

SENATE FINANCE COMMITTEE
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Mr. Chairman, Senator Baucus, Members of the Finance Committee, thank you for inviting me to testify today on the subject of the government's efforts to curtail abusive tax avoidance transactions. This is the third occasion on which I have had the privilege of testifying before this Committee on this important topic.

INTRODUCTION

This Committee has wrestled with abusive tax avoidance transactions for years, and I applaud your efforts to focus on the central solution: disclosure. I also applaud the Committee for enabling Commissioner Rossotti to redesign the administrative apparatus of the Service in a way that permits it to act on a national basis. The organization of the Service by taxpayer type and industry has permitted efforts to address the proliferation of abusive tax avoidance transactions and the technical issues presented by them in a way that the old organizational structure never could have. The new structure not only permits the issues to be addressed on a national basis to assure more consistency in tax administration, but also permits the Service to focus on compliance levels more quickly and efficiently by particular taxpayer groups thus permitting use of resources where most urgently needed.

IDENTIFICATION OF THE PROBLEM

At the hearing on whether to confirm my nomination to be Chief Counsel for the Internal Revenue Service on November 15, 2001, Sen. Baucus asked me how, as Chief Counsel, I would address the problem of proliferating tax shelters. In response, I identified two institutional issues that I believed were recurring obstacles to successful interdiction. These issues were (1) improving the use of existing tools available to IRS, including more effective gathering of information that was needed to analyze transactions and more timely publication of the IRS' view of the proper tax treatment of those transactions; and (2) encouraging the appropriate use of existing enforcement tools to promote "an ideal that the IRS is in the business to help people comply with the law...so that the attitude is not, 'we're looking for a fight,' but 'we're looking to help you pay the right amount of taxes' which this Congress has said the taxpayers owe." Sen. Baucus urged me to pursue these issues.

My testimony before this Committee on March 22, 2002, identified more specific hurdles to interdicting abusive tax avoidance transactions, which the Service refers to as

“technical tax shelters”. To summarize, the Service’s reliance on old audit processes to identify technical tax shelters left it unknowledgeable and incapacitated to interdict the promotion of those transactions. Further, this lack of knowledge was impeding analysis and publication of guidance on which transactions were regarded as abusive. This impediment was occurring at a time when published guidance in general was languishing terribly, despite the obvious fact that effective tax administration assumes that the public knows the positions that the Service believes are correct. The Service was not using its information gathering tools as effectively as it could, and the disclosure, registration and list maintenance requirements had produced limited information.

The Committee on May 31, 2003, received my Report on Abusive Tax Avoidance Transactions which the Committee had requested at my confirmation hearing (the “Report”). By then, with the active support of Pam Olson, Charles Rossotti, and Larry Langdon, I had already begun to implement strategic changes that I shared with the Committee in that Report. The changes involved streamlining the relationship between Counsel’s field operations, its national office technical functions and the Large and Mid-Size Business Division of the Service (“LMSB”), which was charged with responsibility for examining technical tax shelters. In general, these changes included: (1) improving early detection of questionable transactions; (2) improving prompt analysis of questionable transactions; (3) accelerating public notification and guidance on questionable transactions; and (4) vigorously enforcing tax rules to ensure the system works fairly for all taxpayers, including vigorously pursuing information relating to these transactions.

PURSuing PROMOTERS OF ABUSIVE TAX AVOIDANCE TRANSACTIONS – THE SUPPLY SIDE

The supply of tax avoidance transactions cannot be quantified. Nevertheless, the creators of such transactions frequently have legal obligations to register them (Code section 6111) and to maintain a list of investors in them (Code section 6112). Accordingly, the Service has a public duty to examine compliance with these legal obligations. To help the Service discharge this duty, I made clear within days of my appointment that I would support enforcement of summonses for information from promoters. The Service had already requested, 18 months earlier in some cases, information on compliance with registration and list maintenance requirements from promoters and was being largely ignored. Further, I committed whatever resources were needed from Counsel to support this audit activity.

Promoter audits are led by the LMSB Industry Director for Financial Services, at that time Dave Robison and now Paul DeNard. LMSB was well served in this effort by the Industry Counsel, Roland Barral, who received for leading field counsel’s support of the promoter audits the Chief Counsel’s Award, the highest award the Chief Counsel can give. The close working relationship between Counsel, both in the field and the national office, and LMSB is, I believe, a model for future examinations in not only promoter audits (which must continue if the supply side is to be monitored) but also regular income tax audits. Strategic use of audit resources is the most effective way of maximizing them, and I believe

more resources can be justified only after adequate strategic analysis of audit issues is done and implemented.

Although it was impossible to quantify the supply of abusive tax avoidance transactions, it was much more critical that the Service did not know the nature of the transactions being marketed. In general, the Service's analysis of transactions had been undertaken without the benefit of having reviewed the deal documents. There had been few registrations, and even as to those, the Service had not actively pursued examinations. There were even fewer disclosures, so there was no capacity to cross-check investors with promotions. The normal audit process would never give the Service that knowledge. Examining compliance with the registration and list maintenance requirements, however, enabled the Service to gain access to knowledge of the technical tax shelters, past and present, that had been or were then being marketed.

LMSB had published an initiative to encourage disclosure by waiving penalties that otherwise might be imposed on taxpayers who voluntarily participated in the program. See Announcement 2002-2, 2002-2 I.R.B. 304. The disclosure initiative was designed to provide the IRS with information about questionable transactions provided by taxpayers who had participated in a tax avoidance transaction.

Complementing the disclosure initiative, LMSB provided guidelines to IRS examiners regarding the consideration of the accuracy-related penalty under section 6662 in examinations involving listed transactions and other potentially abusive tax avoidance transactions. Together with the disclosure initiative, the penalty guidelines were intended to create a compliance incentive by ensuring that in appropriate circumstances the IRS will consider and apply penalties consistently, impartially, and fairly among all taxpayers.

In my view, the success of the disclosure initiative depended in large part on intensifying the promoter audits. Unless individuals realistically thought that the Service was going to knock on their door, they had little incentive to participate. Promoter audits should produce the list of investors required to be maintained under Code section 6112, and this effect should cause investors to believe that they were at risk for an examination. Of course, that perception could be sustained only if the Service followed-up and examined the investors whose names we received from such audits, a use of resources that could not be assumed.

Information revealing both the investors' identities and the nature of the transactions being marketed should have been kept by the promoter. Accordingly, promoter audits would give us the information we needed about the transactions being marketed and the technical analysis used to justify the tax benefits being claimed. Most importantly, these audits examined current as well as past activities so the audits enabled the Service to bridge the knowledge gap that otherwise would develop during the time between the marketing of the transaction and the review of it in a standard income tax examination years later.

The Service has wide-ranging authority to examine books and records and to conduct interviews of taxpayers. The Service can summons this information under Code section 7602, but if the taxpayer fails to comply, the summons can be enforced only if the Justice Department petitions a federal district court for an enforcement order. Accordingly, to promote the most efficient use of the Service's summons power, I asked that the promoter summonses be pre-cleared with the Justice Department. My objective was to provide the Service with assurance that Justice would file an enforcement petition, if needed. For example, I wanted to be sure that Justice would agree that the scope of the summons was proper and not over-broad. I also wanted to reduce the time necessary for review prior to filing the enforcement petition. Examination teams predictably become discouraged with significant delays in seeking enforcement, and of course, the progress of the audit is impaired.

PURSUING THE INVESTOR – THE DEMAND SIDE

Focusing on investors rather than solely on the promoters is also a key part of interdicting abusive tax avoidance transactions. If the demand for the shelter product is reduced, the supply diminishes. For individuals and smaller businesses, I believe the most critical factor in reducing demand is whether the investor believes the Service will discover the investment and audit their return. This effect on taxpayer behavior makes a follow-up audit imperative. It also places critical importance on the Service using its audit resources strategically, that is, using its audit resources based on informed judgment about the transaction and who has invested in it. For corporations, I believe the most critical factor is the availability of sound technical analysis to the Examination team. Large corporations assume they will be audited, but the question is whether the Service will pursue the right issues with the right arguments, and frequently it does not.

The Service has a tool, independent of list maintenance, for identifying individual investors, but it is awkward and clumsy to use. The Service has the authority under Code section 7609 to ask that Justice petition a district court for permission to serve a "John Doe" summons where it appears that there is reasonable likelihood that the investors have understated their tax liabilities. The benefit from using a John Doe summons is that, if the recipient does not comply within 6 months, the statute of limitations on the investors' underlying tax obligations is suspended. In the first instance, this requires that the Service have analyzed the transaction and concluded that the tax benefits claimed are not meritorious. Then, the Service must show that other reasonable means of identifying the investors have been exhausted. Whether the Service must fruitlessly pursue enforcement of a 7602 summons for the investor list prior to filing a request for service of a John Doe summons was extensively debated between the Chief Counsel's office and Justice.

The value to good tax administration of producing the investors' names is most tellingly revealed in the battles fought over "identity privilege". I have spoken on several occasions about the frivolous nature of the claim that the investors' identities are protected from disclosure to the Service by either the attorney-client privilege or the "tax practitioner's

privilege” of Code section 7525. See, e.g., Speech of June 6, 2002, before the Texas Federal Tax Institute (the “Alamo Speech”) quoted in *John Doe #1 v. Wachovia Bank* (WDNC June 24, 2003). One effect of these battles was to delay audits to the point of losing one or more tax years to the statute of limitations.

THE COMMON THREAD OF THE SOLUTION – ADEQUATE DISCLOSURE

I testified in March, 2002, in support of Treasury’s proposals to expand registration requirements and to adopt a penalty regime for taxpayers’ failure to disclose reportable transactions. Those proposals, as modified by the Chairman’s Mark on the JOBS Act, give the Service all the tools that are needed to interdict abusive tax avoidance transactions, and I am as firmly convinced today as I was then that these proposals are essential to long term management and control of the “shelter problem”. The web of information that would permit cross-checking of promoter information with taxpayer disclosures is a tool that the Service needs for effective tax administration. Access to this information would provide the Service with an early opportunity to analyze the merits of a transaction and to publish guidance on whether the transaction works under current law. Treasury is then in an early position to announce whether policy considerations dictate a review of the current law to consider changes in regulations or the Code. If a transaction is regarded as abusive, Treasury and the Service could list the transaction.

Perhaps the most effective impact of the disclosure regime would be in those instances where the transaction is listed. The web of information reporting and disclosure would permit the Service to connect either the disclosure to the promoter (and thus to all the other investors) or the transaction to the investor. This web of information should enable the Service to regain credibility that the Service will “knock on the door” of the taxpayer. I believe that LMSB is capable and supportive of this effort, and if executed properly, available resources are sufficient to the task. This strategic use of audit resources, however, requires (1) a new flexibility at the Service, and (2) a willingness to reassure taxpayers that the Service is not engaged in chest-thumping.

FLEXIBILITY IS NEEDED

Additional flexibility is needed in the Service’s audits, whether in promoter examinations or in the follow-up ordinary income tax audits, in three important aspects of the process. The first is organizing agents to pursue an audit; the second is encouraging examination teams to rely earlier and more frequently on Counsel’s advice; the third is permitting the examination team the room needed to develop the issues.

There have always been institutional obstacles to effective audits. When the Service was organized geographically, examining a taxpayer with significant operations across districts presented jurisdictional problems. This jurisdictional issue now appears as a problem coordinating the efforts of the different operating divisions. For example, a transaction that is a technical tax shelter may be sold by a taxpayer audited by LMSB. If that transaction is bought by individuals, the examining agents on the income tax audit will

be from the SBSE (Small Business Self-Employed) division not from LMSB. The Service needs to be able to organize and deploy revenue agents and audit specialists in teams that can function across divisions. This reallocation is not “robbing Peter to pay Paul,” rather it is sensibly using resources strategically.

Second, the Service needs to rely more closely on Counsel’s technical expertise. Ultimately, what is at issue is the application of the law, and Counsel as legal adviser should be an integral part of such teams. These teams would be steeped in the technical and factual issues presented by a particular transaction with Counsel with them to advise on the spot. LMSB has started in this direction by working with Counsel to have specific lawyers identified as advisers to each large case examination.

Finally, and most importantly, these teams need the room to develop and pursue the issues identified for audit. Placing artificial demands on shortening the “cycle time” for completing an audit will adversely impact compliance. First, the audit will not uncover important issues because the team will simply not have the time needed to find them. Second, the examination team will not develop issues it finds because the administrative goal of reduced cycle time will determine performance. Extensions of time that have to be justified will simply by default not be made. Some of the field counsel in my office were alerting me to this problem before I left office. Lastly, a shortened cycle time will place new emphasis on routinely issuing summonses because the examination team will not be able to assure completion within the allotted time by pursuing informal requests for information. Routine reliance on summonses will impede the progress of the audit because the formalization of the information request will tend to impair the working relationship between taxpayers and the Service.

THE DANGER OF INDIGNATION

One of the foundation stones of the credibility of the Service with the American public is that the Service proceed analytically rather than emotively. “Abusive” reflects the indignation that the Service feels about a transaction, but the Service’s feelings about a transaction do not state a legal basis for disallowing the tax benefits from a transaction. “Abusive” is not an analytical term, it is an emotive term, and the mission of the Service is to apply the law fairly and impartially, not to apply the law in a manner that is biased toward a result the government wants. In this connection, the institution does not need to be reminded that it is an enforcement agency. Instead, the Service needs to be encouraged to use its enforcement tools in a way that helps taxpayers comply with the law. This was the point of my colloquy with Sen. Baucus at my confirmation hearing, when I stated that the Service does not need an attitude that “we’re looking for a fight”, it needs an attitude that “we’re interested in determining and collecting the right amount of tax” and “we accept your disagreement with us as legitimate.” Taxpayer service is far more than processing returns quickly or answering phone calls pleasantly and accurately; it is the bedrock attitude that the Service should bring to its dealings with taxpayers. It was this insight that Commissioner Rossotti brought to the rehabilitation of the Service after this Committee’s 1997 hearings. In this respect, there should be no pendulum swing between taxpayer

service and enforcement. Compliance with the tax law, by both taxpayers and the Service, should be the overriding objective of tax administration.

Recently, I have seen reports that the Service is being urged to approach the taxpaying public as if it were divided into three categories: (1) those who pay; (2) those who can't pay; and (3) those who don't pay. Further, it is said, the first group deserves "service", the second deserves "help" and the third deserves "enforcement". This truncated view of the American taxpaying public is not only short-sighted but also misguided. Taxpayers "who don't pay" the tax that the government says they owe are not always wrong. Indeed, on occasion the Service has had legal fees imposed on it for taking unreasonable positions. More to the point, however, is that the complexity and intricacy of the tax law is often murky or uncertain, and even if not unreasonable, the government's position may not be right. The Service does not always determine a correct deficiency, and the deficiencies as determined by examining agents may be used to measure compliance, but they are not a fair yardstick. To say that taxpayers "who don't pay" deserve enforcement evidences an emotive sense of indignation that has very little place in the administration of a fair tax system. In this connection, I would urge the Committee to remember the hearings it held little more than 5 years ago.

I would caution the Committee against proceeding with strict liability penalties. First, with regard to disclosure, the size and complexity of many businesses and the returns they file will inevitably result in missed items. In my view, the disclosure regime needs some tolerance for inadvertent mistakes. Second, strict liability penalties tend to suffer one of two extremes in tax administration: either they are employed too sparingly because they are viewed as too draconian or they are used as threats to force resolutions that are not appropriate. Neither should be acceptable to sound tax administration. In particular, the special penalty for engaging in a transaction that lacks economic substance is fraught with potential arbitrariness.

The proposed changes in penalties, both regarding disclosure and the Code section 6662 penalties, require personal involvement of the Commissioner in those limited circumstances in which a penalty can be rescinded. I think is a mistake to require involvement of the Commissioner personally in any case.

CONCLUSION

While the Service still has much work to do, the "shelter problem" is manageable with strategic use of resources and a disclosure regime in place. The Service must, however, demonstrate a continued respect for taxpayers who disagree with it or place at risk its credibility with the American public as a fair and impartial tax collector.

A disclosure regime like that proposed by the Chairman's Mark of the JOBS Act is essential to managing the shelter problem. The Committee's proposed legislation substituting an information reporting requirement for the tax shelter registration requirements of Code section 6111, adding significant penalties for failure to disclose

under Code section 6011 and for failure to maintain lists of investors under section 6112, and limiting the applicability of Code section 7525 should all be enacted as soon as possible.

Thank you again, Mr. Chairman, for the invitation to speak today. I will gladly answer any questions the Committee may have.