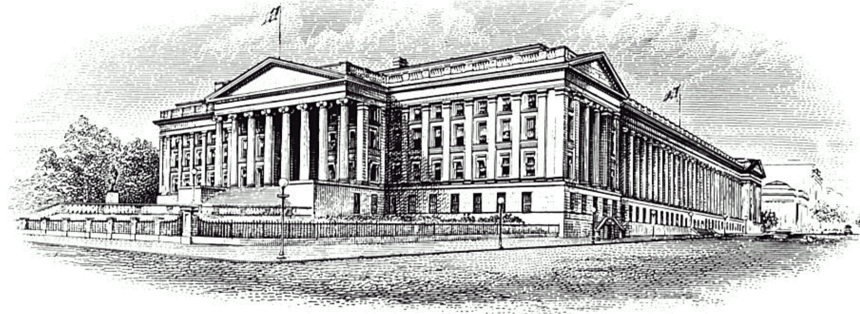

DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

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Statement of
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Committee on Finance
United States Senate

Mr. Chairman, Mr. Baucus and other members of the Committee, thank you for inviting the Treasury Department to testify today on abusive tax avoidance transactions. This Committee has taken a leading role in the public discussions about how to best address this important issue. Over the past year and a half, the Committee has passed a number of bills with provisions that would strengthen the Government's ability to combat these transactions. We appreciate the opportunities that we have had to work with the Committee on these matters. The Committee's support of the Treasury Department and the IRS' efforts sends a clear message to the American public that the Government is committed to ensuring that all taxpayers pay their fair share.

My testimony today is summarized by the following points:

- The complexity of the Internal Revenue Code has created opportunities for abuse; abusive transactions are but the symptom of a larger problem.
- Treasury and the IRS have taken appropriate and aggressive actions to address the abusive transaction problem, more than in any period in recent memory.
- Treasury has made a number of legislative proposals, including new broader disclosure requirements and enhanced penalties, and since worked with the Committee on additional proposals.

In March 2002, this Committee heard from the Treasury Department and IRS on plans to combat abusive transactions. The IRS spoke of the actions that already were underway. Looking forward, the Treasury Department described the need for transparency and certainty – that is, a web of rules, backed by meaningful penalties, that would reinforce each other by

requiring information reporting to the IRS about potentially questionable transactions both by the taxpayers participating in the transactions and by promoters.

The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions, issued in March 2002, described the legislative proposals and administrative actions needed to create this web. The Treasury Department and the IRS didn't wait for the enactment of the legislative proposals, but moved forward with all of the administrative actions described in the Enforcement Proposals, and almost all have been completed. These actions have been important steps in creating the transparency and certainty needed to combat abusive transactions. The legislative proposals would complete and reinforce the web by simplifying the disclosure rules and imposing meaningful penalties on taxpayers and promoters who fail to provide the IRS with requested information. We commend the Committee for including these important proposals in pending legislation, and we look forward to continuing to work with you and Congress to enact these proposals into law.

The right tools are needed to effectively address abusive tax avoidance transactions, but tools alone are not enough. The sophistication of the transactions, combined with the cultural laxity engendered among some taxpayers and promoters in the '90s made them possible. The combination has posed challenges to our efforts to bring taxpayers back into compliance. There is no silver bullet – legislative or administrative – that will rid the system of abusive transactions. We must continue to identify abusive transactions and discourage taxpayers from entering into these transactions in the future. The better we can become at rapid, upfront identification of transactions, the easier the task will be. Even so, the past eighteen months have taught us that persistence, creativity, and a willingness to try new approaches to problems is required.

Commissioner Mark W. Everson will describe the IRS' ongoing efforts to apply the right IRS resources and expertise to the problem as well as the steps being taken to resolve controversies concerning past transactions. These are significant and important steps towards bringing taxpayers back into compliance. I want to commend the IRS for its commitment to develop new processes and strategies for dealing with the challenges presented by abusive tax avoidance transactions. The effort has been marked by a high level of coordination and consultation among many of the organizations within the IRS, and with the Treasury Department, and this to continuing under the strong team of executives assembled by Commissioner Everson. The Treasury Department and the IRS also are working together to identify and evaluate potentially abusive transactions more quickly. In addition, the IRS is continuing its coordination with the Justice Department on promoter audits and cases in litigation involving abusive transactions. Over the past eighteen months, the IRS and the Justice Department have been vigorously pursuing promoters of abusive transactions, and the IRS has reached two significant settlements in this area. This progress is attributable to the joint efforts of these two agencies.

Our ability to better understand the scope of the problem facing us, and the progress of our efforts, depends on the information that will be provided under our new disclosure rules. For the most part, taxpayer disclosures under these rules will not be filed until 2004 when 2003 tax returns are filed. If our legislative proposal to conform the registration rules to the disclosure rules had already been enacted, however, we would have had an earlier indication of how the

rules are working. Nonetheless, the anecdotal information we have suggests that taxpayers and promoters are hearing the message that the Government is committed to identifying and addressing abusive tax avoidance transactions. We have seen some evidence, that taxpayers are taking their disclosure obligations seriously, even before non-disclosure penalties are enacted. None of this means that our job is done, but we are making progress. As a result, in large part, of the Committee's continued focus on this issue and support for our efforts, we believe that we now have a strong foundation for combating abusive transactions.

Our testimony today will highlight the actions we have taken since March 2002 to combat abusive tax avoidance transactions and the importance of the legislative proposals that have been passed by this Committee but not yet enacted into law. It also will emphasize that we must find ways of addressing the complexity of our tax laws. Complexity provides an opportunity and an excuse for engaging in abusive transactions. At the same time, we believe that sunshine on abusive transactions will reduce taxpayers' willingness to take a risk and positively affect attitudes towards tax compliance. We are looking for opportunities to replace a perceived headlong rush to the bottom by some tax advisors with a return to the best practices that should mark the tax profession. Failing at these tasks means the tax system will face in the future the same problems it faces today.

2002 Treasury Department Enforcement Proposals: A Status Report

In March 2002, the Treasury Department released its Enforcement Proposals for Abusive Tax Avoidance Transactions. The proposals, which include both legislative proposals and administrative actions, are designed to give the Treasury Department and the IRS the information needed to identify, evaluate and address abusive transactions before they proliferate. Since March 2002, we have become even more convinced of the importance of these proposals, and we look forward to working with the Committee to ensure that they all are implemented.

Legislative Proposals

This Committee has taken the lead in the effort to enact the legislative proposals set out in the Treasury Department's Enforcement Proposals. We are grateful for the priority that the Committee has given to these proposals. Our efforts to combat abusive tax avoidance transactions can be fully effective only if they are backed by legislation that creates fully consistent disclosure rules and imposes meaningful penalties for non-compliance.

Our goal is a single set of consistent rules for the disclosure of potentially questionable transactions by taxpayers and promoters. A single set of rules, without subjective exceptions, for all types of disclosure will make the law easier for taxpayers to apply and easier for the IRS to administer. More importantly, consistent rules will give the IRS multiple sources of information on potentially questionable transactions. Hiding a transaction with the hope that the IRS will not see it will become a risky course of action.

I will discuss shortly the actions that the Treasury Department and the IRS have taken to align the taxpayer disclosure and promoter list-maintenance rules. The rules for promoter registration, however, cannot be made consistent with these rules until legislation changing the

underlying statute is enacted. Once that legislation is enacted, potentially questionable transactions will have to be disclosed by taxpayers on returns and registered by promoters with the IRS. Based on the disclosure by either the taxpayer or the promoter, the IRS will have the ability to go to a promoter and obtain a list of all taxpayers who engaged in that type of transaction.

We continue to believe that the disclosure regime for potentially abusive transactions must be backed by meaningful penalties. For instance, as the Committee is aware, there is no penalty currently for a taxpayer's failure to disclose a reportable transaction. The Treasury Department has proposed penalties of up to $200,000 for such failures, regardless of whether the tax benefits of the transaction are ultimately sustained on the merits. If a listed transaction results in an underpayment of tax, the Treasury Department has proposed increases in the penalties that will apply to these underpayments if the transaction is not disclosed. In addition, the Treasury Department has proposed requiring the disclosure of these penalties in SEC filings in the case of corporate taxpayers.

Similarly, the existing penalties on promoters for the failure to register a transaction or the failure to maintain lists of participating taxpayers should be increased to meaningful levels. The Treasury Department has recommended legislation to increase the existing penalties for the failure to register a transaction and to impose an escalating time-based penalty for promoters who fail to turn over a list of participants requested by the IRS within a reasonable time period.

The Treasury Department also has proposed a number of other needed legislative changes. Some are administrative or procedural in nature and confirm the Government's ability to seek injunctions against promoters who disregard the disclosure rules and impose new penalties for taxpayers who fail to report foreign bank and other financial accounts. Other Treasury Department legislative proposals are substantive changes to the law that address abusive stripping transactions and the trading in foreign tax credits. Separately, the Administration's FY 2004 budget proposes to eliminate a non-corporate taxpayer's ability to use the federal practitioner privilege as a defense against providing the IRS with requested information about potentially abusive transactions.

The Treasury Department's legislative proposals primarily are intended to give the IRS the information needed to evaluate and, if appropriate, act upon potentially questionable transactions. If the Treasury Department and the IRS conclude that a transaction does not work under the existing technical tax rules, then we believe that it is our obligation to make sure that it is clear to taxpayers. In some cases, transactions may work under existing rules, but produce results that do not represent sound tax policy. In these situations, we will work with this Committee and Congress to make necessary changes to the statute.

We recognize that the Committee is concerned that the doctrine of economic substance may have been misapplied in the case of one type of abusive transaction. We share the Committee's concern that certain taxpayers and promoters may try to read too much into this caselaw to support positions that are without merit. We do not believe, however, that codifying this judicial doctrine will bring more certainty to the law, that it will deter those who are inclined to find economic substance and business purpose in virtually any transaction, or that it will

insure that the doctrine is considered in every situation where it should be considered. Moreover, a statutory rule will bring uncertainty for careful practitioners and taxpayers. The proposed codification is complicated. We believe it is likely, on balance to increase administrative burdens on the IRS. We believe that the judicial doctrines work best when they remain appropriately flexible doctrines and are applied to facts properly developed and presented. The IRS and Justice Department are working together to ensure that the Government's position in litigation, including on these judicial doctrines, reflects a coordinated approach that appropriately and effectively applies the doctrines.

Administrative Actions

The legislative proposals I have described will significantly enhance the Government's ability to combat abusive tax avoidance transactions. While we await those changes, we have been implementing the administrative actions set out in the Treasury Department's March 2002 proposals. These administrative actions focus on broadening and simplifying the rules for taxpayer disclosure and promoter list-maintenance, and we will apply these rules to promoter registration once necessary legislation is enacted.

Proposed disclosure and list-maintenance rules were issued in October 2002 and reissued as final rules in February 2003. Return disclosures under these new rules generally will not be filed until tax returns for 2003 are filed in 2004. These rules provide a single, integrated set of definitions for transactions subject to taxpayer disclosure and promoter list-maintenance and apply to individuals, partnerships, and trusts in addition to corporations. These rules will allow the IRS to move quickly from a taxpayer's disclosure to a promoter's list of investors to other taxpayers who engaged in the reportable transaction. They will create a more effective web that deters abusive tax avoidance transactions by increasing the certainty of IRS detection.

We have targeted for disclosure those categories of transactions with the potential for abuse. These include transactions that we have specifically identified as tax avoidance transactions (known as listed transactions), transactions that generate large tax losses, transactions that generate significant book-tax differences (such as a large tax benefit without a corresponding financial accounting cost), transactions with contractual protection, transactions marketed on a confidential basis, and transactions that result in tax credits even though the underlying assets are held for a brief period of time. These categories are based on indicia of potential abuse to avoid definitions that are so finely tailored that they are easy to avoid. We recognize that, as a consequence, these rules will result in the disclosure of legitimate transactions, and we continue to work with taxpayers and practitioners to ensure that these rules appropriately target potentially questionable transactions. For instance, we expect to issue shortly guidance that will refine the definition of a confidential transaction that must be disclosed. This guidance will reduce the number of disclosures that taxpayers will have to make solely on account of the confidentiality of some part of the subject matter. As we make these and perhaps other changes, simplicity and clarity will remain our guiding principles.

Our new disclosure and list-maintenance rules deliberately cast a broader net than the previous rules. The old rules were being parsed in a way such that many taxpayers and tax advisors convinced themselves that they were not required to make disclosures. Moreover,

abusive transactions clearly have moved beyond corporate taxpayers. In June 2002, we partially extended the disclosure requirements to partnerships, S corporations, trusts, and individuals. When our final disclosure and list-maintenance rules were issued in February 2003, they fully covered these types of taxpayers. In addition, the final list-maintenance rules provide clear rules for identifying persons who are required to maintain customer-lists. Persons who provide tax advice and receive significant fees from a potentially abusive transaction should and will be expected to maintain a list of participants in that transaction. The accounting, legal, and financial services industries are now aware that they have these obligations, and that the IRS is entitled to this information if requested.

The Treasury Department and the IRS are currently working to complete two important administrative actions from the March 2002 Enforcement Proposals. We are working to finalize proposed regulations issued in December 2002 that will preclude a taxpayer from relying on a favorable tax opinion as a defense to the imposition of the accuracy-related penalties if the taxpayer does not disclose a reportable transaction or does not disclose a return position based on the invalidity of a regulation. We also are in the process of preparing further guidance under Circular 230 on standards for tax opinions. Taxpayers rely on opinions for assurance that transactions are proper and will not be subject to penalties, and Treasury and the IRS believe that tax opinions used for this purpose should satisfy standards that represent best practices.

In addition to completing the administrative actions set out in the March 2002 Enforcement Proposals, we are evaluating a number of other possible actions that may bring potentially significant benefits to tax administration. We are working, for instance, on possible revisions to Schedule M-1 of the corporate income tax return to increase the schedule's usefulness to the IRS. Schedule M-1 requires taxpayers to identify book-tax differences. It has not been updated for almost 40 years. We are concerned that the current version of this schedule simply fails to provide the IRS with the information on book-tax differences that highlight issues to which the IRS should devote resources. We are examining ways that the Schedule M-1 might be revised to highlight those book-tax differences that matter the most in an examination of a taxpayer, such as permanent book-tax differences that are more likely to arise from aggressive tax planning. As we move forward, we will work with affected taxpayers to ensure that any changes are manageable for them while meeting our objectives. More broadly, we are exploring ways in which specific areas of tax accounting and financial accounting could be more closely aligned without compromising the policy objectives behind these systems. We are early in the process and look forward to working with the Committee and the Securities and Exchange Commission in this effort.

We also are working with the IRS to explore ways in which its forms can better convey needed information and computer systems can better process data. While the IRS has a tremendous amount of information available to it, existing systems limitations prevent the IRS from fully utilizing this data. Some abusive transactions, for instance, are designed specifically to take advantage of the IRS' current inability to readily access, match, and evaluate all of the information it collects. As a related matter, the Treasury Department and the IRS are continuing efforts to increase the use of electronic filing by corporations and other business entities.

Measuring Compliance

We share the Committee's longstanding interest in better understanding the extent of the problem created by abusive tax avoidance transactions and the ways in which we can measure our progress. In response to questions from the Committee following its March 2002 hearing, we stated that without fuller disclosure, it is difficult for the Treasury Department and the IRS to assess the number of corporations that are engaging in potentially abusive transactions. Rules that will give us that information went into effect in January 2003. Return disclosures under these new regulations, however, will not be filed until next year. While it is too early to assess the scope of the problem, there clearly is much to do in the meantime.

The Treasury Department is committed to supporting a robust compliance research agenda. With the support of this Committee, the first phase of the National Research Program (NRP), a study of individual income tax returns, is well underway. As you know, the NRP is the first broad-based compliance study conducted by the IRS in well over a decade. This study will cover individual taxpayers of all types and from all income levels and will provide valuable information about the extent of voluntary compliance and the nature of compliance problems. The Treasury Department and IRS are now working on plans for the next phases of the NRP, which will cover the business sector. In addition, the IRS is pursuing other research directed at shedding light on particular compliance problems and appropriate solutions.

Looking Forward: Simplification and Compliance

There is a temptation, in discussing the problem of abusive tax avoidance transactions, to focus on the immediate tasks of identifying and addressing abusive transactions that already have occurred and discouraging taxpayers from entering into these transactions in the future. Those are, without question, important and necessary tasks. The Government's answer to abusive transactions, however, cannot be solely an ongoing struggle with the promoters of abusive transactions and the taxpayers who decide to enter into them. If we are to put the problem of abusive transactions behind us, we must address the pervasive complexity of the tax code. Many abusive tax avoidance transactions are designed to take advantage of this incredible complexity to obtain benefits that Congress never intended. The tax code's complexity effectively aids and abets those who seek to improperly reduce their taxes. We are increasing the stakes for taxpayers who enter into abusive transactions and their promoters through the actions we have taken. So long as the complexity remains, however, the risk we face is that the problem we eliminate in one area will simply reemerge somewhere else. We may expect that promoters will continue to mine this complexity to develop and market abusive transactions.

The problem created by complexity is not limited to perceived opportunities for abusive transactions. Complexity imposes costs on both taxpayers and the Government not directly related to abusive transactions. For taxpayers, the cost is the enormous effort required to comply with the law. Many taxpayers must seek professional tax assistance just to understand the law. For the Government, complexity makes it more costly for the IRS to administer the tax system. The Treasury Department and the IRS must write rules to administer complex tax laws, and the IRS must expend resources to administer these laws, including everything from taxpayer assistance to audits of returns. Ultimately, these are resources that the IRS cannot use for other priorities such as efforts to stem abusive transactions.

This Administration has made tax simplification an important priority. Achieving tax simplification is difficult because existing complexity often is a result of well-intended efforts to achieve important policy goals without impacting other policy objectives. In some cases, simplification can be achieved in a manner that can serve all existing policy objectives equally well or even better. In many cases, however, simplification will result in some compromise of other policy objectives. For example, a simpler rule that is easier for taxpayers to apply and easier for the IRS to administer may result in a less precise targeting of a tax benefit. Finding the right balance will not be easy.

The Administration has developed objectives to guide its development of simplification proposals. We focus on reducing the burden of the tax laws on the IRS and on taxpayers, with the intended results of increased voluntary compliance, reduced controversy and reduced distortions caused by the tax laws on business and economic decisions. We believe that simplification proposals meeting these objectives will be good for our tax system and our economy, and we look forward to working with the Committee on what we know is a mutual interest.

Similarly, taxpayers and practitioners must be willing to re-evaluate how they view the tax system and their willingness to abide by the highest standards. Our tax laws are replete with prohibitions, sanctions, and rules of conduct, and these apply both to taxpayers and practitioners. We are examining these rules, particularly with respect to practitioners, to see whether they are fully serving their purpose. Where they are not, we will propose changes. In doing so, we must be mindful of the tendency of rules to establish minimally acceptable conduct and to result in a focus on what practitioners can get away with. We believe the nation and our tax system would be better served by practitioners who aspire to do what is right and adhere to best practices. We have begun discussions with professional associations to see how we might work together to reinforce our mutual interest in protecting society's confidence in the tax system. We are optimistic that we can help tax professionals understand the importance of doing more than satisfying a minimum code of conduct.

Conclusion

In conclusion, our ability to address abusive tax avoidance transactions is part of the larger struggle to preserve the integrity of our self-assessment tax system. Success will require both short-term and long-term efforts. In the short-term, we must put into place the rules and systems necessary to identify and respond to abusive transactions as they occur, and not years after the fact. The administrative actions we have taken are important steps, and the Treasury Department's legislative proposals will allow us to complete the web of information that will bring these abusive transactions out of the shadows. The Treasury Department, the IRS and the Justice Department have been and will continue to work together to address this problem.

In the long-term, a continual battle to root out abusive tax avoidance transactions, without more, will impose significant costs on both taxpayers and the Government. We must begin addressing underlying causes. We should close loopholes as we identify them, ensure statutory provisions produce tax results consistent with the underlying economics, and simplify the rules

wherever possible. We must support the adoption of best practices. These prescriptions are not easy; we believe, however, that they will bring about the increased respect for our tax system that is essential to our self-assessment system.

Thank you again, Mr. Chairman, for the opportunity to speak today. The Treasury Department looks forward to working with this Committee on the important task before us. I would be happy to answer any questions the Committee may have.

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