

**PREPARED TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
MARK W. EVERSON
BEFORE THE
SENATE FINANCE COMMITTEE
HEARING ON CORPORATE TAX SHELTERS
OCTOBER 21, 2003**

INTRODUCTION AND OVERVIEW

Mr. Chairman, Senator Baucus and Members of the Committee, thank you for inviting me to discuss the subject of abusive corporate tax avoidance transactions with you. I mentioned to you at my confirmation hearing in March that enhancement of the IRS' enforcement activities would be one of my priorities, and your invitation to join you today to discuss corporate tax shelters illustrates the Committee's keen interest in a subject that raises significant compliance issues. I welcome the opportunity to speak to you about it today.

I would like to begin my comments today by describing for you how I view abusive transactions from the standpoint of the position I have occupied since this past May.

A theme I have emphasized since assuming my role as Commissioner of the IRS is that "Service plus enforcement equals compliance." To me, this means that, in order for the IRS to pursue the goal of compliance with our tax laws, the IRS must provide a level of service to taxpayers that merits their respect and cooperation. I want to be clear that the overwhelming majority of taxpayers, whether individuals or businesses, are honest and law abiding. Taxpayers deserve efficient, professional and fair tax administration, for this will enhance compliance. Enforcement similarly must reinforce taxpayers' trust that their own good faith in complying with our tax laws is matched by that of their fellow citizens. That is, we need to strike the right balance.

My intention in bringing this message to the Service's employees is to emphasize that both providing service and ensuring compliance are vital to the Service's success in the era after the 1998 IRS Restructuring and Reform Act (RRA 98). The importance of not sacrificing one for the other must mark our approach. My conviction on this point has only grown in the nearly six months I have been at the Service.

Consistent with the clear statutory mandate and strong legislative message of RRA 98 to improve service to taxpayers and to protect taxpayer rights, the IRS has demonstrated unmistakable progress in improving customer service and incorporating and increasing its recognition and respect for taxpayer rights. The

Service will continue to strive to improve service to America's taxpayers building on the important foundation established by Commissioner Rossotti. At the same time, we will make sure that the improvements in the Service's enforcement capabilities continue, as well.

Work needs to be done by the IRS to ensure that all taxpayers pay their fair share of taxes and to support best practices among tax professionals. The Treasury Department has asked Congress to assist in this effort by passing legislation to strengthen certain provisions of the Internal Revenue Code to make them more effective in curtailing abusive transactions. We appreciate this Committee's efforts to secure passage of that legislation, and hope that its enactment will soon occur.

Before discussing what the Service has done with respect to abusive tax avoidance transactions and what I see the Service doing in the future, I want to emphasize several considerations that I believe ought to be taken into account in considering and evaluating the IRS' approach to abusive transactions.

First, abusive tax transactions are a product of the structure and complexity of the Internal Revenue Code. While I do not plan to address technical and definitional issues about abusive tax transactions today, I want to state my belief that many abusive tax transactions are fashioned in the likeness of legitimate transactions that are permitted under the Code. Others are the beneficiaries of the Code's length and complexity, which provide fertile ground for the creativity of tax planners and provide camouflage that the Service's agents must pierce in order to determine that a particular product or transaction is in fact abusive. The latest generation of abusive tax transactions has been facilitated by the growth of financial products and structures whose own complexity and non-transparency have provided additional tools to allow those willing to design transactions intended to generate unwarranted tax benefits.

Second, abusive transactions that are used by corporations and individuals present formidable administrative challenges. The transactions themselves can be creative, complex and difficult to detect. Their creators are often extremely sophisticated, as are many of their users, who are often financially prepared and motivated to contest the Service's challenges.

Third, because of these factors, the Service will always face a variety of tax avoidance products and structures. Some will constitute abusive transactions and will merit Service challenge. Some will come close to that line but not go over it and will not merit enforcement. Still others will straddle the line and will have to be assessed on a product-by-product basis.

The Service will continually evaluate the initiatives and steps that we have taken and that we plan to undertake with respect to abusive tax transactions in light of

the foregoing factors. I expect our decisions going forward to be subject to the following standards.

First, our efforts must be balanced. We must present a real and credible risk of detection and audit for those considering selling or entering into abusive transactions. At the same time, however, we must not emphasize this to the detriment of other priorities.

Second, enhancements to the Service's compliance efforts must be matched by continued improvements in service to taxpayers. Service enhancements will benefit not only the taxpayers but also the Service itself. Better service to taxpayers results in better compliance. For those taxpayers who are the subject of Service compliance efforts, improved service can still result in mutual benefits. Decreasing audit-cycle times, for example, will benefit both the Service and taxpayers because both suffer when audit cycles are prolonged.

Third, we must continue our efforts to ensure that the right resources and tools are being applied to the right problems. This can be achieved through the careful identification of priorities and through the more efficient allocation of resources to meet those priorities. We must look for ways to use additional administrative guidance to decrease controversy if the controversy results from a lack of clear rules. This is important for taxpayers, and it is important for the Service because it allows resources to be focused on other priorities. We must look for ways to continue working with the Justice Department to ensure that the right types and volume of cases are being selected for litigation. Finally, to preserve the balance between compliance, service, and enforcement, we must continue to improve compliance through service initiatives.

Mr. Chairman, the IRS, the Treasury and Justice Departments and the Administration are firmly committed to curbing abusive tax transactions. They are an affront to honest taxpayers and practitioners and undermine confidence in the fairness of our tax system. The Congress and our taxpayers have every right to expect diligence, care and professionalism from the IRS in this effort, and I will do my utmost to see that those qualities are applied to our effort, without compromising taxpayer rights.

LEVERAGE

Faced in recent years with growth in the volume of abusive transactions, including abusive tax shelters, a discernible increase in the variety and non-transparency of financial products and transactions that could be vehicles for abusive tax shelters, and a disturbing decline in corporate conduct and governance, the IRS has undertaken efforts to enhance its response to abusive transactions.

An important criterion in the Service's selection of responses to this enforcement challenge is leverage. Leverage is desirable in order to obtain the maximum effect, relative to the Service's available resources, in ensuring compliance by collecting revenues owed by taxpayers to the Treasury from abusive transactions already in existence, and in influencing current and future taxpayer behavior with respect to abusive tax shelters.

The Service has selected, among the enforcement alternatives identified below, tools that provide good leverage. I believe that the leverage the Service gains from disclosure and other information gathering techniques and from targeting of promoters of tax shelters, including abusive transactions, is particularly effective.

EARLY IDENTIFICATION

Early identification of questionable transactions permits the IRS to gather information and issue guidance. Notifying the public of the IRS's position with respect to current transactions, coupled with a vigorous enforcement of the disclosure, registration and list maintenance requirements discussed below, deters taxpayers from playing the audit lottery and participating in abusive transactions.

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

Once the IRS finds out about a new potentially abusive transaction, the promptness of the Service's response is important. Prompt action, such as through the issuance of public guidance with respect to a new potentially abusive transaction, can be effective in limiting the spread of that shelter. Failure to identify and react to abusive transactions quickly, on the other hand, can allow the transaction to spread, for several reasons.

First, absent prompt challenges to these transactions, taxpayers may assume, incorrectly, that the IRS has tacitly approved the transaction or simply may not catch up with it. A "follow the crowd" mentality can set in. Other taxpayers begin to think that they might as well enter into aggressive transactions themselves. They may perceive a loss of opportunity or a competitive disadvantage if they do not enter into these aggressive transactions and little risk if they do. Indeed, when the IRS finally takes action to shut down the transaction, taxpayers and promoters may have moved on to the next generation of the abusive transaction.

Second, when the IRS is slow to uncover new potentially abusive transactions and loses the opportunity to react quickly to them because of delays in obtaining information about their existence, it must address more cases through audit and litigation. Litigation, for example, will always be necessary to demonstrate to taxpayers that the Service will hold them accountable when other methods have failed. Both audit and litigation are, however, slower processes than published guidance and hence less effective in containing the spread of new tax avoidance transactions.

We want to address the problem of abusive transactions at the front end, and we want to stay apace with the market, in order to retard and curtail their spread.

DISCLOSURE

In February 2003, the IRS issued final regulations under sections 6011, 6111 and 6112 to improve and enhance the disclosure of potentially abusive transactions by taxpayers, the registration of those transactions by “material advisors” (also sometimes known as “promoters”), and the maintenance of customer lists by those advisors. These regulations are designed to improve our information about potentially abusive transactions, about those promoters who market them and about those taxpayers who invest in them, by requiring taxpayers to disclose “reportable transactions” on their returns and to the OTSA, by requiring promoters to register their tax shelters with the IRS, and by requiring promoters and other persons to maintain lists of investors in their tax shelters and furnishing those lists to the IRS upon its request.

A reportable transaction may or may not be an abusive transaction. But by subjecting a range of transactions that should include most abusive transactions to a much greater likelihood of detection by the IRS, we believe these provisions shift the risk/reward calculus of entering into abusive transactions substantially in the government’s favor.

The number of disclosures received from taxpayers has been increasing significantly and we expect to receive more taxpayer disclosures in calendar year 2003 than in any previous year.

IRS RESPONSE TO DISCLOSED AND IDENTIFIED TRANSACTIONS

Early identification is only as valuable as the IRS response to the transactions that have been identified. To avoid the delays that had previously hampered our efforts, the IRS has launched efforts to ensure a coordinated approach and response as quickly as possible to questionable transactions once they are identified.

We believe that, once a transaction becomes listed, taxpayers are reluctant to enter into it. By deterring taxpayers, we save audit resources. In addition,

agents in the field know to focus on these transactions both in promoter and taxpayer audits, and we are better able to assure a coordinated response to these transactions, consistency across the country and fairness. We must identify these transactions more quickly, and I will be working with the IRS' Chief Counsel and Treasury to identify ways to do that. One idea I know Assistant Secretary Pam Olson has mentioned publicly is "yellow light" rulings – where we issue a public announcement that we are aware of and evaluating a transaction even though our analysis may not be complete. There are pros and cons to this idea, but this is an example of the type of idea that we should consider to advance our progress on this front. Signaling the Service's interest or focus can be appropriate even if our conclusion is not fully developed.

The Office of Chief Counsel and the Large and Mid-Size Business Division have implemented transaction-specific task forces to address tax shelters. The task forces are formed for specific transactions or a group of transactions, and include attorneys from the appropriate operating divisions of Chief Counsel, attorneys from the technical divisions of Chief Counsel, the Treasury Department and OTSA. In addition, revenue agents may be assigned to each task force.

Use of such task forces allows the Service to distinguish between sound and problematic transactions and to determine the kind of guidance appropriate to the transaction, and permits both follow-up on the transaction and prompt issuance of guidance. Decisions on whether to issue a notice alerting taxpayers that the IRS will challenge a transaction are made early and jointly with the Treasury Department.

Through improved disclosure and registration regimes, the Service intends to become aware of these transactions earlier, and to be able to address them closer to the start of their life cycle. The task forces will achieve consistency through the system. Furthermore, cross-checking of issues identified on audit with disclosure and registration will become easier. This increases the likelihood that taxpayers who have invested in questionable transactions will be identified and subject to examination.

GUIDANCE

The published guidance program is an important tool that the IRS can use to increase disclosure and compliance. The IRS has in recent years made significant progress in accelerating and increasing its issuance of published guidance and our intention is to continue to improve our performance in this area.

Informing taxpayers through published guidance that we are aware of abusive transactions and who has invested in them will discourage participation in them. And there is another side to the coin – a very positive one that is sometimes forgotten. Some transactions that are worthy of IRS scrutiny may nevertheless prove to be sound under the law. Our willingness to indicate transactions that

the Service believes are permitted under the tax law should encourage promoters and taxpayers to come to us with transactions that they believe are technically sound. In addition, through published guidance in non-shelter areas we can save audit resources that we can then devote to areas with higher risk of noncompliance.

I would like to point out that the Service made great strides in the area of public guidance under the tenure of B. John Williams, the IRS's former Chief Counsel, who left the IRS this summer. I would like to thank B. John for advancing the Service's performance in this key area and I intend to build on those advances.

FOCUS ON PROMOTERS

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

Initiatives focused on promoters can provide a number of benefits. Promoters are required to maintain investor lists that identify taxpayers who participate in or purchase tax shelters that are "reportable" or "listed" transactions under the Service's rules. Such shelters can be and sometimes are abusive. By auditing the promoters and obtaining investor lists and following up with audits of those investors, we can deter the promotion of as well as the thirst for such products.

The IRS has focused its attention in the area of tax shelters on accounting and law firms, among others. The IRS has focused on these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers.

Where the IRS believes a firm has failed to comply with the rules, the Service will not hesitate to audit, whether the firm is a prestigious and well-known organization or a lesser known firm. I believe that validation of the IRS' position in these actions will draw the attention of professional firms and prospective tax shelter purchasers alike.

Promoter Audits and Examinations

Examination and audit of promoters' compliance with the registration and list maintenance requirements of sections 6111 and 6112 are very important tools to combat abusive transactions.

The IRS conducts promoter examinations to determine whether a promoter has complied with regulations requiring identification of potentially abusive transactions by registering such transactions and maintaining and providing investor lists to the IRS upon request. As discussed further below, some promoters have cooperated by giving the IRS the information to which it is entitled; however, others have not.

The IRS has currently approved 112 entities for promoter examinations under sections 6111 and 6112, compared to 22 entities approved by December 2001. There are currently 94 active audits; 12 are approved but not yet started; and 6 examinations have been closed or discontinued. We have issued 305 summonses to 35 promoter entities. Promoters under examination include accounting firms, law firms, insurance companies, brokerage companies, banks and other boutique and mid-size promoters. The Tax Division of the Justice Department has filed summons enforcement actions against 6 promoters to date, and more enforcement actions are likely. We appreciate the strong actions of the Justice Department in this area.

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

COORDINATION OF IRS EFFORTS

I have asked our new Deputy Commissioner for Services and Enforcement, Mark Matthews, to assess our current structure and to assist me to prioritize enforcement initiatives and reengineer processes to enhance compliance with our tax laws, in particular with respect to tax shelters. As some of you may know, Mark comes to us with a distinguished record as a prosecutor, an IRS executive, and a private sector executive. I am also pleased to report that the Service has just recently enlisted John C. Klotsche, a former chairman of the international law firm of Baker & McKenzie, to join the IRS to help coordinate the agency's efforts to combat abusive transactions and improve enforcement processes. John will serve as Senior Advisor to me and will also work closely with Mark. Mark and John will target intra-agency coordination with respect to tax shelters as one of our priorities.

Mark's and John's efforts will build upon the efforts that have already taken place. These include OTSA, which the IRS established in February 2000. OTSA operates under the umbrella of the Large and Mid-Size Business (LMSB) Division. OTSA plans, centralizes and coordinates LMSB's tax shelter operations and collects, analyzes, and distributes within the IRS information about potentially abusive tax shelter activity. It plays a vital role supporting our frontline examiners. OTSA also maintains a Tax Shelter Hotline to which interested persons can submit information on abusive transactions by phone, e-mail, letter or fax.

COORDINATION WITH JUSTICE DEPARTMENT

We have developed a strong working relationship with the Department of Justice. Deputy Attorney General Larry Thompson provided a great deal of support during his tenure with the Department. I am very pleased with the efforts being provided by Eileen J. O'Connor, Assistant Attorney General of the Justice Department's Tax Division, and her staff, and I can testify that the Tax Division is partnering effectively with respect to abusive transactions. IRS Counsel meets regularly with the Department of Justice to assist in litigation of abusive tax avoidance cases and to provide a coordinated process on promoter cases. Counsel attorneys serve too on DOJ trial teams for selected abusive tax avoidance cases. In addition, Counsel regularly coordinates with DOJ regarding issuing and enforcing promoter summonses.

COORDINATION WITH THE STATES

The IRS recently entered into a nationwide partnership agreement with 40 state tax agencies and that of the District of Columbia to combat abusive tax avoidance. Under agreements with individual states, the IRS will exchange information about abusive transaction leads with participating states. This will allow the IRS and state agencies to avoid duplication and to piggyback on the results of each other's work. The states and the IRS will then share information on any resulting tax adjustments, reducing the need for duplicating lengthy taxpayer examinations by both a state and the IRS.

SIGNIFICANT RECENT IRS ACTIONS

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

Disclosure Initiative

The IRS continues to obtain benefits from its tax shelter compliance efforts as we evaluate information produced by the 120-day disclosure initiative that ended on April 23, 2002. The initiative provided taxpayers an opportunity to disclose questionable transactions to the IRS. Under the terms of the initiative, if taxpayers provided all relevant information about the disclosed transactions or items, the IRS would waive certain accuracy-related penalties that may apply to tax shelters and other questionable items that resulted in an underpayment of tax.

OTSA has recorded 1,689 disclosures from 1,206 taxpayers who disclosed their questionable transactions. These disclosures are assigned to field agents who

are contacting taxpayers to determine appropriate resolution of their various issues.

Importantly, the IRS is using the disclosures to identify tax shelter promoters. We are aggressively examining the activities of these promoters to determine whether they complied with their legal obligations to register certain shelters and maintain investor lists. Upon receipt of the investor lists from promoters, the IRS will be able to identify other taxpayers who participated in tax shelters and failed to disclose them.

Settlements

In November 2002, The Treasury Department and the IRS announced that taxpayers involved in three types of tax shelters would have limited times to accept IRS offers to resolve their tax issues. After the settlement periods ended, the IRS began pursuing the remaining cases through its usual compliance processes, including litigation when appropriate.

The settlement offers require taxpayers to pay significant amounts of tax, plus interest. Both the government and the taxpayers avoid expensive litigation on these issues. The specific settlements depend on the merits of each transaction and each case. The IRS will also consider whether penalties should apply where taxpayers did not previously disclose their abusive transactions.

Through this type of initiative, we can solve cases without months or years of costly litigation while making it clear to taxpayers who may consider participating in abusive tax shelters in the future that they will end up in a bad deal.

The IRS identified two of the shelters – known as the Section 302/318 basis shifting and the Section 351 contingent liability – as listed transactions in notices issued in 2001. The IRS has not previously offered any settlements related to these transactions. Participants in the basis shifting transaction had until December 3, 2002, to notify the IRS of their decision to take advantage of this settlement initiative. Those participating in the contingent liability transaction had until January 2, 2003, to apply for resolution of their tax liability under one of two settlement processes. Over 90% of the known participants applied for the 302/318 settlement and the IRS is working with taxpayers to enter into closing agreements to resolve these cases. Of 126 known participants in the 351 contingent liability shelter, 62 applied for resolution under the settlement process.

The third shelter – highly leveraged corporate-owned life insurance (COLI) – has been found to be abusive by the courts. Since August 2001, the IRS has offered those taxpayers with leveraged COLI plans a settlement in which they retain 20 percent of the claimed benefits. This offer is being discontinued because, after several court victories, it was considered appropriate to give taxpayers a deadline to decide whether to accept the offer or litigate. Taxpayers received

letters giving them 45 days to accept the offer before it ended. Twenty-five taxpayers participated in this resolution process.

Workpapers

To help the IRS shut down abusive transactions, the Service may now request tax accrual workpapers when we audit returns that claim a tax benefit from listed transactions.

This limited expansion of when the IRS will request tax accrual workpapers is critical to our ongoing effort to curb abusive tax avoidance transactions and to ensure compliance with the tax laws.

In all other cases, the IRS is continuing to apply its current policy of requesting tax accrual workpapers only when unusual circumstances warrant such a request. Tax accrual workpapers normally are prepared by taxpayers and their independent auditors to evaluate the taxpayer's tax reserves for financial accounting purposes.

KPMG/BDO Seidman

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

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

According to the court filings, KPMG has failed to provide all the documents the IRS had requested in connection with its probe into KPMG's compliance with these requirements and its potential liability for penalties. Although KPMG has produced many documents to the IRS, it has also withheld a substantial number of documents that the government has requested.

Similarly, the court papers filed in the case against BDO Seidman seek to obtain information concerning tax shelter transactions that the Government believes BDO Seidman has marketed. BDO denies that it has promoted any such transactions. This summer the Seventh Circuit upheld our right to obtain the investors' names.

Jenkins & Gilchrist

Earlier this year, the Department of Justice on behalf of the IRS petitioned the United States District Court, Northern District of Illinois, for enforcement of five

administrative summonses and a John Doe summons served on Jenkens & Gilchrist. The summonses ask the law firm to provide information on certain listed transactions or other potentially abusive transactions organized or sold by the firm's Chicago office and identify taxpayers who may have invested in them. This is the first case of its kind involving a law firm.

Grant Thornton

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

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

Ernst & Young

Finally, on July 2, 2003, the IRS announced a closing agreement with Ernst & Young, LLP, resolving issues relating to an examination of Ernst & Young's compliance with the registration and list maintenance requirements regarding the firm's marketing of tax shelters. The agreement requires Ernst & Young to make a non-deductible payment of \$15 million.

In addition to the payment, Ernst & Young agreed to work with the IRS to ensure ongoing compliance with the registration and list maintenance provisions of the Internal Revenue Code and regulations. To this end, Ernst & Young agreed to implement a Quality and Integrity Program to ensure the highest standards of practice and ongoing compliance with the law and regulations. The IRS may, upon its request, review documents prepared as part of this program.

Ernst & Young also agreed to our disclosure of its settlement and certain of the terms of the settlement. I mention this settlement last because I consider it important in spreading our message to other firms in the marketplace.

We are pleased that Ernst & Young has cooperated fully with the IRS in resolving these matters. This represents a real breakthrough and is a good working model for agreements with practitioners.

Differentiation in Approach

Mr. Chairman, looking at the big picture, we are trying to differentiate between those who cooperate with the IRS, who try to remedy past mistakes and who seek transparency in their dealings with the Service, and those others who

simply refuse and continue to peddle abusive transactions. Our intention is to differ in our approach to them based on their behavior.

I also hope that the marketplace will differentiate between those who provide legitimate tax planning advice and those who sell abusive transactions. We question whether most investors want to buy tax products from firms whose professional standards cross over the line.

GOING FORWARD

The challenges presented to the IRS by abusive transactions continue to call for a greater and more effective response from the Service, whether or not the future volume of abusive transactions were to decline. Given the complexity and size of the Code, opportunities to create abusive tax avoidance transactions will always exist. The growth in the use and variety of complex financial products and structures will provide more vehicles for the creation of tax shelters.

Given these factors, how should the Service respond?

First, we must do better with the existing tools at our disposal.

Second, we must consider what additional tools the Service and the Treasury can reasonably ask Congress to provide.

Third, we must weigh what others outside the Congress, the Treasury and the IRS can do to address this problem.

Using Existing IRS Tools

I discussed above the various initiatives and tools that the IRS already has used in trying to address the problem of abusive transactions. It is my responsibility as Commissioner to ensure that the Service uses these tools as effectively as possible. As I indicated above, it is also my responsibility to ensure that, in doing so, the Service does not compromise service, and that indeed service continues to improve.

I regard the areas in which the Service has the greatest potential for improvement in the fight against abusive transactions to be the following:

Prioritization. The Service needs to prioritize its audit focus and apply proportionately greater resources to areas where we believe there are, or where we expect to find, compliance issues. Advances have already been made in this regard by LMSB through the use of pre-filing agreements and limited issue focus examinations, and these efforts must continue and expand.

Transparency. The Service must continue to seek the prompt collection of information about abusive transactions, both actual and potential, through examinations, the registration rules of Sections 6011, 6111 and 6112 and third party contacts. We must then produce published guidance regarding those transactions quickly without compromising the quality of analysis.

Reduction of Audit Cycles. The Service needs to reduce the audit cycle time of corporate and other non-individual taxpayers. An audit duration of 5 years is too long. Audit issues, including those that might arise in connection with abusive tax shelters, often do not become clearer as they age, but rather less clear. Reduction in cycle time is also a worthy goal from a service standpoint. We also need to get more current with the marketplace; that is, audit returns as soon after they are filed as possible, and not 5 or 10 years later. This requires us to take a closer look at a number of alternatives in order to reduce audit cycles: encouraging greater use of electronic filing, reexamining and reengineering the audit process, and more effective use of technology, in particular.

Focus on Promoters. The focus on promoters to date has generated valuable gains to the Service's compliance efforts and shown the promise of generating even more gains. Particular tools that can be utilized with respect to promoters include audit and enforcement of the registration and list maintenance requirements under Sections 6111 and 6112 of the Code. The Service should continue to emphasize and increase this focus.

Increase Allocation of Resources to Enforcement. The IRS must allocate additional resources to enforcement. It must do so in a way that will not impede the continuing increase in the IRS' service levels. I have asked all the Divisions to take a hard look at this to enhance our enforcement performance without jeopardizing improvements in service.

Regulatory Changes. One step the IRS can take is to aim for clear and prompt guidance concerning potentially abusive transactions. The Service needs to answer the tough questions in published guidance before a transaction is entered into and not after an audit or through litigation. I have been advised both by responsible outsiders and by my own personnel that clear and prompt guidance can be an extraordinarily useful resource. It can serve to alert professionals and taxpayers that a transaction has, in the Service's view, crossed the line or merits particular attention from us. Such a message can significantly limit the spread of an abusive transaction, and this benefit is greater the earlier that guidance is issued. The Service also owes the professional and taxpayer communities guidance when the Service determines that a transaction does not cross the line and is in our view permissible under the law.

I am convinced that effective use of clear and prompt guidance will pay substantial dividends in the battle against abusive tax avoidance transactions. In

order to provide such guidance, of course, we must continue to make effective use of the disclosure, registration and list-maintenance requirements.

Obtaining Additional Tools

The Treasury Department has solicited support for a number of legislative proposals intended to curb abusive tax shelters. My colleague Pam Olson will discuss those proposals with you. We appreciate that these proposals have been included in legislation passed by the Committee. In addition, if we identify the need for additional legislation, we will work with the Treasury to bring those areas to the Committee's attention promptly.

Assistance from Outside the Government

Mr. Chairman, at my confirmation hearing last March, I stated that "attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention." Six months later, I believe as strongly as ever in that statement.

I do not believe that most tax professionals are personally engaged in the generation or promotion of abusive tax avoidance transactions. Indeed, I believe that most tax professionals have viewed the marketing of such transactions to taxpayers with dismay and alarm. Some have urged us to pursue promoters and investors in these transactions because they undermine the tax system.

Tax professionals who advise against abusive transactions can be criticized as being too conservative by their clients and potential clients and by the promoters who take business from such honest practitioners. These actions should instead be encouraged.

In that regard, we are working both inside and outside the Service to improve best practices among tax practitioners. On the regulatory side, Circular 230 establishes standards of ethical conduct required of professionals who practice before the IRS. The Treasury and the IRS believe that changes should be made to Circular 230, pursuant to our existing authority, to help curb abusive transactions. Among the subjects we are closely examining in this regard are the standards employed in legal opinions that are used by taxpayers in support of abusive transactions. I have asked Mark Matthews, the new Deputy Commissioner for Service and Enforcement, to make the strengthening of the Service's regulatory authority under Circular 230 one of his priorities.

The Service's Office of Professional Responsibility, which is charged with enhancing the oversight of tax professionals, also is working with associations of tax professionals in dealing with representatives who fail to meet the standards of professional conduct. Tax professional organizations are close working partners with the IRS and they understand the problems that result when members abuse

the tax system. The creation of this office is a direct result of the concerns of the professional organizations. Our goal is to encourage best practices that rise above minimum standards, and these organizations are well positioned and interested in bringing about such a change.

RESOURCES AND BALANCE

Mr. Chairman, concern has been expressed in some quarters that the IRS does not have the resources to deal with the problems that I have described. Clearly, we must provide *both* quality customer service and enforcement, based on a foundation of taxpayer rights, if we are to achieve compliance. There is no question that the IRS has poached resources from enforcement to boost customer service in the wake of RRA 98.

The difference now is that times and conditions have changed. The IRS is continuing to improve its service. Now, the IRS must bring the same focus and energy to improving its compliance efforts as it did to improving the service side.

Our sharpened focus must not come at the expense of taxpayer rights. Quite the contrary, our program will be built on a sound foundation of taxpayer rights.

We will not sacrifice quality standards in casework. We will not relax standards of professional conduct. We will not use statistics to evaluate employees. We will not establish quotas for personnel.

And we will not reduce our commitment to continued quality customer service. We can and must provide customer service and enforce the law. In other words, we can and must have balance. Enhanced compliance and improved customer service are not mutually exclusive. They are the two interlocking pieces that make up compliance. We must succeed at both to succeed in our larger mission.

CONCLUSION

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

We have begun to hear suggestions that the use of abusive transactions among some groups may already have begun to ebb. If this is true, we believe that IRS efforts may have played a significant role in this development. Some promoters and some taxpayers may be recognizing the increased risk of detection and audit of tax returns claiming tax benefits from abusive tax avoidance transactions. In

any event, it is my view that this problem is significant and will be continuing, and we need to increase our diligence and effort in this area

While we may have made some progress, far more needs to be done. We must continue and amplify our efforts, and use our resources more efficiently. I believe that if we continue to focus on the areas described in this testimony, the Service will be able to limit the corrosive effects of abusive transactions and increase trust in our tax system.

I would be very pleased to answer any questions the Committee might have.

Thank you.