS campus to focus specifically on combating false and frivolous claims. The Frivolous Return Program (FRP) centralized the processing of these documents and, in the course of its activities, protected \$3 billion of revenue for FY 2001 and developed nationwide employee training keyed to this problem.

Beginning in October 2001, this unit, working with all 10 submissions processing sites, has detected about 145,700 frivolous claims made up of 91,800 reparations claims, 8,500 other frivolous returns (such as employment tax cases) and 45,500 correspondences using frivolous arguments to respond, for example, to collection notices and exam assessments.

In addition, since March 1999, approximately 8,126 Form 1041 returns claiming Social Security Refunds have been filed and detected. They claimed \$794 million in refunds and came from 46 states, the District of Columbia and Armed Forces in Europe. The IRS was successful in blocking about 99.6 percent or all but 129 of these false claims. The 129 claims that were not detected claimed \$10 million in refunds. We have since recovered \$6 million and are still actively pursuing the \$4 million balance.

Slavery reparations claims proved to be a growing problem. In 2000, the IRS received and detected over 13,000 claims, and during 2001, over 90,000. Again, the IRS successfully stopped over 99 percent, but we estimate that approximately 150 to 200 erroneous refunds were issued in 2001. In one case concerning a slavery reparations refund of \$500,000, the IRS filed an erroneous refund suit and successfully recovered most of the refund.

Mr. Chairman, we have a two-part program to detect the reparations claims. Employees are trained to spot certain characteristics and questionable returns during pipeline processing. This is an important first line of defense. In addition, we have recently begun making use of a computer process developed by the Treasury Inspector General for Tax Administration (TIGTA) to identify illegal slavery reparations claims.

We did experience a delay in updating this program for the tax year 2001 changes. This update has now been made and the program will be run against all previously processed returns to identify any additional false claims that might have resulted in erroneous refunds. It will serve as a second line of defense in preventing issuance of these refunds going forward.

We have also requested the development of a National Standard Application (NSA) that will allow us to implement and maintain permanently a program similar to that developed by the TIGTA. Moreover, this program will include enhanced ability to extract data on other types of frivolous filings.

In addition to the problem presented by taxpayers submitting frivolous returns, this type of promoted schemes manifests itself in another way—by encouraging taxpayers not to file returns at all.

For example, taxpayers may be encouraged to claim a large enough number of exemptions on their W-4 forms that they submit to their employer so that they have no taxes withheld and no need to file a return. Each year, approximately 600,000 questionable W-4s (QW4s) are forwarded to the IRS from employers. A W-4 is considered questionable if the employee claims more than 10 exemptions or claims to be exempt from withholding. Of the 600,000 or so QW4s, we estimate that, after processing, approximately 58,000 cases will require letters to be sent to the employees or employers.

Another problem is that taxpayers with income that is not withheld at the source may simply not file returns. Some portion of these unfiled returns were caused or influenced by promoters encouraging taxpayers not to file returns. While we do not know what proportion of non-filing is caused by promoted schemes, it is clear that even a small portion of this large number makes this a very significant problem.

Warning and Informing

As part of our larger efforts to alert taxpayers and tax practitioners to tax scams and fraud schemes, last July, we linked our www.irs.gov web site to the Criminal Investigation “Tax Fraud Alerts” page located on the Treasury web site. This site puts together in one location a wealth of information on these schemes, as well as case summaries of those convicted of committing the crimes. It can be reached by going to the IRS web site (www.irs.gov) and clicking on the button, “Tax Scams/Fraud Alerts.” Taxpayers can also reach it from the Department of Treasury’s web site (www.ustreas.gov/irs/ci/tax-fraud). As previously discussed, taxpayers who have questions on these subjects call also us at 1-800-829-0433 or they can e-mail us at irs.tax.shelter.hotline@irs.gov.

In August 2001, the IRS Chief Counsel prepared and published a 25-page legal summary addressing false arguments about the legality of not paying taxes or filing returns. “The Truth About Frivolous Tax Arguments” can be viewed and downloaded from our web site. It not only debunks these false arguments, it also provides a summary of the law and relevant legal decisions involving the claims.

We are also working closely with the national and local media to get the truth out to taxpayers about these scams. For example, we issued a nationwide alert in January 2002, “The Dirty Dozen: IRS Warns of 12 Common Schemes,” where we described the more common scams being peddled by con artists. We have also issued press releases/alerts warning taxpayers against the Section 861 and slavery reparations schemes.

In addition, we send letters to employers who appear to be participating in the Section 861 “employer abatement program” schemes, explaining why their claims were false and the serious consequences that can arise from making them. We direct them to make contact with an IRS official to make the appropriate adjustments to their accounts and to correct their employees’ information reports. We also send a letter to affected employees informing them of possible courses of action and their obligations under the law.

Mr. Chairman, many of our volunteer sites also offer tax preparation on specific days to non-filers. For example, on April 6, 2002, the Richmond Territory began working with representatives from the local Taxpayer Education and Communication (TEC) organization and Tax Advocate organizations, along with the state of Virginia, to offer tax assistance to Virginia taxpayers who have not filed federal tax returns for years 1998 and later. It is estimated that 50,000 Virginia taxpayers did not file 1998 tax returns. The majority of these taxpayers reside in the greater Richmond area. The event has been publicized on local television and radio shows, and in area newspapers.

Outreach on the W-4 problem will focus on those locations where research data indicates there is a problem. For example, our Stakeholder, Partnership, Education and Communication (SPEC) organization is currently working with representatives from the Human Resources Department of the Naval Shipyard to develop a flyer, advising workers of the correct procedures for completing the Form W-4. The flyer will provide the rules and regulations, along with the penalties associated with filing a fraudulent Form W-4. It is anticipated that the flyer will be sent with paychecks during the summer months.

Mr. Chairman, I would like to spend a few minutes describing in detail the extraordinary outreach campaign we mounted during the last two filing seasons to inform and warn taxpayers against the fraudulent slavery reparations scam.

Raising public awareness was key. Based on information we provided, stories on slavery reparations claims have appeared on all of the major television news and radio programs, as well as in most major newspapers. We have also made significant outreach to African American media outlets, with stories placed on the "Tom Joyner Morning Show" (radio), *The Washington African American*, *The Chicago Defender*, *Black Voices* and *Black Enterprise Magazine*.

As an adjunct to our media operation, our Taxpayer Education and Communication (TEC) and SPEC organizations have been conducting outreach to leading voices in the African-American community. Materials were distributed nationally and locally to African-American churches and religious coalitions, fraternities, sororities and associations, including the NAACP and the Urban League.

On January 23, 2002, I also met with the Executive Committee of the Congressional Black Caucus to discuss our concerns regarding the increasing number of slavery reparations scams and the significant number of false tax claims. I outlined to the Caucus how the scams work and what kind of person/group the scam promoters are targeting.

The chair of the Caucus, Texas Congresswoman Eddie Bernice Johnson, and other members of the Executive Committee, immediately supported IRS action with regard to this matter. The following day, the IRS issued a press release, "Slavery Reparation Scams Surge, IRS Urges Taxpayers Not To File False Claims." On the same day, the Congressional Black Caucus issued a press release supportive of our actions.

I also appeared at press conferences with D.C. Delegate Eleanor Holmes Norton and Maryland Representative Elijah Cummings. In addition, the IRS Office of Legislative Affairs provided information and statistics to Representatives Bobby Rush (IL), Sheila Jackson Lee (TX), and Eva Clayton (NC), for their use on radio talk shows and on individual press announcements.

Enforcement Actions Against Promoters

Civil Actions

The IRS has taken a number of civil enforcement actions against promoters of these frivolous schemes, including 8 injunctions cases and 4 referrals to DOJ through FY 2002.

For example, the IRS has filed lawsuits against three promoters of Section 861 schemes. Injunctions have been entered against two of the three promoters. District Courts have consistently ruled in the IRS' favor in these cases, including awarding sanctions to the government.

In November 2001, the Department of Justice filed lawsuits in federal courts in three states to crack down on a nationwide bogus tax refund scheme based on a misinterpretation of Section 861 of the Internal Revenue Code. Two of the suits named leading promoters of the "Section 861 argument"—Thurston Bell of Hanover, Pennsylvania and David Bosset, formerly of Clearwater, Florida and now supposedly, Spring Hill, Florida. In the third case, the government sued an Atlanta accountant and tax return preparer, Harold E. "Hal" Hearn, alleging that he had prepared federal income tax returns for taxpayers in 11 states that improperly claimed tax refunds or reported no income.

The Justice Department pointed out that the IRS issued four public announcements in 2001 informing the public that the Section 861 argument is frivolous. Despite these and other warnings, Bell, Bosset and Hearn continued to solicit clients, collect fees for erroneous tax advice, and hamper IRS efforts to collect proper tax liabilities. The Justice Department has asked the three federal courts to enjoin the three men from further promoting the frivolous Section 861 argument and to bar Bosset and Hearn permanently from continuing to prepare federal income tax returns. In January 2002, the court permanently enjoined Hearn from promoting abusive tax shelters and preparing returns with the I.R.C. section 861 argument.

On March 26, 2002, a Federal District Court in Florida ordered David Bosset of Spring Hill, FL to stop preparing bogus tax returns and promoting a fraudulent tax scheme. According to the Department of Justice press release, the court also ordered Bosset to provide the Justice Department a complete list of clients back to 1998, including their social security numbers and other information, and to send the Department copies of every federal tax return or other document he prepares or sends to the IRS on behalf of others.

Eileen J. O'Connor, Assistant Attorney General for the Justice Department Tax Division, stated: "It is impossible to tell how much money the court has just saved the Federal Treasury and law-abiding taxpayers by ordering Mr. Bosset to stop pre-

paring and filing false income tax returns. This court's action should alert people who promote or rely on this or other bogus tax schemes to the fact that their days of defrauding the public are numbered."

Last month, the Justice Department filed suit in federal court in Tampa seeking to stop a Florida man, Douglas P. Rosile, Sr., from promoting a tax refund scheme that allegedly has been used to under-report tens of millions of dollars of tax liability for nearly 200 clients in 32 states. The complaint alleges that all the bogus refund claims prepared by Rosile were based on the erroneous Section 861 assertions.

Assistant Attorney General O'Connor commented, "Taxpayers who participate in this and other patently frivolous schemes risk substantial civil and criminal penalties. The Justice Department is committed to stopping abusive promoters who seek to bilk the U.S. Treasury."

The government complaint states that Rosile's bogus claims, had the IRS not detected them, would have resulted in a loss of over \$36 million to the Treasury. The complaint refers to one refund claim for \$7.3 million. In its complaint, the Government asks the court to order Rosile to turn over his clients' identities and all related records.

In addition, we sent letters to the Department of Justice authorizing the filing of suits for injunction against slavery reparations promoters/preparers in 6 cases. The Department of Justice has now filed two injunction actions.

On March 6, 2002, the Department of Justice filed civil suits in Mississippi and Virginia to enjoin tax return preparers from preparing income tax returns claiming bogus refunds based on a supposed tax credit for slavery reparations. The lawsuits also seek to require the defendants to give the government their complete client lists. The complaints were filed in federal courts in Richmond, Virginia and Jackson, Mississippi.

According to the complaints filed, the two defendants prepared and filed returns and amended returns claiming bogus refunds based on tax credits for reparations for slavery or segregation. One defendant prepared returns claiming bogus refunds in amounts ranging from \$8,000 to \$500,000, while the other prepared returns claiming refunds generally in the amount of about \$43,000.

The complaint filed in Mississippi alleges that Andrew L. Wiley of Durant, Mississippi is believed to be responsible for helping to prepare as many as 3,910 returns claiming a total of approximately \$168 million in improper reparation refunds. The complaint filed in Richmond alleges that Robert L. Foster prepared bogus reparation claims exceeding \$2 million.

Criminal Investigations and Actions

IRS Criminal Investigation is also working closely with all parts of the IRS to investigate and refer for prosecution individuals and companies that willfully failed to file or pay employment taxes. We are making solid progress on this front: case openings increased by 75 percent from FY 2000 to FY 2001 and already during the first quarter of this fiscal year, we are at 56 percent of our totals for last year. And many of those who bought into these schemes soon discovered that they had embarked on a perilous legal and financial path.

Since FY 1999, 141 individuals were sentenced to federal prison, a halfway house or home detention on employment tax issues. Nearly 84 percent of those convicted of evading employment taxes were sentenced to prison for an average of 20 months and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

We have also launched over 20 criminal investigations against promoters of the Social Security "1041" schemes and have seven convictions to date, including one involving a sheriff in South Carolina who steered unsuspecting taxpayers to one of the scam preparers. For those convicted of these crimes, jail time ranged from 36-66 months.

Some promoters of the slavery reparations scam have been charged criminally. For example, in October 2001, Vernon T. James of Carrollton, Texas was convicted of preparing false, fictitious and fraudulent personal federal income tax returns claiming the reparations credit. In January, a federal judge sentenced James to six and one-half years in prison and ordered him to pay \$566,418 million in restitution.

The Internet and Schemes and Scams

Mr. Chairman, at last year's hearing, the Committee expressed concern about promoters using the Internet to hawk their schemes, and also the possibility of the IRS working with the Federal Trade Commission to close these sites on the grounds of consumer fraud.

We are working on this problem in two ways. First, we are using our authority under IRS sections 6700 and 7408 to investigate promoters and to potentially take injunctive action.

In FY 2000, as part of a special project, we identified 26 potentially abusive web sites. These were subsequently reviewed for Abusive Tax Promoter Examination (IRC Section 6700) and possible injunctive action (IRC Section 7408). Seven of these have been formally opened for IRC 6700 Examinations and possible injunctive action. Based on this promising initiative, we developed and implemented last month new computer methods and techniques to detect abusive tax schemes marketed over the Web.

In addition, we have met with the FTC to explore cooperative efforts in this area. We are actively seeking several abusive tax scheme web sites as test cases for making referrals to FTC and to help establish a referral procedure.

The FTC has regulatory and injunctive authority regarding false advertising in the media. This would include Internet advertising, as well as TV, radio, newspapers, and magazines. In our meetings with FTC, they indicated they would review referrals from the IRS for false or misleading advertising on the Internet. If the referral meets the standards established by FTC, then our FTC contacts indicated a willingness to act against the Internet web site.

There are, however, significant limitations to this approach. Disclosure rules (IRC 6103) prevent us from adding information from our internal databases or adding data obtained from investigative/examination work to enhance the referral. Therefore, the referral would need to stand on the content of the web site alone.

Another weakness in this methodology is that promoters of organized tax evasion schemes often maintain multiple web sites. These sites have different names, but use the same or similar web pages from site to site. An FTC action may close one site or several, but promoters can have new sites set up in anywhere from a few days to only a few hours, oftentimes, with new company names.

Finally, another consideration is that many promoters have become more sophisticated with their web page offerings and do not make blatant offers to establish abusive tax schemes, and some potentially abusive web sites are more political in nature than promotional. This would make them difficult injunctive cases for FTC, due to "Freedom of Speech" considerations.

Enforcement Action Against Non-filers

IRS has implemented a multi-functional, comprehensive effort called the National Non-filer Strategy. The overall goal of this strategy is to bring taxpayers back into compliance and keep them there. In addition to nonfilers, the IRS will reach out to individual taxpayers who are not legally required to file, but are potentially entitled to refunds or credits.

On the civil side, we have both the Questionable W-4 processing and Automated Substitute for Return (ASFR) programs. As previously described, each year, approximately 600,000 questionable W-4s (QW4s) are forwarded to the IRS from employers. A W-4 is considered questionable if the employee claims more than 10 exemptions or claims to be exempt from withholding. After data is inputted and reviewed, the subsequent cases are forwarded to the Fresno Service Center where the actual leads are worked.

For those who refuse to file a return, the Service Center ASFR Unit prepares a substitute return for the individual under the authority of the IRC 6020 (B) and issues a Statutory Notice of Deficiency. After the "dummy" return is posted, the IRS sends a letter informing the taxpayer of the proposed assessment and of all appeal rights.

IRS Criminal Investigation vigorously pursues prosecution and prison sentences for individuals who violate the tax laws, including non-filers. In FY 2001, it had 269 prosecution recommendations, 257 indictments/informations and 219 convictions. There was an 83.9 percent incarceration rate and an average of 43 months to serve in prison.

FALSE REPRESENTATIONS OF FACTS TO CLAIM IMPROPER DEDUCTIONS OR CREDITS

What They Are

Although they are sometimes grouped together, this category of promoted schemes is different from those that depend on false descriptions of the law. These devices, marketed primarily to individuals and small businesses, entice the promoters' targets into misrepresenting the facts so they can claim improper deductions or credits. In this regard, they are potentially more serious because it is less obvious to many people that they are bogus and some may believe that they are less likely to be detected by IRS.

For example, so-called home-based business schemes purport to offer “tax relief.” The promoters of this scheme, which is estimated to involve up to 50,000 taxpayers, claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. This scheme usually results in lost taxes of \$5,000 to \$15,000 per case.

The following are some examples of personal expenses that are not deductible, but are commonly claimed as business expenses in home-based business tax avoidance:

- Deducting all or most of the cost and operation of a personal residence. For example, placing a calendar, desk, file cabinet, telephone, or other business-related item in each room does not increase the amount that can be deducted.
- Deducting a portion of the total house payment is not allowable if the business is not real.
- Paying children a salary for services, such as answering telephones, washing cars or other tasks and then deducting these costs as a business expense is not allowed.
- Deducting education expenses from the salary wrongfully paid to children as employees also is not allowed.
- Deducting excessive car and truck expenses when the vehicle has been used for both business and personal use is not allowed.
- Deducting personal furniture, home entertainment equipment, children’s toys, etc. is not allowed.
- Deducting personal travel, meals, and entertainment under the guise that “everyone is a potential client” is not allowed.

Another fraudulent investment scheme induces people to improperly use the Disabled Access Credit. The credit is intended to help small businesses offset costs associated with bringing their businesses into compliance with the Americans with Disabilities Act (ADA).

Many of these ADA credit schemes have surfaced across the country. Most appear to involve Ponzi-type financing and promise erroneous claims of tax benefits. In this scheme, investors are to receive a credit for their investment in providing telephone equipment for the disabled.

Mr. Chairman, the Earned Income Tax Credit (EITC) program also continues to provide an opportunity for unscrupulous tax return preparers to prey on taxpayers in hopes of generating refunds to which they are not entitled.

For example, these crooked preparers may “share” one client’s qualifying children with another client in order to allow both clients to claim the EITC. Under the scheme, if one client has four children, they only need to list two for EITC purposes to get the maximum credit. The preparer will list two children on the first client’s return and list the other two on another client’s tax return. The preparer and the client “selling” the dependents split a fee. The IRS prosecutes the preparers of such fraudulent claims, and participating taxpayers could be subject to civil penalties.

Refund scheme operators may also approach taxpayers wanting to “borrow” their Social Security Number or give them a phony W-2 so it appears that they qualify for a big refund or other credits, including the EITC. They also prepare returns for taxpayers who have children but have no income, inflating income by preparing phony Schedule C attachments showing false income from a business or occupation. The unscrupulous promoters of schemes may promise to split the refunds with taxpayers.

Identifying Schemes, Promoters and Participants

We have a number of important tools at our disposal to identify those schemes involve submitting false returns to claim refunds.

Since its inception in January 1977, the Questionable Refund Program (QRP) has been responsible for the detection of over \$2 billion in fraudulent refunds and has been successful in stopping 86 percent of it. QRP schemes involve tax returns claiming refunds based on false income, false federal income tax withheld and false refundable credits, such as the EITC, Fuel Tax Credit, Foreign Income Tax Credit, etc. In addition, the program has helped identify other scams and schemes, such as abusive trusts and Section 861 frivolous arguments.

To detect these false returns, we placed Questionable Refund Detection Teams (QRDT) at each of our 10 campuses. They are located at Fraud Detection Centers and report directly to the Director of Refund Crimes in our Criminal Investigation division. These teams can sound an alarm at the earliest possible stage when we detect anomalies in refund filings. We also receive alerts from other campus functions, Electronic Return Originators, financial institutions, return preparers and concerned citizens.

We also employ the Electronic Fraud Detection Systems (EFDS)—a computer system used by CI to help identify potentially fraudulent electronically filed (ELF) and

paper returns. It also increases the data available for analysis and assists in the development of information relating to schemes detected by the QRDTs.

In addition, CI's Return Preparer Program (RPP) identifies, investigates and prosecutes abusive return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or incompetent return preparers.

Mr. Chairman, this is a significant problem for both the IRS and our taxpayers. Abusive return preparers frequently prepare bad returns for large numbers of taxpayers who, at best, are stuck with paying additional taxes and interest and at worst, depending on culpability, are subject to penalties and perhaps even criminal prosecution.

In addition to the fraud scheme detection tools, just described, we have other methods to identify potentially erroneous refund claims based on the EITC and other dependent credits and exemptions. One of the most important is the Dependent Database (DDB). Using data provided by the Department of Health and Human Services and Social Security Administration, it is designed to identify potential non-compliant returns during returns processing.

For example, when a child's Social Security Number is used on multiple returns, the database helps determine which taxpayer was likely to be erroneously claiming tax benefits on behalf of that child. We have moved beyond testing to using the DDB application nationwide as part of our Examination Program and for the identification of non-compliant taxpayers and paid preparers.

As part of our multi-year Collection Re-engineering Program, the Electronic Fraud Detection System is also being enhanced to include selected Business Master File data that will permit research, analysis and evaluation of fraud detection scenarios for business returns.

Mr. Chairman, let me finally note that identifying scams based on false deductions is more difficult than detecting some of the refund scams. It is a much more tedious process that requires us to discern patterns in a post-filing environment. Audits often tip us off to an emerging problem. We are currently working to develop new statistical techniques to make this process easier.

Notify and Warn the Public

As is the case with schemes involving false descriptions of the law, public awareness is essential to combating these schemes. Many of the press releases we issued on the bogus "Section 861" scams, such as "The Dirty Dozen", also covered those involving a fraudulent representation of the facts. When a particular scheme appears to be gaining popularity, we correspondingly ratchet up our outreach program.

In February 5, 2002, we issued a press release on Home-Based Deductions. We warned taxpayers that any tax scheme that claims a person can deduct what would normally be personal expenses should be considered highly suspect. We also informed taxpayers, who claimed such deductions on a past tax return and now want to file an amended return, to contact the IRS at our toll-free number at 1-800-829-1040.

We will soon release a tri-fold pamphlet regarding Home-Based Business Tax Avoidance Schemes. This pamphlet will be widely distributed through our web site, and our nationwide network of channels with practitioners, business and trade organizations and educational institutions.

On February 8, 2002, the IRS issued a nationwide press release warning taxpayers, especially the elderly, who are likely targets of the promoters, to be beware of scams involving the Americans with Disabilities Act credit.

To help us better combat these schemes, we are also conducting extensive outreach to the tax practitioner community. These efforts include IRS-authored articles in professional journals and corporate publications, including that of H&R Block. I and senior IRS officials also speak on a regular basis to the annual meetings and conventions of the major national associations, organizations and companies representing practitioners and preparers, such as the National Association of Enrolled Agents, the American Institute of Certified Public Accountants and the National Association of Tax Practitioners, to name but a few.

In addition, we conduct bi-monthly liaison meetings to brief our stakeholders on any emerging issues and then e-mail them any follow-up notices. This year, our highly successful nationwide Tax Forums, which in 2001 attracted 14,000 tax practitioners, will also offer, for the first time, seminars on the tax scams and schemes being discussed today, including refund/credit fraud. This is an excellent opportunity to convey our message to a very large audience, who in turn, can relay it to their clients.

Moreover, to help improve compliance with EITC on returns submitted by tax preparers, we established a nationwide EITC preparer outreach program in the fall of 1998. These practitioners account for 68 percent of the \$8.4 billion in 1998 EITC overclaims.

As part of the program, IRS revenue agents visit tax professionals nationwide to provide individual assistance and to answer any questions about the EITC. Some of these visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met. We have also sent warning letters to hundreds of thousands of EITC taxpayers.

Enforcement Action Against Promoters and Participants

Over the past five years, the IRS has also executed a full range of compliance activities for organized EITC fraud that include criminal prosecutions of promoters. During the past three fiscal years, 176 subject criminal investigations were opened on questionable refund schemes related to fraudulent EITC claimed. These investigations identified a minimum of 7,811 questionable returns claiming a minimum of \$17 million in false EITCs. During this same time period, 130 criminal investigations were recommended for criminal prosecution and 116 persons were criminally convicted of income tax fraud for the various EITC fraud schemes.

Mr. Chairman, we have a solid track record of convictions for those prosecuted for misrepresenting the facts, and the perpetrators have paid a heavy price. For example, on September 4, 2001, in Brooklyn, NY, Jose Raul Diaz was sentenced to 18 months in prison followed by 3 years supervised release. In addition, Diaz was ordered to pay restitution of \$120,000 and a special assessment of \$100. Diaz pled guilty in September 2000 to filing false and fraudulent federal tax returns.

According to the press release, Diaz provided tax services to low-income clients, many of whom were immigrants with poor English language skills and little familiarity with the tax system. Diaz falsely increased his clients' tax refund checks through a variety of fraudulent means, including claiming non-existent children as dependents, misrepresenting the client's filing status, and claiming fraudulent childcare expenses.

In many cases, Diaz forged the clients' signatures on tax returns or had clients sign blank tax returns, so that the clients were unaware of the false information. Diaz also listed his own address as the taxpayer's address, so that the refund check would be delivered to him. He would cash the checks himself, often stealing all or a portion of the fraudulent refund.

Mr. Chairman, I would like to make a last important point regarding the EITC program. Promoted tax schemes are only a part of the problem. Overclaims for a wide variety of reasons—from confusion to unscrupulous preparers—continue to be a problem and we want to develop the best possible solutions. Last month, I announced that we convened a high-level IRS/Treasury task force to review comprehensively the EITC program.

It will develop recommendations to achieve the congressional objectives of the EITC program while making it easier for taxpayers to comply with the rules and for the IRS to efficiently and effectively administer them. The Assistant Secretary for Tax Policy and I are personally overseeing this task force and will present its recommendations to Secretary O'Neill within four months.

SCHMES TO HIDE INCOME USING TRUSTS AND OFFSHORE BANK ACCOUNTS

What They Are

In the last few years, the IRS has detected a proliferation of schemes designed to allow upper income taxpayers to hide income. Of the four categories of schemes, this is the largest in loss of revenue to the Treasury, the hardest to detect, and the most insidious in undermining the fairness of the tax system. Participants in this category of scheme include chief executive officers of large companies, high income professionals such as athletes, actors, doctors, lawyers, authors, business owners and even law professors—in other words, people who should know better.

The devices used to hide income include trusts, both foreign and domestic, and offshore bank accounts. A particularly important device has been the use of credit cards issued by banks in tax haven countries which are used as a convenient and efficient way of bringing back and spending the money that is hidden offshore.

Currently, there are two prevalent fraudulent schemes being promoted: the "domestic scheme" and the "foreign scheme." The domestic scheme involves a series of trusts that are formed in the U.S., while the foreign trust scheme is formed offshore and outside the jurisdiction of the U.S.

The trusts involved in the schemes, either foreign or domestic, are vertically layered with each trust distributing income to the next layer. The goal of this elabo-

rately tiered structure is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, they are, in fact, controlled and directed by the taxpayer.

A network of promoters and sub-promoters, who may charge \$5,000 to \$70,000 for their packages, often market these schemes. This fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees, and to use foreign bank accounts and corporations. In some instances, tax return preparer services are also made available.

Mr. Chairman, let me also stress that while the abusive trusts are the more prevalent of the schemes we see today, the promoters are extremely creative and will use other vehicles, such as partnerships, to try to disguise their illegal activities.

Domestic Abusive Trusts

The abusive trust scheme generally starts with the transfer of a business or other source of professional income to a trust. Taxpayers then typically offset income by overstating business expenses or deducting personal expenses from the income in the trust. To cover their tracks or mislead, these schemes often use tiered multiple entities, such as partnerships, limited liability companies, or secondary level trusts.

For example, in some promotions, taxpayers are advised to create an Asset Management Company (AMC) in order to give the false impression that the taxpayer is not managing his or her business. This starts the layering process.

The next step is to form a business trust, also a domestic trust. In effect, the client elects to change the structure of his or her business from either a sole proprietorship or corporation to a trust. The AMC may be the trustee of the business trust and there may be multiple layers of trusts under the first trust. The scheme gives the appearance that the taxpayer has given up control of his or her business to a trust and progressively reduces the income distributed to the beneficiaries by charging administrative or other expenses at each level. Of course the transfer of income into the trusts is a sham because the taxpayer continues to control and enjoy the use of the income and assets.

Offshore Trusts and Accounts

Similar to the domestic arrangements, foreign packages usually start with an Asset Management Company, a business trust, and distribute income to several trust layers. However, these foreign promotions also attempt to take funds offshore and outside U.S. jurisdiction. These schemes involve offshore bank accounts, trusts, and International Business Corporations (IBC's) created in "tax haven" countries.

Diversion of income to offshore tax havens with strict bank secrecy laws adds an additional layer of complexity, which in turn, has permitted the taxpayers to hide the income more effectively. However, once the income is offshore, the taxpayer has the problem of getting the money back when he or she wants to spend it. One method individuals have been using to divert income to tax havens and evade their U.S. tax obligations, while still maintaining easy access to their funds, is by obtaining credit cards issued by banks in these tax havens.

As *The Wall Street Journal* reported on March 8, 2002, these cards are even hawked on the Internet: "For example, a palm-draped Web site called Cardster this week advertised a top security anonymous offshore no ID ATM Cirrus debit card—as well as other services."

Mr. Chairman, let me emphasize that while it is not illegal to have a credit card issued by an offshore bank, there is ample basis for believing that many people are using offshore credit cards to repatriate funds hidden offshore to evade paying U.S. taxes. These credit cards are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses like groceries, medical bills, gasoline, and other miscellaneous expenses. They provide easy access to offshore funds and accounts in tax haven countries that allow income to be hidden.

Identifying Promoters and Taxpayers: Tools and Results

Organizational Focus

These abusive trust schemes are a significant problem, the magnitude of which we are just beginning to understand. Over the past two years, we have taken aggressive steps to identify systematically promoters who sell these schemes and taxpayers who use them to hide income, including creating an abusive tax scheme program structure. In 2001, Fraud, Anti-Money Laundering, Abusive Schemes and the Lead Development Center were placed under one IRS executive to increase program oversight and allow a better flow of information between these programs. Let me describe how the structure works.

The civil Lead Development Center (LDC) was established to identify and develop cases on abusive tax promoters. The Center works leads received from within the IRS, or from external sources, and conducts Internet searches looking for abusive tax promoters and promotional materials.

Mr. Chairman, in this regard, let me point out that following last year's hearing, we met with representatives of the Federal Trade Commission who had discussed their methods for detecting consumer fraud found on the Internet. Beginning this month, we have been employing similar computer methods and techniques to detect abusive tax schemes marketed over the Web.

Abusive Schemes/Flow-through groups were also established in each of 16 area offices to audit the abusive schemes, tax shelters and John Doe Summons cases once they are identified and developed. In addition, four Special Enforcement Program (SEP) groups were created in IRS Small Business/Self-Employed to focus on the off-shore abusive schemes and the John Doe Summons cases. Each area has identified a manager who will coordinate with the LDC and Abusive Schemes program managers to ensure these cases are timely assigned and properly worked.

The people in this civil structure work closely with the lead development centers in our criminal division to ensure that leads on potential criminal cases are appropriately developed and referred. When our examiners and revenue officers find serious cases of non-compliance from any source, the taxpayers will be referred for criminal investigation. The number of fraud referrals increased by more than 15 percent when compared to last fiscal year.

In addition, one of the most powerful tools that we use to ensure compliance is matching information received from businesses with information reported by individual taxpayers. Trusts and partnerships also must report income to their partners or beneficiaries and we can use this data to identify cases that use trusts and partnerships to hide or underreport income.

This year, the IRS began capturing data from 16.8 million K-1 forms. In 2002, the IRS is changing its processing procedures and will process and match K-1s reporting almost \$700 million of income and also, importantly, reported losses on trusts and passthroughs. This will help us to find potential problem cases and to follow up, when necessary, with audits.

Special Initiative to Identify Offshore Credit Card Accounts

In the past year we have also had considerable success with one major initiative to identify promoters and taxpayers who hide money in offshore tax havens.

A John Doe summons issued in 2000 to MasterCard yielded a large database of transactions using cards issued by banks in Antigua and Barbuda, the Bahamas and the Cayman Islands. Many of these cards appear to have been issued to U.S. customers. Hundreds of cases have been initially identified for civil audits or criminal investigation. The IRS is also matching these cardholders against open and closed examinations and collection, criminal, and bankruptcy cases, as more identification data is developed.

Mr. Chairman, we are following up on this initial action that proved to be so successful. First, on March 25, 2002, we petitioned the U.S. District Court in San Francisco for permission to serve a John Doe summons on VISA International, along the lines of the MasterCard summons, seeking records on transactions using cards issued by banks in over 20 tax haven countries. On March 27, the District Court authorized us to serve the John Doe Summons.

Second, also on March 25, 2002, we filed in the U.S. District Court for the Southern District of Florida a stipulated agreement with American Express to provide a sample of its records for 1998 and 1999 on cards for U.S. taxpayers with transactions in the U.S. and addresses in Antigua and Barbuda, the Bahamas, or the Cayman Islands upon entry of a court order. On March 26, 2002, the District court signed an order directing the agreed-upon production.

Third, we will be seeking permission from District Courts across the nation to serve scores of John Doe summonses on merchants to assist us to identify many more of the actual individual taxpayers using the cards in the MasterCard database.

Notifying and Warning the Public

We want to make sure that potential participants know the serious consequences of these schemes to hide income. These are crimes—plain and simple—and the judicial system has little sympathy for the perpetrators. As described in the following section, those convicted—both promoters and clients—are facing large fines and penalties. Some are losing their homes and are being stripped of their professional licenses. And they are going to prison for substantial amounts of time.

Mr. Chairman, we have taken both a broad and focused approach to educating the public about abusive schemes and scams. As previously noted, our web site

(www.irs.gov) has a hot link from its front page to CI's special "Tax Fraud Alerts" section where taxpayers can learn about both abusive trust schemes and criminally-prosecuted case summaries.

Also listed is the toll-free hotline to report suspected tax fraud activity (1-800-829-0433). Following the suggestions made by the Committee at last April's hearing, we have also added so-called "METATAGS" that will help direct to the CI site taxpayers using search engines to find information about abusive trusts.

As part of our outreach efforts, IRS Criminal Investigation also has a cadre of trained executives who are available and have appeared on numerous radio and television programs, including call-in shows where they are able to answer listeners' questions about these scams.

We know too that these schemes are being marketed to upper-income taxpayers, often professionals, such as those in the medical and other professions. It is important that these individuals know that participating in one of these scams is often a costly endeavor, both personally and professionally. To this end, IRS has written and placed articles, such as "Unscrupulous Trust Promoters Target Medical Profession," in the publications of the American Academy of Otolaryngologists and the American Academy of Orthopedic Surgeons. Other articles have been placed or will appear in other professional journals.

Recently, I also met with the leadership of the American Medical Association, American Dental Association, and numerous other health care professional associations on how their members were being targeted by the scheme promoters. Through this event and the associations represented at it, we have the potential to reach over 750,000 professionals with an important warning. We are making similar outreach efforts to the construction industry.

We are also using our network of national and local relationships with tax practitioners to provide them information about the prosecutions of taxpayers who participate in these schemes so that they can warn their clients and potential clients of the dangers of succumbing to the offerings by unscrupulous practitioners and promoters.

Mr. Chairman, our efforts, in conjunction with those of the Justice Department, on the John Doe summons were significantly noted in the press, including front-page coverage in the New York Times, USA Today and placements in the major newspapers. It also garnered coverage on most of the major nightly news programs, including ABC World News Tonight and CNN.

This observation from a recent *Christian Science Monitor* editorial illustrates the reaction we are receiving: "The Internal Revenue Service often has had a bad-guy image for cracking down on average taxpayers who inadvertently make mistakes. But the agency takes on a distinctly good-guy role when it tracks down egregious tax-evasion scams. After all, those who shun their legal obligation to pay taxes simply put a larger burden on everyone else."

Enforcement Against Promoters and Participants

Our enforcement strategy to combat these schemes focuses on promoters and clients who have willfully used these schemes to evade taxes. Further, fraudulent trust issues are addressed through a national strategy that includes the Department of Justice. As part of this strategy, emphasis is placed on multi-function coordination, the identification of fraudulent offshore promotions, and the use of civil and criminal enforcement actions.

Since 1998, the IRS has closed approximately 5,000 domestic abusive trust cases and proposed \$780 million in taxes for them. Over 100 promoters of these schemes have been identified for whom civil or criminal actions are pending or completed, and another 161 promoter leads are in our database. About 1,500 abusive trust investor cases are currently under examination today.

Suit recommendation letters for injunctions against 11 abusive trust promoters have been referred to DOJ in the past 18 months. We have received one permanent injunction and six suits in total have been filed by DOJ against the remaining 10 promoters. The IRS has been upheld in numerous Tax Court actions on the sham argument. Several prominent criminal convictions have also been obtained in this area, which are discussed at the end of this section.

Since 1997, IRS Criminal Investigation has obtained 156 convictions of individuals for illegal trust schemes. In CY 2001 alone, it had 301 open investigations, including 125 of promoters. Judges have little sympathy or patience for those convicted of these crimes. Here is but one recent example; the CI web site has many more.

On January 7, 2002, in Sacramento, California, three medical professionals were sentenced for their roles in a tax evasion scheme involving the concealment of their

income by routing it through bank accounts in the names of trusts located in the United States and abroad.

Richard Shearer, an ear, nose, and throat specialist, was sentenced to 24 months in prison and ordered to pay a fine of \$10,000. Richard D. Pfeiffer, an orthodontist, was sentenced to 27 months in prison and ordered to pay a fine of \$10,000. In addition, the defendants were sentenced to three years of supervised release. Also, the defendants were ordered to pay restitution to the IRS, an assessment of \$200, and prosecution costs of well over \$1,000. The defendants pled guilty on October 1, 2001, to one count of defrauding the IRS and one count of filing a false tax return.

And in February 2001, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants. IRS Criminal Investigation special agents conducted these enforcement actions as part of a series of investigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

Six individuals from Massachusetts, New Jersey, Washington, California, and Costa Rica were charged on February 26, 2001 in Federal District court in Boston, Massachusetts, all of whom have been arrested. The charges arise out of the criminal complaint filed in connection with the IRS investigation of Anderson Ark and Associates alleging a conspiracy to launder monies through the use of offshore trusts and other offshore entities. Keith Anderson, one of the principals, was recently arrested in Costa Rica and is awaiting extradition to the United States.

The program allegedly involved hundreds of clients who diverted millions of dollars through offshore trusts and bank accounts for the express purpose of evading taxation of income earned in the United States. According to the complaint, each of the defendants was a principal in or provided a referral to Anderson Ark and Associates, a self-proclaimed "free enterprise" or anti-tax organization in the business of creating, promoting, and implementing schemes to assist U.S. taxpayers in the evasion of their true, lawful income tax liabilities.

Benefits Of A Parallel Approach

Mr. Chairman, since last year's hearing, we have dusted off injunctions as another valuable tool we can employ in the fight against these scams and schemes. We have moved aggressively, having sought 10 civil injunctions in cases where some or most have parallel criminal investigations taking place. Without the civil injunctions going forward, these scams would still be operating. Let me provide the context for this promising approach and an excellent example of what it can produce.

While the Internal Revenue Code has both civil and criminal provisions to address abusive promotions, the IRS generally completes a criminal investigation before seeking civil remedies. However, using this methodology to investigate promotions of abusive tax schemes allows the promoters to continue to market the abusive scheme for months or even years while being investigated criminally.

Following the suggestions raised at the Senate Finance Committee hearing in April 2001, a task force was created to determine an effective method of stopping abusive tax scheme promotions while the same promotions are being investigated criminally, i.e., parallel criminal and civil proceedings.

The group was given the task of providing guidelines to the field as to how and when parallel proceedings should be used. Task force members were chosen from the civil and criminal divisions of the IRS, the Office of IRS Chief Counsel and the Department of Justice Tax Division. It is now in the process of making what I am sure will be some important and useful recommendations. We will report these to the Committee at the earliest possible opportunity.

ABUSIVE TAX AVOIDANCE TRANSACTIONS

Mr. Chairman, last month, Assistant Secretary of the Treasury for Tax Policy Mark Weinberger; IRS Large & Mid-Size Business (LMSB) Division Commissioner Larry Langdon; and IRS Chief Counsel B. John Williams testified before the Committee on programs and actions to address the proliferation of abusive tax avoidance transactions.

These transactions are designed and promoted by sophisticated tax professionals and used by both corporations and wealthy individuals to reduce their taxes. They are highly complex and crafted to exploit technical loopholes in the internal revenue laws to obtain substantial and unintended tax benefits.

These abusive tax avoidance transactions 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 obtain the information from third parties.

Abusive tax avoidance transactions are also legally complex. Promoters carefully scrutinize the tax laws to find loopholes and then design complex transactions to exploit them. Consequently, highly complex and very arcane areas of the tax laws are involved. The transactions also 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.

These transactions 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.

Although corporations already have a disclosure requirement, we believe too many are parsing words, narrowly construing the disclosure rules and broadly construing the exceptions.

On December 21, 2001, the IRS issued Announcement 2002-2, announcing a temporary disclosure initiative designed to encourage greater voluntary disclosure. The number of disclosures received has been both encouraging and discouraging for us. 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 at the March 21, 2002 hearing fills those needs.

PROMOTED SCHEMES: MEASURING OUR RESPONSE

Mr. Chairman, as I previously discussed, we are in the process of refining many of the estimates about the extent and scope of the various tax scams and schemes. Indeed, this points to a larger issue. Last summer, the GAO reported to you and Senator Grassley that in order to understand the overall extent of noncompliance and effectiveness of our compliance assurance programs, the IRS has periodically measured voluntary compliance.

Earlier this year, the IRS proposed to reestablish a key component of its ongoing compliance effort to help ensure fairness for America's taxpayers. The National Research Program (NRP) is designed to accurately measure tax compliance while minimizing the need to contact taxpayers during the process.

The NRP is developing innovative approaches to measure taxpayer compliance with the tax law. It will: (1) be far less intrusive and burdensome on taxpayers than previous compliance studies; (2) help the IRS build better compliance programs to more effectively catch tax cheating and help ensure all taxpayers pay a fair share; and (3) help reduce audits of taxpayers who filed an accurate return by at least 15,000 tax returns a year.

As part of ongoing compliance operations, NRP will focus on measuring three key areas of tax administration—filing compliance, payment compliance and reporting compliance. A key element involves measuring the accuracy of reporting information on tax returns. The IRS has overhauled the reporting component to minimize disruptions to taxpayers during the study.

Ultimately, this project will help all taxpayers by giving the agency timely, accurate information about tax compliance. This information will allow the IRS to replace outdated audit formulas and develop compliance efforts directed toward the tax returns most likely to have errors, rather than those from honest taxpayers.

In late fall of this year, the NRP will begin reviewing a small, statistically valid sample of individual returns from the 1040 family. The IRS will work closely with tax practitioners, Members of Congress and other key stakeholders to finalize the project.

Mr. Chairman, let me also point out that in response to a TIGTA report issued last September, LMSB's Office of Tax Shelter Analysis and the Office of Strategy, Research and Program Planning established a research team with the responsibility for: (1) estimating the potential tax revenue impact attributed to these devices; (2) defining the characteristics and behavioral triggers of abusive shelters and (3) developing an abusive corporate issue identification and classification system. In addition, we are developing indicators to measure the organizational progress of our OTSA initiatives.

CONCLUSION

Mr. Chairman, in conclusion, I believe that we are making significant progress combating these illegal tax schemes and scams. However, I do not want to minimize

the scope of the problem and the challenges we face. Many of these ploys and schemes are very well organized. To deal with them effectively requires an enormous commitment of time and resources on our part. At the same time, we must maintain adequate coverage of all other areas of non-compliance. Nevertheless, we will use all of the tools at our disposal to stop these attempts to undermine our tax system and the confidence of the American people in it. Thank you.

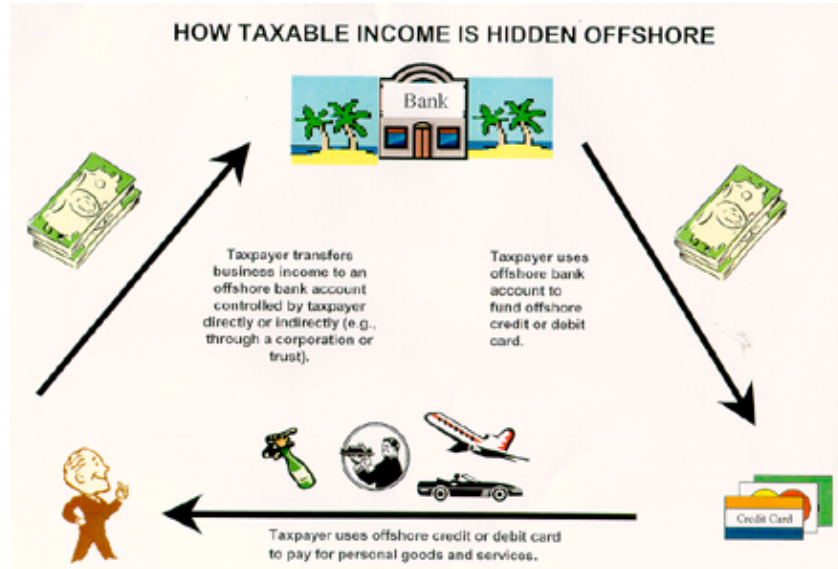
Attachment.

PROMOTED TAX SCHEMES USE A WIDE RANGE OF DEVICES

GENERAL TYPE OF SCHEME	EXAMPLES	TYPICAL PARTICIPATING TAXPAYERS
False Description of the Law	<ul style="list-style-type: none"> Tax Code Unconstitutional Employment Tax Abatement (Section 861) Slavery Reparations Social Security-1041 Refund Scheme 	Less Sophisticated Individuals and Small Businesses
Misrepresentation of Facts	<ul style="list-style-type: none"> Access for Disabled Americans Credit Home-based Deductions: Renaissance 	Individuals and Small Businesses
Use of Trusts and Offshore Bank Accounts to Hide Income	<ul style="list-style-type: none"> Domestic Trusts Foreign Trusts Offshore Bank Accounts Offshore Credit Cards 	Upper Income Individuals
Abusive Tax Avoidance Transactions	<ul style="list-style-type: none"> Basis Shifting LILOs 	Mid to Large Corporations or Very High Income Individuals

IRS USES ALL AVAILABLE TOOLS TO COMBAT SCHEMES

OBJECTIVE	TOOLS	EXAMPLE
Identify Promoters and Schemes	Require Promoter Disclosure	<ul style="list-style-type: none"> § 6111 requires registration of tax shelters
	Require Taxpayer Disclosure	<ul style="list-style-type: none"> Regulation §1.6011-4T requires corporate disclosure of shelter-type transactions
	Execute Search Warrants	<ul style="list-style-type: none"> Anderson Ark and Associates (CI)
	Systematically Evaluate Leads	<ul style="list-style-type: none"> Promoter Lead Development Center (SB/SE)
Identify Participating Taxpayers	Audit Promoter Records	<ul style="list-style-type: none"> 54 promoter cases under examination for possible penalties and injunctions
	Analyze Third Party Records	<ul style="list-style-type: none"> Third-party surrogates: MasterCard, VISA, American Express (SB/SE) K-1 matching (SB/SE)
	Review Returns for Questionable Refunds	<ul style="list-style-type: none"> Questionable Refund Program (CI)
Notify and Warn Public	Review Returns for Audit	<ul style="list-style-type: none"> Selection filters for specific abusive tax schemes to identify participants (SB/SE)
	Issue Notices about Specific Schemes	<ul style="list-style-type: none"> The Dirty Dozen: IRS Warns of 12 Common Tax Schemes (IR-2009-12) (01/13/09)
	Use Media to Inform Public	<ul style="list-style-type: none"> The IRS Warns of Tax Hoax Using Fake Physicians, The Baltimore Sun (02/12/07) Unscrupulous Trust Promoters Target Medical Professionals AAO-HNS Medical Bulletin
	Use Partnerships with Business and Practitioner Groups	<ul style="list-style-type: none"> Work with Congressional offices to warn of slavery reparations scams
Enforce Against Promoters	Letters to Taxpayers	<ul style="list-style-type: none"> Employment Tax Abatement Scheme (§ 861) letter
	Civil Injunctions	<ul style="list-style-type: none"> David Bossert, permanent injunction (March 27, 2002) (§ 861 Scheme)
	Civil Penalties	<ul style="list-style-type: none"> U.S. v. Hensell Henkell and company each fined \$1,254,000
Enforce Against Participating Taxpayers	Criminal Investigations	<ul style="list-style-type: none"> Reparations: Vernon James; Nonfiler: David Kozmar Employment Tax: Michael Long; Return Preparers: Monique Allen Georgia Abusive Trusts: Lorraine Crockett
	Audits	<ul style="list-style-type: none"> FY '02: Service Center and Field Examination will review approximately 70,000 returns
	Civil Penalties	<ul style="list-style-type: none"> § 6062 authorizes imposition of negligence and fraud penalties
	Criminal Investigations	<ul style="list-style-type: none"> Abusive Trusts: Promoter Lorraine Crockett; Clients Drs. Pfeiffer, Sheerer and Bullock Return Preparers: Promoters John and Bruce Rosenberger; 18 clients Nonfiler: Promoter Bertie Kozmar; Client Michael Romanow
Measure Effect of Promoted Schemes	National Research Program	
	Tax Shelter Measurement Project	



RESPONSE TO A QUESTION FROM SENATOR TORRICELLI

Question: Commissioner Rossotti, as you know, Section 1203 of the IRS Restructuring and Reform Act of 1998 subjects IRS employees to a level of scrutiny that no other federal employee must endure. Commonly known as the "Ten Deadly Sins," Section 1203 of the RRA outlines ten infractions for which IRS employees must be fired. One of the ten infractions is the untimely filing of federal income taxes, even when a refund is due.

Commissioner Rossotti, you have stated many times that Section 1203 is having a negative impact on the morale of the IRS workforce and is having a chilling effect on the ability of IRS employees to do their jobs. It appears then that Section 1203 is harming IRS efforts to investigate fraudulent tax schemes and illegal tax shelters. Is this your view? How important is it to the IRS for Congress to approve legislation you have requested for modifications to Section 1203?

Answer: I am responding to the question for the record you submitted on behalf of Senator Robert Torricelli following the hearing on April 11, 2002. Senator Torricelli inquired about the impact of Section 1203 of the IRS Restructuring and Reform Act of 1998 (RRA 98) on the IRS workforce and the efforts to revise this provision. This issue is of great importance to the IRS, and I appreciate the opportunity to state my views for the record.

Although Section 1203 contains important taxpayer protections, certain aspects of the provision have had a chilling effect on employee morale and on the ability of IRS employees to do their jobs in certain circumstances. For example, current law requires the termination of an IRS employee who fails to timely file tax returns, unless that failure is due to reasonable cause and not due to willful neglect. An IRS employee who fails to timely file a refund return (for a year in which the employee is entitled to a refund) may be fired even though a taxpayer who files a refund return late is not penalized. Late-filed refund return cases are a significant percentage of the section 1203 cases to date. I believe these cases do not represent the type of serious conduct to which the penalties imposed by the statute should apply.

Another problem is that a taxpayer's threat of filing a Section 1203 claim against an employee, no matter how frivolous, can cause a great deal of worry for the employee affected. This anxiety is due in part to the fact that current law requires termination for any covered Section 1203 violation unless the Commissioner decides that mitigating factors justify some other personnel action. Therefore, some employees fear their case will not be treated fairly unless they have the *opportunity* to personally convince the Commissioner of the merits of their case.

The Administration included proposed revisions to Section 1203 in its Fiscal Year 2003 Budget Request. The proposals would enhance agency effectiveness by more

carefully tailoring the types of conduct that are subject to sanctions. It would, among other things, remove the late-filing of refund returns from the list of violations. The proposal would also require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by Section 1203. The Commissioner would retain the non-delegable authority to decide whether mitigating factors support a personnel action other than that specified in the guidelines for a covered action. We believe that by making this change, IRS employees will feel more confident in performing the duties of their jobs, knowing that protections built into Section 1203 will allow us to consider the circumstances surrounding their actions should a Section 1203 action be filed against them.

I hope we can count on your support should the Senate consider the Administration's proposals to revise Section 1203. Again, thank you for the opportunity to state my views for the record. If you have any questions, please contact me at (202) 622-9511.

PREPARED STATEMENT OF MARY ELAINE SPEARS

When I met Bob back in 1988, I had been widowed for 8 years. I had raised three teenage boys while working as a sales rep. covering the eastern half of the U.S. I was independent and I wasn't interested in marriage; that is until Bob came charging into my life. What a breath of fresh air! A strong man full of confidence, moral, honest, and with love for his children, his friends & his country. Bob pursued me like he did everything else in life—full speed ahead & doesn't let anything stand in the way of the goal. On top of that he had a boyish, sincere innocence. He wanted to believe that people were honest & good. I'd never met any one like him. He didn't know how to play games especially when it came to love & commitment. He was so blatantly honest about his feelings I feared for his naivete. Commitment was his middle name and he wasn't one bit shy about it. Little did know that the very things I admired about him would cause a wall between us several years later. It was one thing to be fearlessly committed to God, family, friends, business & country. To have that same perseverance to "righting our country's ills" was another story.

The trouble began when Bob had come in contact with information that our income tax, that he had dutifully paid for 40 years, had been put in place without legal due course. This sent Bob on a diligent quest to verify the information & verify it he did. Information flowed in from all parts of the country that convinced him, without a shadow of doubt, that he wasn't liable to pay income tax. He believed that the facts spoke for themselves & felt morally obligated to share this information with others. He was willing to stand in defense of his fellow Americans. As he shared the information with others, Bob quickly came to understand that even though they believed the same information that Bob believed. They were afraid to confront the issue. No wonder? All one has to do is read, watch TV, listen to radio or attend movies, where time and time again the abuses of government are documented, to understand why fear, & helplessness had permeated our society. On top of that his own wife was frightened. There was no way I could go along with his wild dream of being able to confront the system. Many dark days followed. I contacted attorneys, cpas, government representative & even a political journalist trying to find information to help show my husband another perspective. Unfortunately no such help was forthcoming. I struggled with my own alternatives. The easy thing to do would be to seek divorce, but I knew I did not want to end my marriage. I made a vow for richer for poorer, for better for worse, in sickness & health, til death do us part. What I decided to do was to file a separate tax return even though I had no income and owed no tax. I was reprimanded by the IRS for filing a "frivolous" return and fined \$500. I was able to get that straightened out by telling them that I was attempting to separate my actions from that of my husband. My filing separately caused Bob to feel betrayed by me. I was able to convince him that I was neither betraying him or issuing an ultimatum, but rather I just was unable to partner in his actions. I also told him I was not going to do anything to prevent him from pursuing what he felt was "right". Marriage did not give me license to be in charge of my husband's convictions or he mine. I had done all I knew how to bring information to the table for Bob to consider. I had no solid evidence and very little information. It was time for me to let it go and continue to love him through the process. Nothing was solved but an uneasy peace returned to our relationship. It was during this time Bob & I become heavily involved in Bible study & it was in the context of God's understanding that Bob realized the error of his zeal. Our zeal for righteousness needs to start within our own hearts. We cannot change others

only ourselves. Each individual will have the opportunity to change. As we change or do not change our entire environment changes.

Thank you for the opportunity today to give some understanding and hope to others that have become involved in fruitlessness of the lies within the tax protest movement. Our world can change but first it must change within you. God bless you and bring you peace.

PREPARED STATEMENT OF ROBERT SPEARS

Thank you for the opportunity to appear before you today. I want to begin by saying that I am preparing a paper I have titled "The ODYSSEY OF A TAX PROTESTOR". I mention this to shed light on my motive for appearing before this committee. Nothing I have done since I pled guilty to tax evasion has been done to affect the outcome of that decision. I have already been sentenced, so my motive is only to inform others who might be deceived into going where I have been. Many of my remarks today will appear in the paper I am preparing.

A strong, alluring call continues to blow across this great land telling us that the Income Tax is unconstitutional; therefore, illegal and unenforceable. The very nature of a tax that requires us to expose every facet of our lives brings converts to the cause. 'Anti-tax' gurus and Pied Pipers send their "patriotic" calls to ears ready to hear how to get our country back. They appeal to our patriotism, desire for more freedom and privacy, and love of God to encourage us to join in their crusade. They quote the founding fathers and cite court cases, but most of what they provide are, at best, half truths and outright lies meant to enhance our zeal. Tragically, they ask for money in exchange for sharing these "great truths." The real truth is that when the law comes knocking, and the gurus know it will, these gurus disappear over the horizon and you are left on your own to find an attorney able to help you. Believe me, they are a lot harder to find than the gurus. The message you REALLY need to hear is that all the gurus KNOW this day of reckoning will come, but they encourage you anyway. Many encourage you to represent yourself, while following their directions. Believe me, things happen in court that you do not expect and it moves too fast to be dealt with by a novice.

I challenge anyone, anywhere, to find me someone that has challenged this tax, with our without an attorney, and had the tax declared unconstitutional OR was found not subject to the tax for any of the myriad of reasons declared by the gurus.

My journey began in spring of 1993 shortly after I retired. I had formed a foundation for the purpose of teaching our Christian heritage and the Constitution with an emphasis on the First and Second Amendments. I met a realtor who shared my zeal and he loaned me a video made by one of these gurus and I was on my way. I contacted this guru and purchased all he had to offer, as well as books and tapes made by others. This culminated in my purchasing his "un-taxing kit" for ONLY \$1500. I filed a series of letters, which he provided, at very precise times. It all seemed very well thought out and impressive. I filed my status as a non taxpayer with the country register of records and I was now a ex-taxpayer. Funny thing though: the IRS responded a short time later, informing me that I must file and referencing some sections of the Internal Revenue Code. I contacted my guru and he told me the letter had no legal merit and was therefore a "non response." This seemed true because the IRS had not responded to the specific allegations in my un-taxing letters. I continued my research and the next year I filed claims with the IRS demanding a return of the taxes I had paid in the last two years in which I has filed. This was via the advice of yet another guru.

On April 18, 1996 an IRS CRIMINAL investigator left his card in my door. I called the first guru and he advised me to ask them to put in writing exactly what they expected of me. So I sent a copy of my "un-taxing" letters to the criminal investigator and requested he advise me in writing exactly what the IRS expected. I presumed this would end the matter. The response, however, was a bevy of summons' to every bank and stock broker I had dealt with in recent years, requesting all my financial records. Meanwhile the IRS had deemed my requests for return of taxes as frivolous filings, fined me \$500 for each of the two years, and slapped a lien on my home. Again I called my faithful guru and he informed me that the liens were always illegal. I was concerned that the IRS might tie up my assets and I would be unable to defend myself if they pursued me. The guru had an answer for this too. He advised me to send him all my cash and he would invest it offshore. He said it would be safe and an 8% interest rate was guaranteed, but I could expect my money to double. I sent him over \$100,000. Part of it was returned, but the rest is gone.

In February of 1999 I was indicted on three counts of Income Tax evasion (1993–1995), the result of my first guru’s advice, and two counts of fraud (demanding return of my taxes for 1991 & 1992) the result of the advice of my second guru. I want to emphasize the fact that I had the materials of many, many other gurus, supporting my position.

This is when my gurus headed for the hills. NO ADVICE on what attorney to get to represent me. Wouldn’t you think they would know of number of attorney that could plead THEIR case for me? NO ATTORNEYS WERE NAMED; NO, NOT ONE!!

In panic mode I searched for an attorney and found one that believed in my cause. He was, however, new to “the movement,” and was not aware that ALL the arguments he was advancing in my case had been dealt with by the Appellate or Supreme Court. I learned all this later. After spending \$70,000 on my first attorney, I got a new attorney, well versed in these laws and cases and, after being enlightened by him, I pled guilty to one count to tax evasion.

The one point I want to continue to emphasize to those who would consider going where I went is to do your homework before you proceed. Having done that you WILL NOT proceed because you will find that not one of these gurus can show a single case won on any of their arguments.

In summation I would make six observations:

1. Do not refuse to pay taxes as a means of opposing the tax. Remember no courts has ever ruled anyone exempt.

2. Get competent legal advice before doing anything. You will undoubtedly learn that the guru’s belief have been ruled on my the courts.

3. The IRS is not the enemy. It simply administers the tax code.

4. The courts are not the enemy. They simply enforce the tax code.

5. Congress, even though it passes the laws, is not the enemy.

6. If there is an enemy, it is apathy and complacency. One of this country’s framers said that the cost of liberty is eternal vigilance. If America really wants the Income Tax terminated, simplified, or even declared unconstitutional, it is within the power of the people to do it. Your going to jail won’t change a thing!

May God bless America

PREPARED STATEMENT OF JENNIFER PRAGER SODARO

I am an attorney who has practiced law for 16 years, the last 7 or so exclusively as defense counsel for individuals accused of tax crimes, primarily by virtue of using offshore trusts and novel business structures to minimize their tax burden.

I must say novel rather tongue in cheek because while many attorneys and taxpayers are not familiar with business trusts, constitutional trusts and asset protection trusts, these schemes have proliferated for decades, as this body well knows.

I represented Dr. Bullock in his criminal case. A man from Bountiful, Utah, named Lonnie Crockett sold Dr. Bullock an “asset management” tax “avoidance” trust package, then falsely claimed he had a law degree and presented attorney recommendation letters and extensive legal authority. He claimed that Dr. Bullock could legitimately distribute income to an offshore trust and deduct that amount from his taxable gross income. He was to “lose control” of the money and in fact he did not control or communicate with the foreign trustees. However, ultimately the funds came back to the U.S. and were not reported as income. This was because Bullock was shown the section of the tax code which allows a legitimate gift from a foreign individual or entity to be received tax free. Unfortunately he wasn’t told that he could not receive such a gift under these circumstances, this being a circular transaction. He was convicted of conspiracy to defraud the U.S. by defeating the lawful functions of the IRS and for filing false tax returns. He received an 18 month sentence in federal prison and list is medical license.

There is a persistent and rather successful anti-tax movement whether it expresses itself as tax patriot or asset protection. Armed with case law and attorney recommendation letters, they present false credentials and flawed conclusions about tax laws. Yet, tax avoidance is big business and making claims of asset protection and lowering the tax bite is a siren song to independent business owners and intelligent professionals, especially physicians.

Why are these promoters so successful, despite the previous convictions and publicity?

First: Perception that wealthy are not only using tax loopholes, they are doing so with impunity. Taxpayers are told that all the wealthy families use blind trusts and offshore trusts to shelter income.

As an attorney, how can I refute this?

This is difficult when Marc Rich is pardoned and a \$45 million tax bill is forgiven. When Citizens for Tax Justice tell us that GE, Ford and AT&T took even greater advantage of tax breaks and offshore trusts than Enron. It is rumored that these companies appear to have set up offshore entities solely to avoid income tax. I'm speaking obviously not of a statement of fact, but of the perception of the public. The taxpayers, middle class self-employed business owners, farmers and professionals are often backed against the wall, fighting to survive and make payroll, pay their commercial rent bills and provide for their families.

The backbone of our country, I would say.

When unfairness is perceived, rebellion seems the only option. Survival, the inviolate law of nature, kicks in. The taxpayer becomes more susceptible to the promoter's claim of the conspiracy of privilege and corruption within the tax system.

Another reason promoters continue to attract new clients is that as Dr. Bullock's case demonstrates, some IRS enforcement activities continue to include agents in flak jackets, refusal to adhere to mandated administrative procedures and tactics that are not designed to enhance collection efforts but to humiliate, embarrass and harass the taxpayer.

If taxpayers continue to experience what appears to be a corrupt system administered by bureaucrats who never had to make a payroll and who refuse to engage in good faith offers in compromise, there will continue to be no respect for the rule of law.

We can all agree that the right to plan your affairs within the limits of the law is one of the underpinnings of the rule of law, but for that to be respected taxpayers need to clearly know that those limits are and know that those limits are enforced uniformly.

A third reason the peddlers of bogus tax schemes succeed is that lawyers are often uninformed of how the schemes work and are therefore unsuccessful in specifically refuting the positions taken. Without a detailed and complete explanation, the taxpayer aligns with the promoter and believes the claim of their "secret knowledge of the loopholes" and further claims that the unknowing CPA's and lawyers are brainwashed members of the conspiracy team. The promoters use pieces of truthful statements and string them together in a way that is plausible within this climate. For example, while it is true that a taxpayer could in some circumstances, receive a tax free gift from a foreign entity, the bogus trust scam usually involves cycling the taxpayers own income through foreign trusts which is ultimately money laundering.

Rather than rely so heavily on fear to encourage compliance, the IRS must do a better job of educating the public and making the tax code more comprehensible. I am aware of the bulletins offered to the public which discuss these devices in some detail.

However, taxpayers desperately need a qualified and informed professional to examine and discuss the plan they are contemplating or have used. One suggestion that could be implemented is a group taxpayer ombudsmen somehow connected to the IRS, but operating independently who are qualified CPAs and attorneys who can individually advise the public at a reasonable cost. Naturally, if they are paid by the taxpayer, attorney client privilege applies and the taxpayer can get confidential and candid advice. So far, there are only a small number of us that could claim a degree of expert status and clients have difficulty finding us.

We should not be making criminals of middle class business owners but concentrating on stopping the promoters. The process of criminal indictment is too slow to stop the promoters who continue under indictment by filing suit against the government and other similar tactics. An injunction against the promoter for violating §6700 of the IRS Code which prohibits promoting abusive tax shelters would stop the promoter on the day of the hearing and save more taxpayers.

Let me emphasize that in no way do I excuse or condone tax cheating and counsel all clients to make truthful and complete disclosure of any past mistakes. We can be effective in this approach if the Service takes the position that amnesty for past violators is a win-win situation. Revenue is captured, and the client may be penalized civilly and financially, but not criminally. For us to make criminals of otherwise responsible, successful members of the middle class seems wasteful and misguided. Resources should concentrate on improved information and education, more competent professional help and a goal of prosecuting promoters.

Resources should be directed to the huge corporations and promoters who cheat our country out of more taxes than thousands of hard working small business owners combined.

Citizens are enraged with corporate giants fed fat on their sacrifices and tax reform can greatly contribute to a restoration of confidence in our government and compliance with the law. Thank You.

PREPARED STATEMENT OF KELLY STONE

Dear Sirs:

My name is Kelly Stone. My husband, Jeff, and I have been married for 23 years. We have 6 children ranging in age from 20 years to 2 years. We run a small appliance business in Bozeman, Montana and have worked that business since 1985.

In November of 1994 I received a phone call from my sister. She had heard from one of her church friends about a Tax and Insurance Seminar being held at an Insurance Agency in Billings, Montana. The man running this Seminar was supposedly a Christian man with solid morals and an uncanny knowledge of American History. He ran profound business that helped small business owners with tax reduction. Even, though we had to travel 336 round trip miles to this seminar, and find someone to watch our four children, we decided to go.

We had been without health insurance for six years and with the amount of self-employment tax we were paying per year, we were beginning to wonder whether our small business adventure was going to succeed or not.

We walked into this seminar with great expectations, and we were not disappointed.

This man was not only knowledgeable; he was confident and strongly approved of home school and raising your children with a solid, godly foundation. He had a captivated audience and held our attention with stories of our country's founding fathers and how America was established. His plan for our future was compelling. The money we saved on our taxes we would use to buy medical insurance for our family. We would even have enough to invest in a universal annuity life insurance policy for both Jeff and myself. We often talked about what would happen to the kids if we died. Who would be able to afford to raise my four children? Not only did it take care of that problem but at the age of 65 we could draw on the policy for retirement. This man solved all our problems with one easy payment a month.

His plan of action was not simple but was easy to understand. We brought in our three most recent tax returns. His plan was to amend the prior three returns, and with the money the government sent us, we would establish two trusts. A personal trust for \$3500 and a business trust for \$3500. This \$7000 would make us untouchable. No one could sue us for any of our hard earned dollars and the IRS could not take any of our assets to cover taxes they might claim we owed. He would prepare our tax returns from now on. With the money we saved, we would be able to pay for our insurance policies. We got all of this for a mere \$180 a month that was automatically drafted from our checking account.

We signed up for his services in November of 1994 and we were audited the following year. The mode of operation for our tax preparer was to appeal at every turn. He was confident that the IRS would not spend the money to pursue our case. The amount was surely insignificant, and he kept assuring us that they would soon give up. By the time we had run the gambit of appeals almost five years had past. We were told to prepare for audit on the remaining years.

The story doesn't end there, but I was only given 5 to 10 minutes to share 8 years of my life. The bottom line is that my tax preparer was sentenced to 6 years in prison. My fear is that my sentence will be longer. I may not go to prison but the affects may be everlasting. I have paid my lawyer and my new accountant thousands of dollars to help us out of this mess. The state is waiting to hear from the IRS before assessing back taxes, penalties and interest. The IRS put a \$32,000 lien on our home. We filed an offer and compromise with them in July of 1999 and it was denied. We appealed and just received our first letter from them in January of 2002. They want me to re-file all the paperwork they required the first time because so much time has past. In the mean time I can't apply for any loans. I can't supply my family with a safe vehicle to ride in. We went an entire winter with no heat source in our house because our pellet stove broke and we had no money to buy a new one. We hold no hope for the future for us or our children. We have no ability to grow or succeed without the forgiveness of our tax debt.

There will always be predators out there that prey on people like me. There is no way to prevent it. There is no way to change it. But I do feel we have a responsibility to try. If victims such as myself could share their stories with the public, that would be the first step. That you are even listening to my story is another step. My story may be compelling but you are the ones that hold the key. You have the ability to educate the public. You have the backing to initiate an advertising campaign

that could forewarn the very people that voted you into office. In my eyes it is a solid investment. The people who fall victim to this kind of crime will end up costing the government money that could have been used to prevent the crime in the first place. Even if there was a reward offered, for information leading to arrests and convictions, it would still save you money. These criminals destroy lives. Any action you take will not be to soon.

PREPARED STATEMENT OF DAVID C. WILLIAMS

Mr. Chairman, and members of the committee, I appreciate the opportunity to appear before you today to discuss illegal tax activities and their impact on the tax-paying public. I would also like to discuss some of my office's efforts to detect these situations, and proposals for the Internal Revenue Service (IRS) to further reduce illegal tax activities.

Let me begin by outlining the responsibilities of the IRS and the Treasury Inspector General for Tax Administration (TIGTA) as they relate to this topic. It is the responsibility of the IRS to identify and investigate potential violations of the tax laws. Within the IRS, the Criminal Investigation function is the primary unit involved in these activities. As an independent oversight body, TIGTA's responsibility is to investigate allegations that IRS employees have participated in or fostered the continuance of schemes. TIGTA also investigates individuals who impersonate or purport to be IRS agents in the furtherance of these schemes. TIGTA is also responsible for assessing the IRS' systemic controls to ensure that tax returns are successfully processed without allowing questionable deductions or credits.

Income tax schemes are destructive in many ways. While some of the individuals are willing participants motivated by greed, many involved are just unwitting victims who ultimately lose not only the anticipated tax benefit, but also the money they pay to the promoters of the scheme. Some of these taxpayers are elderly Americans who become victims of promoters. Individuals become participants in these schemes frequently through contact by unscrupulous promoters, falsely claiming that they have discovered legitimate, but little known, methods to avoid taxes. The "victims" subsequently learn that, once caught by the IRS, they must not only pay their entire tax liability, but they may also incur interest and penalty expenses, as well as the customary fee paid to the promoter.

It goes without saying that the proliferation of schemes aimed at providing individuals with an avenue to pay less than their fair share of taxes weighs heavily on the IRS' ability to ensure voluntary compliance levels are at their maximum.

I believe taxpayers are more inclined to comply with the tax laws if they trust that the system is fair and structured adequately to identify and penalize those who do not play by the rules. However, increasing concerns that taxpayers doubt the effectiveness of the tax system have begun to surface. In fact, there are indications that citizens are more accepting of tax cheating than in the past.

In calendar year 2001, the IRS requested my office's assistance in helping to improve its internal controls regarding a significant false tax claim—the Reparations Credit. In addition, we are devoting audit and investigative resources to assess other questionable activities including the Disabled Access Credit, Misuse of the Employer Identification Numbers (EIN), Advance-Fee schemes, and Impersonation scams. My office is dedicated to protecting the integrity of the IRS and we're committed to assisting the IRS to better serve the taxpayers and maintain confidence in the tax system.

Reparations Credit

Since the early 1990s, thousands of false claims have been filed with the IRS for reparations credits. Promoters use a variety of techniques to market the promise of a special tax credit to African-American taxpayers, who may be descendants of slaves. However, the Internal Revenue Code does not provide for such a credit. As a result, the IRS tries to identify tax returns containing these claims, deny the claims, and stop any resulting refunds before they are issued to taxpayers. IRS employees use a manual process and identify most of these claims before any data is input to the IRS' computer systems. Because the manual screening of tax returns by IRS employees is subject to human error, some claims for reparations credits are processed and refunds sent to taxpayers.

The number of returns claiming reparations is significant. Prior to Calendar Year (CY) 2001, the IRS did not consistently track the number of returns claiming reparations. In CY 2001, the IRS received over 77,000 returns with an estimated \$2.7 billion in claims. Generally, each claim asks for approximately \$43,000. The IRS has advised us that they are using a multi-faceted public relations approach to thwart

this scheme. These efforts include a large media campaign, community outreach, consumer alert to penalties (\$500) and warning promoters of the potential for prosecution.

In early 2001, the IRS found that its manual controls were not always functioning as intended and some erroneous refunds were being issued. Recognizing the need to improve its internal controls, the IRS requested TIGTA to develop a computer program to identify these illegal claims. TIGTA developed a computer program and also initiated an audit to review the procedures and criteria used to identify these claims. The controls designed by the IRS to identify and stop claims for reparations credits were only partially effective. In some instances, refunds in excess of \$80,000 for married taxpayers claiming reparations credits for each spouse were issued.

TIGTA identified an estimated \$30 million in erroneous refund payments issued to taxpayers during 2000 and in part of 2001. The TIGTA-developed computer program identified over \$18 million in erroneous refunds that were issued in 2000 and over \$12 million in refunds that were issued during the February through April 2001 timeframe. For the remainder of 2001, the TIGTA-developed computer program helped identify an additional 392 claims totaling over \$16.1 million. After TIGTA notified the IRS, the IRS stopped 96% of these refunds. For the remaining refunds that were not stopped, TIGTA recommended that the IRS expand the use of a computer code in the future to stop these refunds during weeks when the IRS accelerates refund processing to avoid paying interest.

The details of our work in this area can be found in our audit report *Computer Programming Can be Used to More Effectively Stop Refunds on Illegal Claims for Reparations* 2002–30–071). (dated March 28, 2002; report number 2002–30–071).

Disabled Access Credit

The Disabled Access Credit is a business incentive credit enacted to help small businesses comply with the applicable requirements of the Americans with Disabilities Act (ADA). In Calendar Year 2000, through outreach and planning efforts, the IRS and TIGTA learned of taxpayers investing in pay telephones with volume controls and claiming Disabled Access Credits of up to \$5,000 on their individual income tax returns.

In September 2001 TIGTA reported that taxpayers were inappropriately receiving the Disabled Access Credit on Forms 1040 despite their tax returns indicating they had no business ownership or participation. Based on a limited sample, many of the taxpayers involved were elderly Americans who were possibly victims of promoters offering to sell expensive, coin-operated telephone equipment with the promise that the taxpayer could claim the disabled access credit because the telephones had volume controls.

In Tax Year (TY) 1999¹, TIGTA identified 391 taxpayers claiming Disabled Access Credits totaling over \$1.09 million although their returns indicated no involvement in a business. The IRS issued refunds or applied overpayments to subsequent years' taxes for 304 of these cases totaling \$1.02 million. The average tax benefit received by these 304 taxpayers was over \$3,300. We now have indications that thousands more taxpayers showing some business activity on their tax returns may have also inappropriately claimed the credit. We recommended that the IRS publicize this issue to help educate taxpayers who may fall victim to fraudulent promotions, and develop a compliance approach for taxpayers taking the Disabled Access Credit without qualifying businesses. By taking this action, the IRS could potentially avoid erroneous payments in the amount of more than \$2 million. The IRS is continuing to develop its compliance approach for taxpayers claiming the Disabled Access Credit.

We also recommended that the IRS assess the results of our computer analyses for TY 1999, and perform similar analyses of TY 2000 returns. To facilitate the IRS' corrective action, we agreed to perform the computer analysis of TY 2000 tax returns. TIGTA subsequently analyzed these individual return filings and issued a report in January 2002. Our audit results showed that, for TY 2000, 28 percent more taxpayers inappropriately received over \$1.25 million in Disabled Access Credits even though their tax returns indicated no business involvement. We also determined that 64 taxpayers inappropriately received the credit for both TYs 1999 and 2000.

Misuse of Employee Identification Numbers (EINs)

Another prevalent scheme involves individuals who misuse IRS-issued EIN's as Social Security Numbers (SSN's) to create a new credit file for businesses or individ-

¹ Individual Income Tax Returns processed in Calendar Year 2000.

uals with poor credit. This scheme is promoted nationwide and although it is illegal, the credit repair packages imply that the IRS endorses them.

The IRS process for issuing EIN's was created to have a unique number to use in filing tax returns. EIN's are the identifying numbers that the IRS assigns to business taxpayers. They identify corporations, partnerships, non-profit associations, trusts, sole proprietorships and similar non-individual entities.

In this scheme, most promoters encourage individuals to describe themselves as a sole proprietor in order to obtain an EIN and use it as an SSN. However, many of these SSN's are already assigned and being used by taxpayers with a legitimate right to the number. The switch is easy to accomplish since both EIN's and SSN's are comprised of nine digits. The only difference is the placement and number of hyphens. As a result, scheme participants could damage the credit histories, or steal the identities of; innocent taxpayers whose SSN's are duplicated.

TIGTA's interest with each EIN scheme is fourfold. First, is to protect the integrity of IRS' EIN Program; second, through investigation, assist the victims whose SSN's are misused; third is to determine whether any IRS employees are involved in the selection and sale of the EIN's; and lastly, address the related damage caused to the social security program. The EIN/SSN duplication scheme wastes scarce IRS resources with time spent reviewing and processing the applications. Improper EIN/SSN duplication also leads to problems with erroneous postings to taxpayer accounts.

Our special agents have investigated crimes involving EIN's since 1995. During the last few years, TIGTA has participated with the Federal Trade Commission (FTC) in providing presentations on the EIN scheme to other law enforcement agencies and U.S. Attorneys' offices. With the continued assistance of the FTC, TIGTA has also initiated a nationwide EIN Project that will enable TIGTA to develop valuable leads and to investigate those responsible for promoting these illegal schemes.

Since April 2001, TIGTA initiated 19 investigations involving the fraudulent use of EIN's as a result of the coordinated efforts with the FTC. In addition, TIGTA has initiated another 18 EIN investigations outside of this project.

Advance-Fee Schemes

This scheme primarily targets the elderly, and is most prevalent in areas of the country where there is a high concentration of senior citizens. This fraud is perpetuated by individuals employing telemarketing techniques to mislead their victims by convincing them that they have won large cash sums or prizes. However, the victim must pre-pay various fraudulent fees and taxes before they can receive the prize. The amounts requested range from \$2,000 to \$20,000. In many cases, taxpayers believe the telemarketers, and they have been convinced to pay this money because the telemarketer has invoked the name of the IRS. Some victims, mostly elderly, have lost more than \$100,000 of their life savings to these scams. The telemarketing operations themselves are scattered throughout the country in boiler room type operations that can be quickly dismantled and relocated when discovered by law enforcement.

Since April 2001, TIGTA initiated 25 investigations involving advance-fee telemarketing. Additionally, TIGTA has closed 18 cases implicating 3 promoters and 3 individuals who lost more than \$296,000.

Many federal law enforcement agencies conduct investigations involving fraudulent telemarketing. TIGTA, however, is concerned with any individuals who purport to be IRS agents or profess that they represent IRS tax collection interests in order to collect money from unsuspecting individuals. The success of these schemes is dependent upon the ability to mislead the victims.

Impersonation Scams

Impersonation is both a stand-alone crime and a tool used by the perpetrators of the schemes described above. Unlike other schemes I testified about earlier, impersonation does not target a specific group within the general population nor is it indigenous to one region of the country. Unscrupulous individuals can work alone or be employed by companies who track down parties who owe them money. In order to illegally obtain personal information, the impersonators give the impression that they are from the IRS and have money that belongs to the individual they are attempting to find. In other instances, impersonators may attempt to obtain personal information such as an SSN and then use the SSN to steal the identity of a person, collect money, or locate an individual. Impersonators are most often con artists, bill collectors, telemarketers, private investigators or disgruntled ex-spouses.

Since April 2001, TIGTA has initiated 158 investigations involving impersonation. TIGTA remains focused on investigating those individuals who purport to be IRS employees. TIGTA is additionally concerned with individuals who use IRS emblems

or insignia in order to appear legitimate to its victims. For example, IRS impostors have used the words "Internal Revenue Service" on company letterhead or displayed fraudulent credentials in order to further a scheme.

In closing, I would like to state that the most effective approach for suppressing these types of crimes combines raising the level of risk to the promoter with better educating the taxpaying public. Past prosecutions of tax scheme promoters have resulted in significant criminal sentences for the promoters. Increased oversight in this area will increase the IRS' ability to identify and prosecute more unscrupulous promoters. Further, a continued public relations campaign will help discredit the promises made by the promoters. I believe the IRS is heading in the right direction in regard to both of these approaches.

