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BRIDGING THE TAX GAP

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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BRIDGING THE TAX GAP

WEDNESDAY, JULY 21, 2004

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

The hearing was convened, pursuant to notice, at 10:40 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Thomas, Baucus, Conrad, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

This hearing is to consider what still is a very serious subject: the tax gap and ways to close the tax gap.

As members of the Finance Committee know, that gap is the difference between the amount of tax due and owing versus the amount actually collected.

Due to a number of factors, especially the war and increased spending, our Nation is looking at deficits. At the same time, the administration and many in Congress do not want to increase the tax burden on the vast majority of honest citizens who pay their fair share of taxes.

Therefore, we must look at ways of dealing with the tax gap to bring revenues to the Treasury and fairness to the Tax Code.

This is even more important as we look to the fall, where we will hopefully have conferences concluding on several issues, each of them with a significant demand for possible new revenue raisers.

In addressing the problem of the tax gap, we have to recognize that we have finite resources and that we are not going to place a heavy burden on honest taxpayers. We must retain the balance, and a proper balance, of service and enforcement, coupled with the respective taxpayers' rights. To achieve that, it is clear that we have to work smarter and more efficiently. We have to target limited resources where they do the most good.

This hearing provides the Finance Committee that opportunity to consider both what the IRS is doing to address the tax gap, and also learn about new ideas and innovations that are being implemented, or could be implemented, at the State level that are being proposed by witnesses today.

I now turn to one of the most consistent members of the committee on this issue of tax gaps because he has spoken out on it so many times, particularly as he questions people who are being

appointed to the Treasury Department and the IRS, Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I appreciate your holding this hearing. As always, you are persistent and do not let a little thing like an evacuation get in the way here, and I deeply appreciate it.

One of the strongest features of our democracy is our system of collecting income taxes through individual self-assessment. President Franklin D. Roosevelt referred to this point, and I am going to quote him.

He said, "In 1776, the fight was for democracy and taxation. In 1936, that is still the fight. Taxes, after all, are the dues that we pay for the privileges of membership in organized society. As society becomes more civilized, a government is called on to assume more obligations to its citizens.

The privileges of membership in a civilized society have vastly increased in modern times, and I am afraid we have many who still do not recognize their advantages. They want to avoid paying their dues."

I think those words remain as true today as they were in 1936. It is easy, of course, to bash the Federal Government. It is easy to bash the IRS. It is easy to bash. That is why it is important for public officials, I think, to take the high road and remind taxpayers of why we pay taxes.

There is a reason. The easy way is to be critical and say that that is taxpayers' money, and it is, and that the IRS is being very abusive in trying to collect taxes, and sometimes it is abusive.

But the main point is, we have got to strike a balance here. We do pay dues for civilized society, and at the same time we want an IRS that is efficient and fair.

After all, people are the employers, and the IRS, as well as us here in this committee, are the employees, and as we are here to serve people, we just have to help make sure the service is the best as it can possibly be.

The dues we pay for privileges of membership in civilized society provide many benefits. For example, education for our children, police and fire protection, safe and efficient highways.

Our Nation's parks are available for not only ourselves, but for generations to come. The elderly through Medicare, and Social Security, for example. They help take care, as I said earlier, of our children.

It does not mean that taxpayers should pay more than they owe. As stated by the great jurist, Learned Hand, "If anyone may arrange his affairs so that his taxes shall be as low as possible, he is not bound to choose the pattern which best pays the Treasury." There is clearly a balance that we must strike, and unfortunately we are now not in that balance.

Over the past 3 years, we in the United States have been on a destructive fiscal path, as we all know. As a result, our Federal budget has gone from the largest surplus in our Nation's history

to the largest deficit in our Nation's history. This year's deficit will likely top $400 billion.

But if that sea of red ink is not bad enough, it is even more disturbing when you consider that a growing percentage of Americans do not believe that paying taxes is their civic duty.

In 1999, 81 percent of Americans agreed that it is their civic duty to pay taxes. In 2002, just a few years later, only 72 percent, a decline of almost 10 percent, agreed with that statement. Last year, the group fell to just 68 percent of the population. Obviously, a disturbing trend.

But it is also very clear that more people believe that cheating is acceptable. This mind-set undermines our Nation's democracy. While honest Americans are doing their part, a number of others are trying to get by without doing theirs, and that is what this hearing about.

Some call it the tax gap, the difference between the amount of the taxes that taxpayers owe the government and the amount of taxes that taxpayers voluntarily and timely pay.

This is not about raising taxes, it is about enforcing tax laws on the books. This is about collecting the taxes that are owed, especially to the Treasury, under the existing Code.

The IRS Office of Research estimates a gross tax gap of $300 billion for taxable year 2001, and only about $55 billion of this will ever be recouped, in part because the IRS does not currently have the resources to ensure that everyone pays what they owe, leaving a net tax gap of $245 billion.

Those figures are based on the IRS's current estimate of an overall taxpayer noncompliance rate of 15 percent. Playing this out, if we have just a 1 percentage point swing in voluntary compliance, we could change revenues and reduce the deficit each year by more than $20 billion.

Moreover, the tax gap exacerbates the long-run imbalance of the Social Security Trust Fund. In 2001, sole proprietors under-reported their income by amounts that reduced Social Security payroll taxes by about $40 billion.

The Social Security actuary tells us that if we could reduce this tax gap by even 20 percent, we could reduce the 25-year actuarial imbalance of Social Security by over 5 percent. This would push back the date that the Social Security Trust Fund exhausts by 1 year, and this would help stave off an increase in payroll taxes or a cut in benefits.

In the same vein, the Medicare actuary tells us that Medicare's 75-year actuarial imbalance would be reduced by almost 3 percent, and its exhaustion date would be pushed back 1 year, from 2019 to 2020.

It is just common sense for us to set a goal, a benchmark of where we should be on tax compliance. In April, I proposed that we shoot for at least a 90 percent tax compliance rate by the end of the decade. That means that by 2010, at least 90 percent of Americans will be filing their taxes and paying their dues. I do not think that is too much to ask.

As we face a Federal deficit of over $400 billion, the government has got to do a better job and we need a plan. Any organization worth its salt has a plan, has dates, has names of people respon-

sible and has data estimates and benchmarks. I do not think the IRS has that, astoundingly. At least, I am not aware of it.

I have pushed very, very hard for names, data, and dates, just a good old business plan. We need a plan, and we do not have a plan that I am aware of. I hope this hearing will show that we are at least beginning to get a plan and some dates, and some end points so we can get a better handle on this problem.

As we face a Federal deficit of over $400 billion, the government has just got to do better. I am also concerned that the IRS does not have the resources it needs to enforce the tax laws.

The IRS's fiscal year 2005 budget request does not account for mandatory pay raises, unbudgeted mandatory expenses such as rent increases and postage, and the inability of the IRS to achieve its projected savings from internal productivity growth.

Just last week, the House Appropriations Subcommittee on Transportation, Treasury, and Independent Agencies reduced the administration's budget request for the IRS, incredibly, by $382 million.

I am concerned that the IRS will not have adequate funding to increase enforcement initiatives and maintain its taxpayer service at the same time. At some point, the IRS could no longer do more with less, and I believe we have reached that point.

It is not just a question of resources, though. We need to ensure that the IRS modernizes the computer systems and improves its research so that it operates smarter and more efficiently.

We must also pass, and have on the President's desk for signature, tax shelter, Enron-related corporate governance and simplification legislation that the Senate has passed many times.

Not only will that help reduce the gap, but it sends a very strong signal to the world and to the community that we are serious about closing loopholes and the Congress is serious about addressing this problem. The failure to enact that legislation, I believe, also sends an equally strong signal in the wrong direction that we are not serious.

There is clearly no silver bullet to close this tax gap. Nevertheless, increasing IRS resources, ensuring a smarter, more efficient, more responsive IRS and a more cooperative Congress, working together, will go a long way toward closing the gap. I very much hope that this hearing marks a signal date and event where we are finally beginning to do something about it.

Thank you, Mr. Chairman.

The CHAIRMAN. You bet.

Our first witness is Mr. Ray Wagner, member of the IRS Oversight Board, and chairs the Board's Human Capital Committee; then Mr. Michael Brostek, Director of Strategic Issues, Government Accountability Office; Pamela Gardiner, Acting Inspector General, Tax Administration, Treasury; Mr. Joseph Bankman, Professor of Law and Business at Stanford Law School; and Mr. Dale Brown, a taxpayer who is awaiting sentencing for his participation in an offshore tax shelter. Then we have an anonymous witness, confidential, we are going to refer to as Mr. ABC.

All of you will have your total longer statement placed in the record. Because of getting started late, it is all the more important that we stay to five minutes, if you can.

I do not want to cut somebody off in the middle of a sentence or a thought, but if you can complete the thought you are on when the red light goes on, we would appreciate it very much.

Mr. Wagner?

STATEMENT OF HON. RAYMOND T. WAGNER, JR., MEMBER, IRS OVERSIGHT BOARD, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. WAGNER. Thank you, Mr. Chairman, Senator Baucus, members of the committee. Thank you for the opportunity to present the Oversight Board's view on the tax gap.

As you know, the tax gap is most recently estimated to be approximately $311 billion. However, that figure is based on data and models more than 15 years old. Given the sea change of taxpayer demographics and behavior since then, the tax gap could be much higher. For example, from 1990 to 2001, the number of individual taxpayers with the adjusted gross incomes over $1 million grew by 215 percent.

At the same time, the Tax Code is more complex and more readily exploited. We have seen a flood of abusive tax avoidance schemes and an erosion of both taxpayer attitudes towards compliance and professional standards. All of these contribute to the national disgrace we call the tax gap.

The tax gap is not just a statistic. Its consequences are all too real and unjust. Honest taxpayers must bear the financial burden of those who do not pay what they owe. Further, we need the extra revenues that closing the tax gap would provide. The tax gap undermines confidence in the fairness of our tax administration system and fuels noncompliance.

Mr. Chairman, the tax gap was not created overnight, nor can it be solved in a single year. It can be attacked, however, by following a multi-year strategic plan offered by the board today.

I will discuss the four complementary parts. First, the board must improve the IRS effectiveness. The board recently approved the IRS's new 5-year strategic plan. Its major theme is service plus enforcement equals compliance.

The board fully endorses this approach and believes that the IRS can achieve the goals that this theme represents through its people, processes, and technology. Commissioner Everson will present a description of this plan, I am sure.

However, I will touch upon the Business Systems Modernization component for a moment. The board has been deeply concerned at the pattern of delays and cost overruns that have plagued the BSN program from its inception.

We applaud the Commissioner's efforts to bring discipline and accountability to BSN, and his actions closely track with the board and others that recommended to get it back on track. Clearly, we cannot allow Business Systems Modernization to fail if we are to address the tax gap appropriately.

The second component of our plan is to provide appropriate additional resources. The board believes that funding for our tax system should be strengthened, not merely maintained at current levels.

In a special report on the IRS 2005 budget, the board argued for reinvesting in the IRS and called for a pragmatic budget that reflects the complex world in which the IRS must operate.

We also need to reevaluate the criteria used to appropriate funding to the IRS to take into account the return on investment realized from the application of additional funding. The IRS is outmanned and outgunned when it comes to enforcing tax laws.

Unscrupulous tax professionals exploit this weakness. We have gotten to the sad point where you can drive an armored car through the tax gap because the IRS does not have the resources to go after known tax cheating.

The numbers speak for themselves. In 2002, the IRS was able to pursue only 18 percent of the known cases of abusive shelters, leaving an estimated $447 million on the table. There is only one chance in four that the IRS will go after someone who does not file a return. I could go on and on.

Mr. Chairman, the IRS is not turning a blind eye toward tax cheating, but we would be blind not to recognize that it cannot do its job without the necessary funding.

The third component of the plan is to measure results. The national research program will provide a solid estimate of voluntary compliance. The NRP will provide accurate baseline measurements from which the IRS can begin to set long-term goals or tax system compliance to help close the tax gap.

Establishing long-term goals can be a very powerful tool in energizing the organization. Take e-filing, for example. Although the 80 percent goal may not be fully realized by 2007, its positive impact has been undeniable.

Long-term compliance goals can similarly energize the IRS and the tax community to work to close the tax gap. Recently, Senator Baucus, as you alluded and mentioned, you proposed that the IRS raise voluntary compliance to 90 percent by the year 2010.

We applaud the spirit of this proposal and we will need to exercise caution in setting that specific numeric goal until we know what voluntary compliance is today.

The fourth, and final, component of the plan is to simplify the tax administration system. The costly, confusing and debilitating complexity of the Tax Code directly feeds the tax gap.

Rather than tinkering at the margins, the board strongly encourages Congress and the administration to explore fundamental ways to simplify our Tax Code, thereby easing the enormous burden and cost of administration for the IRS and taxpayers alike.

Mr. Chairman, in conclusion, the tax gap is an affront to all honest taxpayers. It saps our Nation of precious resources when it needs them most. It is an enormous problem, but in time it can be solved through the strategic approach I have outlined today.

However, the IRS cannot do it alone. This is a shared responsibility. The ultimate success in closing the tax gap rests in all of our hands.

Thank you.

The CHAIRMAN. Thank you for your testimony.

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

The CHAIRMAN. Now we go to Mr. Brostek.

STATEMENT OF MIKE BROSTEK, DIRECTOR, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Mr. Chairman, Senator Baucus, and members of the committee, I am pleased to participate in today's hearing.

In addressing the tax gap, IRS uses many strategies, including obtaining corroborating information from others and analyzing data from taxpayers themselves. Just as IRS sometimes obtains corroborating information, some Federal agencies obtain tax data from IRS to use in ensuring that benefits are properly awarded to applicants.

Related to obtaining corroborating information from others, my testimony covers the extent to which IRS and Citizenship and Immigration Services within the Department of Homeland Security share data.

Related to analyzing information obtained from taxpayers, my testimony provides information on the characteristics of taxpayers that came forward under IRS's offshore voluntary compliance initiative.

Currently, IRS and CIS do not share data. IRS may benefit from using immigration information to select taxpayers that appear to be non-compliant and follow them up with enforcement actions. For example, IRS could benefit if CIS data helped to identify taxpayers who failed to file returns or who under-report their income.

Regarding non-filing, we found that from 1997 through 2004, about 20,000 businesses and organizations nationwide applying to sponsor immigrant workers were unknown to IRS. They were not in any of their data systems.

For under-reporting, we found 10 organizations in a small sample of immigration applications that reported, as a group, over half a million dollars more income to CIS than to IRS.

Although we do not know whether these businesses reported accurately to either CIS or IRS, discrepancies like these can help IRS select firms and individuals for enforcement.

IRS may also benefit if immigration applicants were required to be current on their tax obligations before applying for immigration benefits, because in that case taxpayers would need to come to IRS to have their tax issues resolved.

Regarding the number of potentially non-compliant taxpayers who might come to IRS under such a rule, we found, for instance, that about 19,000 businesses nationwide—again, from 1997 through 2004—had unpaid tax assessments at the time that they applied to sponsor immigrants, with total assessments totaling $5.6 billion as of December, 2003.

CIS may also benefit from IRS's information. IRS data may help CIS officials identify those businesses and organizations that may not be able to pay wages or may not be legitimate businesses when they apply to sponsor immigrant workers, two factors relevant to decisions on immigration eligibility.

As shown in the chart, we found about 68,000 businesses and organizations nationwide had not filed one or more tax returns at the time they applied to sponsor an immigrant worker. In addition, about 20,000 were unknown to IRS.

Especially for smaller businesses, failure to file a return may indicate that a business is struggling financially and cannot support the workers it is attempting to bring into the country.

Although they may benefit from sharing data, CIS and IRS face challenges. For example, CIS does not automate financial data, such as an applicant's income, and the agencies use different tracking numbers.

In addition, the Tax Code does not authorize IRS to disclose taxpayer information for immigration eligibility decision making. CIS would need to see a change to the Code or seek tax applicants' consent for CIS to obtain their tax data directly from the IRS.

Because of the confidentiality of tax data being considered crucial to voluntary compliance, executive branch policy calls for a business case to be made before data sharing occurs. We are recommending that IRS and CIS assess benefits and costs of data sharing.

The Offshore Voluntary Compliance Initiative attempted to bring taxpayers with funds held offshore back into compliance, while gathering information about them and offshore promoters.

Eight hundred and sixty-one taxpayers came forward and IRS officials said they gathered more than $200 million. Taxpayers who applied had incomes ranging from well over $500,000 to substantial net losses.

They lived, as the chart shows here, in 47 States, but with over half the applicants being in just 5 States. They reported over 200 occupations. Some appeared to be intentionally noncompliant and others appeared to have unintentionally fallen into noncompliance.

More than half of the OVCI applicants had complied with their tax obligations and paid their taxes, even on their offshore income, but they had failed to file a Report of Foreign Bank and Financial Accounts, as required by Treasury. Less than 16 percent said they used a promoter.

Given this diversity, multiple compliance strategies may be needed. Because additional tax, interest and penalties collected to date from OVCI applicants who owed tax was a median of only $5,400, personnel-intensive investigations of individual taxpayers who have hidden money offshore may not be very cost-effective.

This puts a premium on IRS developing a means to identify those cases that should be subjected to such investigations and, if possible, alternative compliance strategies for the rest.

This concludes my statement. I would be happy to answer questions.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Ms. Gardiner?

STATEMENT OF PAMELA J. GARDINER, ACTING INSPECTOR GENERAL, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WASHINGTON, DC

Ms. GARDINER. Chairman Grassley, Ranking Member Baucus, and distinguished members of the committee, I appreciate the opportunity to appear before you today to discuss the tax gap prob-

lem, what the Internal Revenue Service is doing to address it, and additional actions that could be taken.

In the past, the prevailing view was that the tax gap was primarily composed of unreported and delinquent taxes from the underground economy. For example, self-employed contractors were suspected of failing to report and pay taxes on the cash payments they received.

However, it has become apparent that, in addition to the problems with tax reporting and payment in those areas, there has been an ever-increasing problem with compliance by corporations and individuals, both domestically and abroad.

The legal and accounting professions have also been identified as contributing to the overall tax gap problem by promoting illegal or questionable tax avoidance schemes.

Additionally, the increased globalization of our economy provides opportunities for corporations and individuals to avoid taxes using tools available in the worldwide marketplace.

These recent increases in participation in tax avoidance schemes and the promotion of them by highly respected firms has evidently fueled a more cavalier attitude toward the tax system among the general population.

Survey results recently released by the IRS Oversight Board indicated that the percentage of people who believe it is acceptable to cheat on their taxes has grown from 11 to 17 percent from 1999 to 2003.

Although the tax gap appears to be growing, no one really knows its true size. The IRS estimates the annual gross tax gap increase from $283 billion in tax year 1998 to $311 billion in 2001. However, IRS would readily admit that this figure is based on outdated information and conservative assumptions, and it may be considerably higher.

Nevertheless, the IRS is making some progress in addressing certain components of the tax gap. For example, in fiscal year 2003, enforcement revenue collected increased by 10 percent after remaining fairly constant during the prior 3 years. In addition, after steadily rising for 6 years, the gross accounts receivable declined in fiscal year 2003.

The IRS is focusing considerable effort on combatting tax shelters. As part of its efforts, the IRS is expanding its partnership with State tax agencies to pursue abusive tax transactions and address other criminal activity.

The IRS has also begun addressing taxpayers' attempts to avoid taxes through the use of offshore techniques, but the results here have been mixed. Although millions in additional assessments have been made, over half of the cases have been closed without any additional assessment.

All in all, we continue to be concerned that the IRS cannot be sure it is deploying its critical compliance resources to most effectively address the latest tax avoidance schemes because its compliance strategy is based on 16-year-old data.

In recent years, TIGTA has made recommendations that address various components of compliance and could supplement the IRS's overall strategy to address the tax gap.

Because noncompliance in the self-employed population remains a significant component of the tax gap, TIGTA maintains that implementing a provision to mandate withholding on non-employee compensation could reduce the tax gap by billions of dollars.

Additionally, various actions could be taken to improve compliance with estimated tax payments such as legislative changes to require monthly payments, and increased promotion of electronic payments. A comprehensive matching program for business tax documents could also identify significant pockets of noncompliance.

Further actions are also needed to ensure compliance among partnerships with foreign partners. Various studies have confirmed the connection between higher examination rates and better rates of voluntary compliance, even beyond that of the individuals audited.

Increasing staffing in the enforcement functions is a necessary component of improving both examination rates and the collection of taxes assessed. The combined collection and examination functions of enforcement staffing has declined from 25,000 at the beginning of fiscal year 1996 to 16,000 at the end of 2003.

Activities of the IRS's Criminal Investigation Organization also have a strong measurable impact on voluntary compliance. However, as TIGTA noted in the report earlier this year, improvements are needed to ensure convicted criminals comply with the terms that were imposed as part of their sentence.

In closing, I would like to reiterate that the IRS has numerous significant efforts under way to address the various components of the tax gap. However, it is particularly critical that the IRS continue to obtain updated information to enable it to revise the compliance data models.

It needs to make more accurate forecasts of the extent of noncompliance and ensure it uses its limited resources in the most effective manner. TIGTA has recommended more actions which, if taken, could assist the IRS's efforts.

Finally, it is important to remember that the complexity of the Tax Code affects both the compliance of the general population and the ability of the IRS to identify and take action on noncompliance.

This concludes my statement.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Now, Professor Bankman?

STATEMENT OF JOSEPH BANKMAN, RALPH M. PARSONS PROFESSOR OF LAW AND BUSINESS, STANFORD LAW SCHOOL, STANFORD, CALIFORNIA

Professor BANKMAN. Thank you for having me.

The tax gap is a topic. I am going to limit my comments today to the tax gap associated with cash business, the cash economy, which is a large segment of the tax gap.

Staff suggested that I further limit comments to outside-of-the-box ideas they thought this committee might not have already considered.

My first suggestion is to consider expanding the reach of third-party reporting. Income that is subject to third-party reporting, like

wages, dividends or the income that may or may not find its way to the tax return.

It is obviously impossible to get all transactions in the reporting system, but I think we could do better and your staff has in writing some of my suggestions of what we might do there.

Having suggested we expand the region of reporting, let me acknowledge a draw-back. It is going to burden taxpayers, at least initially, who are innocent. They are the reporters. Of course, this is a generalized problem with tax enforcement.

That leads me to my second suggestion, that, where feasible, you ought to consider having reimbursement programs for innocent taxpayers that are bearing the burden and are compliant. New Zealand expanded third-party reporting and it is my understanding that they have a reimbursement program.

We could extend this to audits as well. Twenty years ago, Congresswoman Nancy Johnson (Connecticut) suggested that the government consider reimbursement in connection with the old TCMP, now NRP, audits. I thought it was a good idea then and still think it is a good idea. I draw out part of that idea and discuss that in a paper that your staff has.

I have also suggested the idea of reimbursement for garden variety of audits, but limited to cases where taxpayers who go through the audit relatively unscathed. I think reimbursement starts with a common sense notion of fairness, and I think it would reassure your constituents that, in increasing enforcement, you're considering those who are compliant.

My third suggestion is to cross check income tax returns with State property tax returns. Eventually, the cash economy, when enough money accumulates, gets used not to fund consumption, but for property purchases. You will find individuals that have brought millions of dollars worth of property, but have little or no reported income. Ideally, the function used to isolate returns for audits could look at this discrepancy.

My final suggestion is to work with the preparer community, enrolled agents and CPAs, to root out the few bad apples among them, who I think you will find out that a surprisingly high portion of flagrant abuses are associated with a very few number of preparers.

These put the other preparers in an impossible competitive situation. In my belief, they help maintain an equilibrium of low reporting rates in certain segments of the economy.

Tax shelters have been mentioned. I have worked a lot in that area and helped work with California on their legislation. In the interest of time, though, I have not prepared any comments on that, though I am happy to answer questions on that, or on anything else.

[The prepared statement of Professor Bankman appears in the appendix.]

The CHAIRMAN. Now, Mr. Brown?

STATEMENT OF DALE BROWN, TAXPAYER WHO ENGAGED IN AN OFFSHORE TAX SHELTER, INCLINE VILLAGE, NEVADA; ACCOMPANIED BY STEVE WILSON, COUNSEL TO MR. BROWN

Mr. BROWN. Thank you, Mr. Chairman. Good morning.

My name is Dale Brown. This is Mr. Steve Wilson, my counsel. I am 47 years old. I reside in Incline Village, Nevada.

Since leaving the U.S. Air Force in 1986 where I served as a U.S. Air Force B–52 and FB–111 navigator-bombardier for 8 years, I published 22 military aviation novels under my own name, and as a co-author, 17 of which were New York Times bestsellers.

In April of 2004, I plead guilty to one count of violating 26 U.S.C. 7206(1), filing a false tax return, in 1998. I listed deductions on my tax return knowing they were not real. I had control of foreign bank accounts and did not report them. I signed the tax return, knowing they were false entries.

With the Chairman's permission, I would like to, first, tell my family, my friends, and my fellow Americans that I take full and complete responsibility for my actions. I am truly and sincerely sorry for what I have done and I promise it will never happen again. I will guarantee, it is never going to happen again.

I filed the false tax returns because I was greedy, I was vain, I was selfish, and I took bad advice from financial professionals that I trusted. We are all human, and humans make mistakes. But I also believe that we must all pay for our mistakes, and I am prepared to accept any punishment ordered by the court.

How did I get involved in this scheme? Back in 1998, I expressed a desire to pay off my home mortgage. My financial advisor told me that it made no tax sense to do so because of the home mortgage deduction, and told me of a better way to proceed under a program run by Terry Neal of Portland, Oregon.

The plan was to expense corporate funds from the U.S. to an offshore entity, transfer funds by wire from the first to a second entity, then borrow the money from the second entity in the form of a mortgage to which I would pay principal and interest payments like a conventional mortgage.

I would then deduct the transfers as business expenses on my corporate tax returns and deduct the interest paid on the mortgage on my personal tax return.

Why did I not report that I had ownership or control of a foreign bank account on my tax return? It was explained to me by Mr. Neal and my financial advisors that I did not have to report it because the account was not in my name and I had no actual "signature authority" over it. In reality, I had full control of the money and I should have reported it on my tax return. I believed the lie because I wanted to believe it.

Why did I claim all those phony business expenses? For many years, I had been participating in an income-splitting routine set up by my financial advisors, expensing money between various domestic corporations.

The expenses simply became income on some other corporation's tax return, and that company would pay the taxes, usually at a lower rate. The offshore scheme was simply a more sophisticated extension of that same income-splitting program I had been doing for many years. It was supposed to be tax deferral, not tax evasion.

Most of all, however, I believed that if I was doing something really wrong, something so serious that I could land in prison, my so-called financial advisors would steer me clear of it, if not for me,

then at least to protect themselves. That was an extremely bad assumption.

The scheme did not save me one cent. I paid more in interest and penalties than I did in taxes owed, a total of almost $1 million, plus almost 2 years' of attorneys' fees, potential loss of income from two canceled publishing contracts, adverse publicity, enormous stress on myself and my family, and all the penalties associated with being a convicted felon.

I have humiliated myself in front of my family, friends and neighbors, and lost an incalculable amount of business and personal trust and goodwill that may never be recoverable. I am currently awaiting sentencing in Federal court in Portland.

With the Chairman's indulgence, the following is my primary recommendation to the committee regarding my involvement in the offshore scheme. I do not make this recommendation as a way to assign blame or make excuses, but as a possible avenue to resolve similar issues more efficiently.

I subscribed to this scheme because of greed, vanity, selfishness, and taking bad advice from bad persons. But I do not believe I am a bad guy. I think I am a good and law-abiding guy who listened to a bogus sales pitch from unscrupulous persons and was schmoozed, flattered, and conned into signing up for something I knew was not right. I heard only one message, but it was the wrong one.

If the government wants to efficiently recover lost revenue and provide the maximum level of deterrence, it seems to me that they should widely publicize their investigations early on using media outlets that guys like me watch or listen to every day.

If I had been watching "America's Most Wanted," "The O'Reilly Factor," "MSNBC," or "Larry King Live" and heard that the IRS had started an investigation on a program even remotely resembling the one I was involved with, I would be on the phone instantly to a lawyer and another accountant, wanting to get out fast.

As in the U.S. Air Force Strategic Air Command nuclear war fighting game that I was involved in for 8 years, deterrence only works if the other side knows what nuclear weapons you have and you make them believe as clearly as possible that you will use them.

I would like to conclude by thanking the committee for allowing me the opportunity to make this statement, and I pledge to continue doing everything I can to atone for the wrongs I have done, and to earn back the faith and trust of my family, friends, and fellow citizens. Thank you.

The CHAIRMAN. Thank you, Mr. Brown.

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

The CHAIRMAN. Now, Mr. ABC?

STATEMENT OF MR. ABC, AN ANONYMOUS WITNESS

Mr. ABC. Mr. Chairman and members of the committee, I want to thank you for giving me the opportunity to testify today.

I am speaking to you about my experience as an IRS confidential informant who provided original information concerning significant and ongoing tax fraud involving major Wall Street firms.

I speak from firsthand knowledge. I work for a Wall Street investment bank, and through my professional experience I am intimately aware of competitors' fraudulent tax shelters.

The schemes, in some cases, have been ongoing for more than a decade. A couple of the schemes involved Enron. The Wall Street fraud is complex and involves hundreds of millions, if not billions, of dollars of U.S. tax liabilities.

In a nutshell, I blew the whistle on three types of abusive tax shelters. The first abusive concerns the fraudulent transfer of U.S. tax liabilities to foreign entities not subject to U.S. tax.

There are various permutations to the scheme, but one essential component of this fraud is the creation of sham domestic partnerships to serve as fronts for foreign owners who acquire the U.S. tax liabilities, but who have no intention of ever paying U.S. tax.

The second abuse involves the transfer of U.S. tax liabilities to the foreign branches of U.S. taxpayers in order to artificially generate foreign source income and claim additional U.S. tax credits.

The third abuse, which is generally performed in conjunction with the above two, concerns the artificial replication of tax bases solely for the purpose of creating false deductions to be sold to outside taxpayers. These duplicate deductions are then claimed by the unrelated taxpayers as an offset to their otherwise taxable income from other sources.

As a Wall Street insider, I am very knowledgeable about these abuses. I can tell you from experience that about 75 percent of all the transactions specific to my expertise ended up in abusive tax shelters.

Because the IRS has moved too slowly or not at all, the abuses are still ongoing. That has resulted in huge liabilities being avoided. I estimate that the U.S. Treasury has lost at least $400 million of tax revenues every year from these particular schemes.

Another important consequence of this fraud is that U.S. taxpayers who want to engage in transactions legally are being undercut by those engaging in tax abuse. The transaction's true market value depends on compliance with applicable U.S. tax laws.

If the associated tax liability is simply ignored through sham domestic partnerships or by the artificial generation of offsetting credits, then the market value of the transactions erode significantly.

As a result, my livelihood and the business interests of honest U.S. taxpayers are being seriously harmed by the fraudulent practices of others.

In 1998, I decided to come forward and report a particularly abusive group of entities that I knew were engaged in this fraud. I contacted the IRS's Criminal Investigation Division, and through them was put in contact with an IRS Civil Examination agent who just happened to be auditing one of the partnerships that I was concerned about.

That first contact concerned three particular entities, and then over the next few years I provided detailed information concerning more than a dozen other entities and related groups engaged in similar tax abuse.

From the time of that first contact until today, my efforts to correct the abuses have resulted in a series of frustrating and often unproductive dealings with the IRS.

Over the past 6 years, I have literally spent thousands of hours educating and prodding the IRS, urging them to take action. I have traveled across the country at my own expense to have face-to-face meetings with agents.

I have provided the IRS with hundreds of pages of evidence and submitted numerous writings and diagrams explaining the fraud and analyzing the abusive shelters in detail.

As I mentioned, when I first contacted the IRS they had one of the partnerships under audit. Not to fault that particular IRS audit team, but they truly did not know what they were looking at. These are sophisticated tax avoidance strategies concocted by Wall Street.

As a general matter, I observed that the IRS is consistently outgunned and outmatched. From my vantage point, the IRS simply does not understand how the tax shelters work or how these structures and transactions fit together.

When I first met with the IRS in 1998, I submitted an IRS Form 211 concerning the overall abuse. Later, I submitted detailed and separate Form 211s for each of the entities involved. Form 211 is the IRS form for confidential informants to supply information and to apply for a reward under the IRS's Whistleblower Program.

Later in 1998, I provided information about two more entities engaged in significant partnership fraud. In 1999, I provided detailed information about six or seven more entities involved in abusive baseless replication schemes, and about five other entities involved with fraudulent domestic partnerships.

I also identified a major Wall Street bank that was involved in the foreign branch abuse. In 2000, I provided information about yet another Wall Street bank's foreign bank approach, as well as two other additional entities that were utilizing fraudulent domestic partnerships.

In 2003, I provided information concerning two entities that were acting as promoters of various types of transaction scams. In 2004, I provided information to the IRS concerning two other entities conducting baseless replication schemes.

Finally, over all these years, I provided detailed documentation and analysis of the abuses to the IRS through meetings, phone calls, e-mails, and faxes.

I hope that you now have a sense of the quantity of information and assistance that I have provided, as well as the pervasiveness and persistence of the tax shelters themselves.

Together I estimate that the numerous fraudulent schemes on which I provided original information involved over $10 billion of taxable income. Obviously, there are very serious U.S. tax liabilities associated with this income that are being avoided. The combined loss to the U.S. Treasury is immense.

In providing all this information, my experience with the IRS has been extremely frustrating and discouraging. What I have encountered is an agency that is resistant to, and suspicious of, confidential informants, that is, private citizens who are trying to do the

right thing by coming forward and blowing the whistle on significant tax fraud.

I have also encountered an agency that is disorganized and is generally not equipped to deal with the complex and sophisticated tax shelters in an effective fashion.

Let me give you some examples. At the same time that I was actively supplying vast quantities of quality information to the agency, the IRS's service center that was processing my Form 211s simply rejected them out of hand in 2003. There was no valid basis to reject them.

It was just that the IRS center had no idea what was going on, but chose to act anyway, probably just to get the paper of their desk. It then took months to get the Form 211 claims reinstated.

The IRS is also resistant to outside information, even when it comes from a knowledgeable insider like myself. I have often been treated suspiciously, as if I were the bad guy.

There appears to be more of a willingness at the IRS to believe the taxpayer perpetrating the scheme than the informant justly questioning the fraud. I have never understood this attitude because I am putting myself at great personal risk by coming forward.

I stand to lose my career if my identity is discovered, since employers are uniformly hostile to employees who interact with regulators. I just do not understand why the IRS has not welcomed the help and information.

In addition, from my perspective the IRS lacks the staff and resources to take on serious enforcement against Wall Street. Since 1998, I have provided detailed information on over 20 entities and related groups that have engaged in complex and material tax abuse through numerous tax shelters.

To date, action has been taken against only a couple of the entities. I have yet to receive any reward for my efforts as a confidential informant.

In many cases, the information that I provided was simply ignored. One example that I find particularly troubling involves Enron prior to its collapse in 2001. In particular, in 1999, I provided detailed information about a series of fraudulent tax shelters involving a major Wall Street firm and Enron.

The shelters involved the artificial duplication of tax deductions for the sole purposes of generating fictitious book income. Approximately half a billion dollars of taxable income was evaded as a result of Enron's fraudulent tax schemes and, conversely, hundreds of millions of dollars of fictitious book income appeared on Enron's financial statements.

Not only did I provide drafts of a suspect Arthur Andersen opinion letter comforting the shelter, but I also supplied a copy of the investment bank's pitch book to the IRS.

The pitch book specifically outlined the questionable structure and its purported benefits, which included the almost-too-good-to-be-true effect on Enron's GAAP financial statements.

So, although these were tax abuses that Enron and Wall Street were engaged in, at the end of the day the tax shelters permitted Enron to inflate its book earnings.

Obviously, if IRS authorities had pursued the information back in 1999, the Federal Government might have seen what was happened at Enron and Arthur Andersen long before there was a total meltdown.

Remarkably, no one at the IRS inquired about the information or pursued it. The one agent that I worked most with questioned the lack of follow-up internally with the resident Enron IRS audit team and was rebuffed for raising the issues.

Part of the problem is that the regional organization of the IRS audit teams has generated regional in-fighting, so that inquiries from one region are often treated dismissively by another region.

Part of the problem also is that on-site IRS audit staff seem to have divided loyalties, since they work on a daily basis with the entities they audit and often go to work for them after completing government service.

At other times, audit staff can be very protective and rigid because they do not want to reopen audit periods that are formally complete. The lack of staffing and high turnover, generally, also take their toll.

For example, I often had to resubmit the same information multiple times because it would get lose, and the high staff turnover meant that I repeatedly had to bring new people up to speed.

I think that the greatest problem, however, is the agency's resistance to take seriously outside information from knowledgeable insiders. If I had not persisted, all my claims would have been rejected and my information would have been lost.

Actually, the biggest loser in this is the U.S. Treasury, since confidential informants can help the IRS recover hundreds of millions, if not billions, of dollars of lost tax revenues.

Let me end by saying that if the IRS ever wants to put an end to Wall Street tax shelter schemes, they are going to need the help of Wall Street insiders to get the information and expertise that it will take.

Right now, the IRS does not have such resources or expertise and they should welcome the assistance from knowledgeable insiders.

Thank you, Mr. Chairman and members.

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

The CHAIRMAN. We will have five-minute rounds of questioning.

Mr. Brostek, you made a very common-sense recommendation about checking to see that taxes are paid before foreign workers would be admitted.

I would like to have you not go into greater depth about that, but I would like to have you give us other examples that should be considered where there would be a requirement that an individual or business show that they are current in taxes before government benefits would be provided.

Mr. BROSTEK. Yes, Mr. Chairman. There are, of course, other various benefits that people receive by applying to the Federal Government, ranging from research grants to maybe small business loans. So, there are a number of opportunities where a mechanism like this could be employed.

To date, the primary use seems to be from the States. A number of the States have requirements, for instance, that before you can practice law or before you can get a liquor license, or before you

can be a probation officer, you need to provide them a tax compliance check from IRS that shows that you are in compliance with the law.

The CHAIRMAN. Mr. Brostek, I would like to have a broader perspective of how taxpayers get involved with offshore shelters like Mr. Brown referred to, what the Web sites are saying, and the services the promoters are offering.

Mr. BROSTEK. Yes. We had provided a hypothetical illustration in our statement, which will be displayed here in a moment, that shows a very similar situation, actually, where an individual used a promoter who helped him set up an off-shore charity and a business entity that the individual controlled, and then transferred substantial sums of money—$500,000, I believe it was—to the offshore charity, thus being able to take a charitable deduction for having done so.

Money was transferred to the business entity. The business entity then loaned money to the individual for the mortgage, and the mortgage payments from the individual then became deductible.

In essence, I think once someone has decided that they are going to do this kind of thing, they are only limited by their imagination or the imagination of their promoters about what kinds of things could be done here.

There were other instances in which promoters suggested that they could provide a scholarship to the individual's child and that could be deducted.

The CHAIRMAN. Mr. Brown said that he trusted his financial advisor. So for Mr. Brown, but also you, Mr. Brostek. This would be advice to other people. At what point do you start hearing about these tax shelters, that you ought to be concerned about their legality and whether or not you are violating tax law? Mr. Brown, for you, when was that?

Mr. BROWN. I think I knew probably right from the very beginning that there was not something quite right with it, but the advantages, I think, outweighed the risks. I really did not believe there was any true risk. I did not believe I would ever go to prison.

I think if my financial advisors ever said, well, you know, if you sign up for this, there is a good chance that you can go to prison, I do not think I would have ever signed up for it. Of course, they never promoted it that way. But I never thought about going to prison.

The CHAIRMAN. So they obviously would not tell you that, even if they knew you would go to prison, because then they would not get the benefit of selling it to you.

Mr. BROWN. Obviously. Yes.

The CHAIRMAN. Mr. Brostek?

Mr. BROSTEK. Yes. I think Mr. Brown makes a very good point. It is not clear to me that individuals always realize up front that they are getting into something that is not actually allowed by law.

To the extent that they are relying on a financial professional, an attorney, or paid preparer that is assisting them in doing their taxes, if they are trusting that individual and they are not aware from other sources that this is a questionable transaction to be entering into or a questionable financial strategy to be following, they do not know that they should not be distrustful.

The CHAIRMAN. Mr. ABC, I want to thank you for your testimony. I think it shows what whistleblowers mean in terms of bringing forth information that is very valuable in almost any area, but in this area of tax fraud.

I think you touched on this a little bit, but for emphasis, what would you say that the IRS does or does not understand about tax shelters? Second, what do you think needs to be done to improve the IRS's understanding of abusive transactions?

I think maybe the second part of that question, for time's sake, is more important than the first one, because I think you pointed out some of those problems.

So, then to repeat, what do you think the IRS needs to do to have a better understanding of abusive tax transactions?

Mr. ABC. Mr. Chairman, I think the problem stems from how the IRS is structured. The field service level does not understand the technical tax issues and the Office of Chief Counsel level, while they understand the theory, they do not understand the application to the real world.

So what I believe is necessary, is that you need knowledgeable insiders who could bridge the gap, sort of, between the ivory tower in the field, and bring expertise and resources to a collective effort.

Wall Street professionals create these tax shelter schemes, and it is going to take Wall Street professionals to deconstruct them. So, I think what is needed is an effective informant program.

The CHAIRMAN. Thank you, Mr. ABC.

Senator Baucus?

Senator BAUCUS. Thank you very much, Mr. Chairman.

I would like to, first, ask Mr. Wagner about the plan that you mentioned in your testimony. What is it? It sounded pretty general to me.

The CHAIRMAN. Can I interrupt you? I will go vote. We are voting on Morocco.

Senator BAUCUS. All right.

The CHAIRMAN. I will go vote and then come back. I will hurry right back.

Senator BAUCUS. All right. Good.

What are the components of that plan? Could you kind of help this committee?

Mr. WAGNER. Yes, Senator. The components of the plan were, first and foremost, to study and approve——

Senator BAUCUS. Right. Do you have any numbers with that? When you described it, it sounded pretty general to me. To be honest, the more we get more specific with numbers, data and dates, maybe we could get someplace. But do you have any of those?

Mr. WAGNER. In the testimony that I have submitted we have included some numbers, the goals that we are seeking in terms of——

Senator BAUCUS. Can you tell me right off the top what those are? If you cannot, we will submit a request for them. But it just seems to me, we need a more specific plan.

Mr. WAGNER. Senator, probably the most important number to articulate is the budget recommendation that we have made for fiscal year 2005 to support the IRS in its enforcement activities, in particular, the staffing of enforcement officials, auditors, and indi-

viduals to address some of these tax schemes that you have heard about.

Senator BAUCUS. What does the Oversight Board do?

Mr. WAGNER. Well, Senator, we are charged to approve the Strategic Plan, to approve the budget of the IRS.

Senator BAUCUS. To be honest, you have a great opportunity and great responsibility here. To be honest, when I hear about the Oversight Board, I just hear words. I do not hear a lot. Do you have any power to tell the IRS what to do?

Mr. WAGNER. Senator, RRA 98, which created the board, did provide a number of powers to the Oversight Board, including, as I mentioned, approving the annual and long-term Strategic Plan of the IRS.

Senator BAUCUS. Can you change the plan?

Mr. WAGNER. Senator, I think that we do have the leverage to provide the input. With our approval authority, we do have the power to change the plan.

Senator BAUCUS. Do you report separately and independently to anyone else besides the IRS? Do you report to the Congress?

Mr. WAGNER. We do report.

Senator BAUCUS. Separately and independently?

Mr. WAGNER. We do provide separate reports to the Congress. We have a report that is required by RRA 98 to submit to Congress, which I have here in my hand, that speaks to the activities.

Senator BAUCUS. Do you make recommendations to the OMB, to the government, about resources, budgets?

Mr. WAGNER. We do. We independently look at the budget and submit our own budget and send that to Congress, independent of OMB.

Senator BAUCUS. And what is your recommendation?

Mr. WAGNER. This year, the budget recommendation was $11.2 billion, Senator.

Senator BAUCUS. $11.2 billion. And what is the trend in the IRS budget?

Mr. WAGNER. In the past 4 years since the board has been created, the trend has been to request additional resources for the IRS. Starting in 2002, we were at $9.7 billion and we have now worked our way up to the number of $11.2 billion.

Senator BAUCUS. I think Commissioner Rossotti said that an annual 2 percent real increase is necessary to get the IRS back on track.

Mr. WAGNER. In his end-of-term report, he did suggest that a 2 percent increase would bring——

Senator BAUCUS. Real. A real increase.

Mr. WAGNER. Real increase. Yes, Senator.

Senator BAUCUS. Does that make sense to you?

Mr. WAGNER. I cannot speak to the things that existed when Commissioner Rossotti was Commissioner, but I can tell you that the board has taken a good look at it. The numbers that we have recommended do track the numbers that Commissioner Rossotti had recommended.

Senator BAUCUS. I would like anybody to address this. What is the biggest category of noncompliance? What group? Is it international? Is it independent contractors? What is it?

Professor BANKMAN. It is the cash economy, which is your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.

Senator BAUCUS. All right.

Now, would everybody agree with that? Is there anybody on the panel who would disagree with that, that that is the major problem? There are a lot of problems, clearly, but that is the major one.

Would anybody disagree with that? [No response]. All right. So everybody agrees. Let the record show that everybody agrees. [Laughter.] I see heads nodding approvingly. All right.

Second, if that is the major problem, and assuming we should attack the major problem with more vigor, and earlier, what is the solution? Mr. Bankman or Ms. Gardiner? You grabbed the microphone, Ms. Gardiner. Why do you not proceed?

Ms. GARDINER. I grabbed it.

Senator BAUCUS. You own the microphone.

Ms. GARDINER. I think Mr. Bankman and I actually have made similar kinds of comments in terms of third-party reporting. But also, we recommend, as the Taxpayer Advocate has as well, that there be withholding on independent contractors. Some of the things that people have suggested, is that that would be a burden. I agree, it would be a burden.

On the other hand, there are just numerous reasons why it would be a good idea, the aspect that they failed to pay the estimated payments during the year, therefore they have a big, huge tax bill April 15. The most compliant groups of taxpayers are those that do have withholdings.

Senator BAUCUS. Right. Now, that is an interesting thought. You are suggesting what, that the employer or contractor, the person who hired the business person in the first place, withhold a certain percentage of payment?

Ms. GARDINER. Yes. And we have not recommended what that percentage should be.

Senator BAUCUS. I am sorry. You have or have not?

Ms. GARDINER. We have not. The National Taxpayer Advocate, I believe, recommended between 3.5 and 5 percent, depending on the type of income.

Senator BAUCUS. And, second, do you agree with Professor Bankman's point that perhaps there should be some compensation to accommodate the burden of those who comply, or not?

I do not know if in this case you could suggest that or not. A lot of business people are going to say, oh, wait a minute. Gosh, that is an extra burden. That is an extra expense. Why should I not be compensated?

For example, the typical employer, it is pretty easy. It is wages, and you just take off a certain percentage of wages when calculating the paycheck, whereas I, as the independent contractor, it is a little different for me. It is more work. Or my employer has to do more.

Ms. GARDINER. Well, there is truth in that. On the other hand, the recommendation would generally be that businesses are the ones that would withhold. Let us use salespeople as an example, where they would be getting a 1099-Miscellaneous on sales rev-

enue. Say they sell books for a company. Right now, there would be no withholding on that.

That same company, though, most likely would have employees that they are doing withholding on. They already have a payroll process in place. They have secretaries, people to answer the phone, they have people that manufacture goods, so that added burden would be somewhat incremental. Now, that is a simple case, but I think there are many of those simple cases where, right now, that income can just be reported.

Senator BAUCUS. And presumably, the independent business person has to pay an estimated tax.

Ms. GARDINER. They are supposed to.

Senator BAUCUS. Supposed to. Supposed to. Is supposed to pay an estimated tax.

Ms. GARDINER. Right.

Senator BAUCUS. Which is some burden. And you are suggesting, though, a considerably smaller percentage withheld by the employer, the person who employs the business person, the subcontractor. Is that right?

Professor BANKMAN. You know, there are a lot of approaches to this. The good news is, the reporting rates are so low that there has got to be some low-hanging fruit that a lot of these approaches will pick up.

The one thing I will say that I did not mention, because I wanted to focus on things you have not considered, is that increasing the old-fashioned audit rate will also pick up a lot of income.

That is one of the reasons why I also mentioned the idea of reimbursements for taxpayers who undergo and do not owe much, because even with all these other approaches, audits still play a role, and higher audit rates will bring you money, though obviously at an expense.

Senator BAUCUS. That is true. But just playing this out, if there is some reporting up front, the IRS presumably is in a better position.

Professor BANKMAN. Oh, absolutely. Absolutely. To the extent you can easily get things in the reporting system, the audits are much, much less important. The problem is with a lot of small businesses, it is going to be hard getting a lot of these transactions in the reporting systems because you are talking about a business that might be a restaurant and sell food for cash, so there is a limit to how much of this big tax gap you can solve through reporting. But to the extent you can do it, that would be the first place to start.

Senator BAUCUS. This is sort of a political question. Is anybody working with NFIB, the National Federation of Independent Businesses, or other organizations to try to see if there is some way to kind of work together and work this out?

Because presumably they are going to be very upset with any strong push in this area. But, still, it sounds like the evidence is quite overwhelming that that is where the greatest problem lies.

Professor BANKMAN. That is right. I might say that, on the politics of it, it is a little bit funny. I think generally, of course, Senator, you are right. But you also have franchisees and franchisors and they are paying every penny in tax because the nature of their

relationship just does not allow people to put dollars in their pocket.

What you find out is, as a political matter, in the restaurant industry, for example, you have some chains that very much resent having their competitors not pay tax.

Senator BAUCUS. Yes, Mr. Brostek?

Mr. BROSTEK. Senator, I agree with just about everything that has been said on this topic. Joe, in the past, has recommended withholding and information reporting as mechanisms to deal with some components of the tax gap.

One of the things I would mention, is that if a requirement like this were levied, it could be levied at businesses at differing levels of assets, for instance. There are major national companies that use contractors for doing work and they might be the place to start.

Maybe we would have the larger firms that have the more sophisticated accounting systems start with information reporting for their contractors and see how much is gained there, and then make a judgment about how to do it.

Senator BAUCUS. Is there some way to break down this category a little more finely, discretely in different areas? We are talking generally, what, about the cash economy, generally. You are talking about non-C corporation entities and organizations. What size are we talking about? Can this be broken down a little bit more?

Professor BANKMAN. Well, it can, a little bit. Because once an enterprise gets large, even if it is family-owned, the rate of non-compliance falls. That is because it is thought that either the owners, their trusted employees, or their families have to cheat, and you cannot if you have nine outlets. You can really only cheat at the one controlled by the family. This is simplifying things enormously.

So you are talking about smaller enterprises, but you are talking about smaller enterprises that, apart from that, may have nothing in common. That is, they are in different industries. What they have in common is the opportunity to cheat because they are getting a lot of cash or checks, which are almost as good as cash for cheating.

Senator BAUCUS. All right. This is kind of rolling participation here. There is a vote going on.

Senator Thomas, do you want to take over? You are in charge.

Senator THOMAS. Well, are you going to continue on?

Senator BAUCUS. Yes.

Senator THOMAS. Are there going to be people returning?

Senator BAUCUS. I think Senator Conrad may want to come back and ask questions of the panel. I am going to go vote. The Chairman is coming back after he votes. So you are the man.

Senator THOMAS. All right.

I am sorry I missed your statements, because it is an interesting thing. So I suppose any questions I might have, you may already have dealt with.

But I guess I have to say, when I read the background material, I was kind of stunned at the amount of money that is apparently estimated to be lost. Then I also understand that the number of audits for the IRS has decreased. Is there a relationship there? How does that work?

Professor BANKMAN. I certainly think that taxpayers are alive to the audit rates. I did a study with Professor Carlinsky where we interviewed the small business persons in a medium-sized town. They were very alive to the lack of audits.

Of course, nobody likes increasing audits and they are expensive and painful. But there is clearly a relationship between people getting audited and people paying more tax. I think that audits directed at this community would give you revenue.

Mr. BROSTEK. Mike Brostek from the General Accounting Office. If I could add on slightly to that. IRS has done some research on the compliance effect of audits.

Now, this research is a little bit old, but the finding of that was that for each audit that was done, there is sort of a multiplier effect on compliance, not only for the individual that was audited, but for other taxpayers. So when you have a decline in the audit rate, it is not a one-to-one relationship, the decrease in the deterrence effect on the population as a whole.

We do not know what the effect on compliance has been factually of that decline in audits, but the research that IRS is doing currently right now on the compliance rate for individual taxpayers will give us a benchmark about whether individuals' tax compliance has risen or fallen since it was last measured fairly rigorously about 16 years ago.

Senator THOMAS. What about the complexity of the Tax Code? If there were a simpler system of taxation, would that make it easier to audit or be accurate?

Professor BANKMAN. Well, it would certainly help on the high end with the tax shelter side. The small business, I do not think it is a matter of complexity. They are cheating on their State sales taxes, too, which are not that complex. So the cash economy, I think, is less sensitive to the problems of complexity than the high-end schemes you hear about.

Ms. GARDINER. I would actually say it is the high end and the low end, things like the Earned Income Tax Credit and the Child Care Tax Credit, aspects of the Tax Code that are designed for lower income families, are some of the more complex aspects of the Tax Code as well.

Mr. WAGNER. Senator, the IRS Oversight Board has also looked at the question of complexity and has determined and concluded that it is, indeed, a large source of the tax gap, the complexity both on the high end and on the low end.

In fact, it is a primary component that has led to some of the abusive tax schemes that we have heard about from Mr. Brown and Mr. ABC, and that simplification of the Code, while there are many, many policy questions involved in there, would certainly ease the burden of compliance and tax administration and result in many, many dollars.

Earlier, the comment about hiring more auditors and bringing more auditors in, and the audit rate, the board has studied that as well and has reviewed some information that suggests, for every dollar that is invested in enforcement activities and auditors, five dollars is returned to the Treasury. So, that, coupled with eliminating complexity would go a long way toward addressing the tax gap.

Senator THOMAS. I see. You kind of have maybe the general notion that because of increased technology and the availability of computers and all the fancy stuff we have, that it would be easier to keep track of what is going on. Is that necessarily the case?

Ms. GARDINER. Some of the IRS's matching programs are extremely effective. The problem is, they identify more non-filers and more taxpayers that have not paid their accounts receivable, and they cannot even keep up with what they currently have.

Mr. BROSTEK. I would like to follow up on that for a moment, to link back to the discussion we were having earlier about the practicality of more information reporting or withholding on payments.

It is my observation—I do not have a lot of facts to back this up—that a lot of small businesses now have fairly sophisticated computer systems that they use for their billing operations. When I take my car in to the small, independent garage that I go to, they have a computer system that can tell them when they worked on my car and how many times they have worked on different vehicles.

So, the sophistication, I think, of the systems that are available to record payments and provide information and reports may have increased in the economy generally. That is something that is probably worth taking a look at to see if information reporting could be expanded, that being one of the most powerful drivers at the high level of compliance.

Senator THOMAS. I see.

Welcome back, Mr. Chairman. I walked in at the wrong moment and ended up here and over my head.

The CHAIRMAN. I am glad you did.

Senator THOMAS. So, welcome.

The CHAIRMAN. Are you done with your questions?

Senator THOMAS. I am, sir.

The CHAIRMAN. I have been told that Senator Conrad wants to ask questions. Then what I will do until he comes back, is ask a question of Mr. Bankman and Mr. ABC that I did not get a chance to ask.

Some people believe that tax shelters are kind of a fad that are going to go away like hula hoops go away. What are your views about tax shelters being yesterday's news? Professor Bankman, and then Mr. ABC.

Professor BANKMAN. Well, I do think there has been a decrease in the most hyper-aggressive, publicly marketed tax shelters, the things some of the Big Four accounting firms were marketing around the turn of the century.

On the other hand, any time you have hundreds of billions of dollars at stake in ambiguous statutes, ambiguous just because they are written by human beings, you are going to have what we call tax shelters. When you have got kind of a leaky, creaky tax system like we have that is very complex, that is just going to magnify all the problems.

So, I do not think they would go away completely under a simple, ideal tax system, but under our tax system, they are certainly going to be with us for a long time.

The CHAIRMAN. Mr. ABC?

Mr. ABC. I have not seen any material decrease in the amount of tax shelter activity. It is not as public. It is done quieter. Initially with Enron, people were a little bit reticent. They waited to see if there would be any kind of follow-up. There was not a lot of publicity in terms of IRS enforcement action, which hurts. Then everyone just jumps back into the game.

It is very hard to make money. In finance, you are usually dealing with transactions where your focus is on basis points, which is a hundredth of 1 percent. With the Tax Code, you are dealing with, not basis points, but you are dealing with whole percentage points. You are dealing with 40 percent, 35 percent.

So, tax is a very lucrative area for finance professionals to focus. Until the IRS makes it apparent in public that they are not going to tolerate these types of activities, business people are going to look at it as an area of opportunity.

Senator BAUCUS. Mr. Wagner, I appreciate your testimony on the amount of resources that the IRS might need. I do not talk against that, but I do not highlight that quite as much as you do. I also know that the Oversight Board's recommendations have been made for cost savings and some improved efficiency.

I would like to ask, to what extent you feel that that is part of the problem, particularly related to what you said for the need for more resources, and does the Oversight Board have any initiatives on making IRS maybe work smarter instead of just harder and better?

Mr. WAGNER. Senator, of course efficiency and cost savings is a key component of a new IRS. The IRS created after RRA 98 is now up and running, and the board continually looks at the way it is operating and works with the Commissioner and the entire organization to ensure that it is as efficient as it can be.

We are, indeed, focused on efficiency, customer service, finding the right cases, watching out to make sure the IRS is finding the appropriate cases to pursue. We as a board have supported an aggressive approach toward these abusive tax shelters because it is an efficient place to close the tax gap.

Measurements. The board has been very focused on asking for and directing the IRS to create measurements so that we can measure our success and measure the efficiencies within the organization. So, these are some of the things that the board is doing to try to make the IRS a more efficient organization.

Of course, we have a constant eye on the Business Systems Modernization project. We have been very focused on that and somewhat critical of the progress to date. We released a report some time ago.

We are monitoring the human resources/human capital components of the IRS, and as we move from a paper-driven environment to a technology/electronic environment, watching the allocation of human resources. Then, very importantly, is the issue of training, which the board has been concerned about.

The workforce of the IRS is becoming increasingly older, eligible for retirement, and it is important that we bring in capable young professionals, and that they are properly trained to address some of the concerns that Mr. ABC raised a while ago, and the board has

been focused to ensure that training resources are efficiently allocated.

The CHAIRMAN. While Senator Conrad asks questions, I will step out and see some high school students for a minute right outside here. Then when you are done, we will bring up the second panel.

Senator CONRAD. All right. First of all, Mr. Chairman, I want to thank you very much for holding this hearing. It is unfortunate what happened this morning with the delay, but I think this is an extraordinarily important hearing and I thank you for organizing it. I think it has been excellent already. So, I wanted to thank you.

The CHAIRMAN. Well, thank you very much, Senator Conrad.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. This is, I think, a scandal of enormous proportion. Every honest taxpayer ought to be outraged at what they have heard here today because there are a handful of people and companies that are taking advantage of all the rest of us, and they are doing enormous damage to our country.

Let there be no doubt, these phony tax schemes, this failure to pay what they legitimately owe, is shifting the burden onto the rest of us. In addition, we are failing to pay our bills. It has got enormous consequences for the future. All of us know here, we have got the largest deficit in the history of the country, over $400 billion this year.

I believe the tax gap is not $300 billion. I have looked at the numbers, and I am a former tax commissioner and a former chairman of the Multistate Tax Commission. This tax gap is not $300 billion. It is well over $400 billion. It may be approaching $500 billion.

All one has to do is look at the size of the economy and look what is happening to Federal revenues to understand, this tax gap is enormous. Revenue, as a share of Gross Domestic Product this year, is going to be the lowest it has been since 1950. Part of the reason, obviously the biggest part of the reason, is tax cuts and economic slow-down.

Another big part of the reason is cheating. Let us just be clear, that is what is going on. People are cheating. Who are they cheating? They are cheating all the rest of us who are paying what we legitimately owe.

I will tell you, I am eager to get these people behind bars. Lock them up. I will tell you, we will see a lot less cheating when people see there is real punishment for those who do.

The tax gap. Witness ABC here said about the IRS being overwhelmed. He has got it exactly right. The IRS is overwhelmed, and a big part of the reason is this Congress and this administration, because this Congress and this administration have consistently undercut the Internal Revenue Service.

And that may not be politically popular, but if people start paying attention to the implications of the failure to collect what is legitimately owed, you will see what I am saying is true. All the rest of us are hurt. The ability of this Nation to defend itself is hurt by a failure to collect the revenue that is owed this Nation.

Audit rates are down dramatically. Let us just put up a chart that shows what has happened to audit rates. Audit rates from 1997, you can see, have plunged. Now they are starting to stabilize, but we are down dramatically from where we were, and down even more dramatically from where we need to be if we are going to start to close this gap.

Mr. Wagner, you made the point on resources. I thought you made it very well. I hope somebody is listening. Frankly, what you are asking for is far too modest.

As a former tax commissioner, when I was tax commissioner I went to my legislature and I told them I needed 20 percent more money. Not 2 percent, 20 percent. I said, you give me 20 percent more money, I will get you a payoff of $16 for every dollar you give me, and I did.

I got audited left, right and sideways by the legislature to make certain that that was not any funny money accounting, that that was real payoff for the money that they invested in my agency. I will tell you, it can be done at the Federal level.

The first thing we need to do is send a signal that this day of gamesmanship is over and these people who are cheating everybody else are headed to jail. I will tell you, that is when you are going to get a change in attitude and a change in compliance.

When people see, as one of the witnesses here said, I think maybe Mr. Brown, on the media that you watch, if you would have heard that there is an aggressive effort, why, all of a sudden, people get the message.

They get the message when the message is delivered and it is the responsibility of this administration and this Congress to deliver the message, that this game is coming to an end and folks had better get straight and get right or they are going to go to jail. I will tell you, then you will see compliance improve.

Mr. Bankman, I thought you had some excellent ideas. On the property tax front, looking at the property tax returns and checking those with income tax returns, we did that as part of our program when I got the additional money and it paid significant dividends. You could not be more right.

Matching documents. That is absolutely critical. It is the single most important thing. You have got to go out there and cross check. You have got to look at, what are indicators that people have substantial income and cross check it with your tax files. That will have enormous benefit.

I also wanted to say to Mr. Bankman, you had another idea I could not agree with more, and that is with respect to the handful of preparers who are renegades, who are engaged in these schemes and in promoting them and selling them. We ought to have a target group that goes after those folks who are engaged in these schemes and we should make a lesson of them. That would have enormous benefits.

It also is the right thing for the vast majority of preparers who are honest, because they are being undercut by those who are not.

Mr. Brown, you sent a powerful message here today. You sent a powerful message. I commend you for being an honest man. You did something bad. That does not make you a bad person. I think you are not a bad person. I think you are somebody that got en-

gaged in a scheme that is totally wrong, but you 'fessed up and you are trying to make good, and I applaud you for it.

Mr. BROWN. Thank you, Senator.

Senator CONRAD. If I can just conclude, the ABC witness, Mr. Chairman, I hope we get the message that Mr. ABC has delivered, that we have got to have at the IRS people who are capable of understanding complex financial schemes. They are absolutely overwhelmed there.

This is something we ought to put a focus on. We ought to have a SWAT team at the IRS that goes after abusive tax shelters, and as part of those SWAT teams we need to bring in people who have engaged in these enterprises themselves. You ought to bring in people who know how it works, and I hope we will do that.

Thank you, Mr. Chairman.

The CHAIRMAN. Yes. And one other message from Mr. ABC, and that is the value of whistleblowing. We could not do our job of Congressional oversight if we did not have it.

Senator Lincoln?

Senator LINCOLN. Mr. Chairman, thank you. I will try to be brief and quick with my questions. I know you want to move on.

We are grateful that you are here to help us work through these issues. You must have some idea of how frustrating it is to us as we continue to work towards trying to pass legislation that is so necessary for the livelihood and the economy of this country.

Yet, it is always the revenues that we are looking for. We see so much of this as just a missed opportunity. Three hundred and eleven billion dollars a year we know is owed to our country.

Having worked through the prescription drug package, it is the cost of the prescription drug package, almost, over 10 years. We had to really hunt to find a way to pay for that bill.

So, I think it is important, when we look at, 60 percent of identified debt is not pursued and 79 percent of the people that we identify using abusive devices, tax cheats are caught red-handed, are not even pursued. It is enormously frustrating.

Sixty percent of our U.S. corporations pay no taxes. With all of that, you would think that we are trying to fund the men and women, our troops, that we are trying to support in the field, it really borders on something that is enormously difficult for us to handle.

So I guess everybody is looking for where blame can be laid. We wonder if it is Congress, and have we written the laws incorrectly, or is it the IRS? I would imagine it is a little bit of both. We have got to work to figure that out, and the American people are depending on us.

Just a couple of questions. Ms. Gardiner, this is not a fun question to ask, but it is your job and it is my responsibility in Congress, I think, to ask the question.

Do you have any reason to believe or suspect that politics has any influence over any aspect of tax administration? Any evidence that certain groups or classes of people are receiving different levels of attention from the IRS, or that budgets are maybe being skewed for those reasons, or enforcement actions are dropped to avoid political problems?

Ms. GARDINER. No, Senator, I do not have any reason to believe that. We have in the past received allegations about some political influence in certain areas. Quite honestly, the results of those types of reviews, we were never able to say absolutely certainly there was no political influence. It was usually a case of, there was not enough documentation to say one way or the other. Yet, we still believed that the IRS employees were doing things for all the right reasons.

As fa as going after certain individuals or not, everything that we look at, we do a report every year on compliance trends and compare it to staffing and how they are using their resources. It simply is a case of, they have too much work and too few people.

Senator LINCOLN. Well, that kind of leads me to a second question which I had. I guess, Mr. Bankman, maybe you might be the best one to answer this question.

All of our States have balanced budgets amendments. We often struggle to bring every dollar we can into our States. The States also have a tax administrator who has the legal authority to review taxpayer information.

If the IRS, year in and year out, cannot go out and enforce the Federal tax laws because of lack of funds, lack of individuals, or lack of what have you, would it be such a bad idea to grant some of the States the power to review those Federal tax returns and collect on behalf of the Treasury? Even if we brought in just half of what we are missing, would it not make sense to take a look at giving them the ability to do some of that?

Professor BANKMAN. You are asking me?

Senator LINCOLN. It does not matter. Anybody that wants to answer it. But I thought you might be the one.

Professor BANKMAN. All right. Yes. It is kind of a novel form of out-sourcing. We out-source it not to private industry, but to the States. Everything is worth an experiment. My guess is, some States would be very good at it and other States would not be very good at it.

Senator LINCOLN. We could certainly set parameters.

Professor BANKMAN. That is right. That is right. That is not much of an answer for you. I think it really depends on the States. I think you will find some States that have terrific bureaucracies, and the IRS, while it has a million problems, still looks good compared to other States. So, it is like everything else, the devil is in the details.

Senator LINCOLN. Well, I guess my thought is, if the IRS was having problems in terms of the resources it needed and the manpower to do it, perhaps partnerships might be a way to look at that. The States certainly have a vested interest because much of what I know we do in our States actually stem from Federal dollars that we are able to get to the States.

If the Treasury here is more flush or certainly more successful in bringing in the revenues that it is supposed to be bringing in, then it makes sense that you could partner with those groups.

The CHAIRMAN. Thank you, Senator Lincoln.

Mr. WAGNER. Senator?

The CHAIRMAN. Oh. I did not realize she was asking questions. Finish that question, then we will go to the next panel.

Mr. WAGNER. If I may make a comment. I, like Senator Conrad, am a former State tax commissioner. I can tell you, there is a tremendous amount of cooperation between States and the IRS at this point in time, from my experiences, and now in my capacity on the board I am aware of some of that. But it can be improved. I think Mr. Bankman mentioned sort of another form of out-sourcing, third-party collection.

I know that has been an issue that has received some attention here before this committee and elsewhere in the States, and could very well be a reliable source to forge greater partnerships, just as States are doing so with local governments and local prosecutors and so on to collect uncollected State taxes. So, it is another idea that certainly warrants serious discussion.

The CHAIRMAN. I thank you all very much for your kind attention.

I would now invite our second panel to the podium. I am not going to wait until they get here to introduce them because of time.

IRS Commissioner Mark Everson. He comes before our committee quite frequently.

This is probably the first time I have ever had a chance to meet our second witness, Mr. Robert Morgenthau, District Attorney of New York County, but obviously anybody that has been interested in prosecution knows that name very, very well, because he has been in that position for a very long time.

Then we have Debbie Langsea, auditor manager for the California Franchise Tax Board; Ms. Nina Olson, the IRS Taxpayer Advocate. That is a new position, and I did not say it right. It is the National Taxpayer Advocate.Finally, Commissioner for Patents, Nick Godici.

We will start, just as soon as everyone is seated, with Commissioner Everson, then Mr. Morgenthau, then Ms. Langsea, then we have Ms. Olson, then Mr. Godici.

Mr. Everson?

STATEMENT OF HON. MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Commissioner EVERSON. Good morning, Mr. Chairman, Senator Lincoln.

Thank you for the opportunity to testify today regarding the tax gap and tax shelters. I also want to thank you for the opportunity to meet a living legend, Mr. Morgenthau. I got to New York in 1976, 1 year after he took his job.

And because of your selection of him as a witness today, he called me a couple of days ago and we had a very productive meeting that was extended by the fact that you were called out of the office. So, there was some good that came of that.

I appreciate the support this committee has given the IRS in our battle against abusive shelters, in particular, and your dedication to securing adequate funding for the IRS so that we can achieve a balanced program comprising of both service and enforcement.

Our recently issued strategic plan for 2005 through 2009 has established three goals: improved taxpayer service; enhanced enforcement of the tax law; and modernize the IRS through its people, processes, and technology.

The first two goals, improving service and enhancing enforcement, derive from our working formula at the IRS, service plus enforcement equals compliance, not one or the other. The IRS must do both.

Before turning to the tax gap and our attack on abusive shelters, let me touch on our third goal, modernizing the IRS.

I have some good news to share with you this afternoon. After many false starts over a period of decades, last week the IRS began processing the first 1040–EZ returns with the new CADE system. For the first time since the 1960's, the IRS is processing returns and issuing refunds on a new computer system. It is a small number, but it is a start.

While long overdue, this is an important first step in modernizing our return processing technologies. But we still have a long way to go and a lot of work ahead of us.

The significant annual tax gap, the difference between what taxpayers are supposed to pay and what they actually pay, the components of which are non-filing, under-reporting, and non-payment, runs to many billions of dollars.

Beyond the tax gap itself, a point of additional concern is the fact that our surveys indicate that over the last 4 years, the number of Americans saying it is all right to cheat on their taxes has risen from 11 to 17 percent.

We believe both of the operational goals articulated in the strategic plan, improving service and enhancing enforcement, are integral to addressing the tax gap and improving attitudes about compliance.

By service, we mean helping taxpayers understand their tax obligations and facilitating their participation in the system. We have improved our services to taxpayers and will continue to do so.

But to the degree that the complexity of the Tax Code leads to confusion and difficulty for taxpayers trying to comply with the law, I would respectfully suggest that any efforts by Congress to simplify the Code would be welcome.

The members of the committee know that we are working to reinvigorate enforcement at the IRS. I very much appreciate your support for the 10.7 percent increase the President has requested in his 2005 budget to this end.

We will use these monies to pursue our four enforcement priorities: discourage and deter noncompliance with emphasis on corrosive activity by corporations; high-income individual taxpayers and other contributors to the tax gap; ensure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law; detect and deter domestic and offshore-based tax and financial criminal activity; and the subject of your hearing several weeks ago, deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.

Aggressive pursuit of these priorities will help compliance and reduce the tax gap. The centerpiece of these efforts is our fight against abusive tax shelters. It touches all four points. Our efforts in this arena are significant beyond the billions lost each year in abusive transactions developed and marketed by the tax shelter industry.

Our same surveys of taxpayers about which I spoke a moment ago have also indicated that 80 percent of Americans feel it is particularly important for the IRS to enforce the law for corporations and high-income individuals.

This speaks to the sense of fairness which Americans rightly feel should be the cornerstone of tax administration. That is why our shelter efforts, including our criminal investigations and settlement initiatives for abusive shelters like Son of Boss, are so important.

Thank you.

The CHAIRMAN. Thank you, Commissioner.

[The prepared statement of Commissioner Everson appears in the appendix.]

The CHAIRMAN. Now, Mr. Morgenthau?

STATEMENT OF ROBERT M. MORGENTHAU, DISTRICT ATTORNEY OF NEW YORK COUNTY, NEW YORK, NEW YORK

Mr. MORGENTHAU. Thank you for the opportunity to testify.

I am just delighted that this committee is looking into the gap between taxes that should be paid and taxes that are actually paid. It is a huge problem.

Let me just give you a couple of examples. Two years ago, after consultation with the IRS and the Treasury Department, we issued subpoenas to one credit card company for credit cards issued by tax shelter banks and used in the New York metropolitan area in 2001. It came up to 115,000, much more than we had anticipated.

The problem with what we had, was there was a transcript of these transactions and they had accessed more than $110 million in tax secrecy jurisdictions. But they did not know the name.

They had no record of the name of the account holder, so it has been a very difficult investigation. I think that is an issue that needs to be addressed. You can get a credit card from an offshore bank without disclosing the name of the credit card holder.

The largest issuer of these credit cards was a bank called Leadenhall Trust in the Bahamas. We went on the Internet to find out how we can open an account with Leadenhall.

We found an outfit called Beacon Hill, seventh floor of a building in Manhattan, that had sent by wire transfer $6.5 billion overseas, some of it going to the Middle East, some of it narcotics money, completely unregulated. It had 40 accounts at one of New York's biggest banks, and the bank had done nothing about it in New York.

They kicked them out of the London office, but they were operating in New York. You have got to assume that the bulk of this money was for illegal purposes because if it was legal, you would have just gone into a major bank and sent a wire transfer. It was $6.5 billion. They kept no records. You find "$100 million from a valued customer." That's all. So you do not know who is sending the money. In many cases, you do not know who is receiving it.

I would like to call your attention once again to the Cayman Islands. As of December 31, 2003, $1 trillion U.S. dollars were on deposit in the Cayman Islands. One trillion U.S. dollars.

When I have testified before, it was $500 billion. It has gone from $500 billion to $1 trillion. I am glad it is at $1 trillion, because I think that is a number that maybe will stick in people's

minds. That is double the amount of the Defense Department budget. It is more than twice as much money that is on deposit in the banks in the U.S. metropolitan area.

Some of it is obviously there for legitimate purposes, but an awful lot of it is there because of the bank and corporate secrecy rules of the Cayman Islands.

What are we going to do about it? There has got to be better supervision by the banks of who their customers are because the money involved is so big, that it has to go through the banking system. So the banks have got to be much more alert to this illegal trafficking. the regulators have got to be much more careful about the supervision of banks.

One quick point. As a result of Beacon Hill, we found a New York Stock Exchange listed bank, Hudson United, which, in 14 months, had transferred $1.4 billion overseas. That branch had been sold to them by the Federal Deposit Insurance Corporation. So, these are all problems that have to be addressed. I am very happy that this committee is taking a major interest in it.

The CHAIRMAN. Thank you, Mr. Morgenthau.

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

The CHAIRMAN. Now, Debbie Langsea?

STATEMENT OF DEBBIE LANGSEA, CALIFORNIA FRANCHISE TAX BOARD, SACRAMENTO, CALIFORNIA

Ms. LANGSEA. Good morning, Mr. Chairman, Senator Baucus, and members of the committee. I am testifying on behalf of California State Controller Steve Westly and the Franchise Tax Board. On their behalf, thank you for the opportunity to testify on California's efforts to combat the tax gap and tax shelters.

The California income tax gap is about $6.5 billion, and this gap, as you have heard already, is attributable to taxpayers who underreport income, who underpay taxes, or fail to file their tax returns. However, California is increasing its efforts to identify unreported income, consider deterrence to noncompliance, and to modify public perception about voluntary compliance.

During California's Voluntary Compliance Initiative, or our VCI Abusive Tax Shelter Amnesty Program, about 1,200 taxpayers reported over $1.3 billion in additional tax. Of these taxpayers, about 800 individuals reported $900 million, and 400 businesses reported the remaining balance.

Of the 2,200 amended returns filed, 90 percent of VCI revenues came from tax years 1999 and 2002. Essentially, about $13 million a day was raised during VCI, or more than two times more money than any other amnesty program in U.S. history.

So how did California receive $1.3 billion in additional revenues? Well, you have already heard testimony today of many egregious and tax-engineered transactions designed to undermine the tax system. But more disturbing is the rate at which tax shelters were proliferated and marketed.

New variations of complex tax schemes were devised by tax professionals. They were buried in layers of transactions using multiple entities to escape detection. They are packaged as generic tax

products and sold to thousands of taxpayers generating millions of dollars in fees.

As California considered legislative solutions to curtail the tax shelters, Mr. Chairman introduced S. 476, the CARE Act of 2003. Such tax shelter provisions provide desperately needed tools for tax officials otherwise doomed to fight a losing battle to close the tax gap. Due to the number of tax shelters sold in the late 1990's, California quickly moved forward and adopted its own legislation.

On October 2, 2003, California passed S.B. 1614 and A.B. 1601 that enacted new tax shelter penalties. They adopted Federal disclosure and reporting requirements and provided for our Voluntary Compliance Initiative.

Key to VCI's success was publicity from federal, State, and individuals challenging abusive tax shelters, committee hearings, IRS initiative summonses, and information provided through various media.

Another essential element was a joint information sharing agreement between California and the IRS, New York, and other States. California received thousands of leads from the IRS and other sources on potential investors and promoters. These agreements avoided duplication of government resources and took a united approach against abusive tax shelters.

In addition to the thousands of tax shelter leads, we are reviewing information from about 800 taxpayers disclosing reportable transactions and 7,000 investors disclosing over $62 billion of listed transactions.

We recently issued subpoenas on insurance companies suspected of issuing insurance policies to protect clients from adverse tax shelter rulings. We received more information and issued another subpoena to an insurance broker.

California is proposing legislation prohibiting insurance companies from insuring or defending losses due to abusive tax shelters. If we are to effectively curtail the tax gap and abusive tax shelters, we urge Congress to pass tax shelter legislation.

The AICPA and States should follow the SEC's interpretation prohibiting contingency fee transactions, and Congress should fund IRS's compliance and enforcement efforts to address long-term implications of abusive tax transactions.

We are far from closing the tax gap and face ongoing challenges to effectively combat abusive tax shelters. We thank the committee for leading this endeavor and ask that Congress help us bridge the tax gap.

Thank you.

The CHAIRMAN. Thank you, Ms. Langsea.

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

The CHAIRMAN. Now, Ms. Olson?

STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, TAXPAYER ADVOCATE SERVICE, WASHINGTON, DC

Ms. OLSON. Mr. Chairman, Senator Baucus, and members of the committee, thank you for inviting me here today to testify on approaches to reducing the tax gap.

Tax evasion and tax cheating is a serious problem for the tax system and has real victims. If you divide the estimated $255 billion net tax gap by the roughly 130 million individual taxpayers, you see that each individual taxpayer pays, on average, about $2,000 extra in taxes each year. That is why my 2003 annual report to Congress ranked the tax gap after the AMT as the most serious problem facing taxpayers.

The IRS is to be commended for aggressively attacking corporate tax shelters and tax cheating by wealthy individuals. However, IRS must do more to address the fact that the majority of the known tax gap is attributable to under-reporting, non-filing, and underpayments by self-employed persons. We clearly cannot ignore a compliance problem of this magnitude.

In my written testimony, I discuss several ways to reduce opportunities for noncompliance. Where income is reported to the IRS by a payor on a Form 1099, tax reporting and compliance by the payee is very high, roughly 95 percent.

We must do a far better job of ensuring that information required to be reported by third parties under present law is actually reported by them, and in turn reported by the payee on his or her tax return.

The IRS could require taxpayers to affirmatively state on their sole proprietorship schedules whether they have issued all required 1099 forms. It could require taxpayers to report 1099 income separately from other gross receipts.

It could receive information from State and local authorities that issue licenses or impose taxes on the basis of gross receipts. Many businesses have an incentive to correctly report gross receipts for licensure purposes.

Local audit initiatives based on this information could make inroads into the cash economy, what I call "infection audits," because they spread and have a ripple effect.

When a service recipient withholds tax and pays it over to the IRS directly, tax reporting and compliance is almost 100 percent. While no one wants to increase burdens on small business, as a matter of basic fairness the size of the tax gap compels us to explore non-wage withholding.

To decrease the tax gap, the IRS could use voluntary withholding agreements or its Federal payment levy authority, particularly against Federal contractors. Congress could expand the back-up withholding authority and also require withholding at the source in particular instances.

Tax preparers can contribute to noncompliance either by incompetence or by facilitating cheating. The IRS is aggressively targeting practitioners who facilitate improper transactions by corporations and wealthy individuals.

By adopting a regulation regime for unenrolled preparers, as in S. 822, Congress can ensure that these preparers who prepared the majority of returns for middle and low-income taxpayers are also held to high standards.

As IRS ramps up enforcement programs, it is important to ensure that aggressive enforcement of the laws is balanced by aggressive protection of taxpayer rights.

Taxpayer rights are easy to talk about, but how do we make them a reality? In my June 30 report to Congress, I identified three measures to bolster protection of taxpayer rights in an enforcement environment.

First, the Taxpayer Advocate Service will prepare a taxpayer rights impact statement on major IRS initiatives to help the IRS incorporate an awareness of taxpayer rights into its program, planning, and implementation.

Second, TAS is reviewing IRS training to ensure that all employees learn about taxpayer rights on an ongoing basis, including the importance of the access to TAS.

Third, the Taxpayer Advocate Service is working to be no longer the best-kept secret in the IRS. We are conducting an outreach campaign to taxpayers that Congress clearly intends TAS to help.

In closing, I note that taxpayers, too, must claim the moral high ground where tax cheating is concerned and refuse to condone acts of tax cheating, not only with respect to corporations, high-income, or low-income individuals, but also in their own backyards. We need to remember that, just because someone else cheats, that does not make it all right for us to do so. Tax compliance begins at home.

Thank you for your efforts, and I appreciate it.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Now, Mr. Godici?

STATEMENT OF NICK GODICI, COMMISSIONER FOR PATENTS, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Mr. GODICI. Chairman Grassley, Ranking Member Baucus, thank you very much for inviting me to testify today on the patenting of business method inventions, and specifically on patents concerning tax strategies and financial products.

As you know, patents in this area of innovation are a topic of considerable interest and debate. Concerns have been raised about whether business methods should be patentable and whether these patents will help or hinder innovation and commerce. Given the importance of these issues, I commend the committee for holding this hearing.

Mr. Chairman, the basis of our patent system is found in Article 1, Section 8 of the constitution, which provides that "Congress shall have the power to promote the progress of science and useful arts by securing, for limited times, to inventors the exclusive rights to their discoveries."

In order to implement this constitutional directive, our founding fathers designed a patent system based on principles that are proven remarkably successful in promoting 210 years of innovation that has spurred the creation of new industries and jobs.

In administering the U.S. patent laws, the U.S. PTO takes its directive on what subject matter is patentable from Congress and from our reviewing courts. The current act specifies four basic statutory requirements that must be met to obtain a patent.

First, the claimed invention must define eligible subject matter and have utility. Second, it must be novel. Third, it must not have been obvious to a person of ordinary skill in the art at the time the

invention was made. And fourth, it must be fully disclosed so that the skilled practitioner would be able to practice the claimed invention without undue experimentation.

With respect to the first statutory requirement, 35 U.S.C. 101 states, "any person who invents or discovers any new and useful process, machine, manufacture, composition of matter, or any new or useful improvement thereof, may obtain a patent."

Furthermore, the granting of a patent does not give the patent owner the legal right to practice the invention, but only the right to exclude others from doing so.

Congress and our reviewing courts have shaped the current state of patent protection. In the most well-known case with respect to business methods, the State Street Bank decision, the Federal Circuit upheld patentability of a data processing system that transformed data representing discrete dollar amounts into a final share price for reporting purposes.

This constituted the practical application of a mathematical algorithm because it produced a useful, concrete, tangible result.

The Federal Circuit in State Street explicitly rejected the notion that a business method exemption exists in the U.S. patent law.

While State Street did not change U.S. law and practice, it did create a new awareness that business method claims could be patented. Today, the computer-implemented business method area includes business method practices in many fields, such as insurance and insurance processing, reservation and booking systems, financial market analysis, tax processing, and financial management.

While the courts have spoken regarding the eligibility of patents of the subject matter, some have suggested concerns that in certain cases these patients may be overly broad or not truly novel. These fears raise legitimate issues, and the U.S. PTO has taken a number of steps to address them.

In 2001, the U.S. PTO announced a new Business Method Initiative. This includes establishing partnerships with the industries involved.

Additionally, to assist our examiners in finding prior art, we have established electronic information centers which provide examiners with access to over 1,000 non-patent literature databases, over one-third of which contain business, financial, and tax information.

We believe that our Business Methods Patent Initiative has positively impacted the quality of examination of business method inventions.

Today's patent system is one of transparency. Not only are all patents published, but most applications are published 18 months after filing, giving interested parties knowledge of pending patent claims.

Mr. Chairman, we will continue to closely monitor the situation in order to ensure the issuance of high-quality business method patents. In addition, if further administrative action is warranted, the U.S. PTO will take appropriate action.

We can assure that we will comply with the law and that our practices and policies will promote innovation, as Congress and the courts have directed. We look forward to continuing to work with

the committee and to ensure that the U.S. patent system remains the envy of the world.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Godici.

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

The CHAIRMAN. I am going to start my questions with Ms. Langsea. You state in your testimony that California raced against the clock to enact its tax shelter legislation before the statute of limitations expired. I assume that was in connection with what is referred to as Sons of Boss tax shelter transactions.

I would like to have you expand on the statement and tell the committee the revenue losses you were facing from expiring statute of limitations.

Ms. LANGSEA. Certainly. About 2 years ago, California began examining or auditing abusive tax shelters, and we identified about 40 tax shelters at that time. Within 2 years, that number escalated to about 600 cases, totalling about $1 billion in potential abusive taxes.

We basically identified not only tax shelters related to Sons of Bosses, but many variations of other tax shelters in addition to that. Although there were only about 600 cases identified, we had very high income taxpayers and corporations that were involved in schemes that were involved in millions of dollars.

Our tax years that we were mostly focused on, we found were most prevalent through 1999, 2000, and 2001, hence why our legislation addressed those open years for us.

The CHAIRMAN. All right.

Now, along that line, we might be coming up to a problem here at the Federal level on statute of limitations.

If I could have Senator Baucus' attention, I would like to say that our JOBS bill contains a measure that would hold open the statute of limitations on a transaction listed by the Treasury Secretary or the Treasury Department as a tax shelter.

The Son of Boss is a listed transaction, but this measure only applies to taxable years that are still open to audit after the JOBS bill is enacted.

The IRS has a voluntary self-disclosure program where Son of Boss investors can turn themselves in and have their penalties reduced. However, there are a large number of Son of Boss investors who did not enter this self-disclosure program and are hoping, quite frankly, that the clock would run out on the statute of limitations before the IRS would find them.

On August 15, it is my understanding that the statute of limitations will close for calendar year 2000 tax returns. These non-disclosing Son of Boss investors will escape IRS prosecution after that date.

What is really troubling is, most of the Son of Boss transactions were sold in the year 2000, and the IRS will procedurally lose these cases by August 15. I was just wondering if you would agree with my assessment of that situation.

Senator BAUCUS. Yes, Mr. Chairman, I am fully aware of this. I also hear that the IRS recently discovered several hundred of these non-disclosing investors, and suspects that there are many more hiding in the weeds.

The IRS will find them as they continue to audit the promoters. I do not think we should let these tax cheats off the hook. I think, therefore, we should modify the JOBS bill to extend the August 15 statute of limitations for Son of Boss investors that did not participate in the self-disclosure program.

The CHAIRMAN. Of course, I agree. Tax cheats should not get the chance to escape by the bell. The IRS now knows who they are and just has not had time to bring them to court. We need to extend the time to catch the people avoiding taxes. I hope that our colleagues in the House would help us do that.

Senator BAUCUS. There is also another problem with these cases concerning the suspension of interest while the case is pending. Because of a provision enacted as part of the IRS Restructuring and Reform Act of 1998, the accrual of interest on most Son of Boss cases was suspended.

This means that abusive taxpayers who participated in these transactions and have now been caught will not have to pay the IRS interest, despite their huge understatements. The JOBS Act contains a provision that would turn off the interest suspension in the case of listed transactions, a provision that was effective as of March 5, 2004.

The CHAIRMAN. That is an abuse that we should also shut down. As you said, the JOBS bill fixes this problem, but does not do it in time to hit the Son of Boss transactions.

I suggest that we repeal the interest suspension general rule for transactions that are listed as the date of the enactment of the legislation, and that we continue to allow it for taxpayers that turn themselves in under these voluntary disclosure programs.

Senator BAUCUS. Good idea.

Commissioner EVERSON. Mr. Chairman, may I make a comment?

Senator BAUCUS. Before you do, Mr. Commissioner, I just have one final statement here. That is, that we get the staff started on this. That is, for inclusion in the final JOBS bill, making it much more costly to hide in the weeds, it should push more taxpayers to come forward.

The CHAIRMAN. I would agree with you, and our staff will cooperate with your staff on that.

Mr. Everson, it is all right for you to speak.

Commissioner EVERSON. I just want to thank you for those strong statements and for your strong support for our Son of Boss settlement initiative that you have had throughout this process.

We are pleased with where we stand, but we absolutely need to take firm actions, and are already doing so with those who have not come forward. What you are suggesting sends a strong message that you support us, so thank you.

The CHAIRMAN. All right. And thank you for your leadership, because I know that you briefed us on it several months ago, and I hope it is working according to your expectation.

Obviously, there is a lot that do want the clock to run out. As you can tell, we are a bipartisan team here. We want to make sure that your job will be easier, and if people owe taxes, they will pay it.

I want to get back to Ms. Langsea. You state in your testimony that California has issued subpoenas against two insurance compa-

nies that are writing policies to insure taxpayers against liability from shelters.

On May 5, a Wall Street Journal article described the growth of these policies after the IRS and after the Treasury Department removed insurance coverage as a factor in disclosing shelters as reportable transactions. The article says many taxpayers are doing this to cover low-risk transactions.

Is that what you have found in your investigations, and are taxpayers taking insurance policies on harmless transactions?

Ms. LANGSEA. Basically, the subpoenas that we are assessing to insurance companies are those that we have identified that were involved with insuring taxpayers that were involved in high-risk transactions such as the abusive tax shelters.

We are currently going through that information now, but we hope to be able to identify those investors who utilized or accessed themselves to that type of insurance coverage.

The CHAIRMAN. Mr. Everson, and also I think Ms. Olson, might want to listen to this question. The General Accounting Office report highlights a disturbing trend.

It seems that much of the Federal Government not only has little interest in helping the IRS do its job, but sadly it seems several government agencies seem to be actively hindering the work of the IRS to enforce tax laws.

You were a former number-two person at the Immigration Service. Why not take the simple step of the General Accounting Office testimony and its recommendations?

Why not just require a business, that before they can bring in a foreign worker, that they have to be square with the IRS. And if it makes sense to require it here, what about in many other situations?

I would ask Ms. Olson to comment on this matter. It is similar to your suggestion that Federal contractors be right with the IRS before they get Federal tax dollars.

Mr. Everson?

Commissioner EVERSON. I think, Mr. Chairman, this is a question of competing public interests. As you know, one of the fundamental principles in the tax law is the confidentiality of information.

That notwithstanding, I think it is entirely appropriate for the Congress to weigh other considerations where law enforcement is served or sound principles of tax administration are served. Right now, we are limited, though, in this area.

The CHAIRMAN. That is the privacy section. Is that what you are saying?

Commissioner EVERSON. Yes, sir.

The CHAIRMAN. All right. Then we will just have to take that into consideration, because that will be a problem for our committee then.

Ms. Olson?

Ms. OLSON. I think there are ways of doing that information checking without even messing with 6103, the confidentiality statute, using a consent agreement, making it a condition for someone who is a sponsor to obtain a document that states from the IRS that they are in compliance.

There are ways of doing that procedurally. The beauty of the Federal contractor provision is that the IRS already has the information on Federal contractor payments made by Federal agencies, and we are doing very little with that information to collect on that.

The CHAIRMAN. Yes.

I am going to turn to Senator Baucus. But I hope that you can stay, because I have another round of questions I need to ask. Particularly, I want to ask Mr. Morgenthau some questions.

Can you stay, Mr. Morgenthau?

Mr. MORGENTHAU. Absolutely.

The CHAIRMAN. All right.

Go ahead, Senator.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Everson, I want to get started off the top here. What is the size of the tax gap, do you think, today?

Commissioner EVERSON. Well, we do not precisely know, Senator.

Senator BAUCUS. Your best guess. You are the IRS. You are the Commissioner. You have to have some sense. You had better have some sense or we are in more trouble than I thought.

Commissioner EVERSON. Well, I think you know that the old figures that have been issued and are cited in three different sources in your testimony have it at over a quarter of a trillion dollars.

That is based on the old models, last updated in 1988, and then carried forward for changes in demographics and changes in economics. It does not reflect changes in behaviors of taxpayers during the 1990's.

As you know, under some pressure from Congress, we did not update the methodologies during the 1990's to get better information. We are doing that now. We have 46,000 individuals under audit and are just about to complete that. So, early next year we will be able to come back to the committee with much better information on this.

Senator BAUCUS. I thought that the figure based on 1988 assessments was $311 billion. That is what I heard.

Commissioner EVERSON. That is the gross gap. The net gap after slow payments or payments over time and enforcement actions gets us down another $55 billion.

Senator BAUCUS. Well, let us just talk about gross because that is apples and apples.

Commissioner EVERSON. Sure.

Senator BAUCUS. And that is 1988.

Commissioner EVERSON. That is 2001, based on the 1988 model.

Senator BAUCUS. Excuse me. That is 2001, based on 1988. That is correct.

Well, what do you think it is today?

Commissioner EVERSON. I hesitate to say.

Senator BAUCUS. Best guess. Best guess.

Commissioner EVERSON. I do not have a best guess. I think what I am disturbed about——

Senator BAUCUS. Surely you have a best guess.

Commissioner EVERSON. No, I do not. Honestly, I have had lots of discussions with our research folks and asked them the same

question just as doggedly as you are asking me. They are quite persistent in saying, let us wait until we roll this up.

Now, I am concerned, as are you, that there were changes in behaviors, particularly in these abusive shelters, that took place over the 1990's that we are addressing, and we will have to see what the impact of that was, obviously, as we go through this.

Senator BAUCUS. How can you run an organization if you cannot give at least a best guess? How can you run an organization without knowing what the size of the problem is?

Commissioner EVERSON. Well, obviously we have to understand the size of the problem and we are working to do that, and we will continue to do so. I would suggest to you that——

Senator BAUCUS. When are you going to know the magnitude of the problem?

Commissioner EVERSON. As I indicated, we will start to get the first results, hard results, from these 46,000 audits early next year. We will be able to update components of the tax gap. We will then also work on partnerships and flow-through entities. As you know, there are different components to it.

Senator BAUCUS. By what date next year?

Commissioner EVERSON. Oh, I would say, in the first half of next year.

Senator BAUCUS. You said early in the first part of next year. How about the first quarter?

Commissioner EVERSON. We will give you updates of components of the tax gap in the first quarter. I am happy to say that.

Senator BAUCUS. And then what are the components?

Commissioner EVERSON. That is the work we are doing now on individuals. But I have got to explain to you that once these audits are completed, and they will be completed over the course of the next few months, they then need to be modeled for some of the things you have already discussed.

For example, what about the people who are not even under the audits and the assumptions as to those folks who are not filing? So, there are a lot of different components and a lot of different testing that the statisticians do before they tell me that I have got a number that is good to go.

Senator BAUCUS. So we have a date, March 31.

Commissioner EVERSON. I will give you what we have by then. Yes, sir.

Senator BAUCUS. All right. I appreciate that.

I was intrigued with some of the comments that Ms. Langsea was saying. What lessons can we learn from California's experience? Let me ask this question. What is California's tax gap?

Ms. LANGSEA. California's tax gap is $6.5 billion.

Senator BAUCUS. Six and a half billion.

Ms. LANGSEA. Correct.

Senator BAUCUS. And how much did this program bring back, did you say?

Ms. LANGSEA. $1.3 billion.

Senator BAUCUS. $1.3 billion out of $6 billion. That is about 16 percent. Well, my math is not great, but it is in there somewhere. It would be great if we could knock that much out of the Federal

tax gap. What have they done right in California that we can learn?

Commissioner EVERSON. Well, I think that Ms. Langsea spoke to some of the things that worked, which include the cooperation of the Federal Government with the State government. As you know, we executed an agreement with 46 States some months ago. We have now shared 28,000 leads with different States.

The impact of our aggressive efforts, like Son of Boss, and active criminal investigations that involve the technical tax shelter area send a very strong signal. For the first time, we are working very closely with prosecutors where, when we go criminal, we do not neglect the civil side.

Before, our criminal investigators would back away if a case was being pursued on the civil side. We are working on all of these things now. I think there is some understanding out there—to go back to Mr. Brown's comments earlier—that risks are greater than they were before. He spoke about risk.

I think there is clearly an understanding that the risk of noncompliance is greater. That means, when Ms. Langsea comes up with something that she came up with or we come up with Son of Boss, more people will come forward to get right with the law.

Senator BAUCUS. Let me ask Ms. Langsea the same question. What are some of the lessons learned in California that might be applicable to the Federal level?

Ms. LANGSEA. I would say the primary advantage that California had was its tax shelter legislation. If you do not have increased penalties and curtailments to assess against people who are involved in tax shelters, the IRS, California, and other States will face the same issues.

California's legislation increased substantially its penalties. We issued almost 15 new or increased penalties so that those who have participated in these abusive tax schemes would be penalized.

Currently, I think some of the data that the committee has reviewed, some of these promoters are basically assessed $14,000 worth of penalties, but in return are receiving millions of dollars in fees.

Under the current statutes that the IRS has, there certainly is no incentive for tax shelter investors to come forward because there is not the substantial penalties that they would be assessed by being involved.

Senator BAUCUS. Could you compare California's recently enacted penalty provisions along with the anti-shelter provisions that this committee enacted that has not yet passed in the Congress?

Ms. LANGSEA. Correct. We actually modeled our legislation after the Chairman's S. 476 bill. Many of the provisions and penalties, we tailored after. We modified it for California's purposes, but basically with those penalties, taxpayers came forward because without it there was no enforcement that we could wield without that type of legislation.

So I would say that the legislation is probably the most key factor in bringing these taxpayers forward. Otherwise, you will get the same result.

Senator BAUCUS. All right.

Now, based on your experience, would you modify the provisions that this committee and that the Senate passed, but has not yet passed the Congress?

Ms. LANGSEA. I would go with any provision at this point. I would agree with the provisions that this committee is bringing forward, yes. We definitely need that type of legislation.

The other danger, is California is under a great deal of criticism because we are the only State that has such tax shelter legislation. If we do not have support from the Federal level, we are getting highly criticized for being out of conformity with Federal legislation.

Senator BAUCUS. Could you expand on that, please? I am just trying to build a record as much as possible to get this legislation passed and on the President's desk.

Ms. LANGSEA. Right. Basically, most taxpayers are looking at the Federal legislation as taking the lead against these abusive tax shelter schemes. When California has penalties that are distinctly different from the Federal legislation, taxpayers complain that we are out of conformity with what the Federal legislation provides, and therefore must abide by or be subject to different rules and different penalties at a State level that the Federal Government is not in support of.

Senator BAUCUS. So when taxpayers make those arguments, who do they make them to, what relief are they trying to get, and how often do they get relief based upon that differential?

Ms. LANGSEA. Well, I have heard them. They make them to the agency. They also raise them to our State legislature as well, too.

Senator BAUCUS. Mr. Everson, this sounds pretty compelling that we have got to get this passed.

Commissioner EVERSON. We have had this discussion before. Getting these penalties is absolutely an imperative. You know the work that you have done on this, and that the Permanent Investigations Subcommittee did, where things that were made public last year clearly indicated that the penalties were just considered speed bumps for the attorneys and accountants.

Senator BAUCUS. Do you raise this with the White House?

Commissioner EVERSON. This is a priority and it has strong support. Yes. Everybody is for this.

Senator BAUCUS. A priority out of how many priorities? One of a thousand or one of one?

Commissioner EVERSON. I cannot speak to the whole basket of priorities for the administration. This is strongly advocated right up the line.

Senator BAUCUS. I hear you, Mr. Commissioner. I just suggest you make this a big issue, and publicly. Start speaking about this.

Commissioner EVERSON. I am happy to do that.

Senator BAUCUS. We have to get this passed. I mean, that will help you and your work, it seems to me.

Commissioner EVERSON. I agree.

Senator BAUCUS. And according to Ms. Langsea, significantly.

Commissioner EVERSON. The penalties are central. But the other pieces of this, as I have indicated, are sending the strong criminal message. I would suggest to you, if I could, a couple of other things that need to be done. We do need to augment the resources.

I am very concerned about the President's request for an almost 11 percent increase in IRS enforcement funding. Thus far, that has met with, as I have made the rounds, a great reception, until we get to the point of the mark-up. Then you get the traditional clash over dollars.

It is just so important that you get us the resources. The other thing that we need to do, touching on a couple of points that were made is to upgrade our workforce.

For example, I was very disturbed that an arbitrator ruled a week ago that the IRS may not increase the standards for its revenue agents to have more accounting skills. This is what we are up against as we try to upgrade the workforce. So, we are doing a lot of things, but the penalties are certainly amongst the most important.

Senator BAUCUS. My time has expired. But before I do, I also ask you to strongly suggest to your boss, the Secretary of Treasury, to make a big issue out of this, too, publicly. We need to get this tax shelter legislation passed this year.

Commissioner EVERSON. Yes, sir.

Senator BAUCUS. Because just think of the consequences if we do not. What signal does that send? Congress discusses and talks about tax shelter legislation, but then does not do anything about it.

If I were a practitioner or a taxpayer and I attempted to skirt the law a little bit, I would think they were not serious over there in Washington, the White House is not serious, the Treasury Department is not serious.

We passed this legislation over here. The problem is over there, the other body. I think the White House would have a great influence, and the Treasury Secretary could have a great influence, on getting this legislation passed. You have to speak up.

Commissioner EVERSON. I will certainly carry that message.

Senator BAUCUS. Thank you.

The CHAIRMAN. Thank you.

Mr. Morgenthau, your District Attorney's Office, of course, is in the front line of fighting financial crime and detecting terrorism financing, and you are to be commended for the great job you have done. Tax cheats and terrorists use the same illegal tricks to move their money.

The crimes that your office has uncovered and scandals in the banking industry made me concerned that maybe we are not being vigilant enough against fighting terrorism. If we cannot stop terror funding through regulated banks, I do not know how we are ever going to stop it through other methods.

It is clear in your testimony and recent events that we are catching the financial misdeeds at big banks too little and too late. Your office alone has uncovered millions of illegal transactions and tax evasions that banks should have caught.

So, to my question. First, do you think the regulators are hesitant to get tough with banks because they worry primarily about safety and soundness, or is there some other reason?

Mr. MORGENTHAU. Well, I think that there is certainly concern about the stability of the bank. If you start charging one of the big

banks or one of the small ones with misconduct, it can create all kinds of problems for them.

But I think, from time to time, there are political pressures. I mean, I remember, back when I was U.S. Attorney, getting the Regional Director and the Controller of the Currency in and asking him to take a look at the agencies of several foreign banks. He said, oh, Mr. Morgenthau, I cannot do that. I said, why not?

He said, because ten minutes after I did that the clearinghouse banks would be calling my bosses in Washington and complaining. I said, why would they do that? Because they would be concerned that there would be retaliation against the branches of American banks overseas.

I remember when we were investigating in Abu Dhabi—that was the BCCI investigation—and the ruler called in the American ambassador and said if anybody close to me is indicted, we are going to withdraw our money from the United States, and we have $18 billion on deposit.

So, the American ambassador reported that to the State Department, and the Office of International Operations in the Justice Department called me. I said, you are in great shape. All you have got to say is, we do not control that crazy bastard in New York. [Laughter.]

But I mean, there is no doubt that there are political pressures brought from time to time. There is nothing corrupt about the FDIC. They did not realize that that branch, a branch of the Connecticut Bank of Commerce that went belly-up, was sold to Hudson United.

So when we started saying that no records were being kept, money was going to the Middle East to known terrorist organizations, we said, how could you let that happen? They said, FDIC sold it to us. It never occurred to us that there was a problem there.

So, some of it is incompetence. Some of it is concern about the bank's ability. From time to time, there is political pressure. We do not want to offend our foreign allies. We are in a nice position because we do not have any foreign policy responsibilities.

The CHAIRMAN. I believe you have seen some information about the Treasury's new plan to insure Bank Secrecy Act compliance. I would like your opinion on that. And what do you think of the idea of a central regulator to monitor Bank Secrecy Act compliance?

Mr. MORGENTHAU. I thought about that quite a bit. I do not think it is a good idea because the way you are going to find out about tax abuses is at the working level. When an auditor is in there, they should uncover that.

If you set up a whole new superstructure, they are going to have to send investigators in and start all over again. I think we have got to lean hard on the current supervisors and make sure that they are doing their job, rather than create a new organization.

I think the banks have got to be put on notice and they have got to be penalized if they do not do the job. Basically, the job is, know your customer. Know your customer. What we are saying is, the banks do not know their customers, in many cases.

The CHAIRMAN. All right.

I am very concerned about tax cheats, as this whole hearing has said. But I am also even more concerned about terrorism financing, a real threat to our National security. As you know, terrorists often use the same tricks as crooks do to move their money.

I would like to get your perspective on what kind of suspected terrorism financing your office has seen, and I would also like to hear what you think of how it is being investigated by authorities, and what the challenges are in these cases.

Mr. MORGENTHAU. I think it is a very serious problem. You take Beacon Hill, which moved $6.5 billion overseas and kept no records of who the customers were. So we go in there and they honestly who they are sending it to. We find somebody that sent $100 million over, and the notation is "a valued customer."

Well, that is easy to understand. A hundred million dollars makes you a valuable customer. But you do not know who is sending the money and you do not know in detail who is receiving it. I mean, you find the Arab bank in Ramallah is receiving the money. You can make some assumptions, but you do not really know who is receiving it.

So, I think that the banks have got to be much more vigilant in knowing their customers. They have got to keep the proper records. Then the bank examiners, whether it is FDIC, or the Federal Reserve, or the Controller of the Currency, have got to be much more alert to what is going on in those banks.

I mean, I could not be more happy that you are holding these hearings, and I think you ought to hold them every three or 4 months and find out what people are doing, because it is pretty simple. You have got to know your customers and you have got to make sure that that is enforced.

The CHAIRMAN. Your written statement includes examples of foreign countries who are helpful in your investigation, such as the Channel Isles. But tracking down money and financial records overseas is obviously difficult. Can you tell us what some of the problems are, such as the slow MLAT process and what could be done to fix this?

Mr. MORGENTHAU. The MLAT process is pretty close to a disaster, with the ability to move money anywhere around the world almost simultaneously. We go in and we use the MLAT procedure. By the time we get the records, which is anywhere from 6 months to 2 years, the money is long gone.

So I am hoping that, under the Patriot Act, the banks will have to give us that information directly. In other words, the bank that clears in New York for a foreign bank, give it to us directly so we do not have to go through that MLAT procedure. For State and local prosecutors, that is a disaster.

The CHAIRMAN. Yes.

What do you think of the idea of the Treasury Department and the IRS helping you and other local agencies by bringing in the big guns when foreign entities do not cooperate?

Also, if Treasury or the IRS cut off access to U.S. markets for not cooperating, or even threatened that sanction, do you think that you would see better cooperation?

Mr. MORGENTHAU. Let me say this. I mean, I think the IRS, under Commissioner Everson, has taken an entirely new direction

in terms of law enforcement. I am just delighted by what they are doing.

There was a Commissioner of Internal Revenue when I first became U.S. Attorney who publicly stated he did not believe in criminal enforcement of the tax laws. This Commissioner believes in it, and he is devoting resources.

But in terms of putting pressure on, I think it is got to be the Treasury Department, because obviously they can help with some of these jurisdictions like Switzerland. If you say it is a tax case, they say we will not touch it.

If you tell them it is a fraud case on narcotics, they will help you. So in some of these situations, the IRS, even though they want to be helpful, cannot be because the foreign companies do not want to help us enforce the tax laws.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I would just like to generally ask all of you whether you agree or disagree with the earlier panel. I asked that panel whether the greatest problem, the biggest category, is sole proprietorships and the cash economy. I went down the list of everybody on the prior panel and I did not find anybody who disagreed with that. They all nodded their agreement.

I would like your response. Mr. Everson, what do you think? Is that right or not?

Commissioner EVERSON. I agree, that is the biggest problem. But as you know, where we have started is with the corporations on the high end. We have done that because of the perception of fairness and the permeation that goes through the system. We do need to focus, though, increasingly, as you say, on the smaller businesses and the individuals at that end.

Senator BAUCUS. How about the thought of requiring withholding?

Commissioner EVERSON. I think that one word that is very important in this is burden. I am not, at this time, in favor of requiring the withholding. I want to work to put some teeth into enforcement so people know that there is a presence if they are not complying, see how we can do with that based on good, strong measurements, as you are advocating. I would be hesitant at this time to suggest that additional burden.

Senator BAUCUS. Ms. Olson, your response? Does anybody have a different view, or a slightly different view?

Ms. OLSON. Well, in my annual report we discussed this issue at great length. And since it was published in January, I have met with over 30 small business groups and trade associations to discuss this issue, including 22 at one time, which was an interesting discussion to have.

We actually have had trade associations coming to us saying, our members want to enter into voluntary withholding agreements under the laws that are on the books right now.

Others have proposed to us using expanded backup withholding, so where we actually identifying individuals who are not compliant based on past NRP document matching and things like that, that we can go to the payor and, under backup withholding authority,

say, in this particular case, withhold a flat 20 percent until the person comes into compliance.

Then that does not even get to just doing some kind of mandatory withholding for types of industries where the NRP data shows that there is noncompliance.

I also want to support Professor Bankman's proposal about working with the States. There are many different ways to get information on gross receipts at the State level in terms of licenses.

The property tax is a good approach, but there are many types of licenses that are based on gross receipts. People who are contractors estimate what the volume is of their jobs, the dollar volume of the building projects that they do. That is information the States have. And if that does not jive with what we have got on their tax returns, that is something we should look at.

Senator BAUCUS. Sure. It just sounds like there could be a cross comparison here as a pretty fertile field. Professor Bankman also mentioned looking at State property taxes, because after a while wealth accumulates and people start investing money in one thing or another.

We have talked earlier, but I have forgotten the agency. Was it the Immigration Service earlier today? That data and some of the benefits there, and some of the privacy issues.

Could some of you address, where can there be cooperation? Where is the field most fertile for more transferring a comparison of data?

Commissioner EVERSON. I will certainly let the others comment, but let me just say one thing that was inexplicable to me. The data sharing has been one way, where we have given the States a list of the Federal non—filers for years, but it has never come back to us.

We have just recently been working it out with the States as a follow-up to this agreement that I mentioned that we did last year with the leads that we gave to California and others, that now we will get the list of all their filers and we will see if somebody has not filed in the U.S. system. That is incredible. That is a fairly basic piece of information.

Senator BAUCUS. I am sorry. You say you gave information to the States?

Commissioner EVERSON. If we do an audit and find somebody has not done something, the States routinely get that data match. The State of Virginia will say, because the IRS audited you and you got an additional assessment of $5,000, you owe us $400. It does not go the other way. We do not get the list of filers from California so that we can see who did not file federally. Now we are going to get that.

Senator BAUCUS. You are getting that how?

Commissioner EVERSON. Now we are going to get it. We are in the status of agreeing with all the States as a follow-up to all of these exchanges.

Senator BAUCUS. States. All right. So, that is progress.

Commissioner EVERSON. That is progress. But I could not believe that it was not a two-way street from the beginning.

Senator BAUCUS. All right.

Ms. Langsea, could you expand on that? What other kinds of data sharing would be beneficial here?

Ms. LANGSEA. I would also agree that the information sharing between the States and with the IRS is essentially critical. We are also working with the other States who have signed a Memorandum of Agreement.

There are about 45 States and cities who have signed such an agreement, as well as with the IRS as well. We are also currently setting up a central repository or database where we can have our leads shared amongst each other as well, too.

I think that States are definitely committed to providing that sharing of more data and information. A lot of it has to do with technology, being able to transfer that information, but we definitely see the added value in doing so.

One other thing that I might add, is you mentioned earlier as far as the percentage or significance of where most of the under-reporting for the tax gap is. Like the IRS, we believe that 80 percent of that is from people who do report income, but they under-report their total amount of their income. So these are taxpayers that we have access to, however, they are not reporting all of their income entirely.

Senator BAUCUS. And generally what income are they not reporting?

Ms. LANGSEA. Well, abusive tax shelters fit in that category, as well as the cash economy that Professor Bankman talked about as well, too.

Senator BAUCUS. So we have their names and they are reporting something. At least you have got a start.

Ms. LANGSEA. But you do not know what is not on the return. Correct.

Senator BAUCUS. Right. Right.

In addition to income tax sharing, what other data is shared that is potentially fruitful here? You mentioned property taxes. Immigration Service data has been suggested. Where is there more opportunity here? Or is there? Is that about it?

Commissioner EVERSON. I think that i would like to give you a considered response on the other areas where we can enhance that sharing. I think we have moved very aggressively. We have got this agreement that we just signed last year. We have already started sharing information.

We now sort of have a working network, if you will, to take these things forward and we have got improving relationships, both with the States and cities, and other places. So, I think we will see a lot of creativity here.

Senator BAUCUS. As we discussed earlier, I suggested 90 percent compliance by 2010. Is that reasonable?

Commissioner EVERSON. I think we should have that discussion, Senator, after we start to get you some numbers on the tax gap next year. I am uncomfortable setting a target until we know the magnitude of the problem more precisely.

Senator BAUCUS. And the percentage currently is what?

Commissioner EVERSON. Well, I would not say that we know what the percentage is currently, again. It is all based on the old models.

Senator BAUCUS. I know. But you extrapolate.

Commissioner EVERSON. The conclusion in 1988 was that it was about 5 percent short of that.

Senator BAUCUS. But certainly whatever that cranks out to be——

Commissioner EVERSON. Yes. It was about 5 percent short of that.

Senator BAUCUS. Whatever it is, we know we could do a lot better.

Commissioner EVERSON. I could not agree with you more.

Senator BAUCUS. All right.

So whatever it is, can we agree? I am trying to get something like a percentage improvement over each of the next several years until 2010.

Commissioner EVERSON. We are going to re-engineer our business processes on the enforcement side, just as we did on the service side. We are going to have ruthless prioritization and do things with criminal and other areas to get the leverage.

We need help on the resources and on the legislation, as you have mentioned. If we can get all those things, we can set very ambitious goals, but we need to know the starting point, first.

Senator BAUCUS. Right. Well, I will make you a deal. We will get the legislation passed if you can increase the percentage by two or 3 percentage points each year.

Commissioner EVERSON. Get me the money, too. [Laughter.]

Senator BAUCUS. Well, you have got no problem with this committee there.

Mr. MORGENTHAU. May I say something?

Senator BAUCUS. Certainly.

Mr. MORGENTHAU. There has been a lot of emphasis on tax shelters and that is important. But there are more and more people who just are not paying their taxes. They are booking their profits overseas. They are transferring their cash overseas.

I really think we are at the tipping point. I mean, nobody enjoys paying taxes, but they will do it as long as they think everybody else is paying taxes. Once the word gets out that you do not have to pay, more and more people are not going to pay. I mean, just take the sales tax business. Going out, originally, there was a referral from FINCEN involving the chairman of the board of a major Washington bank.

But based on that investigation, we have actually collected $24 million in sales tax, which was evaded by some very prominent people in New York City. But once the word is out there, you do not pay, nobody is going to pay.

I just think we are pretty close to that tipping point where more and more people are going to say, what am I, a sucker? Why should I pay when other people are not? The tax shelter business is obviously of great importance, but the people are not using any recognized tax shelter. They are just not paying their taxes. When you have a trillion U.S. dollars on deposit in the Cayman Islands, you have got to say something is really wrong here.

Ms. OLSON. Senator, if I might make a point about this. My office has sponsored some research that we called "The Tipping Point

Study." We have attached the first part of that to our testimony here.

We were concerned that more and more taxpayers, not just very, very wealthy, but the moderately affluent, were beginning to buy into things. They were not really the technical tax shelters, but they were things like slavery reparations, or the home-based business schemes, or the handicapped access scheme.

We have asked the IRS research office to partner with us to look at why these taxpayers, if I may use the word, tip, where they are normally compliant taxpayers. Is it the person who is delivering the message? Is it that their neighbors are doing it? Is it the vehicle?

Is it where they are hearing about it, in churches, in community groups, or whatever? We are trying to come up with a taxonomy of schemes and then approaches, what sells them to people, hoping that the IRS can use this information to identify schemes in the future before they have tipped. You just see the signs as they are building up.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Godici, you will be the last question I will ask. It comes from your testimony about taking cues from Congress in deciding what to patent.

So, I would like to give a cue: stop issuing patents on tax shelters. Why not just simply check with Treasury in deciding to issue a patent, and if Treasury says that is a tax shelter, then you do not patent it? I mean, I think it is that easy. If it is not, tell me.

Mr. GODICI. Well, Mr. Chairman, certainly the patent laws do not trump the responsibility and oversight that the IRS has with respect to those regulations. Additionally, when we allow or issue a patent, that does not give the patent owner or inventor the legal right to practice that invention, only to exclude others.

Some of the case law that has been decided recently around this issue seems to concentrate on the fact that other regulatory agencies like the IRS or the FDA should be the agencies responsible for public policy and protecting the public, and our expertise would be with respect to intellectual property in deciding whether or not the inventor is entitled to patent protection.

Having said that, I have had conversation with Commissioner Everson. We stand ready to work with the IRS in any capacity that we possibly can. Patents are a transparent process. The patents are available on our Web site. They can be searched.

The technology and the subject matter can be searched, as well as applications, now, and are available so we know what is coming down the pipeline. We can certainly work with the IRS in any way that they see fit in terms of these types of inventions we are seeing.

The CHAIRMAN. Mr. Everson, do you look at these patents as a source of information for people who might be avoiding taxes?

Commissioner EVERSON. We have not done much in this area, and we need to do more. As the Commissioner has indicated, we have started a dialogue. As in so many areas you have highlighted, we need to do more on this.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Yes. I find this patent matter intriguing. I just pulled out my trusty constitution. The patent provision of the con-

stitution that you referred to says, "To promote the progress of science and useful arts by securing, for limited terms, to authors and inventors exclusive right to their respective writings and discoveries."

Well, our founding fathers say it is to promote the progress of science and the useful arts. I would not describe this as a science or useful art.

Mr. GODICI. Actually, Senator Baucus, we have had many decisions in our courts, in our oversight courts, particularly one I mentioned in my oral testimony, the State Street Bank decision, which have explicitly said that this type of technology—they call this technology—or this type of innovation is eligible for patenting. In the State Street decision, it was actually a scheme for determining the value of a mutual fund program.

Senator BAUCUS. For 17 years?

Mr. GODICI. Pardon me?

Senator BAUCUS. What is the life of a patent?

Mr. GODICI. The life of a patent is 20 years from the filing of that patent.

Senator BAUCUS. The writing. I thought it was 17 years. It is for drugs.

Mr. GODICI. It has changed in the last several years.

The CHAIRMAN. The treaty changed it to 20.

Mr. GODICI. It was changed in 1999, actually. It is now 20 years from the filing of the patent.

Senator BAUCUS. Do you have generic versions?

Mr. GODICI. Pardon me?

Senator BAUCUS. Do we have generic versions? We have got brand-name drugs. Are we going to have generics now?

Mr. GODICI. With respect to patents?

Senator BAUCUS. Yes. Once the 20 years is up.

Mr. GODICI. The bottom line is, obviously, once a brand name in the drug industry goes past the 20 years, then that technology is available for all to produce.

Senator BAUCUS. No, no, no. I believe the drug companies have come up with all kinds of ingenious ways to avoid that. It is incredible.

The CHAIRMAN. Our Medicare law, though, changed some of that. I do not know whether it changed it all, but it did the scheme they were using to hold the generic drug off the market. We changed that.

Senator BAUCUS. Yes. As you know, Prilosec is the same as Nexium. It is just one modest little thing changed.

Commissioner EVERSON. If I could venture a remark, I think some of these shelters are more creative and artistic than anything else. [Laughter.]

Mr. MORGENTHAU. I do not think the people that are getting these patents want their work protected. They just want the imprimatur of the U.S. Government that this is patented.

Senator BAUCUS. Yes. That is a good point.

Mr. MORGENTHAU. That is what it is all about, I think.

Senator BAUCUS. That is right.

Well, we have got a lot more to discuss here, but we do not have time to do it. I would just like to figure out some kind of way to get some accountability here, more than we even have.

That is, by certain dates, a certain amount accomplished, a certain percentage of the so-called gap reduced and an assessment of where the greater problems still lie.

Mr. Morgenthau makes some very good points about the trillion dollars in the Cayman Islands as an example of the kinds of problems that are probably occurring. Funds travel at the speed of light anywhere in the world, and so forth.

Mr. Chairman, I am not exactly certain how to do this in a fair, solid way. But Mr. Everson, you are going to indicate to us by March 31 what you think the initial results are of the new—I have forgotten the name it is called.

Commissioner EVERSON. The National Research Program.

Senator BAUCUS. It is the son of the 1988 kind of data.

Commissioner EVERSON. We do not say son, that is Son of Boss. So, stay away from that.

Senator BAUCUS. All right. Well, anyway, the next generation.

Commissioner EVERSON. Yes, sir.

Senator BAUCUS. The next stage, and so forth.

What else can you suggest to this committee that you can provide? What kinds of information, by what dates, do you think make sense so we have some mutual understanding and to avoid misunderstanding of where we really are?

Commissioner EVERSON. Right. I think that is the real starting point. We can go from there. Again, I am very anxious that we get some of these teeth in with these penalties. If we can get that done, we have got a new regulatory scheme in place. We are working on something called Circular 230, which is a governance standard for practitioners. That is terribly important.

If we can augment our resources in an appropriate way, then we can have a pretty intelligent discussion, I would suggest, and we will see things like the results of Son of Boss, or what happened in California.

Senator BAUCUS. Well, that is just Son of Boss. I am concerned about the sole proprietor/cash part of all this and you are disinclined to do anything about it.

Commissioner EVERSON. Not at all. I am not disinclined to do anything about it. What I was talking about was weighing the issue of the withholding.

Senator BAUCUS. Third party.

Commissioner EVERSON. Yes. That is the issue for me.

Senator BAUCUS. Well, that is such a huge problem, this area, we all agree. It seems to me we have got to tackle it and figure out some date by which we are going to address the problem rather than just saying, well, the burden is an issue. Well, sure it is an issue, but what is the solution? What is the burden solution?

Commissioner EVERSON. I think that we have to carefully weigh the burden against how far we get on the reestablishment of the enforcement programs.

Senator BAUCUS. There is always a way to skin a cat. You can accomplish your objective a third way, it is not either/or, by reduc-

ing the burden. There is always a way. There is always a way. We just do not say no, because it is a burden.

So by the same date, can you provide this committee with ways, alternatives of how you have the payors provide withholding, or the third party, or whatever it is?

Commissioner EVERSON. Fair enough.

Senator BAUCUS. And also ways to deal with the legitimate burden.

Commissioner EVERSON. What I do commit to is to look at it and give you more details on that segment and the various alternatives that exist.

Senator BAUCUS. And how much would be raised under various alternatives that you have, how much the tax gap would be reduced by each of the various alternatives that you suggest.

Commissioner EVERSON. If, in fact, the research is being done will support that, of course.

Senator BAUCUS. Well, do you not think that is the case, that it will reduce the tax gap? Everybody here thinks so.

Commissioner EVERSON. Well, the question is the level of specificity you get into. I do not want to over-promise you.

Senator BAUCUS. No, no. But you can come up with it. You are the man here. You are the IRS Commissioner.

Commissioner EVERSON. That sounds pretty good.

Senator BAUCUS. So you can come up with various alternatives, the most stringent, the most lenient, the moderate, that addresses this area of the tax gap problem.

Commissioner EVERSON. We can certainly develop options.

Senator BAUCUS. With numbers under the most stringent—you can call it something else. I do not care what you call it—the most moderate, and the most lenient.

Commissioner EVERSON. We can certainly——

Senator BAUCUS. Can you do that? Three different alternatives. One is stronger, one is less strong, and one is still less strong.

Commissioner EVERSON. All right. We will look at alternatives in that specific area.

Senator BAUCUS. In that specific area, and with the number of dollars the gap could be reduced, by what dates.

Commissioner EVERSON. There will be a lot of qualifications, just so you know.

Senator BAUCUS. Well, you do not have to qualify a lot. We will work with you. We want to work with you.

Commissioner EVERSON. All right. Well, we will do that. We will start having discussions as to what that would be.

Senator BAUCUS. And if you could really do that. Because, as you know, your record—and to be honest, my record—is not good on this. Namely, I have asked similar kinds of questions of you in the past to which you have not responded very fully by any stretch of the imagination. I am bad because I have not followed up with those non-responses in a timely way either. But let us both be much more responsive, both of us.

Commissioner EVERSON. All right.

Senator BAUCUS. So I hope you are responsive. If you are not, then it is up to me to be very responsive immediately. Is that fair?

Commissioner EVERSON. That is fair.

Senator BAUCUS. All right.

I have no further questions.

The CHAIRMAN. All right.

Well, this has been a very good and informative hearing, and has given the committee a good grounding as a way to bridge the gap. It is our responsibility to follow up on it. I thank the panel very much.

The hearing is adjourned.

[Whereupon, at 1:35 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Mr. ABC

Testimony of Mr. ABC:

Mr. Chairman and Members of the Committee. I want to thank you for giving me the opportunity to testify today.

I am speaking to you about my experience as an IRS "Confidential Informant" who provided original information concerning significant and ongoing tax fraud involving major Wall Street firms.

I speak from first-hand knowledge. I work for a Wall Street investment bank, and through my professional experience I am intimately aware of competitors' fraudulent tax shelters. The schemes in some cases have been ongoing for more than a decade. A couple of the schemes involved Enron. The Wall Street fraud is complex and involves hundreds of millions, if not billion of dollars of US tax liabilities.

In a nutshell, I blew the whistle on three types of abusive tax shelters:

The first abuse concerns the fraudulent transfer of US tax liabilities to foreign entities not subject to US tax. There are various permutations to the scheme, but one essential component of this fraud is the creation of sham "domestic" partnerships to serve as fronts for foreign owners who acquire the US tax liabilities, but who have no intention of ever paying US tax.

The second abuse involves the transfer of US tax liabilities to the foreign branches of US taxpayers in order to artificially generate foreign source income and claim additional US tax credits.

The third abuse, which is generally performed in conjunction with the above two, concerns the artificial replication of tax basis solely for the purpose of creating false deductions to be sold to outside taxpayers. These duplicate deductions are then claimed by the unrelated

taxpayers as an offset to their otherwise taxable income from other sources.

As a Wall Street insider I am very knowledgeable about these abuses. I can tell you from experience that about 75 percent of all of the transactions specific to my expertise ended up in abusive tax shelters. Because the IRS has moved too slowly, or not at all, the abuses are still ongoing. That has resulted in huge tax liabilities being avoided. I estimate that the US Treasury has lost at least $400 million of tax revenues every year from these particular schemes.

Another important consequence of this fraud is that US taxpayers who want to engage in transactions legally are being undercut by those engaging in the tax abuse. The transactions' true market value depends on compliance with applicable US tax laws. If the associated tax liability is simply ignored through sham domestic partnerships, or by the artificial generation of offsetting credits, then the market value of the transactions erodes significantly. As a result, my livelihood and the business interests of honest US taxpayers are being seriously harmed by the fraudulent practices of others.

In 1998, I decided to come forward and report a particularly abusive group of entities that I knew were engaged in this fraud. I contacted the IRS' Criminal Investigative Division, and through them was put in contact with an IRS Civil Examination agent who just happened to be auditing one of the partnerships that I was concerned about. That first contact concerned 3 particular entities, and then over the next few years I provided detailed information concerning more than a dozen other entities and related groups engaged in similar tax abuse.

From the time of that first contact until today, my efforts to correct the abuses have resulted in a series of frustrating and often unproductive dealings with the IRS. Over the past 6 years, I have literally spent thousands of hours educating and prodding the IRS, urging them to take action. I have traveled across the country at my own expense to have face-to-face meetings with agents. I have provided the IRS with hundreds of pages of evidence, and submitted numerous writings and diagrams explaining the fraud and analyzing the abusive shelters in detail.

As I mentioned, when I first contacted the IRS they had one of the partnerships under audit. Not to fault that particular IRS audit team, but they truly did not know what they were looking at. These are sophisticated tax avoidance strategies concocted by Wall Street. As a general matter, I observe that the IRS is consistently outgunned and outmatched. From my vantage point, the IRS simply does not understand how the tax shelters work, or how the transactions and structures fit together.

When I first met with the IRS in 1998, I submitted an IRS Form 211 concerning the overall abuse. Later, I submitted detailed and separate Form 211s for each of the entities involved. Form 211 is the IRS form for confidential informants to supply information, and to apply for a reward under the IRS' whistleblower program.

Later in 1998, I provided information about 2 more entities engaged in significant partnership fraud. In 1999, I provided detailed information about 6 or 7 more entities involved in abusive basis replication schemes; and about 5 other entities involved in the fraudulent domestic partnerships. I also identified a major Wall Street bank that was involved in the foreign branch abuse. In 2000, I provided information about yet another Wall Street bank's foreign branch approach, as well as 2 other additional entities that were utilizing fraudulent domestic partnerships. In 2003, I provided information concerning 2 entities that were acting as "promoters" of various types of transaction scams. And, in 2004, I provided information to the IRS concerning 2 other entities conducting basis replication schemes.

Finally, over all of these years I provided detailed documentation and analysis of the abuses to the IRS through meetings, phone calls, emails and faxes. I hope that you now have a sense of the quantity of information and assistance that I have provided, as well as the pervasiveness and persistence of the tax shelters themselves.

Together, I estimate that the numerous fraudulent schemes on which I provided original information involved over $10 billion of taxable income. Obviously, there are very serious US

tax liabilities associated with this income that are being avoided. The combined loss to the US Treasury is immense.

In providing all this information, my experience with the IRS has been extremely frustrating and discouraging. What I have encountered is an agency that is resistant to and suspicious of confidential informants...that is, private citizens who are trying to do the right thing by coming forward and blowing the whistle on significant tax fraud. I have also encountered an agency that is disorganized, and that is generally not equipped to deal with complex and sophisticated tax shelters in an effective fashion.

Let me give you some examples. At the same time that I was actively supplying vast quantities of quality information to the agency, the IRS Service Center that was processing my Form 211s simply rejected them out of hand in 2003. There was no valid reason to reject them. It is just that the IRS Center had no idea what was going on, but chose to act anyway - probably just to get the paper off their desk. It then took months to get the Form 211 claims reinstated.

The IRS is also resistant to outside information - even when it comes from a knowledgeable insider like myself. I have often been treated suspiciously, as if I were the "bad guy." There appears to be more of a willingness at the IRS to believe the taxpayer perpetrating the scheme than the informant justly questioning the fraud. I have never understood this attitude because I am putting myself at great personal risk by coming forward. I stand to lose my career if my identity is discovered, since employers are uniformly hostile to employees who interact with regulators. I just do not understand why the IRS has not welcomed the help and information.

In addition, from my perspective, the IRS lacks the staff and resources to take on serious enforcement against Wall Street. Since 1998, I have provided detailed information on over 20 entities and related groups that have engaged in complex and material tax abuse through numerous tax shelters. To date, action has been taken against only a couple of the entities. I have yet to receive any reward for my efforts as a confidential informant.

In many cases, the information I provided was simply ignored. One example that I find particularly troubling involves Enron prior to its collapse in 2001. In particular, in 1999 I provided detailed information about a series of fraudulent tax shelters involving a major Wall Street firm and Enron. The shelters involved the artificial duplication of tax deductions, for the sole purpose of generating fictitious book income. Approximately half a billion dollars of taxable income was evaded a result of Enron's fraudulent tax schemes. And, conversely, hundreds of millions of dollars of fictitious book income appeared on Enron's financial statements.

Not only did I provide drafts of a suspect Arthur Anderson "opinion letter" comforting the shelter, but I also supplied a copy of the investment bank's "pitch book" to the IRS. The pitch book specifically outlined the questionable structure and its purported "benefits" - which included the almost too-good-to-be-true effect on Enron's GAAP financial statements. So, although these were tax abuses that Enron and Wall Street were engaged in, at the end of the day the tax shelters permitted Enron to inflate its book earnings. Obviously, if IRS authorities had pursued the information back in 1999, the federal government might have seen what was happening at Enron (and Arthur Anderson) long before there was a total melt down.

Remarkably, no one at IRS inquired about the information or pursued it. The one agent that I have worked most with questioned the lack of follow-up internally with the resident Enron IRS audit team and was rebuffed for raising the issues.

Part of the problem is that the regional organization of IRS audit teams has generated regional in-fighting, so that inquiries from one region are often treated dismissively by another region. Part of the problem also is that on-site IRS audit staff seem to have divided loyalties, since they work on a daily basis with the entities they audit (and often go to work for them after completing government service). At other times, audit staff can be very protective and rigid because they do not want to reopen audit periods that are formally "complete." And, the lack of

staffing and high turnover generally also take their toll. For example, I often had to resubmit the same information multiple times because it would get lost, and the high staff turnover meant that I repeatedly had to bring new people up to speed.

I think that the greatest problem, however, is the agency's resistance to take seriously outside information from knowledgeable insiders. If I hadn't persisted, all of my claims would have been rejected and my information would have been lost. Actually, the biggest loser in this is the US Treasury since Confidential Informants can help the IRS recover hundreds of millions, if not billions of dollars of lost tax revenues.

Let me end by saying that if the IRS ever wants to put an end to Wall Street tax shelter schemes, they are going to need the help of Wall Street insiders to get the information and the expertise that it will take. Right now the IRS does not have such resources or expertise - and they should welcome the assistance from knowledgeable insiders.

Thank you Mr. Chairman and Members.

Testimony of Professor Joseph Bankman
Ralph M. Parsons Professor of Law and Business
Stanford Law School
Stanford, CA
July 21, 2004

The tax gap is a big subject. I'm going to limit my comments to the largest part of the tax gap – that associated with the cash economy. In the interests of time, I'm going to focus on possible (partial) solutions to the problem that the Committee may not have already considered.

My first suggestion is to increase the reach of third-party reporting. Taxpayers who receive income subject to third-party reporting, from wages, dividends or the like, accurately report this income on their tax returns. It is income that is not subject to third-party reporting, such as cash and checks received by sole proprietors, that is the source of most of the tax gap. It is obviously impossible to extend third-party reporting to all transactions. But the current reporting rules are particularly arbitrary and easy to avoid. (To take but one example, payments to individuals and partnerships are subject to third-party reporting, but payments to S Corporations are not.) I've written elsewhere some of the ways these rules could be tightened up, and better enforced. See Bankman, Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs, 2004 TNT 134-43.

Unfortunately, the burden of third-party reporting falls (at least initially) on taxpayers who are not even suspected of evasion. This is a general problem of enforcement in this area and leads to my second suggestion: wherever feasible, reimburse "innocent" taxpayers for their compliance burden. Reimbursement comports with a common sense notion of fairness and will reassure taxpayers that the government is taking their compliance costs into account when setting enforcement policy. For that and other reasons, I believe reimbursement will may be a necessary predicate for some enforcement initiatives. New Zealand has explicitly tied an increase in third-party reporting to a reimbursement plan; we might explore a similar system.

We might also consider reimbursement in connection with audits. Twenty years ago, Congresswomen Nancy Johnson (Connecticut) suggested the government reimburse taxpayers for the cost of the old TCMP "super" audit. It was a good idea then and is still a good idea. I've elsewhere suggested the government extend reimbursement to garden variety audits in which the taxpayer is found to owe little or no tax. See http://www.law.nyu.edu/colloquia/taxpolicy/042204.pdf One obvious way to reduce the tax gap is to increase the audit rate and I assume you are already weighing this option. I suspect an increase in audit rates, like other initiatives in this area, would be more popular if tied to an reimbursement system.

My third suggestion is to cross check tax returns with state property tax records. Eventually, income from cash business that is not reported is used – if there is enough of it – to fund property purchases. Some individuals will report virtually no income yet purchase millions of dollars worth of property. Huge discrepancies between property purchases and reported income might be built into the program that sifts out returns for audit. I understand California may develop a pilot program here – the federal government may want to monitor the success of

that program.

My fourth suggestion is to work with the preparer community to more aggressively pursue the (few) bad apples in that community. A small number of dishonest preparers are responsible for a disproportionate amount of evasion. These preparers put honest preparers at a competitive disadvantage and help maintain an equilibrium of low reporting rates in certain segments of the economy.

The most highly publicized component of the tax gap is, of course, that associated with high end tax shelters, rather than the cash economy. The loss from tax shelters may be small compared to the loss from the cash economy but it is absolutely large. I have written on the problem of tax shelters and worked with California to develop legislation in that area. See Bankman, Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs, 2004 TNT 134-43 (and articles cited therein). I'd be happy to discuss tax shelters with members of the Committee but as my time is limited, will not offer any prepared remarks on the subject.

Committee
On Finance
Max Baucus, Ranking Member

NEWS RELEASE http://finance.senate.gov

For Immediate Release
Wednesday, July 21, 2004

Contact: Russ Sullivan
202-224-4515

Statement of U.S. Senator Max Baucus
"Bridging the Tax Gap" Hearing

One of the strongest features of our democracy is our system of collecting income taxes through individual self-assessment.

President Franklin D. Roosevelt said:

> "In 1776, the fight was for democracy in taxation. In 1936, that is still the fight. Taxes, after all, are the dues that we pay for the privileges of membership in an organized society. As society becomes more civilized, a Government is called on to assume more obligations to its citizens. The privileges of membership in a civilized society have vastly increased in modern times. But I am afraid we have many who still do not recognize their advantages and want to avoid paying their dues."

These words remain as true today as they were in 1936.

It is easy to bash the IRS. It is easy to bash the government. And that is why it is important for public officials to take the high road and remind taxpayers of why we pay taxes.

The dues we pay for the privileges of membership in a civilized society provide education for our kids. They provide police and fire protection. They ensure safe and efficient highways. They make our nation's parks available for generations to come. They take care of the elderly. And they help take care of our children.

This does not mean that taxpayers should pay more than they owe. As stated by the great jurist Learned Hand, "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury." So, there is clearly a balance that we must strike. Unfortunately, we are not in balance.

Over the last 3 years, we have been on a destructive fiscal path. As a result, our federal budget has gone from the largest surplus in our nation's history to the largest deficit in our nation's history. This year's deficit will likely top $400 billion.

But if that sea of red ink is not bad enough, it is even more disturbing when you consider that a growing percentage of Americans do not believe that paying taxes is their civic duty.

In 1999, 81 percent of Americans agreed that it's their civic duty to pay taxes. In 2002, only 72 percent agreed with that statement. And last year, that group fell to just 68 percent of the population.

This trend is disturbing. But it is also very clear that more and more people believe that cheating is acceptable. This mind-set undermines our nation's democracy.

While honest Americans are doing their part, a number of others are trying to get by without doing theirs. And that's what this hearing is about.

Some call it the "tax gap" — the difference between the amount of taxes that taxpayers owe the government and the amount of taxes that taxpayers voluntarily and timely pay.

This is not about raising taxes. This is about enforcing the tax laws on the books. This is about collecting the taxes that are owed to the Treasury under the existing tax code.

The Internal Revenue Service's Office of Research estimates the gross tax gap at $311 billion for tax year 2001. And only about $55 billion of this will ever be recouped, in part because the IRS does not currently have the resources to ensure that everyone pays what they owe. This leaves a net tax gap of $255 billion.

These figures are based on the IRS's current estimate of an overall taxpayer noncompliance rate of 15 percent. Playing this out, if we just had a one percentage-point swing in voluntary compliance we could change revenues and reduce the deficit each year by more than $20 billion.

Moreover, the tax gap exacerbates the long-run imbalance in the Social Security Trust Fund. In 2001, sole proprietors under-reported their income by amounts that reduced Social Security payroll taxes by about $40 Billion. The Social Security actuary tells us that if we could reduce this tax gap by even 20%, we could reduce the 75-year actuarial imbalance in Social Security by 5.3%.

This would push back the date that the Social Security Trust Fund exhausts by one year. And this would help stave off an increase in payroll taxes or a cut in benefits.

Similarly the Medicare actuary tells us that Medicare's 75-year actuarial imbalance would be reduced by 2.6% and its exhaustion date would be pushed back by one year: from 2019 to 2020.

It is just common sense for us to set a goal — a benchmark of where we should be on tax compliance. In April, I proposed that we shoot for at least a 90 percent tax compliance rate by the end of the decade. That means that by 2010, at least 90 percent of Americans should be filing their taxes and paying their dues. This is not too much to ask.

As we face a Federal deficit of over $400 billion, the government has to do a better job of collecting the taxes owed. We need a plan of action to close the tax gap.

I am concerned that the IRS does not have the resources it needs to enforce the tax laws. The IRS's fiscal year 2005 budget request does not account for mandatory pay raises, unbudgeted mandatory expenses -- such as rent increases and postage -- and the inability of the IRS to achieve its projected savings from internal productivity growth.

And just last week, the House Appropriations Subcommittee on Transportation and Treasury, and Independent Agencies reduced the Administration's budget request for the IRS by $382 million.

I am concerned that the IRS will not have adequate funding to increase enforcement initiatives and maintain its taxpayer service at the same time. At some point, the IRS can no longer do more with less. I believe we have reached that point.

But it is not just about more resources. We need to ensure that the IRS modernizes its computer systems and improves its research so that it operates smarter and more efficiently.

We also must pass the tax shelter, Enron-related, corporate governance, and simplification legislation that the Senate has passed several times.

There is no silver bullet to closing the tax gap. Nonetheless, increasing IRS resources, ensuring a smarter and more efficient IRS, and enacting specific legislation will go a long way to closing the tax gap. We have to start somewhere. And we have to start now. Enough talk. I want some action. I look forward to hearing from our witnesses on the schemes used to avoid paying taxes, the nature and size of the tax gap and on recommendations to close the tax gap.

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United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

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TAXPAYER INFORMATION

Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions

Statement of Michael Brostek
Director, Strategic Issues

GAO-04-972T

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-04-972T, a testimony before the Committee on Finance, U.S. Senate

July 21, 2004

TAXPAYER INFORMATION

Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions

Why GAO Did This Study

Data sharing can be a valuable tool for federal agencies. The Internal Revenue Service (IRS) can use data from taxpayers and third parties to better ensure taxpayers meet their obligations. Likewise, Congress has authorized certain agencies access to taxpayer information collected by IRS to better determine eligibility for benefit programs.

GAO determined (1) the extent to which the IRS and Citizenship and Immigration Services (CIS) within the Department of Homeland Security share and verify data and (2) the benefits and challenges, if any, of increasing such activities. GAO also studied IRS's Offshore Voluntary Compliance Initiative (OVCI) to provide information on (1) the characteristics of the taxpayers who came forward under OVCI and (2) how those taxpayers became noncompliant.

What GAO Recommends

GAO is making a recommendation to the Secretary of Homeland Security and the Commissioner of Internal Revenue to assess the benefits and costs of data sharing to enhance tax compliance and improve immigration eligibility decisions. IRS and CIS officials generally agreed with GAO's recommendation.

GAO is not making recommendations on the OVCI program.

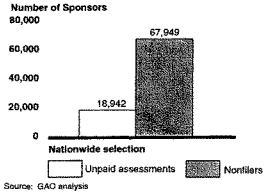
www.gao.gov/cgi-bin/getrpt?GAO-04-972T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

IRS and CIS do not share data with each other to ensure taxpayers meet their tax obligations or to determine immigration eligibility. IRS officials believe that data on taxpayers' income they currently use are more accurate and useful for enforcing tax law than CIS data. In a nationwide selection of 413,723 businesses applying to sponsor immigrant workers from 1997 through 2004, GAO found 19,972 (5 percent) businesses and organizations that were unknown to IRS. Information like this can be used to select taxpayers for audit or other enforcement efforts. Further, CIS officials believe IRS taxpayer data would useful for immigration decisions. In our nationwide selection, GAO found that 67,949 (16 percent) businesses applying to sponsor immigrant workers from 1997 through 2004 did not file one or more tax returns. Failure to file a return could be relevant to a CIS adjudicator's decision about whether a business meets the financial feasibility (ability to pay wages) and legitimacy (proof of existence) tests for sponsoring an immigrant. For data sharing to occur, challenges must be overcome, including I.R.C. Section 6103's limitation on IRS's ability to share data with CIS and technological problems like the lack of automated financial data at CIS. Because the confidentiality of tax data is considered crucial to voluntary compliance, executive branch policy calls for a business case to support sharing tax data. IRS and CIS have not analyzed data sharing benefits and costs.

Businesses Sponsoring Immigrant Workers That May Not Have Met CIS Financial Feasibility or Legitimacy Requirements, 1997–2004



Source: GAO analysis

The OVCI program attempted to quickly bring taxpayers who held funds offshore illegally back into compliance while simultaneously gathering more information about them and the promoters of offshore schemes. Under OVCI, 861 taxpayers came forward and IRS received more than $200 million in unpaid taxes, penalties, and interest. According to IRS data, OVCI applicants are a diverse group, with wide variations in income, geographic location, and occupation. Some applicants' noncompliance appears to be intentional, while others' appears to be inadvertent. Given this diversity, multiple compliance strategies may be needed to bring taxpayers holding money offshore back into compliance.

Mr. Chairman and Members of the Committee:

I am pleased to participate in the committee's hearing today on issues related to the tax gap, the difference between what taxpayers annually report and pay and what they should have reported and paid in taxes. In addressing the tax gap the Internal Revenue Service (IRS) uses many strategies, two of which are obtaining corroborating information on taxpayers' circumstances from third parties and analyzing data obtained from taxpayers themselves. Just as IRS sometimes obtains corroborating information from others, some federal agencies obtain tax data from IRS to use in ensuring that benefits are properly awarded to applicants. Related to obtaining corroborating information from others, as requested, my testimony covers (1) the extent to which the IRS and Citizenship and Immigration Services[1] (CIS), within the Department of Homeland Security (DHS), share and verify data and (2) the benefits and challenges, if any, of increasing data sharing and verifying activities. Related to analyzing information obtained from taxpayers, and also as requested, my testimony provides information on (1) the characteristics of the taxpayers who came forward under IRS's Offshore Voluntary Compliance Initiative (OVCI) and (2) how those taxpayers became noncompliant.

My statement today will address each of these topics in turn. Our scope and methodology for each of the topics is briefly summarized early in each section of the testimony, and more detailed explanations of our scope and methodology are presented in appendix I for data sharing analysis and appendix II for our analyses related to OVCI. We conducted our work from July 2003 through June 2004 in accordance with generally accepted government auditing standards.

Regarding data sharing, in summary we found that IRS and CIS are not sharing data with each other to ensure taxpayers are meeting their tax obligations or to determine immigration eligibility but that data sharing appears to have the potential to assist IRS in identifying noncompliant taxpayers and to improve CIS eligibility decisions in granting

immigration benefits. For example, IRS may be able to use immigration information to help identify taxpayers with no record of recent filing activity and that are not easily identified via current compliance efforts, such as self-employed and small business taxpayers. In our nationwide selection of 413,723 businesses applying to sponsor immigrant workers from 1997 through 2004, we found 19,972 businesses and organizations that were unknown to IRS. Although IRS does not currently use CIS data, information like this can be used to select taxpayers for audit or other enforcement efforts. IRS officials believe that data on taxpayers' income they currently use are more accurate and useful for enforcing tax law than CIS data. Similarly, CIS may benefit from obtaining IRS data. For example, in our nationwide selection, 67,949 businesses and organizations applying to sponsor immigrant workers did not file one or more tax returns. Failure to file a return could be relevant to a CIS adjudicator's decision about whether a business meets the financial feasibility (ability to pay wages) and legitimacy (proof of existence) tests for sponsoring an immigrant. Although CIS officials believe IRS taxpayer data would be useful, CIS does not obtain data from IRS primarily because, under Internal Revenue Code (I.R.C.) Section 6103, CIS is not authorized to directly receive information from IRS. To enable data sharing between IRS and CIS, several challenges must be first overcome, including the limitations of I.R.C. Section 6103 and technological problems such as the lack of automated financial data at CIS. Because the confidentiality of tax data is considered crucial to voluntary compliance, executive branch policy calls for a business case to support sharing tax data. IRS and CIS have not analyzed data sharing benefits and costs.

We are making a recommendation to IRS and CIS to assess the benefits and costs of data sharing to enhance tax compliance and improve immigration eligibility decisions. IRS and CIS generally agreed with our recommendation.

Regarding the OVCI program, in summary, IRS's database shows that 861 taxpayers voluntarily came forward, and IRS officials say they have received more than $200 million in previously unpaid taxes, penalties, and interest during this attempt to quickly

[1] The U.S. Citizenship and Immigration Services (CIS) was formerly called the Bureau of Citizenship and

bring taxpayers who held funds offshore illegally back into compliance while simultaneously gathering more information about them and the promoters of offshore arrangements.[2] Under the OVCI program, IRS did not impose certain penalties for those taxpayers who voluntarily come forward, admitted they illegally held money offshore, and provided amended returns and complete information about their offshore arrangements for tax years after 1998. IRS used information provided by the taxpayers to build a database containing information such as the taxpayers' income, additional taxes owed, and use of promoters of offshore tax schemes. Since the data are limited to taxpayers who voluntarily admitted they illegally held offshore assets, they are not necessarily representative of any larger population of taxpayers who used offshore arrangements to avoid paying U.S. taxes. The taxpayers who applied for inclusion in the OVCI program were a diverse group, with wide variations in income, geographic location, and occupation, although some commonalities emerged for certain of these characteristics. In addition; some applicants' noncompliance appears to be intentional, such as those who used fairly elaborate schemes, while others' noncompliance appears to be inadvertent. Further, more than half of the OVCI applicants in each year we examined generally had reported their offshore income and paid taxes but had failed to file a Report of Foreign Bank and Financial Accounts (FBAR), and less than 16 percent said that they used promoters. Given this diversity, multiple compliance strategies may be needed to bring taxpayers holding money offshore back into compliance. Because additional tax, interest, and penalties collected to date from OVCI applicants who owed tax have been relatively modest—a median of about $5,400—personnel-intensive investigations of individual taxpayers who have hidden money offshore could significantly reduce the net gain to Treasury from these cases.

The next section describes in more detail our analyses related to data sharing between IRS and CIS. It is followed by detailed information about the participants in IRS's OVCI.

Immigrations Services when established in 2002.

[2] Illegal offshore arrangements are those that are used to avoid paying U.S. taxes. These could include arrangements to shelter unreported domestic income or any income earned offshore, such as interest income, investment returns, or ordinary business income. Promoters are those who market such illegal offshore schemes and cause some taxpayers to become noncompliant.

Data Sharing Between IRS and CIS

Our key findings resulting from our look at data sharing between IRS and CIS are as follows:

- IRS may benefit from immigration information to select taxpayers who appear to be noncompliant for enforcement actions and, if immigration applicants were required to be current on their tax obligations before applying for immigration benefits, from taxpayers coming to IRS to resolve tax issues. Regarding improving IRS's selection of potentially noncompliant taxpayers, IRS could benefit if CIS data helped it identify taxpayers who fail to file tax returns or who file but underreport their income. For nonfiling, we matched a nationwide selection of automated immigration applications from 1997 through 2004[3] with IRS taxpayer information and found that of the 413,723 businesses with Employer Indentification Numbers (EINs) or Social Security Numbers (SSNs)[4] in CIS's database that applied to sponsor immigrant workers, 19,972 businesses and organizations were unknown to IRS. For underreporting, we found 10 business/organization sponsors in our nonprobability sample of hard copy immigration applications[5] that reported more taxable income to CIS than to IRS. One business reported approximately $162,000 in taxable income to CIS in 2001 and no taxable income to IRS for the same period. Although we do not know whether these businesses reported accurately to either CIS or IRS, discrepancies like these often are considered by IRS in selecting firms or individuals to audit. Regarding the potential numbers of taxpayers who would need to resolve their tax situations if CIS applicants were required to be current on their tax obligations

[3] In order to study the nationwide implications of data sharing, we used data from CIS's nationwide Computer Linked Application Information Management System (CLAIMS 3) database. Although this database did not include financial information, it included EINs and SSNs that we could use to determine whether IRS had received a tax return and, if so, the status of the taxpayer's account.
[4] Individuals who operate a business and report income and losses on a Schedule C attached to their individual income tax return use their SSN.
[5] Results from nonprobability samples cannot be used to make inferences about a population, because in a nonprobability sample some elements of the population being studied have no chance or an unknown chance of being selected as part of the sample. We selected hard copy application files because CIS's

before applying for benefits, we found, that 18,942 businesses in our nationwide selection sponsoring immigrants from 1997 through 2004 had unpaid tax assessments at the time of application; the assessments totaled $5.6 billion as of December 2003. Further, in addition to the 19,972 businesses unknown to IRS mentioned above, all of the taxpayers that IRS already knew had not filed one or more tax returns but that applied for immigration benefits—67,949 according to our match of a nationwide selection of immigration applications—also would need to resolve their tax issues.

- At the same time, CIS may also benefit from having access to IRS taxpayer information when making immigration eligibility decisions. For example, IRS taxpayer data can help CIS officials identify those businesses and organizations that may not have met the requirements for financial feasibility (ability to pay wages) or legitimacy (proof of existence) when they apply to sponsor immigrants. We found that 67,949 of 413,723 (16 percent) of business sponsors in our nationwide selection were in IRS's nonfiler database at the time of their application to sponsor an immigrant worker. These business sponsors had not filed one or more income or Federal Insurance Contribution Act (FICA)/Federal Unemployment Tax Act (FUTA) employment returns between 1997 and 2004. Additionally, 19,972 business sponsors (5 percent) were unknown to IRS. Especially for smaller businesses, failure to file a return may indicate the business is struggling financially. CIS officials told us that access to IRS taxpayer data could also improve the efficiency of making eligibility decisions by reducing decision-making time and decreasing rework/follow-up work, which, in turn, could help CIS address its backlog for processing immigration applications.

- CIS and, to a lesser extent, IRS face significant challenges for establishing a data sharing relationship. CIS faces several technology challenges, including CIS does not automate any financial data, such as the applicant's income, and both agencies use different tracking numbers—that is, CIS uses alien registration

automated systems did not have income or other tax related information that could be used to match with

numbers, which CIS assigns to individuals and businesses, while IRS uses SSNs or EINs for individuals and businesses. Given CIS's data limitations, IRS would need to determine whether and how it could efficiently access and use CIS data to identify potentially noncompliant taxpayers. In addition, since I.R.C. Section 6103 does not authorize IRS to disclose taxpayer information for immigration eligibility decisions, CIS would need to seek a legislative change to I.R.C. Section 6103 or ask taxpayers for consent to obtain tax data directly from IRS. However, because the confidentiality of tax data is considered crucial to voluntary compliance, executive branch policy calls for a business case to support sharing tax data. Further, the Computer Matching and Privacy Protection Act of 1988 generally requires that no matching program between agencies can be approved unless the agencies have performed a cost-benefit analysis for the proposed matching program that demonstrates the program is likely to be cost effective. IRS and CIS have not analyzed and do not currently have plans to analyze data sharing benefits and costs.

Our findings related to data sharing are based on interviews, reviews of agency documents and various publications, and matching of immigration and IRS taxpayer data. We used two sets of CIS data to match with IRS taxpayer data to determine the potential value for increased data sharing and matching. First, we used nationwide selection of automated CIS applications that included SSNs and EINs from immigration applications submitted to CIS service centers from 1997 through 2004. Approximately 3.4 million of 4.5 million automated immigration records had SSNs or EINs that could be used to match with SSNs and EINs in IRS databases. We used this data to determine whether businesses and others that had applied to sponsor immigrant workers or immigrants applying to change their immigration status had filed a tax return with IRS and, if so, whether they owed taxes to IRS. Because the nationwide selection did not include any financial information, we could not use it to determine whether CIS applicants reported the same income amounts to IRS as well as to CIS. Therefore, we also selected a nonprobability sample of about 1,000 immigration hard copy applications

IRS databases. We transcribed personal and financial information from CIS's paper files.

for citizenship, employment, and family-related immigration and change of immigration status filed by businesses and individuals from 2001 through 2003 at 4 immigration locations.[6] We used the hard copy applications to build a database of personal and financial information. We used this sample to determine whether CIS applicants reported the same income information to IRS as to CIS and also as a second source of information on the extent to which CIS applicants may not have filed tax returns and may have owed taxes to IRS. We assessed the reliability of IRS's Individual Master File (IMF) and Business Master File (BMF) data and the CIS's Computer Linked Application Information Management System, Version 3.0 (CLAIMS 3), which is a database containing nationwide immigration data. We determined that the data were sufficiently reliable for the purposes of this testimony.

Background

As we have previously found, federal agencies are increasingly using data sharing to help verify applicant-provided information.[7] To facilitate this, Congress has authorized a number of agencies to access federal taxpayer information collected by IRS to improve the accuracy of eligibility decisions. The Social Security Administration (SSA) is one agency, for example, that has an extensive data sharing relationship with IRS, which aids in administering Social Security benefit programs and ensuring taxpayer compliance. Overall, SSA is responsible for paying approximately $42 billion monthly in benefits to more than 50 million people. This relationship, which has been in place for almost 30 years, provides the basis for matching of employee earnings reported to SSA and IRS; allows for the disclosure of taxpayer mailing address information for the Personal Earnings and Benefit Estimate Statement program; and helps SSA determine the eligibility of applicants and recipients of Supplemental Security Income. IRS, on the

[6] CIS has four service centers nationwide established to handle the filing, data entry, and adjudication of certain applications for immigration services and benefits. District offices are responsible for providing certain immigration services and benefits to residents in their service area, and for enforcing immigration laws in that jurisdiction.

[7] As used in this testimony, "data sharing" means obtaining and disclosing information on individuals between federal agencies, such as IRS and CIS, to determine eligibility for benefits and to ensure taxpayers have met their tax obligations. U.S. General Accounting Office, *The Challenge of Data Sharing: Results of a GAO-Sponsored Symposium on Benefit and Loan Programs*, GAO-01-67 (Washington, D.C.: October 20, 2000).

other hand, uses SSA-processed wage and earnings information to ensure tax compliance by verifying individuals' income tax return information against that reported by their employers. SSA officials say that sharing and verifying taxpayer information is cost and time efficient, reduces waste and fraud, and is mutually beneficial for both agencies.

Although such data sharing arrangements can be useful, privacy advocates, lawmakers, and others are concerned about the extent to which the government can disclose and share citizens' personal information, including sharing with other government agencies. Historically, lawmakers and policymakers have created legislation to address these concerns. For example, the Privacy Act of 1974[8] regulates the federal government's use of personal information by limiting the collection, disclosure, and use of personal information maintained in an agency's system of records. The Computer Matching and Privacy Protection Act of 1988[9] further protects personal information by requiring agencies to enter into written agreements, referred to as matching agreements, when they share information that is protected by the Privacy Act of 1974 for the purpose of conducting computer matches.

As one of the largest repositories of personal information in the United States, IRS is often at the center of these concerns. IRS receives tax returns from about 116 million individual taxpayers who have wage and investment income and from approximately 45 million small business and self-employed taxpayers each year. IRS performs a variety of checks to ensure the accuracy of information reported by these taxpayers on their tax returns. These checks include verifying computations on returns, requesting more information about items on a tax return, and matching information reported by third parties to income reported by taxpayers on returns (i.e., document matching). IRS's document matching program has proven to be a highly cost-effective way of identifying underreported income and thereby bringing in billions of dollars of tax revenue while boosting voluntary compliance.

[8] Pub. L. No. 93-579, December 31, 1974.

I.R.C. Section 6103, amended significantly by the Tax Reform Act of 1976,[10] is the primary law used to restrict IRS's data-sharing capacity. The law provides that tax returns and return information are confidential and may not be disclosed by IRS, other federal employees, state employees, and certain others having access to the information except as provided in I.R.C. Section 6103. I.R.C. Section 6103 allows IRS to disclose taxpayer information to federal agencies and authorized employees of those agencies for certain specified purposes. Accordingly, I.R.C. Section 6103 controls whether and how tax information submitted to IRS on federal tax returns can be shared. I.R.C. Section 6103 specifies which agencies (or other entities) may have access to tax return information, the type of information they may access, for what purposes such access may be granted, and under what conditions the information will be received. For example, I.R.C. Section 6103 has exceptions allowing federal benefit and loan programs to use taxpayer information for eligibility decisions. Because the confidentiality of tax data is considered crucial to voluntary compliance, if agencies want to establish new efforts to use taxpayer information, executive branch policy calls for a business case to support sharing tax data.

CIS is part of DHS, which was established by the Homeland Security Act of 2002.[11] CIS is responsible for administering several immigration benefits and services transferred from the former Immigration Services Division of the Immigration and Naturalization Service. Included among the immigration benefits and services CIS's offices oversee are citizenship, asylum, lawful permanent residency, employment authorization, refugee status, intercountry adoptions, replacement immigration documents, family- and employment- related immigration, and foreign student authorization. CIS's functions include adjudicating and processing applications for U.S. citizenship and naturalization, administering work authorizations and other petitions, and providing services for new residents and citizens. CIS's employees for reviewing immigration benefit applications and determining if they should be approved are its adjudicators, while CIS's Fraud Detection Units (FDU) investigate cases in which there are trends or patterns that

[9] Pub. L. No. 100-503, October 18, 1988.
[10] Pub. L. No. 94-455, October 4, 1976.
[11] Pub. L. No. 107-296, § 451, 116 Stat. 2195.

suggest potential fraud. CIS staff work with applicants through the adjudicatory process beginning with initial contact when an application or petition is filed, through the stages of gathering information on which to base a decision. This contact continues to the point of an approval or denial, the production of a final document or oath ceremony, and the retirement of case records.

IRS and CIS Do Not Share and Verify Data for Tax Compliance or Eligibility Decisions

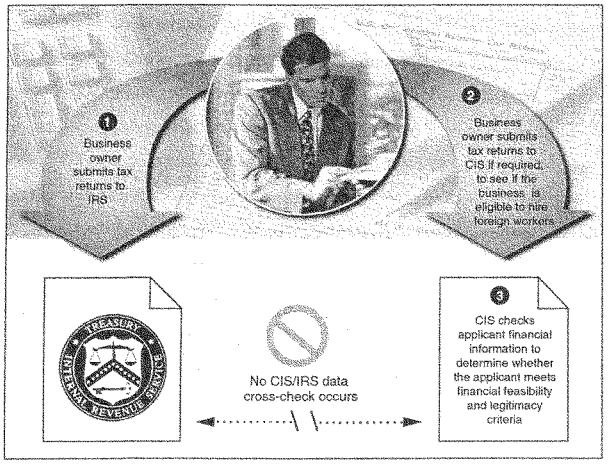
IRS does not use personal information collected and maintained by CIS to ensure that taxpayers meet their tax obligations because IRS officials believe that data on taxpayers' income they already receive from taxpayers and third parties is more accurate and useful for enforcing tax obligations than CIS data. IRS officials cite a previous data sharing effort with CIS that was ultimately ended due to incomplete data and increased costs. In the mid-1980s, CIS and IRS entered into a cost-reimbursable data sharing agreement that enabled CIS to share immigrant data with IRS by completing IRS Form 9003.[12] According to IRS officials, IRS used form 9003 to help identify whether individuals who filed for U.S. permanent residency had filed tax returns and properly reported their income. CIS and IRS shared form 9003 data for about 10 years but ended this arrangement in 1996, according to an IRS official. Much of the form 9003 immigrant data received from CIS lacked SSNs–a primary mechanism IRS uses for tracking individual taxpayers, which made it increasingly difficult for IRS to use the data to determine whether individuals had filed taxes and properly reported income, according to IRS officials. Additionally, the costs associated with the data sharing agreement escalated each year, to the point that, in IRS's opinion, it was no longer cost effective.

Under I.R.C. Section 6103, CIS is not authorized to receive taxpayer information from IRS directly. Although CIS officials would like to use IRS taxpayer data to help make

[12] CIS completed Form 9003 whenever an immigrant filed for lawful permanent residency status. The form contained personal identifying information on the immigrant such as name and SSN as well as financial information on an individual's income. CIS provided a contractor with the Form 9003s, and the contractor then transcribed the Form 9003 immigrant data onto tape and sent it to IRS's Martinsburg Computing Center (MCC). IRS conducted matches of the Form 9003 immigrant data against its own databases to determine whether the individuals had filed taxes and properly reported their income.

immigration eligibility decisions, they have not sought it due to perceived difficulty in overcoming the I.R.C. Section 6103 limitation. CIS obtains self-reported personal and financial information provided by (1) businesses and individuals applying to sponsor immigrant workers, (2) individuals applying to sponsor relatives, and (3) individuals applying to enter the country, extend their stay or obtain citizenship. CIS also obtains information from third parties, not including IRS, to verify applicants' self-reported data. Although CIS adjudicators sometimes ask businesses and individuals to provide them with either official income tax returns from IRS or unofficial copies to verify financial information reported on immigration forms, immigration officials we spoke with in five field locations said applicants could alter or falsify those documents. Figure 1 illustrates the current lack of data verification activities between CIS and IRS during the immigration application process.

Figure 1: Illustration of the Current Lack of Data Verification between CIS and IRS



Source: GAO.

Increased Data Sharing May Benefit IRS's Tax Compliance Efforts and CIS's Immigration Eligibility Decisions

Increased data sharing and verification between IRS and CIS may result in IRS increasing tax compliance and CIS making better immigration eligibility decisions. CIS data may be useful to IRS in identifying businesses and organizations unknown to IRS and those that may not have reported the same income to both agencies. Further, IRS data may enable CIS to (1) better identify businesses or individuals that may not have met immigration eligibility criteria because they had unpaid assessments or did not file tax returns and (2) improve the efficiency of adjudicators' eligibility decision making.

IRS May Benefit From Using CIS Information to Identify Taxpayers with No Recent Filing Activity or That Report Different Incomes to Both Agencies

IRS may be able to use immigration information to help identify taxpayers with no record of recent filing activity and that are not easily identified via current compliance efforts, such as self-employed and small business taxpayers. IRS shares with and receives from other agencies, such as SSA, personal and financial information via document matching to help identify individuals and businesses with tax obligations. However, document matching is not very effective for taxpayers that have sources of income not subject to such reporting. For example, the income of self-employed taxpayers and others that receive income directly from clients is not always subject to third party reporting. Both GAO and the Treasury Inspector General for Tax Administration (TIGTA) have previously reported on these document-matching limitations and stated that certain taxpayers, such as those who are self-employed, are much less compliant in fulfilling their tax obligations than those whose income is subject to information reporting.[13] IRS has also acknowledged that those taxpayers that are not well covered by document matching programs represent the biggest portion of taxpayers that do not voluntarily and timely pay their full taxes. IRS reports taxpayers served by

[13] U.S. General Accounting Office, *Reducing the Tax Gap: Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157 (Washington, D.C.: June 2, 1995). U.S. Department of the Treasury, Inspector General for Tax Administration, *Management Advisory Report: Comparing the Internal Revenue Service's Verification of Income for Wage Earners and Business Taxpayers* (Washington, D.C.: September 2001).

IRS's Small Business and Self-Employed Division are among those least covered by their document-matching programs. As of March 2001, these taxpayers accounted for 64 percent of IRS's accounts receivable database—which contains taxes assessed but not paid.

Immigration information may be potentially useful to IRS in identifying taxpayers required to file but that have not and that may be applying to (1) sponsor immigrants, (2) seek citizenship, or (3) extend their stay in the country. We matched a nationwide selection of automated applications of 413,723 business and organizations applying to sponsor temporary, permanent and religious workers between 1997 and 2004 and found 19,972 businesses and organizations that were unknown to IRS. We matched a nonprobability sample of hard copy immigration applications submitted between 2001 and 2003 and found 20 of 475 business/organization sponsors had established an identity with IRS at some time in the past but had no record of tax activity in the past 5 years. An additional 13 businesses/organizations in our nonprobability sample were unknown to IRS. For example, one company sponsoring a temporary worker reported a gross annual income of $156 million on its CIS application, but the EIN listed on its application does not match any of IRS's master file databases. Five business sponsors in our nonprobability sample submitted income tax returns to CIS with their applications, but IRS had no record of receiving these returns.

In order to determine whether these businesses/organizations were operating, and thus, likely to have had filing requirements, we searched the business/organizations' web sites, "LexisNexis,"[14]and the online yellow pages. We found 31 of the 33 total business/organization sponsors that had established an identity or were unknown to IRS appeared to be in operation. For example, one business sponsoring a permanent worker had a website, a listing on LexisNexis, and on the online yellow pages, all with the same address.

[14] LexisNexis is an information/research tool that, among other things, maintains public records on businesses and individuals.

Although the majority of businesses and organizations applying to sponsor immigrant workers in our nonprobability sample reported the same income to both agencies, we identified 10 business/organization sponsors that had submitted tax return information to CIS with significantly different income than they reported to IRS. As a group, the 10 business sponsors reported over half a million dollars more to CIS in taxable income than to IRS for the period from 2001 through 2002. For example, one business reported a little over $162,000 in taxable income to CIS in 2001 and no taxable income to IRS for the same period. Although we do not know whether these businesses reported accurately to either CIS or IRS, discrepancies like these often are considered by IRS in selecting firms or individuals to audit.

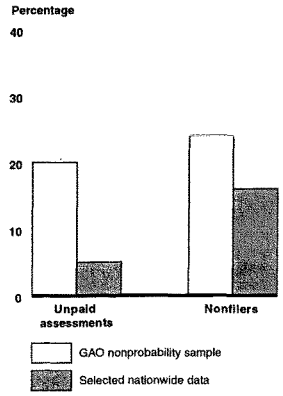
IRS Might Also Benefit if Applicants for Immigration Benefits Were Required to Be Current on Their Taxes

IRS might gain an additional benefit from establishing a data sharing relationship with CIS if immigration applicants were required to be current on their taxes before they could apply for immigration benefits. That is, if sponsors or immigrants were required to provide CIS with evidence from IRS that they had no outstanding tax obligation before any immigration benefit application could be processed, sponsors and immigrants would need to have filed returns and paid taxes due. IRS officials said that such a requirement would likely help with tax compliance and would be similar to procedures IRS currently follows in certain other situations.

Although the information sharing to help target IRS enforcement efforts, as previously discussed, would help IRS identify and follow up on some sponsors and immigrants that may not be fully compliant, a requirement that all immigration benefit applicants be current on their tax obligations has the potential to increase the total number of noncompliant taxpayers that would be brought into compliance. For example, requiring all immigration benefit applicants to be current on their tax obligations would mean that delinquent taxpayers IRS knows about but that have not yet settled their tax debts would need to do so. Based on our nationwide selection, we found that 18,942 of 413,723 (5

percent) businesses applying to sponsor workers entering the country from 1997 through 2004 had unpaid assessments of $5.6 billion at the time they applied to CIS, and 67,949 business sponsors had not filed one or more required income or employment tax forms. Finally, the 19,972 business sponsors in our nationwide selection that applied to CIS for which IRS had no record of receiving a tax return would need to resolve their tax status with IRS. Figure 2 shows our results on business sponsors that have unpaid assessments or are nonfilers for both our nationwide selection and nonprobability sample of immigration applications.

Figure 2: Businesses Who Owed IRS Taxes or Nonfilers Known to IRS When They Applied to Sponsor Workers to Enter the Country, 1997 to 2004



Source: GAO analysis.

IRS has established a process for taxpayers that need to demonstrate clean tax records before they can apply for benefits. Taxpayers can obtain a "fact of filing" or "fact of payment" document to demonstrate that they have been filing required tax returns and paying their taxes. For example, the state of Nevada requires casino employees to be current on their federal taxes, and applicants must sign taxpayer consent forms allowing the state to verify tax information with IRS via the "fact of filing" or "fact of payment."

CIS May Benefit from Using IRS Taxpayer Data to Make More Accurate Immigration Eligibility Decisions

CIS headquarters officials told us immigration adjudicators use two basic criteria for evaluating the eligibility of businesses and individuals to sponsor immigrants: (1) the sponsor's financial feasibility and (2) the legitimacy of the sponsor's existence. Financial feasibility refers to the sponsor's ability to pay wages to or financially support the individual being sponsored. For example, if a company is sponsoring an immigrant for employment, that company must show that it has sufficient ability to pay the worker. IRS information on a taxpayer's income and the status of a taxpayer's account is relevant and useful to the adjudicator's decision on the ability to pay, according to CIS officials. In the case of a nonworker petition (e.g. a relative), such as with the Affidavit of Support (I-864) that accompanies forms such as the Application to Register Permanent Status or Adjust Status (I-485)[15], the sponsor must provide evidence that his or her household income equals or exceeds 125 percent of the federal poverty line. Information on tax returns filed with IRS would show income levels and could be used to validate applicant-provided information. Legitimacy, in the case of worker petitions, refers to whether a sponsoring business or organization actually exists, has employees, and has real assets. IRS tax data could be used to verify these facts, according to CIS officials. In the case of nonworker petitions, legitimacy refers to the relationship between the sponsor and immigrant as being entered into in "good faith." For example, with the Petition to Remove the Conditions on Residence (I-751), which is based on an immigrant's marriage to a U.S. citizen or permanent resident, the immigrant must show evidence of that relationship through documents such as financial records including tax returns. IRS tax data could be used to help verify the marital status of individuals.

In the case of immigrants applying for citizenship, adjudicators also use a test of "good moral character" as one of the criteria in determining an immigrant's eligibility for citizenship. In testing for "good moral character," CIS asks such things as whether the applicant was ever imprisoned or failed to file a federal, state, or local tax return.

[15] The Application to Register Permanent Residence or Adjust Status form is used by a person in the U.S. to adjust their temporary immigration status to a permanent status or register for permanent residence.

Adjudicators said that having evidence directly from IRS on whether an immigrant answered the tax-related questions accurately would be very useful in their decision-making process.

Our analysis identified sponsors and immigrants that IRS classified as nonfilers and therefore may not meet immigration financial feasibility and legitimacy tests. In our nationwide selection submitted between 1997 and 2004, we found 67,949 of 413,723 (16 percent) businesses applying to sponsor immigrant workers did not file one or more tax returns, such as income or employment tax forms.[16] In addition, knowing that IRS had no record of receiving a tax return from 19,972 businesses that applied to CIS to sponsor immigrants would be relevant to adjudicators' decisions. Similarly, 112 of 475 (24 percent) businesses in our nonprobability sample for sponsorship of temporary, permanent, and religious workers from 2001 through 2003 did not file one or more tax returns, such as income or employment tax forms.

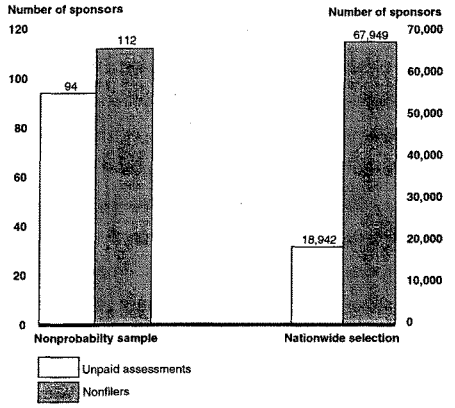
Of the individuals applying to sponsor family members' or workers' entry into or stay in the country, 791 of 51,169 individuals in our nationwide selection were in IRS's nonfiler database, meaning these sponsors did not file one or more returns during the period from 1997 through 2004. According to IRS, these individual sponsors are classified as nonfilers but may not be required to file for a variety of reasons, including insufficient income. This reason, however, may raise questions about whether the sponsor is able to meet CIS's financial feasibility and legitimacy tests. We also found that some individual immigrants applying to extend their stay were classified as nonfilers. We found that 25,662 of 2,009,046 individuals in our nationwide selection applying to CIS from 1997 through 2004 did not file income tax returns. Some of these individuals may not have been required to file.

Our analysis also identified business and individual sponsors that had unpaid assessments with IRS and therefore may not have met immigration's financial feasibility and legitimacy tests. Our nationwide results showed that 18,942 of 413,723 business (5

[16] IRS knows about these business nonfilers because of previously filed returns.

percent) sponsors applying to sponsor immigrants from 1997 through 2004 had unpaid assessments at the time of application; the assessments totaled $5.6 billion as of December 2003. We found that 94 of 475 (20 percent) businesses in our nonprobability sample applying to sponsor immigrants from 2001 through 2003 collectively had unpaid assessments at the time of application. The assessments totaled $39 million as of December 2003. CIS officials said IRS information on small businesses would be especially helpful in assessing whether small businesses have the necessary income or financial feasibility to support the workers. We identified instances in which businesses sponsored a number of workers over several years but had unpaid assessments to IRS and failed to file numerous tax forms. For example, one company sponsored more than 600 workers from 1997 through 2004 but is currently delinquent on 12 tax returns for $8 million and failed to file 3 income tax returns, employment tax returns, or both. We found that 6,894 business sponsors in our nationwide selection of immigration applications matched on IRS databases containing both information on unpaid assessments and nonfilers. Figures 3 and 4 show matching results identifying nonfilers and those with unpaid assessments from our nationwide selection and nonprobability sample.

Figure 3: Business Sponsors in GAO's Nonprobability Sample and the Nationwide Selection That May Not Have Met Financial Feasibility or Legitimacy Requirements



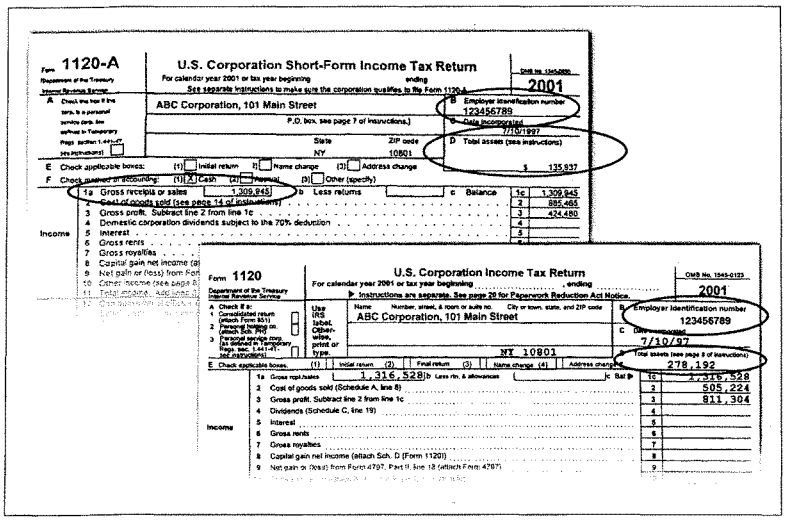
Source: GAO analysis.

Note: Data from immigration files was matched with IRS's Business Master File including the Accounts Receivable Database, which contains IRS data on unpaid assessments and the Nonfiler Database, which contains IRS data on businesses that should have filed a tax return but did not.
Source: GAO Analysis

Some individuals applying to sponsor immigrants also had unpaid assessments when they submitted applications to CIS. Of 51,169 individual sponsors in our nationwide selection for which CIS included SSNs, 889 had unpaid assessments when they applied to CIS and the assessments totaled $49.8 million as of December 2003. Fourteen of 273 individual sponsors in our nonprobability sample had unpaid assessments when they applied to CIS; the assessments totaled $84,761 as of December 2003. We also found individual immigrants applying to extend their stay had unpaid assessments at the time they applied to CIS. We found 38,877 of 2,009,046 individuals immigrants from our nationwide selection that applied to CIS from 1997 through 2004 had unpaid assessments at the time of application; the assessments totaled $328 million. Similarly, 20 of 804 individuals immigrants in our nonprobability sample applying to CIS from 2001 through 2003 had unpaid assessments at the time of application.

Immigration officials we spoke with at five field locations told us receiving and using IRS taxpayer information would be very valuable in helping them make better decisions for immigration requests and in investigating potential benefit fraud cases. Adjudicators expressed concerns about the legitimacy of tax returns they review when making immigration eligibility decisions and stated they would like to verify applicant/sponsor provided data–including copies of tax returns—against what is maintained in IRS's databases. They told us they have no way to check tax return information when they suspect applicants have submitted (1) bogus returns that can be printed from home computers using readily available tax preparation software and (2) returns that falsify so-called "IRS-certified tax returns." For example, adjudicators in the Vermont service center told us about an instance in which a company sponsoring multiple immigrants provided copies of tax returns that contained the same company name and EIN but reported differing income and assets for the same year (see fig. 5). Additionally, this company submitted the income tax return for U.S. corporations (IRS Form 1120) with one application and the short-form income tax return for U.S. corporations (IRS Form 1120-A) with the other application for the same tax year, even though it did not meet the IRS Form 1120-A's filing requirement of having gross receipts under $500,000.

Figure 5: One Business Sponsor Submits Different Tax Returns to CIS



Source: GAO presentation of CIS materials.

Note: We used a fictitious business name and EIN to protect the identity of the CIS applicant.

CIS Fraud Detection Unit (FDU) officials begin an investigation when they notice significant trends among a certain class of sponsors, immigrants, or both, such as certain temporary worker sponsors submitting inflated tax returns to demonstrate financial feasibility.[17] Currently, FDUs verify self-reported data through third party sources, such as a private sector company that taps into state-level data to verify the legitimacy of a company, and state data on company balance sheets. Obtaining these types of data is a time-consuming process for CIS fraud staff and the results are questionable, according to officials we spoke with at the California and Texas Service Centers. FDU officials said that IRS taxpayer information would be more helpful for verification purposes because (1) they could determine directly if the sponsor and immigrant provided the same information to IRS that they did to CIS and that it was accurate, (2) they believed they

[17] An alien convicted of an "aggravated felony" such as tax evasion in which the revenue loss to the government exceeds $200,000 as defined in 8 U.S.C.1101(a)(43), is deportable.

would be able to obtain IRS data quicker, and (3) IRS data would be more reliable than the self-reported and third-party data. However, FDU officials explained they have not pursued obtaining this information from IRS due to I.R.C. Section 6103's restrictions.

CIS May Benefit from Using IRS Data to Make More Timely Immigration Eligibility Decisions

Both the adjudicator and fraud staff at the five locations we visited said that access to IRS taxpayer data could also improve the efficiency of making benefit decisions because it would result in reduced decision-making time and decreased rework/follow-up work.[18] More efficient benefit decisions have the potential to help CIS address application backlogs. For example, adjudicators said that if they could match applicant data against IRS data early in the review process, they would spend less time researching and following up on the validity of those data (e.g., they would send fewer requests for evidence [RFE] to the applicant). According to adjudicators, it could take as long as 12 weeks to receive responses from applicants for a certified IRS tax return, during which time, the application file sits on a "suspense" shelf, thereby extending the application processing time. Due to this time gap, in certain cases, background checks must be redone, which further lengthens the application processing time. Additionally, as we reported in May 2001,[19] CIS officials said that lengthy processing times have resulted in increased public inquiries on pending cases, which, in turn, has caused CIS to shift resources away from processing cases to responding to inquiries. As a result, the time to process applications have further increased.

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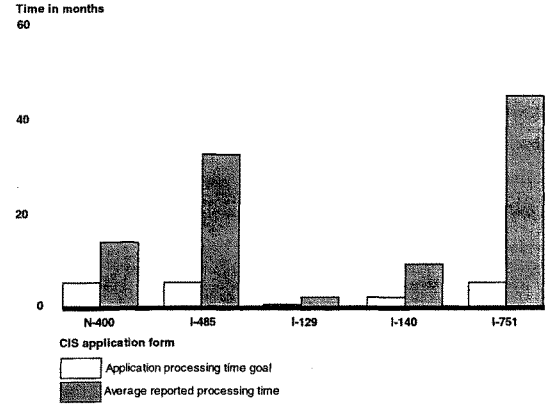
[18] Additionally, we and other agencies have found, and staff at some of the field locations we visited agreed, that access to IRS taxpayer information may also tangentially aid CIS in its homeland security efforts. GAO and the Department of Justice's Office of Inspector General have identified weaknesses in CIS locator information for immigrants. For example, in November 2002, GAO reported that CIS investigators determined that CIS's address information was inaccurate for 45 immigrants who may have known some of the terrorists responsible for the September 11, 2001 terrorist attacks (GAO-03-188).

[19] U.S. General Accounting Office, *Immigration Benefits: Several Factors Impede Timeliness of Application Processing*, GAO-01-488 (Washington, D.C.: May 4, 2001).

As we reported in January 2004,[20] CIS used $80 million in appropriated funds annually in fiscal years 2002 and 2003 for the President's backlog initiative, a 5-year effort with a goal to achieve a 6-month average processing time per application, and will continue to use $80 million of its appropriations through fiscal year 2006 for the initiative. Figures 6 and 7 show CIS's application processing times and its backlog of pending applications, respectively.

Figure 6: CIS Application Processing Time Goals and Average Reported Processing Time for Fiscal Year 2003

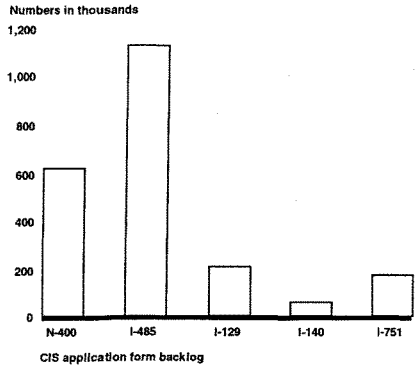


Source: GAO.

Notes: Average reported processing time projected as of October 30, 2003. Applications forms are described in appendix I.

[20] U.S. General Accounting Office, *Immigration Application Fees: Current Fees Are Not Sufficient to Fund U.S. Citizenship and Immigration Services' Operations*, GAO-04-309R (Washington, D.C: Jan. 5, 2004).

Figure 7: CIS Application Backlogs - End of Fiscal Year 2003



Source: CIS's Performance Analysis System.

Note: Applications forms are described in Appendix I.

Sharing Data Presents Challenges

While data sharing may be beneficial for IRS and CIS, CIS, and to a lesser extent, IRS, face significant challenges for establishing a data sharing relationship. CIS must address a number of technological challenges in order to lay the foundation that would enable data sharing to take place efficiently and effectively. For example, IRS and CIS currently use different identifiers to track individuals, so their systems may not interact with each other, automate different pieces of data, and face concerns regarding maintaining the confidentiality of electronically shared immigration and taxpayer data. IRS and CIS have two options for overcoming the legal challenge and accessing information for benefit determination purposes: use the existing I.R.C. Section 6103 taxpayer consent authority or seek a legislative change to I.R.C. Section 6103. Finally, both IRS and CIS need to further evaluate data-sharing options and their related costs to determine whether such a relationship could be cost beneficial.

CIS Faces a Wide Range of Technological Challenges

Although CIS and IRS may benefit from data sharing, CIS faces a wide range of technological challenges that must be overcome in order to lay the groundwork that would enable data sharing to take place between the two agencies.

- **CIS does not maintain any automated financial data on applicants.** Although CIS automates certain personal information from benefit applications, such as an individual's name and alien registration number, it does not automate any financial data that are reported on the benefit application or in accompanying documents such as tax returns.
- **CIS locations automate data inconsistently.** Although CIS service centers have servicewide automated case management and tracking systems for the applications they process, the CIS district offices do not. Instead, most applications are processed manually at the district offices. Plans are underway to have a nationwide system in place for the districts by the end of fiscal year 2006.
- **CIS systems contain inaccurate data.** GAO and the Department of Justice's Justice's Office of Inspector General (OIG) have criticized CIS systems because they contain inaccurate data for identifying pieces of information (such as immigrants' addresses).
- **CIS databases could encounter interaction difficulties.** CIS uses immigrant registration numbers as tracking identifiers whereas IRS uses SSNs or EINs. Although CIS's systems capture SSNs/EINs if they are provided on applications, CIS does not require them to be entered into its systems. A little over 1 million of 4.5 million nationwide immigration records did not have SSN or EIN identifiers that could be matched against IRS's databases.

While I.R.C. Section 6103 Does Not Allow Data Sharing for Immigration Eligibility Decisions, CIS Has Options for Gaining Access to Taxpayer Information

Information May Be Disclosed with Taxpayer Consent

IRS cannot disclose taxpayer information to other federal agencies without specific statutory authorization. As previously mentioned, CIS is not authorized to directly receive taxpayer information for immigration decisions under I.R.C. Section 6103. However, individual taxpayers may authorize IRS to disclose their return information to agencies through written consent. Under I.R.C. Section 6103(c), a taxpayer may designate a third party to receive his or her tax return or return information from IRS. Examples of third-party entities to which IRS provides information pursuant to taxpayer-signed waivers include financial institutions (including the mortgage banking industry); colleges and universities; and various federal, state, and local governmental entities.

Using this authority however, CIS could require applicants to allow IRS to share personal and financial information with CIS. IRS already has a process in place to accomplish this through the use of several forms, such as IRS Form 4506, Request for Copy of Tax Return; IRS Form 4506-T, Request for Transcript of Tax Return; and IRS Form 8821, Tax Information Authorization. Form 4506 allows taxpayers to request that CIS receive copies of their tax returns (at a cost of $39 to the taxpayer per copy) directly from IRS. By signing form 4506-T, the taxpayer consents to another party, like CIS, receiving a tax return transcript, tax account transcript, information from Form W-2, Wage and Tax Statement, Form 1099 series information,[21] record of account, or verification of nonfiling directly from IRS, all at no charge to the taxpayer. Form 8821 allows a third party to inspect taxpayer information, receive taxpayer information, or both for specific tax matters listed on the form. This form is different from the others in that the authority expires upon written request from the taxpayer, whereas the other two authorities are one-time requests.

[21] One type Form 1099 is the Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc.

Treasury and IRS's National Taxpayer Advocate[22] have expressed concern about the systematic use of taxpayer consent. Further, IRS's National Taxpayer Advocate suggests that taxpayer consents should be used in conjunction with pilot tests. A pilot test would help address whether the disclosure can result in substantial program benefits. For example, from October 2002 through March 2003, the Department of Education (Education) conducted a test in which the department electronically verified a select number of students' (or parents') tax returns instead of requesting hard copies of the returns. The students were asked to authorize IRS to release their tax information to their academic institutions via the Internet. After authorizing the release, IRS then sent the individuals' tax transcripts to the schools, which then resolved any inconsistencies between information on the tax transcripts and on financial aid applications. According to an Education official, the department received positive feedback from the participating schools and taxpayers.

However, using taxpayer consent may affect the taxpayer's right to privacy and IRS's implementation of I.R.C. Section 6103. The Joint Committee on Taxation and Treasury's Office of Tax Policy warn that the use of consents for programmatic governmental purposes potentially circumvents the general rule of taxpayer confidentiality because the taxpayer waives certain restrictions on agencies' use of the data. In addition, recordkeeping, reporting, and safeguard requirements do not apply to agencies that use taxpayer consent. Furthermore, IRS is not required to track taxpayer consent disclosures and, as a result, cannot report on how the return information is used or what safeguards are in place to protect the information. Finally, according to IRS officials, taxpayer consents can be costly and resource intensive to implement, primarily because the information has to be retrieved manually unless the taxpayer makes a request via telephone. IRS estimates that it receives more than 800,000 requests from taxpayers directing that their returns or return information be sent to a third party.

Changes to I.R.C. Section 6103 Could Enable CIS to Access IRS Taxpayer Information

[22] Internal Revenue Service, *National Taxpayer Advocate: 2003 Annual Report to Congress* (Washington,

Over the years a number of exceptions have gradually been added to I.R.C. Section 6103 that allow access to taxpayer information. In his March 10, 2004, testimony before the Subcommittee on Oversight, House Committee on Ways and Means, IRS Commissioner Mark Everson noted that IRS is broadly restricted under I.R.C. Section 6103 from sharing taxpayer information with third parties, including other government agencies, except in very limited circumstances. According to Treasury, the burden of supporting an exception to I.R.C. Section 6103 should be on the requesting agency, which should make the case for disclosure and provide assurances that the information will be safeguarded appropriately. Table 1 lists the criteria Treasury and IRS have applied when evaluating specific legislative proposals to amend I.R.C. Section 6103 for governmental disclosures.

Table 1: Criteria Applied by Treasury and IRS When Evaluating Specific Proposals for Governmental Disclosures

Criteria to be addressed by the requesting agency	Is the requesting information highly relevant to the program for which it is to be disclosed? Are there substantial program benefits to be derived from the requested information? Is the request narrowly tailored to the information actually necessary for the program? Is the same information reasonably available from another source?
Criteria to be addressed by the requesting agency and Treasury/IRS	Will the disclosure involve significant resource demands on IRS? Will the information continue to be treated confidentially within the agency to which it is disclosed, pursuant to standards prescribed by IRS? Other than I.R.C. Section 6103, are there any statutory impediments to implementation of the proposal?
Criteria to be addressed by Treasury/IRS	Will the disclosure have an adverse impact on tax compliance or tax administration? Will the disclosure implicate other sensitive privacy concerns?

Source: Office of Tax Policy, Department of the Treasury.

D.C.: Dec. 31, 2003).

Data-Sharing Costs Have Not Been Analyzed

Although the results of our matching of IRS and CIS data indicate that IRS and CIS may benefit from data sharing and verification, not all of the potential benefits likely would be realized and determining whether and how those benefits should be pursued also would depend on the cost of any data-sharing arrangements. Neither IRS nor CIS has documented benefits that may be gained from additional data sharing nor have they considered the cost that would be associated with implementing a data sharing arrangement. The cost of data sharing would depend on a variety of factors, such as whether CIS would match data from all benefit applications or some subset and whether the matching processes would be primarily manual or automated.

Although our work shows potential benefits to IRS and CIS from sharing data to enhance tax compliance and improve immigration eligibility decisions, not all of those benefits likely would be realized. For example, IRS is unable to pursue all of the current leads that it receives from existing data corroboration efforts, like document matching. Therefore, to the extent that obtaining and analyzing additional data from CIS developed more leads for possible enforcement actions, IRS likely would only be able to pursue some portion of those cases. Further, some of the apparent noncompliance may not be substantiated. For example, some of those who appear not to have filed tax returns may actually have been provided inaccurate information to CIS or otherwise not have a filing obligation. Of the taxpayers with delinquent taxes, some portion may already have entered into arrangements with IRS to pay the taxes and no further IRS action may be needed. From CIS's perspective, although we found that many businesses and individuals may not have filed tax returns or may be delinquent in paying taxes, some of these situations may not be significant enough to affect a CIS adjudicator's decision about their financial feasibility or legitimacy. For instance, some of the businesses applying to sponsor immigrant workers that have delinquent taxes may not owe enough to raise doubts about their ability to pay the worker. This may be especially true for larger businesses.

The Computer Matching and Privacy Protection Act of 1988 established requirements for agencies entering into routine data matching arrangements. In general, the act states that no matching program can be approved unless the agency has preformed a cost-benefit analysis for the proposed matching program that demonstrates the program is likely to be cost effective. Similarly, Treasury's criteria for considering whether a statutory change should be made for the sharing of tax data stress the importance of documenting whether a substantial benefit is likely and what the resource demands on IRS would be to support sharing the data. In the case of using taxpayer consents, Treasury suggests that agencies conduct pilot tests to support a business case for routine use of such consents.

Conclusions

Data sharing and verification between IRS and CIS appears to have the potential to better guide IRS's efforts to identify and correct noncompliance by taxpayers and result in more informed, accurate, and timely eligibility decisions by CIS adjudicators. Although IRS terminated its previous data sharing relationship with CIS for individual taxpayers because it judged that relationship not to be cost effective, our matching results show a greater potential for improving tax compliance for businesses than individuals. Our analysis also shows the potential to improve thousands of eligibility decisions if CIS has access to IRS data. However, more needs to be known about the extent to which the potential benefits likely would be realized if greater data sharing and verification were to occur and about the costs that would be incurred to implement a data-sharing effort. The benefits and costs are key, since both Congress and executive branch policies stress that sharing of data, and especially tax data, be well justified given concerns about possible adverse effects on tax compliance if the confidentiality of taxpayer's data is compromised.

Recommendation for Executive Action

The Secretary of Homeland Security and the Commissioner of Internal Revenue should assess the benefits that may be obtained and the costs that may be incurred to share information to enhance tax compliance and improve immigration eligibility decisions.

Agency Comments

Agency officials provided official oral comments and generally agreed with our recommendation. We talked with knowledgeable agency officials in IRS and CIS about our findings and recommendation. They had no major concerns with doing a study on the potential benefits and costs of establishing a data sharing relationship. IRS officials said I.R.C. 6103 prevents them from sharing taxpayer data with CIS for immigration eligibility decisions. IRS officials said the use of taxpayer consents would be an alternative but IRS would need to evaluate resource implications associated with processing the potentially large number of requests to verify taxpayers' status that could be associated with this proposal. CIS officials said they want to have IRS data to assist with immigration eligibility decisions but have not pursued obtaining IRS data because of the challenge they would face in trying to change I.R.C. Section 6103.

IRS's OVCI Program

The major points arising from our review of the information available on the taxpayers who came forward under the OVCI program and how they became noncompliant are as follows:

- Of the more than 1 million taxpayers that IRS estimated might be involved in an offshore scheme when it initiated the OVCI program, 861 taxpayers came forward. IRS officials say they have received more than $200 million in previously unpaid taxes, penalties, and interest from them. The taxpayers that applied for inclusion in the OVCI program were a diverse group, with wide variations in income, geographic location, and occupations, but some commonalities emerged for certain of these characteristics.

- OVCI applicants reported an annual original adjusted gross income (AGI)[23] ranging from over well over $500,000 to substantial net losses. Because these large outliers tend to skew the distribution of the income data, we used the population's annual median income to describe the population's income levels. OVCI applicants' annual median original AGI ranged from about $39,000 to about $52,000 for tax years 1999, 2000, and 2001. For 2001, the annual median adjustment to the original AGI of OVCI applicants who had not properly paid tax on money held offshore was about $23,000, and the median amount of tax, penalties, and interest was about $5,400.[24] The 81 applicants who composed the top 10 percent of originally reported AGIs in 2001 accounted for more than half of the total reported AGI amount.

- For each year covered by the OVCI program, more than half of the applicants had generally reported all of their income and paid taxes due—even on their offshore income—but had failed to disclose the existence of their foreign bank accounts as is required by Treasury. Their applications sought relief from FBAR penalties. IRS assesses FBAR penalties at a rate of up to 100 percent of the value of the assets in the account. These penalties were waived for OVCI applicants.

- OVCI applicants came from 47 states and the District of Columbia, but half of all applicants came from only 5 states: Florida, California, Connecticut, Texas, and New York.

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[23] AGI is the amount of income the taxpayer reported minus certain income adjustments the taxpayer made on his or her tax return. The original AGI is the amount the taxpayer reported on his or her original federal tax return. In applying for the OVCI program, the taxpayer also supplied IRS with amended federal returns with an adjusted AGI.

[24] Taxpayers could apply for the OVCI program for any tax year after 1998 and could apply for one or more years. The overwhelming majority of applications fell in tax years 1999 through 2001, but some applicants applied for years prior to 1999 or subsequent to 2001. We only included those taxpayers who were noncompliant in 1999, 2000, or 2001, or in a combination of these years, in our analysis. We used the year 2001 in this testimony for all tables because it is the most recent year for which we have data and because the data in 2001 were fairly representative of each of the 3 years that we are reporting.

- OVCI applicants reported more than 200 occupations. We classified more than one-third of applicants' occupations as either retired individuals, business executives, or business/self-employed.

- Less than 16 percent of OVCI applicants said they used a promoter in 2001. Some promoters offered inexpensive, ready-made package deals that bundled a standardized set of services together while others offered more expensive, tailor-made arrangements.

- Some taxpayers appear to have deliberately hidden money offshore through fairly elaborate schemes involving, for instance, multiple offshore bank accounts. Other applicants appear have fallen into noncompliance inadvertently, for example, by inheriting money held in a foreign bank account.

We used IRS's OVCI database to develop a profile of the characteristics of the taxpayers that came forward under OVCI. Our information is limited to those taxpayers who voluntarily admitted they held offshore assets, so the information we are providing is not necessarily representative of any larger population of taxpayers who used offshore arrangements to avoid paying U.S. taxes. We limited our analysis to tax years 1999, 2000, and 2001 because the vast majority of the OVCI applicants applied for inclusion for these 3 tax years. IRS officials said they verified the accuracy of the data entered into the database, and we observed the verification process. We analyzed IRS's data reliability processes and verified some of the entry accuracy ourselves and as a result, we believe the data we are using are sufficiently reliable and useful for reporting on the characteristics of those who came forward under the OVCI program. In addition, we reviewed 35 case files judgmentally selected based on factors such as particularly high or low AGIs, high or low adjustments to original AGI, or high or low taxes, penalties, and interest owed to verify IRS's data entry and to obtain information about how taxpayers became noncompliant and about the promoters, if any, they used. In addition, we visited 25 promoter Web sites to gain a better understanding of the type and cost of the services they provide. The Web sites were judgmentally selected to ensure the sample included a

variety of geographic locations. We did our work at IRS's campus in Philadelphia and its National Office in Washington, D.C. We conducted our fieldwork for this portion of the testimony from January 2004 through June 2004. Appendix II provides more details on our methodology.

Background

Launched in January 2003, OVCI was an attempt to quickly bring taxpayers who were hiding funds offshore back into compliance while simultaneously gathering more information about those taxpayers as well as the promoters of these offshore arrangements. It is not illegal to hold money offshore. It is illegal, however, for a taxpayer to not disclose substantial offshore holdings including, if applicable, not reporting income earned in the U.S. and "hidden" through offshore arrangements and any income generated through them to IRS on a tax return. As an incentive to come forward, IRS said it would not impose the civil fraud penalty for filing a false tax return, the failure to file penalty, or any information return penalties for unreported or underreported income earned in 1 or more of the tax years ending after December 31, 1998. However, taxpayers were required to pay applicable back taxes, interest, and certain accuracy or delinquency penalties. In addition, Treasury agreed to waive the penalty associated with the failure to file a Report of Foreign Bank and Financial Accounts (FBAR penalties).[25] To be eligible for the OVCI program, applicants had to supply certain information about themselves, including

- personal information, such as their names, taxpayer identification numbers, current addresses and telephone numbers;

- copies of their original and amended federal income tax returns for tax periods ending after December 31, 1998; and

[25] Under the Bank Secrecy Act, U.S. residents or individuals in and doing business in the United States must file a report with Treasury if they have a financial account in a foreign country with a value of more than $10,000 at any time during the calendar year. Taxpayers comply with this requirement by noting the

- information on any related entities that the applicants caused to be involved in offshore tax avoidance.

In addition, taxpayers had to provide details on those who promoted or solicited the offshore financial arrangement. IRS is using this information to pursue promoters and to identify other clients who did not come forward under OVCI. Taxpayers were required to provide

- complete information about the promoter, including the promoter's name, address, and telephone number and any promotional materials that the taxpayer received;

- descriptions of offshore payment cards, foreign and domestic accounts of any kind, and foreign assets; and

- descriptions of any entities through which the taxpayer exercised control over foreign funds, assets, or investments.

IRS used this documentation to build a database of descriptive information about the OVCI applicants and any promoters of offshore schemes that they used. IRS plans to eventually utilize the data to analyze taxpayer characteristics and then use this information to try to make taxpayer compliance programs more effective. Specifically the database contains information on (1) the taxpayer, such as income, citizenship status, occupation, and compliance history, and (2) the promoters of offshore tax schemes, such as how much the promoter charged the taxpayer and the country in which the promotion was located.

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account on their tax return and by filing Form 90-22.1. Willfully failing to file an FBAR report can be punished under both civil and criminal law.

OVCI Applicants Were a Diverse Group, but Some Common Characteristics Emerged

When it initiated the OVCI program, IRS estimated that 1 million taxpayers might be involved in offshore schemes covered by the program; 861 taxpayers came forward under OVCI.[26] IRS required taxpayers to calculate the additional tax they owed and remit that amount with their OVCI application. IRS has received more than $200 million from taxpayers. IRS has verified through audits that $140 million of that amount was properly due and is continuing to audit the remainder. In some ways the taxpayers in the OVCI program were a diverse group. Applicants reported widely varying annual median original AGIs in 1999, 2000, and 2001. The applicants were geographically dispersed across the country and were involved in more than 200 occupations. Despite the diversity, OVCI applicants reported an annual median original AGI from approximately $39,000 in tax year 2001 to $52,000 in tax year 2000; half came from five states; and about a third were retired individuals, business executives, or business/self-employed. In addition, less than 16 percent said they used a promoter to help them set up their offshore arrangements. Finally, more than half of OVCI applicants for each year generally had reported their income and paid taxes but had failed to disclose the existence of their foreign accounts.

OVCI Applicants' Income

For the 3 years of the OVCI program we reviewed, 1999 through 2001, OVCI applicants reported an annual original AGI ranging from well over $500,000 to substantial net losses. Because these large outliers tend to skew the distribution of the income data, we believe

[26] IRS has previously reported that 1,321 taxpayers applied to the OVCI program. This figure includes 400 entities that were set up by applicants to handle their offshore funds. To avoid double counting, we excluded these cases from our audit. We also excluded 49 applicants because they did not meet program requirements and 16 applicants that applied for tax years outside the scope of our audit, that is either before 1999 or after 2001. As a result, we identified 861 unique, individual taxpayers who applied to the OVCI program. IRS has also previously reported that it had received $200 million for all years while the database showed that only $140 million had been collected. IRS officials said it recorded in the database only those amounts that it had finished auditing and will enter the additional money received as it completes audits of more OVCI applicants. In addition, much of the money IRS received from OVCI applicants was for tax years either before 1999 or after 2001.

the most representative method of describing the "average" applicant is by using the population's annual median income, that is, the point in the income distribution where half of the applicants fall above that point and half fall below that point, rather than the mean AGI. As shown in table 2, the median original AGI of applicants was from $38,761 in tax year 2001 to $51,663 in tax year 2000. Appendix III contains more taxpayer income information.

Table 2: OVCI Applicants' Original AGI Statistics, Tax Years 1999–2001

		Original AGI			
Tax year	Number of applicants	Mean	10th percentile[a]	Median	90th percentile[b]
1999	806	$332,443	$0	$49,469	$545,196
2000	817	1,191,997	0	51,663	583,188
2001	808	242,515	0	38,761	582,593

Source: GAO analysis of IRS data.

[a] The 10th percentile represents those taxpayers who were in the bottom ten percent of the distribution of the original AGI. Due to the number of taxpayers who reported negative original AGIs or were nonfilers, the value for the 10th percentile was zero in all three years we reviewed.

[b] The 90th percentile represents those taxpayers who were in the top ten percent of the distribution of the original AGI.

Within the OVCI population, there were three distinct types of taxpayers:

- Those who had filed their tax returns but omitted their foreign financial assets.
- Those who failed to file tax returns for 1 or more of the years covered by the OVCI program.
- Those who filed returns each year and included their offshore holdings in their reported income but failed to meet their FBAR reporting requirements.

As shown in table 3, the taxpayers in these groups varied in their reported median original AGI; adjustment to original AGI; and taxes, penalties, and interest assessed. In the table, the nonfilers' median original AGI is shown as zero because, according to an IRS official, they did not file tax returns, even though they had taxable income offshore. An IRS official said that for those applying to the program for relief from FBAR penalties,

the data show an original AGI because they generally reported all of their income and paid taxes due, but had failed to disclose the existence of their foreign bank accounts.

Table 3: OVCI Applicants' Income and Amount Owed for Tax Year 2001

Population	Number	Median original AGI for 2001	Median adjustment to original AGI	Median additional tax owed[a]	Median penalties assessed	Media interes owed
led federal tax turns but nitted foreign sets	326	$55,869	$20,460	$4,289	$523	$2
nfilers	24	0	82,561	7,573	2,431	8
lers and nfilers mbined	**350**	**$49,303**	**$22,951**	**$4,401**	**$657**	**$3**
led returns but iled to meet BAR quirements	458	$31,667	$0	$0	$0	
tal	**808**	**$38,761**	**$0**	**$0**	**$0**	

Source: GAO analysis of IRS data.
[a]These figures represent the median for the amount IRS has verified through audits that taxpayers owed IRS. As IRS continues to conduct audits of OVCI taxpayers, the median may rise or fall somewhat.

For each of the 3 years of the OVCI program that we reviewed, more than half of the applicants to the OVCI program applied to get relief from FBAR penalties. This is a substantial relief for taxpayers because an IRS official told us that IRS can assess FBAR penalties at a rate of up to 100 percent of the value of the assets in the account.

A few individuals with substantial offshore holdings accounted for a large percentage of the original AGI reported. For tax year 2001, the 81 applicants with the top 10 percent of originally reported AGIs accounted for more than half of the total reported AGI amount.

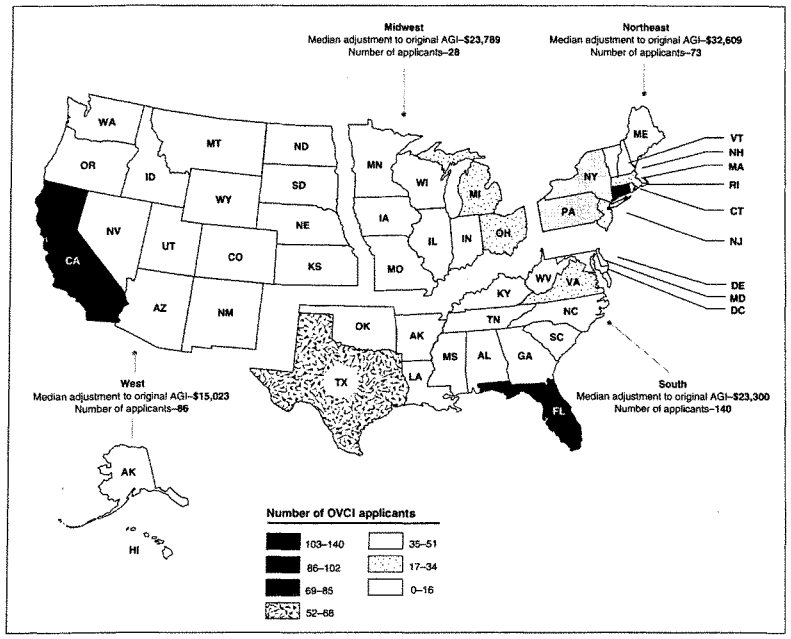
OVCI Applicants' Geographic Characteristics

Taxpayers from 47 states and the District of Columbia applied for inclusion in the OVCI program in at least 1 of the 3 years of the program (see app. IV for more geographic information about the applicants to the OVCI program). In tax year 2001, applicants for whom we have data were most commonly from the South (43 percent), but about 22 percent of all applicants came from the Northeast and more than 26 percent came from the West. The Midwest accounted for the fewest number of applicants (about 9 percent).[27] However, half of all applicants came from only 5 states (Florida, California, Connecticut, Texas, and New York).[28] Three states had no taxpayers apply to the OVCI program. As shown in figure 8, median adjustment to original AGI for taxpayers who filed tax returns but omitted foreign assets or were nonfilers ranged from a low of about $15,000 in the West to a high of about $32,500 in the Northeast.

[27] A small number of taxpayers who applied to the OVCI program lived outside of the United States or in Puerto Rico. We are not disclosing any specific information about these taxpayers due to concerns over the information being used to identify the taxpayers.

[28] These states accounted for about one-third of all individual income tax returns filed in tax year 2003, indicating that they accounted for a higher concentration of OVCI applicants than would be explained by the number of tax returns filed from those states.

Figure 8: OVCI Applicants' States of Residence and Regional Breakout of the Median Adjustment to Original AGI for Non-FBAR applicants, Tax Year 2001



Source: GAO.

OVCI Applicants' Occupations

Applicants listed over 200 occupations on their federal tax returns, including accountants, members of the clergy, builders, physicians, and teachers, so we grouped the applicants' professions into 18 categories in order to better analyze them. For all 3 years, the most common professions of applicants to the OVCI program were retired individuals, business executives, and business/self-employed. Table 4 provides information on taxpayers' occupations and the associated AGI information for 2001.

Table 4: Individual OVCI Applicants' Profession, Median Original AGI, and Median Adjustment to Original AGI for Tax Year 2001 (Filers and Nonfilers but not FBAR applicants)

Profession	Applicants	Median original AGI	Median adjustment to original AGI
Retired	52	$43,881	$25,074
Executive	47	158,183	23,302
Business/self employed	32	73,134	22,006
Banking/ finance/ insurance[b]	27	3,596	22,951
Sales	22	91,000	24,329
Medical profession	22	95,928	8,397
Engineer	21	55,941	5,722
Other	20	23,286	15,197
Analyst/consultant	11	49,892	20,277
Computer/ technology	11	39,348	6,461
Attorney	9	137,661	23,302
Administrative[a]	8	105,804	11,028
Building trades	5	22,684	6,569
Education[c]	5	0	36,364
Scientist	5	26,599	8,538
Real estate	4	1,100,241	291,871
Pilot	4	123,705	14,566
Arts	3	123,945	70,799
Missing	42	0	54,094
Total[e]	**350**	**$49,598**	**$23,124**

Source: GAO analysis of IRS data.

[a] A small number of taxpayers who applied to the OVCI program listed their occupations as secretary but their incomes were each in excess of $1 million for each of the years 1999, 2000, and 2001.

[b] Although a large number of applicants were from the banking/finance/insurance sector, a large number of these applicants reported large losses on their tax returns. As a result, the median original AGI was relatively low.

[c] Some occupations had more nonfilers apply to the OVCI program than filers, so for these cases the median original AGI was zero.

[d] Seven applicants were identified as "deceased", and we included these people in the "other" category.

[e] We did not include FBAR applicants in this table because, according to IRS officials, there is no adjustment to the FBAR applicants' original AGI. These applicants generally reported their offshore holdings on their original federal tax returns and incurred no additional taxes or interest owed. Because these applicants made up more than half of all applicants, if we included them in the table, the median adjustment to original AGI, taxes, and interest would all be zero.

Few Applicants Said They Used Promoters

Less than 16 percent of all OVCI applicants said they used a promoter.[29] The services provided by promoters ranged from simple incorporation offshore to more elaborate schemes involving such things as bogus charities.

The relatively small percentage of OVCI applicants reporting use of a promoter may be due in part to the definition of a promoter used in the OVCI instructions. IRS defined a promoter as any party who "promoted or solicited the taxpayer's use of offshore payment cards or offshore financial arrangements." Some taxpayers may have learned about offshore arrangements from friends, an attorney, a paid preparer, or others. However, IRS did not record detailed information in the OVCI database about how the taxpayers learned about the offshore arrangement and therefore we do not know the extent to which taxpayers learned of the offshore arrangement from these individuals. If OVCI applicants did learn of the arrangements from these individuals, they may not have considered them to be promoters under IRS's promoter definition, particularly if they did not feel that the individual actively sought them out to encourage or convince them to use an offshore arrangement. IRS did record information on whether the OVCI applicants used a paid preparer. For example, 326 of the 350 tax year 2001 OVCI applicants, or 93 percent, said that a paid preparer prepared their original tax return.

Recognizing that the data may change as IRS completes additional investigations on promoters, taxpayers who said they used a promoter had similar median original AGIs to those who reported not using a promoter. For example, in 2001, those who said they used a promoter reported a median original AGI of about $41,000, while those applicants who said they did not use a promoter reported a median original AGI of about $39,000.

[29] We cannot be precise about the number of taxpayers who said they used a promoter. IRS officials said that they had identified 269 potential promoters from 140 participants. IRS has opened investigations into 53 but does not have sufficient information yet on the remainder to conclude whether they are bona fide promoters. In addition, IRS compiled its statistics on the number of taxpayers and associated business entities that identified promoters—140—but not the number of unique taxpayers who identified promoters.

For those taxpayers who said they used a promoter, the fees they paid those promoters varied from nothing to a high of $85,000 for the promoter's services.

One possible explanation for the range in fees is that promoters offer different services, from off-the-rack services to custom-tailored arrangements. We visited 25 Web sites maintained by individuals or companies promoting offshore investments to gain a better understanding of the type and cost of the services they provide. The Web sites were judgmentally selected to ensure the sample included a variety of geographic locations. Of the 25 Web sites we visited, 19 offered off-the-shelf offshore companies or package deals. One company advertised that taxpayers could incorporate offshore within the next day by buying an off-the-shelf company, which is an existing company that has been set up by the promoter. At a cost of $1,500, the taxpayer would receive a package of services that would include an agent and local office, mail forwarding, nominee corporate directors and officers, offshore credit card applications, banking forms, and the payment of all government fees. These companies are not legitimate business enterprises. Instead, they exist strictly to provide taxpayers a way to quickly and easily move money offshore and repatriate it without declaring that money to IRS.

Several taxpayers who used promoters of this type to avoid paying taxes appeared to be scammed themselves. For example:

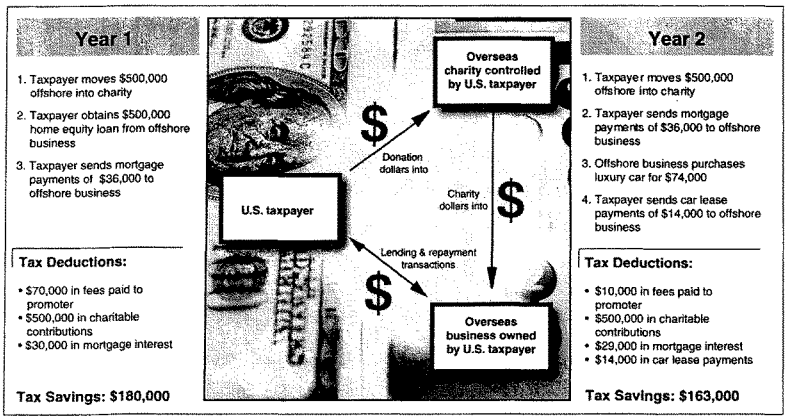
- One taxpayer was persuaded by a promoter to create an offshore corporation. The taxpayer also opened an offshore bank account and gave the promoter over $50,000 in cash to deposit into the account. The promoter told the taxpayer that the money was stolen before it was ever deposited in the account, leaving the taxpayer with practically nothing.

- Another taxpayer invested over $30,000 in an offshore investment opportunity that promised a return of 20 percent per year. The taxpayer got the money he/she invested through credit card advances. The taxpayer received returns on the

investment for a while, but the payments soon stopped. The taxpayer said he/she still owes money on the credit cards.

Other promoters' schemes are more complicated and targeted toward wealthy taxpayers interested in avoiding taxes. Figure 9 is a hypothetical example based on an actual case of how a promoter can help taxpayers repeatedly send money offshore and repatriate it later, avoiding hundreds of thousands of dollars in taxes. We calculated the tax savings below using a popular tax software program.

Figure 9: Hypothetical Example of a Self-Employed Taxpayer Filing Singly and Filing a Schedule C (for Profit and Loss from a Sole Proprietorship Business)



Source: GAO representation of analysis of several OVCI cases and PhotoDisc, images.

In our hypothetical example, the self-employed taxpayer reports $3 million in annual business income on his Schedule C (the form attached to a tax return that is used to calculate profit or loss for a sole proprietor business). The first year, the taxpayer hires the promoter to set up an offshore scheme for a fee of $70,000 for financial planning services and tax preparation. The promoter creates a bogus offshore charity that actually has no charitable activity and a corollary offshore business entity. The taxpayer controls both organizations by sitting on the board of directors. The taxpayer then sends

money offshore, basically to himself, through a $500,000 "donation" to the offshore charity, which in turn sends the money to the offshore business entity. The offshore business entity then gives the taxpayer a $500,000 "home equity loan," which actually repatriates that amount to the taxpayer's domestic bank account. Throughout the year, the taxpayer sends monthly mortgage payments to the offshore business entity. The taxpayer can then deduct the promoter's fees as a business expense on his Schedule C and the charitable donation and mortgage interest as part of his itemized deductions on his Schedule A. These false deductions would reduce the taxpayer's tax liability from about $1.1 million to about $920,000, a savings of about $180,000.

In the second year, the promoter would charge our hypothetical taxpayer less—only $10,000 for tax preparation services. The taxpayer can send the $500,000, repatriated as a home equity loan, back to the offshore charity as a donation and continue to send mortgage payments offshore. In a new wrinkle, however, the offshore business entity has purchased a luxury automobile worth about $74,000 and leased it back to the taxpayer. The taxpayer would have use of the automobile and would send lease payments to the offshore business entity. On his tax return for the second year, the taxpayer can deduct his charitable contribution of $500,000, the interest on the home loan, the lease payments, and promoter fees as business expenses. These false deductions would reduce the taxpayer's taxes by about $163,000.

Therefore, in return for promoter fees of about $80,000, the taxpayer has avoided more than $340,000 in taxes in just these 2 years. The taxpayer received more than a 300 percent return on his money, a high return when compared with those on other traditional investments. In addition, the taxpayer receives a level of asset protection from potential creditors. If, at some time, creditors were to pursue the taxpayer to collect money, they may be unable to reach the assets because it would appear that his house is heavily mortgaged and that his expensive car is leased.

There are many more options for transferring money offshore and then repatriating it. For example, according to some promoters' Web sites, an offshore charity could award a

"scholarship" to the taxpayer's child to defray college expenses, or a business entity could provide administration services such as bookkeeping for the taxpayer. An IRS official conservatively estimated that one promoter of this type of scheme has cost the U.S. Treasury about $100 million in tax revenues.

Some Taxpayers' Noncompliance Appears Deliberate, Others Appears Inadvertent

Some taxpayers went to great lengths to establish and maintain offshore bank accounts and credit cards, creating the appearance that the noncompliance was deliberate,[30] whereas others appeared to be unaware of their U.S. tax obligations for foreign holdings. Deliberately noncompliant taxpayers would include some of the taxpayers who, as discussed earlier, used promoters and, for example, put funds into their offshore arrangements on a cash basis. Examples of other taxpayers who appear deliberately noncompliant include the following:

- A taxpayer who reported an original AGI of less than $20,000 on his/her federal tax return and claimed the Earned Income Tax Credit. This taxpayer's amended federal return showed income in 1 year of over $1 million and multiple foreign bank accounts. Before applying to the OVCI program, the taxpayer never paid any tax on any income received. IRS told us that had this taxpayer not applied for inclusion in the program, it is doubtful the taxpayer's tax avoidance would have ever been discovered.

- A taxpayer who maintained multiple bank accounts in different foreign countries. Each of the accounts contained funds invested in various financial instruments. The taxpayer traveled abroad and physically brought the money back into the United States.

[30] IRS rejected OVCI applicants who did not divulge the entirety of their scheme to avoid paying U.S. taxes. IRS told us that 49 applicants were rejected for that reason, and those cases were sent to IRS's Criminal Investigation Unit.

- A taxpayer who initially hired attorneys to create an offshore entity, and then used wire transfers and a mailbox abroad to route after-tax income from the United States to the foreign account for deposit. The taxpayer did not pay U.S. taxes on the interest income earned on these funds and claims to have not repatriated any of the foreign deposits during that time.

In an increasingly global and mobile world, taxpayers may hold foreign accounts and credit cards for a number of legitimate reasons. For example, taxpayers may have worked or traveled overseas extensively or inherited money from a foreign relative. Some taxpayers in these situations told IRS that they were unaware they had to pay U.S. taxes on this income and that their noncompliance was unintentional. For example:

- One taxpayer said that he/she had made a personal loan overseas and had not reported the interest income of about $10,000 he/she had received. Because the taxpayer held about 1 percent of his/her original AGI offshore and had paid taxes on all other income, it appears that this taxpayer may not have intentionally avoided his/her tax obligation.

- Another taxpayer along with a sibling invested an inheritance in a joint account in a foreign country for convenience. The taxpayer realized, when the OVCI program was announced, that the interest income on this account should have been reported. He/she reported, through the OVCI program, interest income of less than $2,000 over the years covered by OVCI. The taxpayer paid taxes on all other domestic income during this time and appeared to have overlooked the interest income.

- A young taxpayer got a job overseas. The taxpayer did not believe he/she needed to file tax returns in the United States because he/she was paying income taxes in the country in which he/she was working. When the taxpayer found out that he/she was required to file in the United States, the taxpayer contacted IRS. The

taxpayer was eligible for the Foreign Tax Credit, which offsets some or all U.S. taxes owed. As a result, the U.S. tax obligation was less than $10,000 for all of the years covered by the OVCI program.

An IRS official told us that detecting offshore income would be particularly difficult without many of these taxpayers applying to the OVCI program. Typically, IRS compares taxpayers' information returns, such as the W-2 forms for wages or forms 1099 for interest or dividends, to their income tax returns to identify underrreported income or nonfilers. An IRS official said that since offshore entities, such as foreign banks, are generally not subject to U.S. information reporting requirements, identifying underreported foreign income would be difficult. For IRS to investigate the taxpayer's return beyond the documentation provided on income and various information returns would require investigating those entities and the accuracy of the transactions reported. Such investigations could be very labor intensive.

Concluding Observations

The diversity of the OVCI population indicates that multiple compliance strategies may be appropriate for addressing those taxpayers holding money offshore. For example, increased educational efforts might be effective for those who became noncompliant inadvertently or those who were unaware of the need to report their offshore holdings to IRS. For those taxpayers who deliberately held money offshore illegally to avoid paying taxes, investigation of promoters or others who may have assisted taxpayers may both help reduce the spread of evasion to other taxpayers and identify those already out of compliance for corrective action. However, because the median AGIs for OVCI participants were relatively modest and the additional tax, interest, and penalties collected to date have also been relatively modest, personnel-intensive investigations of individual cases who have hidden substantial amounts offshore could significantly reduce the net gain to Treasury from these cases. This puts a premium on IRS developing means to identify those cases that should be subjected to such investigations and, if possible, alternative compliance strategies for others.

Messrs. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the committee may have at this time. For further information on this testimony, please contact Michael Brostek at (202 512-9110) or [brostekm@gao.gov]. Individuals making key contributions to this testimony include Susan Baker, Tom Bloom, Michelle Bowsky, Laura Czohara, Michele Fejfar, Jyoti Gupta, Signora May, Karen O'Conor, Amy Rosewarne, Jeff Schmerling, Tina Smith, Jonda Vanpelt, and Jim Ungvarsky.

Appendix I: Objectives, Scope, and Methodology

Our objectives were to determine (1) the extent to which IRS and CIS share and verify data for immigration eligibility decisions or taxpayer compliance purposes and (2) the benefits and challenges, if any, of increasing data sharing and verifying activities.

We performed our work at various IRS offices, including the Office of Governmental Liaison and Disclosure, the Office of Safeguards; the Office of Program, Evaluation, and Risk Analysis; and the Privacy Advocate's Office. Our work also included interviews with employees in IRS's Wage and Investment Operating Division and Small Business/Self Employed Operating Division, the Department of the Treasury's Office of Tax Policy and Office of Inspector General for Tax Administration, and program offices at CIS, and with CIS officials in selected service centers and district offices. We collected and analyzed information on the extent of data sharing and verifying activities between IRS and CIS from January 1997 through March 2004. To respond to your initial request on data sharing and verifying between IRS and selected agencies, we also interviewed Social Security Administration (SSA) officials and collected and analyzed information on data sharing and verifying between IRS and SSA. To illustrate a long-standing data sharing relationship, we summarized the IRS and SSA data sharing relationship in the background section.

To determine the extent to which IRS and CIS share and verify data for benefit decisions or taxpayer compliance, we interviewed IRS and CIS officials about the existence of a data sharing relationship. We identified the legislative and regulatory authorities that govern disclosure of personal and taxpayer information. Additionally, we identified the types of personal and financial information CIS and IRS maintain for immigration decisions and tax compliance, respectively.

To determine the benefits of increasing data sharing and verification activities, we collected and analyzed immigration and taxpayer information. We interviewed IRS and CIS officials to obtain views on possible impediments or missed opportunities to verify information to make better programmatic decisions, and reviewed existing studies or

reports on data verification activities. We determined what personal and financial information IRS collects but does not verify with CIS and why, and whether officials believe verification with immigration would be useful for tax compliance purposes. We determined what personal and financial information CIS receives but does not verify with IRS and why, and whether immigration officials believe verification with IRS would be useful for immigration eligibility decisions.

We used two sets of immigration data from CIS to match with IRS taxpayer data to determine the potential value for increased data sharing and matching. First, we used a nationwide selection of automated data on certain immigration applications: I-129 (Petition for a Nonimmigrant Worker), I-140 (Immigrant Petition for Alien Worker), and I-360 (Petition for Amerasian, Widow(er), or Special Immigrant[31]) submitted from January 1, 1997, through March 5, 2004, to CIS service centers for immigration benefits. We used only those applications in CIS's Computer Linked Application Information Management System, Version 3.0 (CLAIMS 3), a database containing nationwide data, that contained an individual's Social Security Number (SSN) or a business's Employer Identification Number (EIN) –3.4 million out of 4.5 million had usable SSNs or EINs– for the matching process. We obtained automated data for those years because CIS's automated system had historical data not readily available in hard copy files. Because the nationwide selection did not include any financial information, we could not use it to determine whether CIS applicants reported the same income amounts to IRS as to CIS.

Second, we visited five CIS field locations and selected a nonprobability sample of 984 immigration files covering the period of 2001—2003 at four of the locations because they contained personal as well as financial information. These hard copy files were applications for citizenship, employment, and family-related immigration and change of immigration status applications. We used the hard copy immigration files to build an automated database of certain personal information, such as the individual's SSN or business's EIN and income reported to CIS. We obtained hard copy files for those years because the CIS offices we visited had immigration applications for those years onsite.

Immigration offices send older files to storage. Since each district and service center organized and stored its applications in a different way and immigration officials could not always provide an updated count of applications by form number, we developed an approach to selecting applications that included pulling approximately every 50th file in immigration file rooms. We generally selected approximately 50-75 files at each field location for the following forms: I-129 (Petition for a Nonimmigrant Worker); I-140 (Immigrant Petition for Alien Worker); N-400 (Application for Naturalization); I-751 (Petition to Remove the Conditions on Residence); I-360 (Petition for Amerasian, Widow(er), or Special Immigrant); and I-864 (Affidavit of Financial Support). We planned to select 50 files for Form I-829 (Petition by Entrepreneur to Remove Conditions) but only reviewed 12 files due to resource constraints and the voluminous nature of the application files. The matching results for our nonprobability sample included Form I-829s for a small number of individual immigrants who had unpaid assessments or were nonfilers and none for business or individual sponsors.

We matched the SSNs/EINs in our nationwide selection of immigration applications and our nonprobability sample of immigration applications with IRS's Business Master File (BMF) and Individual Master File (IMF) and other subsets such as the Revenue and Refunds Database. We identified immigration applicants/taxpayers that (1) matched with the IRS master files, (2) had unpaid assessments, (3) were nonfilers, (4) were businesses/organizations that had no record of tax activity in the last 5 years, and (5) did not match IRS master files. Additionally, to ensure we identified only business and organization sponsors whose EINs were unknown to IRS, we had IRS perform three additional matches using its BMF Taxpayer Identification Number Cross-Reference File, the BMF Entity File and the IMF Entity File.

We assessed the reliability of IRS's BMF and IMF data and the CIS's CLAIMS 3, a database containing nationwide data, by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that

[31] The I-360 applications in our sample were submitted by religious organizations sponsoring religious workers.

produced them, and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purposes of this testimony.

Our review was subject to some limitations. We relied on IRS officials to identify offices that use personal information because there is no central, coordinating point within IRS for receipt of this type of information. We relied on CIS officials to identify immigration forms they believed would most benefit from data sharing with IRS, and we relied on IRS and CIS officials' views on possible impediments or missed opportunities to verify information, any additional data sharing and verification needs, and the benefits of increased disclosure of taxpayer information. Because our sample of 984 hard copy applications at selected CIS field locations was not a probability sample, we cannot make inferences about the population of applications. In addition, because EINs/SSNs were only available for 3.4 million of the 4.5 million applications in our nationwide selection of automated applications, our findings from these records are not representative of the entire population. IRS identified the limitations of its database that affect our results. Immigration applicants/taxpayers who were in IRS's nonfiler database could include individuals who did not meet IRS filing requirements. Immigration applicants/taxpayers in IRS's unpaid assessment database may include taxpayers that have entered into an installment agreement, have proposed an offer-in-compromise or are in litigation with IRS about amounts due. Since IRS searched its tax data for the last 5 years (1999–2004) and we collected 7 years of immigration data (1997-2004), a small percentage of the businesses that submitted applications during 1997 and 1998 but are unknown to IRS could no longer be in operation.

We conducted our work from July 2003 through June 2004 in accordance with generally accepted government auditing standards.

Our two objectives were to provide information on (1) the characteristics of taxpayers who came forward under IRS's Offshore Voluntary Compliance Initiative (OVCI) program and (2) how those taxpayers became noncompliant.

To develop information on the characteristics of OVCI taxpayers, we relied on IRS's OVCI database. We used data from the applicants' original and amended federal tax returns, including adjusted gross income (AGI), taxes, penalties, and interest owed; the applicants' state and country of residence; and the applicants' occupational information. We also obtained information on applicants' use of promoters. Our information is limited to those taxpayers who voluntarily admitted they held offshore assets, so the information provided is not necessarily representative of any larger population of taxpayers who used offshore arrangements to avoid paying U.S. taxes. Of the 1,321 taxpayers who came forward under the OVCI program, 16 did not apply for relief for 1999, 2000, or 2001. An additional 400 were entities that were set up by and associated with applicants to handle the taxpayers' offshore funds. The tax liabilities, if any, of these entities would be reflected in the additional taxes, penalties, and interest of the individual taxpayers in IRS's OVCI database. In addition, IRS rejected 49 applicants for not divulging the entirety of their schemes. Therefore, the numbers we reported here were limited to the 861 applicants for whom we had data for 1 or more of the years 1999, 2000, and 2001.

To assess the reliability of the IRS data we present in this testimony, we reviewed IRS's data verification procedures. For example, according to a senior manager, all financial data entered into the OVCI database was compared to the taxpayer's account on IRS's Individual Master File. IRS also told us that after all data were entered, a manager rechecked each entry for errors. We reviewed a judgmental sample of 35 cases files based on factors such as particularly high or low AGIs, high or low adjustments to original AGI, or high or low taxes, penalties, or interest owed at IRS's campus in Philadelphia to compare the data in the applicant's files to what was transcribed in the

OVCI database. In addition, we analyzed IRS's data reliability processes and conducted our own limited data verification. We believe the data we used are sufficiently reliable and useful for reporting on the characteristics of those who came forward under the OVCI program.

To determine how OVCI applicants became noncompliant, we talked to IRS officials and obtained information on the taxpayers' circumstances while reviewing the 35 cases in Philadelphia, such as their reasons for noncompliance and their experiences with promoters, if any. To better understand taxpayers' use of promoters, we also visited 25 Web sites maintained by individuals or companies promoting offshore investments to gain a better understanding of the type and cost of the services they provide. The Web sites were judgmentally selected to ensure the sample included a variety of geographic locations. We also reviewed examples of intricate schemes employed by some OVCI applicants to avoid paying taxes by holding money offshore illegally to develop a hypothetical illustration of such schemes.

We did our work at IRS's campus in Philadelphia and its National Office in Washington, D.C. We conducted our fieldwork from January 2004 through June 2004 in accordance with generally accepted government auditing standards.

Appendix III – OVCI Applicant Income Information by Tax Year for 1999, 2000, and 2001

As shown in tables 5, 6, and 7, there are yearly variations in OVCI applicants' median original AGI; adjustment to original AGI; and the taxes, penalties, and interest.

In the tables, the nonfilers' median original AGI is shown as zero because they did not file tax returns, although according to an IRS official, they did illegally hide money offshore and incurred taxes, penalties, and interest. According to another IRS official, for those applying to the program for relief from Report of Foreign Bank and Financial Accounts (FBAR) penalties, the data show original AGIs because they generally reported all of their income and paid taxes due, but had failed to disclose the existence of their foreign bank accounts. There is no adjustment to original AGIs because they had already reported their offshore holdings on their original federal tax returns and, consequently, incurred no additional taxes or interest owed. In addition, the Department of the Treasury waived the FBAR penalties.

Table 5: OVCI Applicants' Income and Amounts Owed for Tax Year 1999

Population	Number	Median original AGI	Median adjustment to original AGI	Median additional tax owed[a]	Median penalties assessed	Median interest owed
Filers	323	$79,394	$24,914	$5,685	$800	$1,116
Nonfilers	21	0	67,086	3,011	1,178	1,243
FBAR	462	34,722	0	0	0	0
Total	**806**	**$49,469**	**$0**	**$0**	**$0**	**$0**

Source: GAO analysis of IRS data.
[a]These figures represent the median for the amount IRS has verified through audits that taxpayers owed IRS. As IRS continues to conduct audits of OVCI taxpayers, the median may rise or fall somewhat.

Table 6: OVCI Applicants' Income and Amounts Owed for Tax Year 2000

Population	Number	Median original AGI	Median adjustment to original AGI	Median additional tax owed[a]	Median penalties assessed	Median interest owed
Filers	331	$87,530	$25,664	$5,591	$674	$655
Nonfilers	27	0	71,782	7,288	1,810	1,295
FBAR	459	41,448	0	0	0	0
Total	**817**	**$51,663**	**$0**	**$0**	**$0**	**$0**

Source: GAO analysis of IRS data.

[a] These figures represent the median for the amount IRS has verified through audits that taxpayers owed IRS. As IRS continues to conduct audits of OVCI taxpayers, the median may rise or fall somewhat.

Table 7: OVCI Applicants' Income and Amounts Owed for Tax Year 2001

Population	Number	Median original AGI for 2001	Median adjustment to original AGI	Median additional tax owed[a]	Median penalties assessed	Median interest owed
Filers	326	$55,869	$20,460	$4,289	$523	$263
Nonfilers	24	0	82,561	7,573	2,431	860
FBAR	458	31,667	0	0	0	0
Total	**808**	**$38,761**	**$0**	**$0**	**$0**	**$0**

Source: GAO analysis of IRS data.

[a] These figures represent the median for the amount IRS has verified through audits that taxpayers owed IRS. As IRS continues to conduct audits of OVCI taxpayers, the median may rise or fall somewhat.

Appendix IV - OVCI Applicant Geographical Information by Tax Year for 1999, 2000, and 2001

Tables 8, 9, and 10 show the number and median original AGI of applicants to the OVCI program by state. In all 3 of the years shown, applicants from Florida, California, Connecticut, Texas, and New York make up half of all applicants to the OVCI program. In all 3 years, seven states had only one applicant to the OVCI program and at least three states had no applicants.

Table 8: State, Number of Applicants, and Original Median AGI for Tax Year 1999

State	Applicants	Median AGI
Florida	114	$51,318
California	101	64,590
Connecticut	87	30,354
Texas	58	45,868
New York	45	96,648
Pennsylvania	37	36,480
Ohio	22	41,891
Massachusetts	21	93,187
Michigan	20	63,212
Maryland	19	52,964
New Jersey	19	95,994
Arizona	18	66,831
Virginia	17	24,097
Illinois	16	118,621
South Carolina	15	79,394
Georgia	14	107,968
Colorado	12	46,407
North Carolina	12	59,901
Nevada	10	24,615
Oklahoma	10	770
Washington	9	26,546
Minnesota	8	119,810
Alabama	5	5,343
Indiana	5	86,853
Iowa	5	57,964
New Hampshire	5	17,699
Total[a]	**806**	**$49,469**

Source: GAO analysis of IRS data.

[a]Because few OVCI applicants resided in the following states, we are not disclosing specific information about them due to concerns that the information could be used to identify the taxpayers: Alaska, Arkansas, Delaware, District of Columbia, Hawaii, Idaho, Kansas, Kentucky, Louisiana, Maine, Mississippi,

Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, Puerto Rico, Rhode Island, South Dakota, Tennessee, Utah, Vermont, West Virginia, Wisconsin, and Wyoming. Therefore, the totals do not reflect only numbers shown in the table.

Table 9: State, Number of Applicants, and Original Median AGI for Tax Year 2000

State	Applicants	Median AGI
Florida	115	$55,831
California	97	73,330
Connecticut	89	35,706
Texas	58	50,965
New York	47	132,642
Pennsylvania	39	37,332
Ohio	25	44,635
Massachusetts	22	95,317
Michigan	22	45,786
Arizona	19	93,711
New Jersey	19	101,675
Maryland	18	93,894
Illinois	16	82,666
South Carolina	16	81,730
Virginia	16	28,273
Georgia	14	155,554
North Carolina	13	51,123
Colorado	12	47,051
Oklahoma	11	8,570
Nevada	10	64,896
Washington	9	28,412
Minnesota	8	133,935
Alabama	5	42,908
Indiana	5	11,928
Iowa	5	84,034
New Hampshire	5	15,587
Total*	**817**	**$51,663**

Source: GAO analysis of IRS data.

* Because few OVCI applicants resided in the following states, we are not disclosing specific information about them due to concerns that the information could be used to identify the taxpayers: Alaska, Arkansas, Delaware, District of Columbia, Hawaii, Idaho, Kansas, Kentucky, Louisiana, Maine, Mississippi, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, Puerto Rico, Rhode Island, South Dakota Tennessee, Utah, Vermont, West Virginia, Wisconsin, and Wyoming. Therefore, the totals do not reflect only numbers shown in the table.

Table 10: State, Number of Applicants, and Original Median AGI for Tax Year 2001

State	Applicants	Median AGI
Florida	115	$42,589
California	98	40,123
Connecticut	87	30,895
Texas	57	49,892
New York	47	112,299
Pennsylvania	39	19,880
Ohio	25	41,013
Massachusetts	21	112,460
New Jersey	20	55,463
Michigan	19	46,662
Illinois	18	76,783
Maryland	18	83,913
Arizona	17	48,917
Virginia	17	0
South Carolina	16	77,732
Georgia	13	83,423
North Carolina	13	50,509
Colorado	12	35,278
Oklahoma	11	1,232
Washington	10	33,495
Nevada	9	292
Minnesota	8	121,779
Alabama	5	30,130
Indiana	5	39,036
Iowa	5	68,655
New Hampshire	5	18,456
Total [a]	**808**	**$38,761**

Source: GAO analysis of IRS data.

[a]Because few OVCI applicants resided in the following states, we are not disclosing specific information about them due to concerns that the information could be used to identify the taxpayers: Alaska, Arkansas, Delaware, District of Columbia, Hawaii, Idaho, Kansas, Kentucky, Louisiana, Maine, Mississippi, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, Puerto Rico, Rhode Island, South Dakota, Tennessee, Utah, Vermont, West Virginia, Wisconsin, and Wyoming. Therefore, the totals do not reflect only numbers shown in the table.

Appendix V – OVCI Applicant Occupational Information by Tax Year for 1999, 2000, and 2001

As shown in tables 11, 12, and 13, retired individuals account for the most applications in each year. The three most common occupations for each year are executives, business/self-employed individuals, and those involved in banking/finance/insurance.

Table 11: Individual OVCI Applicants' Professions, Numbers, Median Original AGIs, and Median Adjustments to Original AGI for Tax Year 1999 (Filers and Nonfilers but not FBAR applicants)

Profession	Number of applicants	Median original AGI	Median adjustment to original AGI
Retired	52	$61,543	$24,894
Executive	47	236,031	40,614
Business/self Employed	31	49,443	36,795
Banking/ finance/ insurance	26	48,778	37,748
Sales	22	105,251	40,586
Engineer	21	83,695	8,685
Medical profession	18	84,952	14,847
Analyst/consultant	12	44,699	6,852
Computer/ technology	10	53,118	6,887
Attorney	8	116,753	5,381
Administrative[a]	8	77,292	27,356
Scientist	5	12,832	7,801
Education[c]	5	0	9,266
Real estate	4	892,885	239,931
Pilot	4	115,778	75,128
Building trades	4	16,974	55,203
Arts	4	178,432	90,998
Other	19	13,515	28,245
Missing	44	28,562	42,663
Total[e]	**344**	**68,626**	**$28,432**

Source: GAO analysis of IRS data.

[a] A small number of taxpayers who applied to the OVCI program listed their occupations as secretary but their incomes were each in excess of $1 million for each of the years 1999, 2000, and 2001.
[b] Although a large number of applicants were from the banking/finance/insurance sector, a large number of these applicants reported large losses on their tax returns. As a result, the median original AGI was relatively low.
[c] Some occupations had more nonfilers apply to the OVCI program than filers, so for these cases the median original AGI was zero.
[d] Seven applicants were identified as "deceased," and we included these people in the "other" category.
[e] We did not include FBAR applicants in this table because, according to IRS officials, there is no adjustment to the FBAR applicants' original AGI. These applicants generally reported their offshore holdings on their original federal tax returns and incurred no additional taxes or interest owed. Because these applicants made up more than half of all applicants, if we included them in the table, the median adjustment to original AGI, taxes, and interest would all be zero.

Table 12: Individual OVCI Applicants' Professions, Numbers, Median Original AGIs, and Median Adjustments to Original AGI for Tax Year 2000 (Filers and Nonfilers but not FBAR applicants)

Profession	Number of applicants	Median original AGI	Median adjustment to original AGI
Retired	57	$71,939	$19,192
Executive	48	258,665	42,943
Business/self employed	33	74,387	38,576
Banking/ finance/ insurance	24	104,129	81,372
Sales	23	123,315	48,587
Medical profession	22	108,723	20,948
Engineer	21	66,765	7,529
Analyst/consultant	11	134,351	20,210
Computer/ technology	10	53,427	3,721
Administrative[a]	8	113,736	29,043
Attorney	8	161,341	13,095
Other	19	27,074	24,133
Education	6	20,945	23,886
Arts	5	62,631	59,230
Scientist	5	23,946	41,127
Building trades	4	15,689	32,313
Pilot	4	98,423	33,955
Real estate	4	1,133,868	198,818
Missing	46	735	36,873
Total[e]	**358**	**$41,448**	**$27,033**

Source: GAO analysis of IRS data

[a] A small number of taxpayers who applied to the OVCI program listed their occupations as secretary but their incomes were each in excess of $1 million for each of the years 1999, 2000, and 2001.

[b] Although a large number of applicants were from the banking/finance/insurance sector, a large number of these applicants reported large losses on their tax returns. As a result, the median original AGI was relatively low.

[c] Some occupations had more nonfilers apply to the OVCI program than filers, so for these cases the median original AGI was zero.

[d] Seven applicants were identified as "deceased," and we included these people in the "other" category.

[e] We did not include FBAR applicants in this table because, according to IRS officials, there is no adjustment to the FBAR applicants' original AGI. These applicants generally reported their offshore holdings on their original federal tax returns and incurred no additional taxes or interest owed. Because these applicants made up more than half of all applicants, if we included them in the table, the median adjustment to original AGI, taxes, and interest would all be zero.

Table 13: Individual OVCI Applicants' Professions, Numbers, Median Original AGIs, and Median Adjustments to Original AGI for Tax Year 2001 (Filers and Nonfilers but not FBAR applicants)

Profession	Number of applicants	Median original AGI	Median adjustment to original AGI
Retired	52	$43,881	$25,074
Executive	47	158,183	23,302
Business/self employed	32	73,134	22,006
Banking/ finance/ insurance	27	3,596	22,951
Sales	22	91,000	24,329
Medical profession	22	95,928	8,397
Engineer	21	55,941	5,722
Other	20	23,286	15,197
Analyst/consultant	11	49,892	20,277
Computer/ technology	11	39,348	6,461
Attorney	9	137,661	23,302
Administrative[a]	8	105,804	11,028
Building trades	5	22,684	6,569
Education[c]	5	0	36,364
Scientist	5	26,599	8,538
Real estate	4	1,100,241	291,871
Pilot	4	123,705	14,566
Arts	3	123,945	70,799
Missing	42	0	54,094
Total[e]	**350**	**$49,598**	**$23,124**

Source: GAO analysis of IRS data.

[a] A small number of taxpayers who applied to the OVCI program listed their occupations as secretary but their incomes were each in excess of $1 million for each of the years 1999, 2000, and 2001.

[b] Although a large number of applicants were from the banking/finance/insurance sector, a large number of these applicants reported large losses on their tax returns. As a result, the median original AGI was relatively low.

[c] Some occupations had more nonfilers apply to the OVCI program than filers, so for these cases the median original AGI was zero.

[d] Seven applicants were identified as "deceased," and we included these people in the "other" category.

[e] We did not include FBAR applicants in this table because, according to IRS officials, there is no adjustment to the FBAR applicants' original AGI. These applicants generally reported their offshore holdings on their original federal tax returns and incurred no additional taxes or interest owed. Because these applicants made up more than half of all applicants, if we included them in the table, the median adjustment to original AGI, taxes, and interest would all be zero.

(450237)

TESTIMONY OF DALE BROWN

Dear Members of the Senate Finance Committee:

My name is Dale F. Brown. I am 47 years of age and reside in Incline Village, Nevada. Since leaving the U.S. Air Force in 1986, where I served as a B-52G and FB-111A navigator-bombardier for eight years, I have published twenty-two military aviation novels, under my own name and as co-author, seventeen of which are New York Times best-sellers.

In April of 2004 I pled guilty to one count of violating 26 USC 7206 (1), filing a false tax return, in 1998. I listed deductions on my tax return knowing they were not real, and I signed the tax return knowing there were false entries.

With the Chairman's permission, I would first like to tell my family, friends, and fellow Americans that I take full and complete responsibility for my actions; I am truly and sincerely sorry for what I've done; and I promise it will never happen again. I made those false entries because I was greedy, vain, selfish, and took bad advice from financial professionals I trusted. We are all human and humans make mistakes, but I also believe that we must all pay for our mistakes as well, and I am prepared to accept any punishment ordered by the Court.

I came to claim those false tax deductions because I participated in an offshore money transfer scheme in which I paid others to form offshore corporations, then transferred money to these entities, claimed those transfers as business expenses, then listed those expenses as legitimate deductions on my tax returns. The purpose of these transfers was to create a pool of money that I could access via loans to myself.

I was introduced to this scheme by my long-time tax preparer, bookkeeper, and financial advisers, Roger and Kim Steele, of Steele Accountancy Inc. of Carson City Nevada. I had been working with the Steeles since 1992 when I was recommended to them to do corporate tax returns after forming a Nevada corporation to produce a television series. I was told that Roger Steele was a CPA and was well-versed in how to take maximum advantage of Nevada corporate and federal tax laws.

Following the Steele's advice, I had formed numerous domestic corporations in the states of Nevada and Wyoming for the purpose of "income splitting," or expensing money between various entities for the purpose of reducing the overall tax liability by taking advantage of lower tax rates and taking multiple deductions for business expenses. By 1997 we were transferring money between three Nevada and one Wyoming corporations. Depending on the

amount of money necessary to "expense" and the tax year-end of the particular corporation, the Steeles would direct me to transfer funds between entities. The Steeles prepared all of the corporate and my personal tax returns.

The process seemed simple and I was satisfied with the results and had no reason to believe any of this was improper. I understood and believed that I was not evading taxes but merely deferring the tax liability until some time in the future--the taxes would eventually have to be paid, but the time value of money suggested that I would benefit the longer I delayed paying the taxes. All of the corporations paid taxes and all filed tax returns. I consulted with the Steeles on a regular basis, usually monthly but more often at the end of the year when funds had to be transferred. The Steeles were treasurers of all of the corporate entities and had access to all the corporations' records and bank accounts.

In 1998 I expressed my desire to Roger Steele to pay off my home mortgage. He advised me that it made no tax sense to do so because of the home mortgage deduction and told me of a better way to proceed using a program run by Terry Neal of Portland, Oregon. Mr. Steele provided me with Mr. Neal's books and audiotapes and assured me that he and his program were legitimate and above-board, so in the summer of 1998 I flew Mr. Steele and myself to Portland, Oregon to meet with Mr. Neal.

After meeting and speaking with Mr. Neal, I agreed to pay to form two offshore corporations, Original Concepts Ltd. (OC) and Atlantic Smythe Inc. (AS), both based in Nevis, West Indies. The plan proposed by Mr. Neal and accepted by myself and Mr. Steele was to expense my corporate funds from the U.S. to OC, usually by wire transfer; transfer funds by wire from OC to AS; then borrow the money from AS in the form of a mortgage to which I would pay principal and interest payments like a conventional mortgage. I would then deduct the transfers as business expenses on my tax returns, and deduct the interest paid on the mortgage on my personal tax return. I paid to form the two corporations, paid an annual maintenance fee for each entity, paid wire fees for each transfer, paid the Steeles to prepare the tax returns, paid an attorney to prepare deeds of trust for filing for the home mortgage, and paid fees to a mortgage collection service to collect and disburse the mortgage payments offshore.

At the time this scheme made complete sense. To me, it was simply a more sophisticated extension of the income splitting routines we had already been doing for many years. I understood and believed that the taxes would eventually have to be paid on all the funds I sent offshore, but they would be paid sometime in the future when I brought the funds back into the U.S.

outside of a mortgage or other loan. I never believed that I was evading taxes. As before, the Steeles oversaw and directed when and how much money should be "expensed" offshore depending on what numbers they needed for the tax returns; as before, they prepared all of my corporate and personal tax returns.

It was explained to me by Mr. Neal and backed up by Mr. Steele that using anonymous offshore corporations was more private, secure, and free of regulatory or government examination versus domestic corporations. No tax returns were due on the foreign entities. My name was not on any bank or corporate ownership records, which meant I did not own or control any foreign bank accounts and was therefore not required to report anything on my tax returns.

I was instructed, and took great care, to be sure that I serviced each mortgage and loan I made with AS. Although I was well aware that nothing would happen to me if I failed to pay (the mortgage collection agency would charge a small late fee), I was told in no uncertain terms that it was vital to pay each loan regularly and promptly in order to maintain the appearance of a conventional loan.

This program continued from 1998 through most of 2002. Roger Steele had personal problems and left the accounting firm in 2000, but his (now ex) wife Kim continued doing all of the books and tax returns and advising me on a wide range of financial matters, including the offshore scheme. I terminated my relationship with Kim Steele and stopped making payments offshore when I learned I was the target of a criminal investigation in December 2002.

Upon the advice of legal counsel and my wife Diane, I decided immediately to cooperate with the government. In the winter of 2003 I met with the Assistant U.S. Attorney from Portland and the IRS and answered their questions on my involvement in the offshore money scheme. In the spring of 2003 I signed a plea agreement with the government and testified before a federal grand jury that indicted Terry Neal. By July 2003 I had paid all of the taxes owed on all of the money I had transferred offshore, plus paid all interest and penalties assessed by the IRS. Also in 2003 I supplied information to the IRS to assist them in their investigation of the Steeles, and in the spring of 2004 met with the IRS to answer more questions about the Steeles. I have also supplied information to the government on other matters relating to offshore banking schemes.

Along with all of the above, I have retained a new CPA firm to handle all of my business and personal financial matters. The new firm has wound up and dissolved all of the questionable schemes and entities established by the

Steeles over the past several years, and I consult with them regularly on all matters relating to money, finances, investments, and business.

This incident has left me and my family in a serious financial situation and may have ruined my writing career. I liquidated my savings and pension accounts and got a second mortgage on my home to pay the taxes, interest, and penalties due. My latest publishing contract has been canceled; I may be forced to pay back advance money I received on two unpublished books that the publisher now says he will not publish; and the publisher is currently retaining money due me from a previous contract until the matter is settled.

The scheme did not save me one cent—in fact, I paid more in interest and penalties than I did in taxes owed, a total of almost one million dollars, not to mention almost two years of attorneys' fees, potential loss of income, adverse publicity, enormous stress on myself and my family, and all of the penalties associated with being a convicted felon. I have humiliated myself in front of my family, friends, and neighbors, and lost an incalculable amount of business and personal trust and goodwill that may never be recoverable.

I am currently awaiting sentencing in federal court in Portland.

Here are my lessons learned from this nightmarish debacle:

I unfortunately re-learned the old adage "if it sounds too good to be true, it probably is." I knew that the expenses were not real, but I went ahead and made them anyway. I made myself believe this scheme was legitimate because I was greedy, because I didn't think I'd get caught and I didn't think I'd go to prison if I did get caught, and because I never thought about the consequences to my family and to my personal and business life if I did get caught.

I learned that I must deal with the real world, not just the imaginary worlds that I create for my novels. I learned I must pay closer attention to all of my affairs, gather information from more than one or two sources, and not be swayed or make decisions based on information from the first person I meet, or someone who can shmooze or flatter me the best. I should have interviewed more than one firm when choosing a financial adviser; I should have asked more questions from neutral third parties before agreeing to participate in the offshore scheme.

I have also learned to trust others in my business decisions and not think I know it all. My wife Diane is a retired Sacramento police lieutenant and is a keen judge of character. The Steeles did not pass her "smell test" early on. But I had worked with the Steeles for many years before I knew Diane, and I

chose to ignore her warnings. I have since learned to trust others with all decision-making, and to especially seek advice from those who have more than just a financial relationship with me.

With the Chairman's indulgence, the following is my primary recommendation to the Committee regarding my involvement in the offshore scheme. I do not make this recommendation as a way to assign blame or make excuses, but as a possible avenue to resolve similar issues more efficiently:

As I mentioned above, I should have sought advice from neutral, licensed, disinterested third party professionals before retaining the unscrupulous financial advisers and signing up for this bogus scheme. But if I had known at any time that Terry Neal or this offshore scheme was under investigation by the government, I would have terminated my involvement on the spot.

Obviously I would not have received such a warning from my own financial advisers, since they were involved in the scheme all the way and were probably receiving some sort of commission from Terry Neal the whole time. I suspect that would be the case in most situations. I now understand from the Assistant U.S. Attorney as well as my attorney that the IRS had been examining Terry Neal since 1998, the year I subscribed to the offshore scheme!

I subscribed to this scheme because of the reasons already mentioned: greed, vanity, selfishness, and taking bad advice from bad persons. But I do not believe I'm a bad guy; I think I'm a good and law-abiding guy who listened to a bogus sales pitch from unscrupulous persons and was shmoozed, flattered, and conned into signing up for something I knew was not right. I heard only one message, and it was the wrong one.

If the objective of the IRS and Justice Department's investigations are to put guys like me in prison, then they are doing what they need to do: keep the investigations secret and deter others by widely publicizing those that are successfully prosecuted or have pled guilty to an offence.

But if the government wants to efficiently recover lost revenue and provide the maximum level of deterrence, it seems to me that they should widely publicize their investigations early on using media outlets that guys like me watch or listen to every day. If I had been watching "America's Most Wanted," "The O'Reilly Factor," MSNBC, or "Larry King Live" and heard that the IRS had started an investigation on a program even remotely resembling the one I was involved with, I'd be on the phone instantly to a lawyer and another accountant, wanting to get out FAST.

I believe that if the government had a regular TV or radio show or a segment in "Parade" magazine (the Sunday paper insert) listing its current investigations, guys like me who think they're getting away with it will turn themselves in or take steps to undo whatever they're doing. The government may offer an amnesty program, but I don't think that would be necessary for most offenders--just the HINT that I might be under the gun would cause me to jump for the phone as soon as I read or heard about it.

The only downside to this idea is that it might cause the organizers of the scheme to close up shop and disappear once the word got out that they were being investigated, so the "big fish" might get away and the efforts and resources of the investigators up to that point might be considered wasted. But it's the ultimate objective that needs to be addressed: if the government is seeking maximum revenue, maximum compliance, and maximum deterrence from normally honest and law-abiding guys like me, they should widely publicize their investigations and do everything possible to compel offenders to turn themselves in. As in the U.S. Air Force Strategic Air Command nuclear war fighting game that I was involved in for eight years, deterrence only works if the other side knows what nuclear weapons you have and you make them believe as clearly as possible that you will use them.

I would like to conclude by thanking the Committee for allowing me the opportunity to make this statement, and I pledge to continue doing everything I can to atone for the wrongs I have done and to earn back the faith and trust of my family, friends, and fellow citizens.

Respectfully submitted,

Dale F. Brown
Incline Village, NV
25 June 2004

WRITTEN STATEMENT OF
COMMISSIONER OF INTERNAL REVENUE
MARK W. EVERSON
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARING ON "BRIDGING THE TAX GAP"
July 21, 2004

INTRODUCTION

Mr. Chairman, Senator Baucus, and distinguished members of the Committee, thank you for the opportunity to testify today regarding the problem of the tax gap and the Internal Revenue Service's approach to bridging the tax gap. The IRS shares this Committee's concerns regarding the tax gap – the difference between what taxpayers are supposed to pay and what is actually paid – and is committed to reducing it.

My testimony today will address the critical need for a better understanding of the nature and scope of the tax gap. While the IRS is undertaking this important task, we are moving forward and addressing the compliance problems that we believe are important contributors to the tax gap. I will highlight the aggressive steps the IRS is taking to address these issues and narrow the tax gap.

BETTER INFORMATION IS NEEDED REGARDING THE TAX GAP

The tax gap consists of three main components: (1) filing noncompliance (i.e., relating to taxpayers who fail to file required returns); (2) payment noncompliance (i.e., relating to taxpayers who fail to pay the full amount shown due on a return); and (3) reporting noncompliance (i.e., relating to taxpayers who fail to report all tax due on a return). Only the second component – payment noncompliance – can be stated with any degree of accuracy because it is based on current information filed by taxpayers. The IRS does not have the information needed to make reliable estimates of the filing noncompliance and reporting noncompliance components of the tax gap, the relative sizes of these three main components to the tax gap, or the total size of the current tax gap.

Simply put, the information on noncompliance currently available to the IRS is over 15 years old, and in many cases even older. The IRS' Taxpayer Compliance Measurement Program (TCMP) last evaluated data from 1988. Compliance data for corporations and other business entities are even less current. Although the information from the TCMP indicates that noncompliance was and remains a significant threat to our voluntary compliance system, the TCMP data does not provide a reliable estimate of the current level of noncompliance – i.e., the tax gap.

The IRS is in the process of compiling updated compliance data through the National Research Program (NRP), the first broad-based compliance study since the TCMP. When completed, the NRP not only will provide the IRS updated data regarding the level of tax compliance by individuals, but also will assist us in understanding the areas and nature of noncompliance. In addition, the IRS is pursuing other research directed at shedding light on particular compliance problems so that we can formulate appropriate solutions.

ROOT CAUSES OF THE TAX GAP

The reasons for noncompliance are many, and once the NRP is completed, the IRS will have a much clearer sense of the areas of noncompliance that give rise to the tax gap and the reasons for that noncompliance. We believe, however, that a significant factor contributing to the tax gap is the enormous complexity of our tax laws. For taxpayers, complexity makes it harder to understand and apply the tax laws. The ever increasing percentage of Americans who each year turn to return preparers and tax preparation software is a reflection of the complexity of our tax laws. For the Government, complexity makes it more costly for the IRS to administer effectively 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.

Complexity gave rise to the latest generation of abusive tax avoidance transactions. Taxpayers engaging in these abusive transactions attempt take advantage of the Code's length and complexity by combining a myriad of technical rules to claim tax benefits not intended by Congress. These transactions often involve complicated structures and sophisticated financial instruments that IRS agents must penetrate to determine whether a transaction is, in fact, abusive. These so-called "technical tax shelters" proliferated in the 1990s because taxpayers and promoters believed that taxpayers could enter into aggressive transactions with little risk of detection and with little risk of owing anything more than the tax due and interest even if caught. I will highlight in greater detail below the Administration's approach to these transactions, which is fundamentally shifting the risk-reward calculus for taxpayers considering an abusive transaction.

We also are exploring ways of altering the attitudes of Americans about noncompliance. Over the last four years, the number of Americans saying it is OK to cheat on taxes rose from 11 to 17 percent. Sixty percent of Americans believe that people are more likely to cheat on taxes and take a chance on being audited. As discussed in greater detail below, the IRS has acted aggressively to restore confidence in the tax system by halting the promotion of abusive transactions and bringing taxpayers back into compliance with the tax laws, while improving service to taxpayers.

OUR AGGRESSIVE ACTIONS TO NARROW THE TAX GAP

The tax gap problem requires a comprehensive solution that will provide the IRS with the information, tools, and resources necessary to address noncompliance. In this regard, we have taken significant and important steps towards bringing taxpayers back into compliance. In addition, we are committed to developing new processes and strategies for dealing with the challenges presented. We currently are following a broad-based, multifaceted strategy to combat noncompliance that includes:

- Identifying compliance priorities and applying resources appropriately;
- Improving service to taxpayers;
- Ensuring that the IRS has the right tools and resources; and
- Coordinating with other tax administrators to identify and combat noncompliance.

Identifying Compliance Priorities and Applying Resources Appropriately

In my testimony before this Committee last October, I highlighted the need for the IRS to prioritize its audit focus and to apply proportionately greater resources to areas where we believe there are, or where we expect to find, compliance issues. In that regard, we have identified the following areas as compliance priorities:

(1) Discouraging and deterring egregious non-compliance;

(2) Ensuring that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law;

(3) Detecting and deterring domestic and off-shore based tax and financial criminal activity; and

(4) Deterring abuse within tax-exempt and governmental entities.

1. Discouraging and deterring non-compliance, with emphasis on corrosive activity by corporations, high-income individuals and other contributors to the tax gap. The abuses of recent years have to a very real degree strained the credibility of our tax administration system. Enforcing compliance in these sectors is critical to maintaining Americans' faith that our system is fair. Combating abusive tax schemes and abusive transactions is the centerpiece of this effort, which involves several key components.

Aggressive Son of Boss Settlement Initiative. This sophisticated abusive transaction initiative involved thousands of taxpayers and six billion dollars in understated tax. We are getting tough on this abusive transaction because it is so egregious. Many transactions have generated tax losses between $10 and $50 million, and several greater than $500 million.

To achieve uniformity and enhance overall compliance with the tax laws, taxpayers will not be afforded the traditional administrative Appeals process. For the first time, IRS has required a total concession by the taxpayer of losses claimed--one hundred percent. For the first time, penalties (10 or 20 percent) are mandated as a settlement condition for certain taxpayers. More than 1,500 taxpayers filed Notices of Election by the June 21 deadline. About 85% of participants then known to the IRS filed elections and more than 300 participants unknown to IRS have filed elections. These taxpayers must still complete the process established for the initiative in order to resolve their cases, but we are very pleased by the response. Mr. Chairman, without the support shown by you and Senator Baucus, we would not have had this kind of success.

Anyone who does not come forward can still challenge the IRS in court. If so, we will vigorously pursue the full tax due, applicable interest, and the maximum penalty. Taxpayers should not expect to settle court cases more favorably than the IRS settlement initiative. We have already begun to contact the taxpayers who did not file Notices and expect to begin enforcement action soon.

Three states, New York, Connecticut, and New Jersey, have issued their own Son of Boss settlement initiatives as part of broader amnesty programs.

Early Disclosure of Questionable Transactions. The Administration has made transparency a key element of its effort to combat abusive transactions. In March 2002, based on our experience with regulations issued in early 2000, the Treasury Department announced a significant revision of the rules requiring taxpayers to disclosure potentially abusive transactions to the IRS. These revisions have been completed, and I am confident that they will be a significant step towards bringing abusive transactions to light as they take place, rather than years afterwards. The early identification of potentially abusive transactions permits the IRS to gather information and issue guidance before a transaction proliferates. Notifying the public of the IRS's position on an abusive transaction, coupled with robust disclosure, registration, and list maintenance requirements, deters taxpayers from playing the audit lottery and participating in abusive transactions. The alternative is unacceptable because the IRS must devote a tremendous amount of resources to address an abusive transaction after it has spread in the market.

Early disclosure rests upon the three provisions in the Code that require taxpayers to provide requested information on returns and promoters to registers certain transactions with the IRS and provide lists of participants in potentially abusive transactions to the IRS upon request. The Administration has proposed legislation that will allow these three provisions to work together seamlessly and back up the failure of a taxpayer or promoter to follow these disclosure rules with meaningful penalties. I commend the Committee for the lead it has taken in moving these Administration proposals closer to enactment.

Prompt Guidance on Abusive Transactions. The early identification of abusive transactions is only as valuable as the effectiveness of the IRS' response - once the IRS identifies a potentially abusive transaction, it is imperative that the IRS responds quickly. Prompt action, such as through the issuance of public guidance with respect to a newly identified abusive transaction, will limit the spread of an abusive transaction. If we do not promptly challenge these transactions, taxpayers may assume, incorrectly, that the IRS has tacitly approved the transaction or that the IRS simply will not detect it. In the absence of a clear signal from the IRS, taxpayer may adopt a "follow the crowd" mentality about an abusive transaction.

To avoid the delays that had previously hampered our efforts, the IRS has launched efforts to ensure a coordinated approach involving the IRS operating divisions, Chief Counsel and the Treasury Department to formulate a response. We believe that once guidance has been issued that a transaction does not work or, in some cases, has been designated a "listed transaction" (which signals our very strong concerns about a transaction and commitment to identify taxpayers who have participated in the transaction), taxpayers will be reluctant to enter into it. By deterring taxpayers from entering into these transactions, we save audit resources. In addition, this guidance directs agents in the field to focus on these transactions in taxpayer and promoter audits and ensures that these cases will be uniformly developed. If the IRS is slow to uncover new potentially abusive transactions or does not react quickly to them, then the IRS will be required address more cases through audit and litigation. That is a far slower and more resource-intensive process than published guidance and is significantly less effective in containing the spread of new abusive transactions.

Better Information from Taxpayers. Although increased disclosure of potentially abusive transactions under our revised disclosure regime is a critical compliance priority, it is not enough. We are taking aggressive actions to make sure that we identify noncompliance by

making it more transparent on a return. Increased filing of electronic returns is a key element of this effort. Electronically-filed returns allow the IRS to use all of the information on a return. Although we experienced substantial growth in electronic filing again this year, we are committed to fulfilling our mandate to expand and encourage electronic filing.

In addition, we are revising our forms so that they elicit the information we need to detect noncompliance. For example, we recently announced the release of the new Schedule M-3, which will be effective for large corporations this year. The Schedule M-3 accomplished a much needed, comprehensive overhaul of the present Schedule M-1, which had not been updated for almost 40 years. The new Schedule M-3 will make differences between financial accounting net income and taxable income more transparent. Schedule M-3 provides information that will help the IRS better identify taxpayers that may have engaged in aggressive transactions and therefore where additional scrutiny is warranted. The new disclosures from Schedule M-3 will help us focus our examination efforts on high-risk areas, which will improve and streamline the audit process.

The IRS also is working to examine returns earlier. It is imperative that we get current in our audits. The IRS must identify abusive transactions promptly so that potentially abusive transactions can be shut down early on, before they spread. It currently takes two years on average before complicated corporate returns find their way into the hands of the assigned examiner, and it takes five years from the date the return is filed for us to complete the audit of a large, complex corporation. (These figures do not include the appeals process, which may take another two years before the matter is settled or goes to court.) As a result of this time lag, the IRS did not detect and deter the abusive transactions of the 1990s on a timely basis because we did not have an informed view of current taxpayer behavior, only an historical understanding of events long past.

The challenge to get current and to focus swiftly on emerging issues and evolving business trends is becoming greater every day. But, I am convinced that meeting that challenge will give us a quicker, more current and more efficient examination process that is aimed at those returns with the greatest compliance risk. Technology will help. For example, electronic filing by corporations will facilitate our analysis of data and help us calibrate risk. Through speedier audits we will provide better service to the compliant taxpayer by resolving differences earlier, and hold accountable those who seek to game the system.

Reduced Controversy through Published Guidance. A significant proportion of our audit resources are being consumed addressing issues that could be clarified through additional published guidance. The Treasury Department and the IRS have published guidance for issues such as capitalization, cash-method accounting, and the research credit, that historically have resulted in considerable controversy between taxpayers and the IRS. These guidance projects are continuing, and we will continue working on guidance that establishes clear rules that will resolve uncertainty and controversy. Published guidance is an important tool that the IRS can use to increase compliance and free up audit resources that we can then devote to areas with higher risks of noncompliance. We have made significant progress in accelerating and increasing its issuance of published guidance and we will continue to improve our performance in this area.

2. Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law. When I started work at Arthur Andersen in New York as a young

auditor, in 1976, I was not yet twenty-two years old. All of us — in fact I would dare say anyone at a big eight accounting firm or leading law firm of the time — were given an unmistakable understanding of professional expectations and standards: your first responsibility was to make sure your client followed the law and observed appropriate standards. Then, if you could, you attempted to differentiate the firm based on service.

Let me emphasize that the vast majority of practitioners are honest and scrupulous. But even the good ones—the vast majority—suffered from the erosion of ethics—because they are being subjected to untoward competitive pressures. Over the last three decades, with an accelerated slide in the 1990s, the model for accountants and attorneys changed. The focus shifted from independent audit and tax functions premised on keeping the client out of trouble, to value creation and risk management. Promoters of abusive transactions had a corrupting influence. It got so bad that in some instances blue chip professionals actually treated the decision of whether or not to comply with the law as a business decision. They weighed potential fees for promoting abusive transactions but not following the law against the risk of IRS detection and the size of our penalties.

Our system of tax administration depends upon the integrity of tax practitioners. The IRS is committed to improving professional standards. We are pursuing an integrated approach to maximize the effectiveness of the Office of Professional Responsibility (OPR) that includes: (1) providing OPR the necessary resources and ensuring that those resources are deployed efficiently; (2) establishing administrable standards for practice before the IRS that address current compliance issues; and (3) improving coordination and outreach between OPR, the IRS Operating Divisions, and the Department of Justice (DOJ). To help us achieve these objectives, we have augmented OPR by doubling its size and appointing as its Director a tough, no nonsense, former prosecutor.

The IRS also has focused attention on the role of accounting and law firms, among others, in the proliferation of abusive transactions. The IRS has focused on these firms because in some instances tax professionals were acting as promoters of abusive transactions, and not simply as tax or legal advisers. Initiatives that focus on promoters provide a number of benefits to tax enforcement. Promoters are required to maintain investor lists that identify taxpayers who participate in potentially abusive transactions that are "reportable" or "listed" transactions under Treasury Department regulations. By auditing the promoters, obtaining investor lists, and following up with audits of those investors, we can deter the promotion of, as well as the demand for, abusive transactions. The IRS also has effectively utilized penalty sections 6707 and 6708 of the Code against those promoters and preparers who fail to comply the registration and list maintenance rules.

The IRS is also focusing on tax return preparers. The Small Business/Self Employed Division (SB/SE) established a Lead Development Center (LDC) in April 2002 to centralize the receipt and development of all potential leads on abusive transactions and tax schemes marketed used by return preparers and promoters. The LDC sends authorized investigations to the field. Last year, SB/SE's LDC and Return Preparer Program increased our compliance efforts against abusive return preparers. Problem preparers are now referred to the LDC for consideration of an injunction investigation. As of June 2004, the IRS SB/SE Division has 927 promoters and return preparers under Section 6700 and/or 6701 investigation.

In extraordinary cases involving promoters and return preparers, we have worked with the DOJ to file suit in U.S. District Court under Code sections 7402, 7407 and 7408 to seek injunctions to halt further abusive conduct. Such action can permanently bar an individual, or group of individuals, from participating in such activity. Since the beginning of 2000, 186 promoters (some of whom were also return preparers) have been referred to the Department of Justice for injunctions. The Department of Justice has filed injunction suits against 101 of those promoters, and declined to sue 36 of them. Of the 101 sued, 67 have been enjoined (by temporary restraining order, preliminary injunction, or permanent injunction), and 34 are awaiting court action. The Department of Justice is evaluating 49 referred promoters for possible suit. Another 55 cases are being reviewed by Chief Counsel for possible referral.

3. Detect and deter domestic and offshore-based criminal tax activity and financial criminal activity. Our Criminal Investigation Division (CI) is a storied and proud law enforcement agency. CI is currently pursing a number of significant and complex abusive tax scheme investigations in which they are collaborating with SB/SE and Large and Midsize Business Division (LMSB). With this internal synergy, we are aggressively detecting and deterring domestic and off-shore tax and financial criminal activity.

CI has focused its efforts on abusive tax schemes that utilize multiple flow-through entities as an integral part of the taxpayer's effort to evade taxes. These tax schemes are characterized by the use of trusts, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards, and other similar instruments. The schemes are usually complex, involving multi-layered transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

CI's expertise covers not just criminal tax matters but other financial crimes. Our investigators are the best in law enforcement at tracking and documenting the flow of funds. In addition to our tax investigations, the IRS has over 100 agents assigned on an ongoing basis to support the President's Corporate Fraud Task Force. We will continue to intensify these important efforts.

4. Discourage and deter non-compliance within tax-exempt and government entities, and the misuse of such entities by third parties for tax avoidance or other unintended purposes. We are taking a close look at tax-exempt organizations to ensure that they are operating within the bounds of the law. As I testified before the Senate Committee on Finance last month, our Tax-Exempt and Governmental Entities Division (TEGE) plays a significant role in combating abusive transactions. While the vast majority of tax-exempt entities follow the law, and abuses in this sector may still be isolated, we must act quickly to check those abuses. We have seen instances of lavish compensation packages for executives, inappropriate related-party transactions and, in some cases, operation of what is essentially a profit-making entity with no public purpose in the guise of a charity to escape the payment of taxes or regulatory oversight.

We are addressing non-compliance by tax-exempt entities on a number of fronts. In one area of particular concern, credit counseling organizations, we have launched an unprecedented audit effort. We are also initiating a broader review of foundations that ultimately will involve examinations of approximately 400 entities. Half of the examinations will be somewhat akin to our detailed NRP audits already underway for individuals. Furthermore, we are enhancing our cooperative efforts with state charity regulators. If we do not take actions to preserve the

integrity of our charities, there is a risk that Americans will lose faith in, and reduce their support more broadly, for charitable organizations, damaging a unique and vital part of our nation's social fabric.

Finally, we cannot overstate the seriousness of the involvement of tax-exempt and government entities as accommodation parties to abusive transactions. A significant proportion of the transactions identified to date as listed transactions under the return disclosure regulations rely to some degree on the use of a tax-exempt party. In response, we have revised our Form 8886, Reportable Transaction Disclosure Statement, to require the identification of all parties to a listed transaction to improve the detection of accommodating parties, including tax-exempt entities. We will continue to explore whether additional changes to the disclosure rules and forms are necessary.

Improving Service to Taxpayers

Enhancements to the IRS' compliance efforts must be matched by continued improvements in service to taxpayers. Achieving better service will improve the willingness of taxpayers to meet their tax obligations, increase tax revenues, and reduce the tax gap.

Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he, she or it owes. By service, we mean helping people understand their tax obligations and making it easier for them to participate in the tax system. Adam Smith, the Scottish economic philosopher, believed that the "tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought to be clear and plain to the contributor, and to every other person."

We have an obligation to help taxpayers navigate the tax laws and make it as easy as possible for them to comply. The IRS has demonstrated unmistakable progress in improving customer service and increasing its recognition of and respect for taxpayer rights. While the ultimate desired level of customer service remains to be reached, the IRS's improvement and commitment with respect to these core goals has been incontrovertible, established and measurable.

Our objectives for continued improvement in taxpayer service are three-fold: (1) improve and increase service options for the tax-paying public; (2) facilitate participation in the tax system by all sectors of the public; and (3) simplify the tax process. These objectives are based on a recognition of the dynamics of a rapidly changing world, one in which the Internet will be the dominant communications tool. Yet we realize there will remain a wide range of computer and technological literacy among individual taxpayers, and we must not fail to provide the same level of service to all taxpayers, regardless of their technological sophistication. Our objectives also recognize an America with an increasingly diverse population, and that diversity will create challenges for us as tax administrators. Nevertheless, we are confident that we can and will serve all Americans effectively.

Ensuring the IRS Has the Tools and Resources it Needs

In addition to the steps outlined above, we have been working closely with our partners in the Treasury Department to make sure that the IRS has the tools and resources it needs to fight noncompliance. As this Committee is aware, the Treasury Department's March 2002 Enforcement Proposals to Combat Abusive Tax Avoidance Transactions have been included in the Administration's Fiscal Year 2005 Budget and will provide important tools for the IRS. These proposals include confirmation of the Government's ability to seek injunctions against promoters who disregard the disclosure rules and the imposition of new penalties for taxpayers who fail to report foreign bank and other financial accounts. The Administration also has proposed legislation that will increase the penalty for frivolous returns and permit the IRS to disregard other submissions, such as requests for collection due process (CDP) hearings, that are based on frivolous arguments. In addition, the Administration's proposals will make changes to the substantive tax laws where necessary to combat specific abuses. Finally, we have provided valuable assistance to the Treasury Department's development of new legislative proposals that close loopholes and target identified abusive transactions and abusive practices.

To provide the IRS additional resources, the Administration has asked for a 4.8 percent increase for the IRS budget for Fiscal Year 2005 — ten times the average increment for non-homeland, non-defense agencies. The Administration's strong commitment to tax administration will provide a 10 percent augmentation to our enforcement resources.

Coordination with Other Tax Administrators to Identify and Combat Noncompliance

The IRS is not alone in its efforts to combat noncompliance. State tax administrators, as well as our foreign counterparts, are tackling the problems of noncompliance with the tax laws in their jurisdictions. Our recent efforts to improve coordination and information sharing with these agencies are yielding dividends.

IRS Coordination with the States. The IRS is continuing to work with state tax officials in the nationwide partnership to combat abusive transactions that was announced in September 2003. This nationwide partnership now includes 48 states, the District of Columbia, and the New York City Department of Finance

Early this year, information exchanges began with the states and cities. The IRS shared information regarding approximately 28,000 taxpayers who engaged in potentially abusive transactions. The IRS already has received significant information back from states, including information about multi-million dollar tax schemes. In one notable example, data provided by the California Franchise Tax Board in response to an IRS request for state information regarding a high profile transaction the IRS currently is examining resulted in the identification of additional participants. As a result, the IRS will be able to bring these additional participants into compliance.

Cooperation with the States is expanding and the IRS is developing additional initiatives with the States. These initiatives, which involve closer coordination and the increased exchange of information, include the following:

(1) State Income Tax Reverse Filing Match. Under this initiative, we are using increasingly sophisticated document-matching programs to uncover nonfilers by comparing state filing and payment information with Federal data. A test program is currently underway in California, Minnesota and New York that has already helped identify thousands of filing discrepancies.

(2) Title 31 Money Services Business (MSB) Memorandum of Understanding (MOU). This program will improve the Federal/State exchange of MSB examination information. Improved information sharing will enhance compliance by MSBs regarding Federal and State laws and regulations, including the detection of money laundering. Once executed, the MOU will provide the basis for a partnership between IRS, the Treasury Department's Financial Crimes Enforcement Network (FinCEN), and State regulatory agencies.

(3) Federal State Offshore Credit Card Matching Initiative. Under this program, the IRS is expanding use of state databases to assist in identifying and locating taxpayers who have participated in off-shore credit card abuse.

In addition to greater cooperation in sharing leads in the area of abusive transactions, the flourishing new partnership with the States has provided opportunities for joint outreach and education activities to counter the claims of those marketing tax schemes and scams. We also are working with the States on other initiatives that will improve compliance by reducing taxpayer burden through closer coordination of state and federal tax obligations. For example, the Federal-State Internet Employee Identification Number (EIN) program will enable taxpayers to obtain both an EIN from the IRS and a registration number for sales tax and/or income tax from their home State in one location on the Internet. This one-stop approach will reduce paperwork burden for taxpayers.

Expanding International Coordination. The IRS is not the only tax agency facing the compliance challenges I have outlined. We are working with the tax authorities of Australia, Canada, and the United Kingdom to form a joint international task force to increase collaboration and share information about abusive transactions that are occurring in and out of our four countries. I expect that our joint effort will enable the four countries to share expertise, best practices and experiences in order to identify and better understand abusive transactions and those who promote them; to exchange information about specific abusive transactions and their promoters and investors within the framework of our countries' existing bilateral tax conventions; and to carry out our individual enforcement activities more effectively and efficiently.

CONCLUSION

Mr. Chairman, we are steadfastly committed to understanding and bridging the tax gap. We believe that the initiatives and actions I have highlighted are important steps toward that goal. Although we have made significant progress, we will continue our efforts to combat noncompliance.

Thank you.

Questions from Senator Baucus

1. The Director of the IRS's Office of Research said that the estimated gross tax gap of $311 billion for the tax year 2001 is likely to underestimate the current annual gross tax gap.

   a) To what extent is the tax gap underestimated?

   Response:

   The IRS estimate cited was extrapolated from various IRS studies. Although the tax gap has three components -- (1) filing noncompliance (relating to taxpayers who fail to timely file required returns); (2) payment noncompliance (relating to taxpayers who fail to timely pay the full amount shown due on a return); and (3) reporting noncompliance (relating to taxpayers who fail to report all tax due on a return) -- current information is available only for the payment noncompliance portion of the tax gap. The filing and reporting compliance portions are based on the Taxpayer Compliance Measurement Program (TCMP) data that are over 15 years old. These projections assume constant compliance rates for the major components of the tax gap. If compliance rates have substantially changed over time, the resulting estimates may overstate or understate the true tax gap. As a consequence, while the IRS can develop an estimate, we can give no assurance that such estimate would bear any relation to the actual tax gap. Nevertheless, we can conclude that overall compliance remains a significant issue and one that merits our focus and commitment.

   We are undertaking a study of individual income tax reporting compliance for Tax Year 2001 as part of the National Research Program (NRP). This study will provide us with much needed data on current areas of noncompliance and allow us to update estimates of the tax gap for this important segment of the population.

   b) To what extent is the $311 billion tax gap attributable to deliberate tax cheating versus mistakes or incorrect interpretations of the tax laws?

   Response:

   The tax gap generally consists of three main components: (1) filing noncompliance; (2) payment noncompliance; and (3) reporting noncompliance. We can estimate the second component – payment noncompliance – with a fairly high degree of accuracy because it is based on current IRS information.

Inadvertent mistakes, misinterpretations of complex tax provisions, deliberate misstatement of tax liability or related attributes, and intentional non-filing all contribute to the reporting noncompliance component of the tax gap. Our estimates for filing compliance and reporting compliance will be further refined and developed as we obtain information through studies conducted as part of the NRP. The compliance data we have generally is very dated and generally inconclusive as to the magnitude of the specific causes of non-compliance.

c) Why doesn't the IRS drill down into noncompliance to get a better understanding of how to close the tax gap?

Response:

The IRS is committed to identifying the causes of noncompliance and to developing effective strategies to combat noncompliance. A cornerstone of this commitment is the completion of the ongoing individual income tax reporting compliance study under the National Research Program (NRP). The NRP is the first broad-based compliance study since the TCMP. We expect that analysis of the data collected will provide insights into the causes of non-compliance and also help develop effective strategies to combat it.

In addition we will build on our experience with the first phase of the NRP reporting compliance study (focusing on individuals, including sole proprietorships) and are evaluating the best method for extending the NRP to the broader business population.

2. GAO recommends that IRS study the benefits and costs of data matching with CIS to enhance tax administration. Will you do so? Do you have the resources you need to do this in a timely manner? When can we expect to learn the results of your study?

Response:

The IRS will perform a study to determine the costs and benefits associated with the data matching with CIS, including an analysis of the impact on tax administration. Close coordination with CIS will be necessary to accurately study the costs and benefits of data matching. We have already begun planning for the study and the anticipated coordination with CIS. We plan to meet on October 30, 2004. After the meeting, we will establish a deadline for the expected completion of the study.

3. In reacting to GAO's testimony, IRS raises the concern that dealing with taxpayers who would come to IRS if they were required to meet their tax obligations before applying for an immigration benefit could stretch IRS's resources. Does IRS need more resources to handle these cases? If so, have you asked or do you plan to ask for more resources?

Response:

Please see the response to Question for the Record No. 2. A key element of the forthcoming study on data matching with CIS will be the amount of IRS resources needed to complete the tax compliance checks. Once the study is completed, we will be able to estimate the benefits of and the resources required by such a program if implemented.

4. Citizenship and Immigration Services' data may help IRS identify certain likely noncompliant taxpayers and take enforcement action to bring them into compliance. However, if those applying to CIS for immigration benefits had to be fully current in meeting their tax obligations, IRS would not need to ferret out the noncompliant, they would need to come to IRS and come into compliance. Do you believe this would be a preferable way to improve tax compliance than for IRS to use its traditional enforcement tools?

Response:

Please see the response to Questions for the Record Nos. 2 and 3. The forthcoming study will analyze the costs and benefits associated with the data matching with CIS along with the expected impact on tax compliance. Completion of the study will provide the IRS necessary information to determine whether a matching program would be an effective way to improve tax compliance that would be preferable to existing enforcement tools.

5. In March 2004, the subcommittee on oversight from the House Ways and Means Committee held a hearing on the 2004 Tax Season and the IRS Budget for Fiscal Year 2005 and was told that IRS had asked for 80 more criminal investigators (a cost of approximately $12 million) beginning in October to join the 160 it has already assigned to penetrate the shadowy networks that terrorist groups use to finance the plots like the September 11 attacks and the recent train bombing in Madrid. But the Administration did not include the request in the President's proposed budget for FY 2005. Why didn't the Administration include the request in its proposed budget?

Response:

The President's FY 2005 Budget proposes to increase the total IRS budget by 4.8 percent — significantly above the average for non-defense, non-homeland discretionary spending — to ensure compliance with the tax laws, while maintaining customer service to taxpayers. If Congress adopts the President's FY 2005 Budget, the IRS will have the strongest hiring year in Criminal Investigation's history -an increase of over 14 percent of our special agent resources. If approved, we will hire over 400 new special agents to add to our current staffing of approximately 2,750 special agents. We also will be hiring an estimated additional 200 employees to support our agents in the field.

In addition to requesting in the FY 2005 Budget additional resources to be used for increased staffing, the President has made available non-staffing resources for the Treasury's Counterterrorism Fund. On December 17, 2003, the President authorized $7 million to be used to support IRS special agents in overseas and domestic counterterrorism efforts. The funding has been used to finance the deployment of IRS special agents to the Middle East and Europe to support the Iraqi repatriation mission and to fund additional equipment, technology investments, and training for IRS counterterrorism special agents involved in the Joint Terrorism Task Forces and other counterterrorism efforts.

6. In the aftermath of the terrorist attacks of September 11, 2001, federal law enforcement agencies have been mobilized to fight terrorism. The Federal Bureau of Investigation's Joint Terrorism Task Force (JTTF) was created to strengthen efforts to combat terrorism by enhancing cooperation between federal, state and local law enforcement agencies throughout the country. In support of this national effort IRS Criminal Investigation has devoted its resources to the staff of JTTF and is playing an important role. Why isn't the Administration dedicating the $12 million necessary to pursue the currency that funds terrorism?

Response:

The war on terrorism is a top priority of the IRS. Our agents possess unique and valuable skills in investigating financial crimes The IRS has never declined a request to assist in pursuing terrorists.

As explained in the response to Question for the Record No. 5, if the President's FY 2005 Budget is approved, IRS Criminal Investigation (CI) will hire over 400 new special agents to add to our current staffing of approximately 2,750 special agents. We will also be hiring an estimated additional 200 employees to support our agents in the

field. The distribution of agent resources will be based on specific program needs while balancing mission objectives and goals.

IRS special agents currently have, and will continue to play, a critical role in supporting the war on terrorism. CI's efforts in terrorist financing matters include the following:

- On a national level, CI is embedded with the FBI in all 84, and soon to be 100, JTTFs, concentrating on the financial infrastructure and fundraising activities of domestic and international terrorist groups, with particular emphasis on the abusive use of charitable organizations as a terrorist funding mechanism.

- On September 17, 2001, Attorney General John Ashcroft directed all United States Attorneys' Offices to take several immediate steps in the fight against terrorism. The Anti-Terrorism Advisory Council (ATAC) was designed to serve as a conduit for sharing information among federal and state authorities, a coordinating body for carrying out the anti-terrorism plan, and an organizational structure for responding to any future terrorist incidents. CI currently is embedded in all ATACs concentrating on financial infrastructure and fundraising activities of domestic and international terrorist groups.

- In August 2003, the Department of Treasury and the government of Saudi Arabia created the JTFTF, based in Riyadh, to deal specifically with terrorist financing. The task force is comprised of FBI, IRS CI, and Saudi investigators. Task force agents both provide and receive investigative lead information on various terrorist financing matters. CI has and will continue to deploy special agents to this task force as necessary.

- Through the experience CI has gained during the last two years, we have identified areas in which CI can have a substantial impact addressing terrorism related financial issues without duplicating the efforts of other law enforcement agencies. CI is piloting a counterterrorism project in Garden City, New York, which, when fully operational, will use advanced analytical technology and leverage valuable income tax data to support ongoing investigations and pro-actively identify potential patterns and perpetrators.

- In addition, as discussed in the response to Question for the Record No. 5, the $7 million funding approved by the President on December 17, 2003, has been used to fund the purchase of equipment, technology investments, and training for IRS counterterrorism special agents involved in the JTTFs and other counterterrorism efforts.

7. In July 2003, the IRS released the results of a study, commissioned by the IRS and undertaken by the Fair Isaac Corporation, which estimated the cost of abusive corporate tax shelters. The study concluded that abusive corporate tax shelters cost us as much as $18.4 billion per year. As high as this number is, it is likely that it understates the problem of tax shelters significantly. For instance, it leaves out shelters undertaken by small corporations, partnerships, and wealthy individuals. The estimate is also based on outdated notions of exactly what constitutes a shelter and what kinds of abusive sheltering techniques taxpayers are using.

   a) How has the IRS used the information from the July 2003 study?

   Response:

   The Fair Isaac Corporation Phase II study from July 2003 related to large corporations with assets in excess of $250 million. This study consisted of: (1) a model designed to estimate the extent of noncompliance due to abusive corporate transactions; and (2) a ranking model designed to estimate the relative risk of a large taxpayer participating in an abusive tax avoidance transaction (ATAT) or other aggressive tax behavior.

   The first phase of the Fair Isaac study estimated that cost of noncompliance related to corporate ATATs was $18.4 billion for the 1999 tax year. However, Phase II of the Fair Isaac Corporation study did not identify a reliable or accurate methodology for estimating the size of the tax gap due to abusive transactions for any taxpayer population – that is, the earlier $18.4 billion estimate is not reliable.

   The ranking model component of the study, once validated, may be of key importance in assisting the IRS selecting returns for audit and in allocating scarce audit resources. Beginning in August 2003, IRS's Large and Midsize Business (LMSB) division began a field validation of the ranking model. This validation will be substantially completed in December 2004 and the results are expected to be incorporated into future return scoring models to identify the risk of participation in an ATAT by a corporation.

   b) Given the limitations of this study, has the IRS taken any actions to commission further studies that would take into account the significant tax sheltering activities of smaller corporations, pass-through entities, and wealthy individuals?

Response:

Since the Phase II model was commissioned, LMSB's database of known participants in abusive transactions has grown five fold. In order to benefit from this richer dataset, LMSB is requesting funding to build a Phase III ATAT model that would improve current methods of identifying risk for mid-sized corporations (those with assets greater than $10 million and less than $250 million). If a proposed Phase III is successfully completed, the IRS will be better equipped to identify participants in abusive transactions throughout the corporate population.

c) How large a share of the $311 billion dollar tax gap results from corporate tax shelters?

Response:

Please see the response to Question for the Record No. 1. The IRS does not have information needed to make a solid estimate of the tax gap resulting from abusive corporate transactions.

d) What percentage of IRS enforcement resources is going toward corporate tax shelters?

Response:

The examination of abusive corporate transactions is conducted primarily by our LMSB operating division. In FY 2004, approximately 20 percent of LMSB's audit workload includes ATATs. In addition, SBSE will expend more than 9 percent of its examination resources in FY 2004 to investigate promoters of ATATs, examine returns filed by participants in domestic and offshore abusive transactions and schemes, and provide support to LMSB regarding corporate ATATs.

8. The IRS's Offshore Credit Card Project ("OCCP") uses domestically available information (data accumulated by credit card companies and merchants) to identify users of credit and debit cards. In August 2003, Treasury Inspector General for Tax Administration (TIGTA) determined that IRS does not have an effective management information system to give management sufficient data with which to make decisions in combating abusive offshore credit card accounts. In July 2001, the IRS indicated that it had obtained 1.7 million records that included over 235,200 credit card numbers. In August 2003, the Treasury Inspector General for Tax Administration's review indicated that only 1,740 cases were assigned to the IRS field and over 360 cases were still awaiting

classification. As of June 30, 2003, according to TIGTA, IRS assessed only $3.3 million with only $744,546 having been collected.

a) To date, how much has IRS assessed?

Response:

To date, we have completed 897 OCCP examinations, assessed $8.1 million, and collected approximately $528,000 in tax revenue. We expect the additional 1,674 examinations currently in process to bring the amount assessed to approximately $30 million in total.

Additionally, we believe the most egregious non-compliant taxpayers are yet to be contacted. We are in the process of analyzing summonsed information recently received from MasterCard (2nd summons), as well as VISA, and other domestic credit card processing companies such as Credomatic.

b) How much has IRS collected?

Response:

To date, the IRS has collected approximately $528,000 on assessments of $8.1 million.

c) Does the IRS have the adequate resources to work these cases? Please explain?

Response:

The collection of tax liabilities related to abusive offshore transactions and schemes has been a priority for the past two years, and we have made significant progress in this area. Accordingly, we have instituted a collaborative effort between revenue agents, revenue officers and Counsel attorneys to maximize our effectiveness in dealing with these cases where taxpayers continue to shield assets through abusive offshore and domestic arrangements. Please see the response to Question for the Record No. 9 for additional information regarding the IRS's efforts to combat noncompliance in the offshore arena.

We are committed to pursuing taxpayers that have engaged in offshore transactions to avoid their tax obligations. If fully funded, the FY 2005 initiative (Curb Egregious Noncompliance) in the President's budget request will allow us to further expand our programs to identify and deal with taxpayers engaged in abusive

schemes of all types, including abusive offshore activities. In addition, we are evaluating our International program, which serves the compliance needs (both customer service and enforcement) of U.S. taxpayers living abroad, to determine the impact of adding more resources to address abusive offshore schemes.

d) Why do you believe that so few taxpayers came forward under OCCP?

Response:

We believe that this question refers to the Offshore Voluntary Compliance Initiative (OVCI). Information regarding OVCI is provided in our response to Question for the Record No. 11.

e) Does the low number of OCCP applicants indicate that these efforts are not very effective in reaching taxpayers involved in offshore schemes and bringing them back into compliance?

Response:

We believe that this question refers to the Offshore Voluntary Compliance Initiative (OVCI). Information regarding OVCI is provided in our response to Question for the Record No. 11.

f) Does the IRS have an estimate of how much taxpayers avoid annually using these offshore schemes? If so, how much is the estimate? If not, why not?

Response:

The IRS currently does not have an estimate of the amount of tax avoided annually by taxpayers participating in offshore schemes. At this time, the IRS is continuing to pursue participants in offshore schemes and is beginning to contact the most egregious non-compliant taxpayers from current leads. Based on the incomplete data available, it is impossible to accurately estimate the amount of tax avoided at this time.

9. Some of the schemes for hiding money offshore are very elaborate, involving multiple bank accounts, phony charities, bogus business transactions, and other counterfeits to avoid paying taxes. Even in the simpler cases, it appears that IRS will have difficulty first identifying individuals who may be noncompliant and then developing sufficient facts to judge what the tax assessment should be. Does IRS have a cost-effective way of addressing noncompliance among these populations? If

so, please describe it. If not, what more do you plan to do to address the problem of offshore noncompliance?

Response:

To address noncompliance in this important area more effectively, we are utilizing a multi-pronged approach that includes: (1) identifying promoters of these arrangements; (2) understanding the methods used to transfer assets offshore; (3) determining how and by whom assets are controlled; and (4) detecting how and when offshore assets are repatriated. We are applying lessons learned from both the OVCI and OCCP programs to better understand how taxpayers use these arrangements to avoid tax and the types of taxpayers who are likely to engage in these activities.

In order to identify promoters of Abusive Tax Avoidance Transactions (ATAT) including offshore schemes, the Small Business/Self-Employed Division (SB/SE) established the Lead Development Center (LDC) in 2002. The LDC coordinates promoter investigations with Chief Counsel, Criminal Investigation, and the Operating Divisions. The Large and Mid-Size Business Division (LMSB) also processes promoter leads through its Office of Tax Shelter Analysis (OTSA).

To provide technical support and guidance to agents working the cases, we have established Issue Management Teams (IMT) for a number of ATATs including Offshore Credit Cards and Foreign Trusts. The function of an IMT is to support the identification, development and resolution of issues related to ATATs, including promoter investigations. When the investigation of abusive scheme promoters uncovers illegal activities, cases are referred to the Department of Justice for potential court action, including the granting of temporary and permanent injunctions.

As we develop more experience with these types of taxpayers, we will continue to explore and analyze various approaches to find the most efficient and cost effective ways to address their noncompliance.

10. Has IRS considered other options in addressing the problem of offshore noncompliance -- for example, we learned from Mr. Brown's experience that the organizers of these offshore schemes are published authors with thousands of books and audiotapes on the market; they have Web sites; they hold seminars all over the country. It doesn't seem hard to find them. Why can't we shut them down sooner?

Response:

The IRS recognizes that promoters have played a significant role in the proliferation of offshore schemes. Accordingly, the IRS has focused its efforts on halting the promotion of these schemes and finding ways to shut down promoters more quickly. One important tool is the power to stop tax schemes by seeking and obtaining injunctions in federal court. Injunctions prohibit promoters from selling illegal tax schemes on the internet, at seminars or through other means.

In order to obtain an injunction under IRC § 7408 for violations under IRC § 6700, the Government must show that the promoter promoted or sold "an entity, plan or arrangement" within the meaning of the statute. The government must develop facts with respect to promoter actions to establish that the conduct of offshore promoters is actionable (i.e., that the promoter organized or sold a plan or arrangement that contains false or fraudulent statements concerning the availability of tax benefits). In some cases, this showing requires detailed investigation as promoters may not advocate in writing the non-filing of returns, the non-payment of taxes, or the filing of false or fraudulent returns. Also, there are First Amendment considerations that make it difficult to pursue an injunction against authors. At the same time the IRS is increasing the number of promoter investigations, it is providing agents the skills and training needed to aggressively pursue these cases and quickly shut them down.

a) Does the IRS publicize all of its new or ongoing investigations of tax schemes and scams? If so, how does it do it? If not, why not?

Response:

The IRS maximizes publicity of its ongoing investigations of tax schemes and scams as part of its strategy to combat abusive tax schemes. The IRS publicizes criminal tax convictions and abusive scheme promoter injunctions, generally in conjunction with the Department of Justice. This information is available on the IRS and Department of Justice websites and is provided to the media.

IRS media relations specialists also work with print, radio and television media to alert the public to specific schemes and scams and to handle incoming inquiries proactively. For example, the IRS routinely issues public guidance and press releases regarding common tax schemes and scams to inform taxpayers who may encounter the false positions in promotional materials or news

accounts. In addition, the IRS posts extensive general information about abusive schemes, including off-shore transactions, on the Internet at www.irs.gov. This site is updated frequently and its use by the public as a resource is increasing.

In addition, IRS partners with tax professional organizations, states, trade and professional associations, educational institutions, and other stakeholders to alert and inform the public about abusive schemes. We also have entered into an agreement with 48 states, New York City, and the District of Columbia to exchange data about taxpayers who participate in abusive schemes.

b) Are there ways to improve the dissemination of such information to help shut down these schemes? If not, why not?

Response:

In addition to utilizing our traditional avenues in the press and expanding the visibility of our website, we continue to develop new relationships with stakeholder organizations, including trade and professional organizations, educational institutions, payroll and practitioner societies, to help us effectively warn the public to beware of abusive tax schemes.

The Internal Revenue Service Advisory Council (IRSAC) is currently reviewing the Service's efforts to educate and inform the public about abusive tax schemes. IRSAC provides an organized public forum for IRS officials and representatives of the public to discuss relevant tax administration issues.

c) Does IRS have a sufficient number of staff with the expertise in uncovering sophisticated schemes to do an adequate job of policing offshore arrangements?

Response:

Pursuing taxpayers who have engaged in offshore transactions to avoid their tax obligations is complex work which challenges traditional audit techniques. As a consequence, keeping the expertise of our agents up to date through formal training is a daunting task, but one to which we are committed. As mentioned earlier, we also have established Issue Management Teams to provide technical support and guidance to the agents working these cases. In addition, our Lead Development Center continues to play a vital role in identifying promoters of Abusive Tax avoidance Transactions, including offshore schemes.

If fully funded, the FY 2005 initiative (Curb Egregious Noncompliance) in the President's budget request will allow us to further expand our programs to identify and deal with taxpayers engaged in abusive schemes of all types, including abusive offshore activities. In addition, we are expanding our International program, which serves the compliance needs (both customer service and enforcement) of US taxpayers living abroad, to assist in addressing abusive offshore schemes.

We also are working with the tax authorities of Australia, Canada, and the United Kingdom to form a joint international task force to increase collaboration and share information about abusive transactions that are occurring in and out of our four countries. We expect that our joint effort will enable the four countries to share expertise, best practices and experiences in order to identify and better understand abusive transactions and those who promote them; to exchange information about specific abusive transactions and their promoters and investors within the framework of our countries' existing bilateral tax conventions; and to carry out our individual enforcement activities more effectively and efficiently.

d) What kinds of skills are required and what is IRS doing to develop those skills in its staff?

Response:

Offshore cases may involve complex arrangements of legal entities, set up in multiple jurisdictions. These arrangements may have been designed using complexity and secrecy to mislead and confuse the examiner.

Accomplishing a quality examination requires knowledge of the various types of offshore vehicles, offshore jurisdictions, tax treaties and information exchange agreements, information returns required with respect to the involvement of US persons with foreign corporations and foreign trusts and the penalties for not filing, as well as IRC § 982 which gives special force to a summons aimed at offshore records.

To develop and enhance the required skills to address abusive schemes, the IRS continually updates training materials and internal published guidance. Just-in-time training is developed and provided to examiners as the need for new skills is identified.

The skills used to combat tax schemes are the same skills IRS special agents, revenue agents and revenue officers use to combat sophisticated money laundering schemes, corporate fraud, terrorist financing, and every other financial crime investigated by IRS. Our ability to follow the money is the primary means for successfully investigating these schemes.

CI special agents are uniquely trained and skilled, possessing particularly strong accounting, financial and computer skills. CI is the only federal law enforcement organization that has a minimum accounting and business educational requirement for all prospective special agents. The unique blend of accounting and law enforcement skills enables CI special agents to analyze complex, often unusual, financial transactions and also equips them to investigate corporate fraud, organized crime and terrorism-financing cases. No other Federal law enforcement agency's special agents have this blend and depth of skills (as well as an 85 year history and mission of "following the money").

e) Are there any tools IRS needs that it currently doesn't have?

Response:

We have been working closely with the Treasury Department to ensure that the IRS has the right tools to shut down abusive transactions, such as the offshore schemes described in your question. In March 2002, the Treasury Department announced a number of legislative proposals and administrative actions designed to combat abusive transactions. The Treasury Department and the IRS have completed virtually all of the administrative actions announced in 2002.

The legislative proposals announced in March 2002 along with additional proposals included the Administration's FY 2005 Budget would provide the IRS additional tools to combat these offshore schemes. I am pleased that many of the proposals from the Administration's FY 2005 Budget are reflected in legislation passed by this Committee.

11. Under the Offshore Voluntary Compliance Initiative (OVCI) how many taxpayers came forward to participate in the program?

Response:

We received a total of 1,321 applications, representing 3,436 returns, in response to the Offshore Voluntary Compliance Initiative (OVCI). Under the terms of the OVCI, we required taxpayers to file corrected returns and pay applicable taxes and penalties associated with the initiative at the time they submitted the completed package to us.

a) To date, how much has IRS assessed?

Response:

The conditions of the OVCI Project included the filing of corrected returns and payment of applicable tax and penalties. As of July 6, 2004, we have collected over $200 million in pre-payments, and are in the process of posting the full amount as assessed taxes.

b) How much has IRS collected?

Response:

As of July 6, 2004, we have collected over $200 million from this initiative.

c) At the time OVCI was announced, IRS indicated that there might have been as many as 1 million noncompliant taxpayers using offshore schemes – but only about 861 taxpayers came forward. Why do you believe that so few taxpayers came forward under OVCI?

Response:

OVCI was implemented on January 14, 2003, and taxpayers had until April 15, 2003, to apply for the program. We received 1,321 applications, representing 3,436 returns. This program was the first of its kind, and we believe that some taxpayers may have taken a "wait and see" attitude to see how the program worked. It is impossible at this time to accurately estimate how many taxpayers have participated in these schemes. However, based on the information regarding promoters and these arrangements we have received from taxpayers participating in the OCVI, we are aggressively pursuing other noncompliant taxpayers in the offshore arena.

d) Does the low number of OVCI applicants indicate that these efforts are not very effective in reaching taxpayers involved in offshore schemes and bringing them back into compliance?

Response:

The fundamental goal of OVCI is to enhance voluntary compliance by identifying taxpayers engaged in abusive offshore activities. These cases represent some of the most complex and abusive cases in our history. As part of multi-pronged approach to combating abusive offshore schemes, OVCI was effective in identifying promoters of these arrangements and in enhancing our understanding of the methods used to transfer assets offshore, how and by whom assets are controlled, and how and when offshore assets are repatriated. We are applying lessons learned from both the OVCI and OCCP programs to better understand how taxpayers use these arrangements to avoid tax and what types of taxpayers are likely to engage in these activities. This information is also being used to maximize the effectiveness of the OCCP identification units. These efforts together will increase voluntary compliance from taxpayers involved in offshore schemes.

12. It is disturbing that so many OVCI applicants used paid tax preparers to prepare their original, inaccurate returns. Will IRS be taking action to identify those paid preparers who have multiple clients using illegal offshore tax schemes and what, if any, action does IRS expect to take with them?

Response:

IRS has taken a number of steps to ensure that problem preparers are identified and that misconduct is properly addressed. The Return Preparer Program (RPP) is a priority within the IRS, and efforts to address abusive preparers are underway. The SB/SE Promoter Lead Development Center (LDC) works closely with the RPP program, the Office of Professional Responsibility (OPR) and Criminal Investigation (CI) to coordinate enforcement action against problem preparers.

The LDC also coordinates with CI under new parallel investigation procedures adopted last year, which allow a civil investigation to be conducted concurrently with a criminal investigation. This approach often results in civil injunctions against promoters long before the criminal case is ready for prosecution. We currently have over 200 of these parallel investigations ongoing.

In addition, the LDC notifies OPR of pending investigations of Circular 230 practitioners. This practice gives OPR an opportunity to

pursue the preparers and, if warranted, to seek to disbar them from practicing before the IRS.

a) IRS has been revising Circular 230, which sets the standards for certain tax practitioners. What, if any portion of the revisions will help deter future filings of inaccurate returns in circumstances like those found in the OVCI?

Response:

Circular 230 applies to return preparers who are attorneys, certified public accountants or enrolled agents – tax professionals who represent taxpayers before the IRS. The existing provisions of Circular 230 provide OPR authority to take action against a practitioner who prepares false or inaccurate returns if the practitioner had knowledge of the client's offshore account or failed to exercise due diligence to determine whether the client had an offshore account. Circular 230 permits a practitioner to rely on reasonable representations from his or her client, but he or she may not ignore information furnished by the client or actually known by the practitioner.

b) Do you believe any further changes are needed to the Circular to better address the responsibilities of paid preparers given what you have learned through the OVCI?

Response:

Please see the prior response.

13. What is IRS's current estimate of the number of taxpayers who may be using offshore schemes?

Response:

The IRS currently does not have sufficient information to make a reliable estimate of the number of taxpayers who may be using offshore schemes. However, the Small Business/Self-Employed Division is designing a research project to estimate the number of potential promoters and participants involved with abusive tax avoidance transactions.

14. How much money do taxpayers avoid annually using these offshore schemes?

Response:

The IRS currently does not have sufficient information to make an estimate of the amount of money avoided annually using these offshore schemes.

15. GAO's analysis of OVCI results suggests average working Americans are also becoming conversant with how to avoid taxes by going offshore. Does this represent a serious risk to our system of voluntary compliance with the tax laws?

Response:

Taxpayer noncompliance through offshore tax avoidance transactions represents a serious risk to our system of voluntary compliance with the tax laws. Because of this risk, the Service has aligned its strategic priorities to address abusive tax avoidance transactions, including offshore tax avoidance transactions and schemes. Please see the response to Question for the Record No. 10 for more information regarding the IRS' efforts to combat noncompliance through offshore arrangements.

16. Charities are required to register with IRS and meet certain standards before they qualify to receive tax-deductible donations. How is it that a taxpayer could set up a bogus offshore charity and not be caught? What, if any, changes to IRS's processes for reviewing applications for charitable status under section 501(c)(3) are you considering given what has been learned about such bogus offshore charities?

Response:

Except under unusual circumstances that would be governed by a tax treaty and not likely to be applicable here, contributions to charities created or organized outside the United States and its possessions are not deductible as charitable contributions by U.S. individuals, regardless of whether the charity applied for and received section 501(c)(3) recognition. IRS letters of recognition to foreign charities specifically state that contributions are not deductible, and consequently we believe that such bogus offshore charities would seldom apply for recognition.

We believe offshore charity promotions generally do not involve IRS recognition of exempt status because there is little to gain and potentially much to lose from IRS scrutiny and the public transparency involved in annual reporting requirements. One of the means used to avoid being detected is to attempt to evade IRS

oversight altogether. Although we are working on ways to improve our application process, we believe that changes to the process would not address this problem.

17. A GAO report on Vehicle Donations indicated that IRS failed to audit any of the referred in-kind donations returns (about 4,000) determined to have audit potential during the fiscal years 2001 and 2002. Why?

Response:

The IRS selects cases for examination based on this and other information. We did not audit the subject returns because we determined that our compliance resources were better directed to other enforcement priorities. Nevertheless, as we told GAO in our response to their report, we are reassessing our compliance program in this area. In addition, we note that the Administration FY 2005 Budget proposes legislative changes to address abuses involving the in-kind donation of used automobiles. We would look forward to meeting with you to discuss this issue further.

a) What other types of compliance issues prevented IRS from auditing any of the referred returns?

Response:

Please see the prior response.

b) What was the amount of the audit potential in dollars of the referred returns?

Response:

The potential avoided tax varies by property type. The potential avoided tax with respect to automobile donations, for example, is believed to be significantly lower than the average audit results for individual returns examined by field revenue agents. Higher amounts are associated with other types of donated property, such as boats.

c) What was the amount of the audit results in dollars of the other types of compliance issues handled in the field?

Response:

The average audit results for individual returns examined by field revenue agents were $19,551 in FY 2001 and $17,581 in FY 2002.

d) Does IRS have the resources to effectively monitor and audit in-kind donations? If not, what resources are needed to achieve this goal?

Response:

The IRS has the necessary tools to effectively monitor in-kind donations. The federal individual income tax return, Form 1040 Schedule A Itemized Deductions, provides line 16 for taxpayers to reflect their total of in-kind donations other than by cash or check. From this information, the IRS can monitor the size and extent of total in-kind donations.

In addition, when an in-kind donation is sold, or otherwise disposed of, by a charitable organization within two years after the original gift was made, charitable organizations are required to file Form 8282, Donee Information Return, with the IRS. When a Form 8282 is received by our Ogden Campus, the return of the Donor is requested for the year in which the gift was made. The Donors return which should have Form 8283, Noncash Charitable Contributions Appraisal Summary attached for in-kind gifts totaling more than $500, is compared to Form 8282 to identify any difference in value. From this information, the IRS can monitor in-kind donations that are ultimately sold by a charitable organization within two years. Whether by analyzing Form 1040, Schedule A, line 16 total in-kind donations or focusing on those in-kind donations reported on Form 8282 compared to Form 8283, the IRS has the ability to identify cases with questionable donations.

18. IRS funding does not cover salary pay raises, unbudgeted mandatory expenses (such as rent increases and postage), and the inability of the IRS to achieve its projected savings from internal productivity growth, how will this affect resource levels for the various IRS enforcement initiatives and taxpayer service?

Response:

We will make every effort to protect the enforcement initiatives in the FY 2005 Budget request. However, if Congress provides an unfunded pay raise, it likely would have a detrimental impact on the proposed FY 2005 initiatives. To continue to realize the returns on the proposed FY 2005 initiatives, such a shortfall would be covered with other base resources in both the PAM and ISY appropriations. Approaches for minimizing the impact on the FY 2005 initiatives could include: not replacing 1,000 FTE lost through attrition, accelerating efficiency initiatives, further cost cutting in general

administrative and overhead budgets, and decelerating modernization efforts.

19. Commissioner Everson, you testified earlier this year that for every dollar in enforcement, we get back six dollars, and that does not include the indirect effect. IRS research puts the figure at a ten to one return on our investment in the IRS. What is the Administration doing to educate the Office of Management and Budget to view additional resources to the IRS in a new light i.e., as investments with a return?

Response:

In 1994, the IRS established a methodology for computing direct return on investment (ROI) for enforcement initiatives. During 1995, the Government Accountability Office (formerly known as the General Accounting Office) conducted a sensitivity analysis of the IRS' ROI methodology based on IRS' 1995 hiring initiative and declared it to be sound, and the calculations used by IRS to be accurate.

Over the years, the methodology has been refined and updated to reflect changes in economic factors, productivity, training and the marginal yield of working additional cases. Further refinements to the ROI methodology are being studied. By improving and effectively explaining the methodology behind ROI and using it to justify budgets, IRS aims to illustrate for others that additional enforcement resources likely would equate to direct revenue returns.

20. Just last week the House Appropriations Subcommittee on Transportation and Treasury, and Independent Agencies reduced the Administration's budget request for the IRS by $382 million. Where are the cuts going to hit -- IRS enforcement initiatives? Taxpayer service?

Response:

The IRS' FY 2005 Budget request includes a substantial increase in funding for IRS enforcement activities, a cornerstone to stemming non-compliance among those taxpayers who choose not to fulfill their tax obligations. The $382 million reduction in funding proposed by the House committee would jeopardize the enforcement initiatives in the request and place at significant risk our ability to hire an additional 4,100 enforcement personnel. Assuming the reduction in funding is limited to enforcement programs, the effect on service to taxpayers, however, would be less intrusive and the IRS likely would be able to maintain current service levels with base resources. Although the impact of the reduced funding on taxpayer compliance is difficult to quantify, we believe that, if enacted, the proposed cuts would reverse the progress we recently made in key enforcement areas.

21. Commissioner Everson you have stated on several occasions that Compliance = Enforcement + Service. If the appropriation for the IRS is lower than IRS's budget request for fiscal year 2005 does this mean that Enforcement = Compliance – Service?

Response:

The enforcement initiatives in the FY 2005 Budget request would be substantially reduced or eliminated if the appropriation is less than the President's request. The Budget assumes that current high service levels can be maintained without additional budget increases. Any potential impact on IRS service programs would depend on whether the reduced funding levels would be significant enough to cover potential mandatory inflation increases, such as additional unfunded pay raises, for IRS employees in Service functions. If the $382 million funding cut proposed by the House subcommittee is approved, approximately 1,000 FTE attrition losses would not be replaced in order to fund mandatory inflation increases.

Regardless of whether the appropriation is lower than the FY 2005 Budget request, the IRS is committed to continuing efforts to improve taxpayer compliance through better service – reduced funding will not alter our basic operating equation.

Questions from Senator Rockefeller

1. According to former Commissioner Rossotti even if the IRS grew at 2 percent every year through 2010, the staff would still be substantially smaller than it was in 1990. Yet the economy can safely be projected to have grown more than 75% since then, and our tax laws will certainly be more complex.

   Do you believe that the staff of the IRS needs to grow with the size and complexity of the economy?

   Can you describe how the growth of the IRS staff will compare to the growth of the economy over the next two years, based on the President's budget requests?

   Response:

   The growth and complexity of the economy represent a challenge to the IRS. Even as the size (number of filings) and complexity (changing mix of business vs. individual, tax schemes etc.) of the economy grows, we are committed to improving taxpayer compliance and achieving our operating objectives. The IRS must maintain our customer service workforce and increase our compliance workforce in order to maximize our approach -- Compliance = Enforcement + Taxpayer Service.

   To meet these challenges, the IRS workforce must grow. This growth must reflect our overall performance expectations. For example, some parts of our workforce, which deal with submission processing (mail room clerks and tax examiners) are declining, based on investment in new technologies and increased e-filing. On the other hand, as we try to restore our enforcement workforce to address noncompliance and to ensure that we fairly enforce key compliance areas (e.g. offshore accounts and complex tax avoidance transactions), we need to increase our numbers of Revenue Agents, Special Agents, Revenue Officer and Tax Compliance Officers.

   It is difficult to compare staffing needs in 1990 to those in 2010. Because of the dramatic changes in technology since 1990, IRS employees have the potential to become much more productive. In particular, computer technology has multiplied the productivity of employees. There has also been a shift from larger numbers of lower level employees, such as clerks and secretaries, to a smaller number of more professional level employees. Thus, it is not merely the total number of employees that matters but the total productive capacity in performing the job at hand.

2. Legislation to close tax loopholes, including some of those used by Enron, has passed this committee and the Senate a number of times. It was included in the Senate version of energy legislation. It was also included in the Senate version of the $350 billion tax cut last year. Yet in both of those cases, it was struck from the final compromise at the insistence of the House of Representatives.

   Last November, most of the Democrats on this committee cosponsored S. 1937, legislation with the sole purpose of shutting down those tax shelters.

   President Bush has been a very energetic advocate for tax cuts. Clearly reforming our tax code has been one of his top priorities.

   Can you please tell me what steps the President has taken to encourage Congress, and specifically the House of Representatives, to enact legislation to close indefensible loopholes in our tax code?

   How many times since S. 1937 was introduced last November has the President spoken with public audiences about the need to close down egregious tax shelters?

   How many times since S. 1937 was introduced last November has the President spoken with public audiences about the need to enact tax cuts?

   Response:

   The Administration has taken a leading and vigorous role in combating abusive tax avoidance transactions. In March 2002, the Treasury Department announced comprehensive legislative proposals and administrative actions to target these transactions, the promoters who market them, and the taxpayers who engage in them. The Treasury Department and the IRS have completed virtually all of the administrative actions announced in March 2002, including the complete revisions to regulations that now require all taxpayers to separately disclose potentially questionable transactions on their returns and promoters to maintain lists of taxpayers who engage in these transactions and provide those lists to the IRS upon request. These regulations will help end the "hide-and-seek" tactics of promoters and taxpayers and are allowing the IRS to respond more quickly to abusive transactions as they occur. These regulations, and the many other actions taken by the Treasury Department and the IRS over the past three years to address abusive transaction, are described more fully at http://www.treas.gov/press/releases/js1184.htm.

   The Administration has consistently and strongly supported legislation that will aid the Treasury Department and the IRS in combating tax

abuses. The March 2002 legislative proposals have been included in each of the Administration's budgets since they were announced. The Administration's FY 2005 budget also includes a number of additional legislative proposals to shut down specific abusive transactions, including so-called sale-in/lease-out (SILO) transactions. The Administration looks forward to continuing to work closely with Congress to enact these proposals into law.

The Administration's FY 2005 Budget also demonstrates the Administration's commitment to providing the IRS with the resources and support needed to ensure that all taxpayers pay their fair share. The Administration's FY 2005 Budget includes an additional $300 million for IRS efforts to ensure compliance with the tax laws, and increases the total IRS budget by 4.8 percent – significantly above the average for non-defense, non-homeland security discretionary spending. The budget continues a three year trend of increasing resources for the IRS to improve taxpayer compliance and to target abusive transactions, while maintaining customer service to taxpayers.

3. The IRS has taken great pains to develop an elaborate pre-certification program for the Earned Income Tax Credit. This program may actually require a parent to ask their clergy to submit documentation to the IRS certifying that the child lives with the parent claiming the credit.

   Can you please tell me whether the IRS is developing any other programs to require taxpayers to pre-certify for credits they may claim on their taxes?

   If not, why is the IRS not interested in pursuing such an approach to crack down on other tax credit fraud?

   Response:

   The IRS has adopted a new mission statement for their EITC program: The mission of the Earned Income Tax Credit (EITC) Office is to lead and manage an integrated, cross-functional EITC program, working closely with internal and external stakeholders, to increase the number of eligible taxpayers who claim the EITC and to reduce the number of EITC claims that are paid in error. This mission statement stresses the balance between reducing erroneous payments and ensuring that all eligible taxpayers claim the EITC.

   Consistent with this mission statement, the IRS is exploring different alternatives for achieving these goals. One alternative the IRS is currently exploring consists of testing whether a certification requirement for a subset of the EITC-eligible population could reduce error without deterring eligible people from claiming the credit. The IRS

is currently testing a certification requirement for 25,000 taxpayers. We have developed a thorough evaluation plan that looks at both error rates and participation, and have no plans to implement a certification requirement until our test and evaluation are complete. If test results indicate that certification may be an effective tool, we will actively engage external stakeholders, and in particular Members of Congress, before proceeding further.

The IRS does not now, nor does it ever plan to, require parents to ask their clergy to submit documentation to the IRS in this or any other EITC-related activity. However, the test we are currently conducting does provide taxpayers with the option of allowing their clergy to complete an affidavit that certifies that the qualifying child satisfies the residency requirement with respect to the taxpayer claiming the EITC. This option was one of many we included after lengthy discussions with external stakeholders. Our objective is to provide taxpayers with a number of ways to certify and to include as many options as possible that would be least burdensome from the taxpayer's perspective.

As noted above, we will evaluate this and every aspect of the certification test, report our findings to Congress, and consult extensively with stakeholders before proceeding with an expansion of current initiatives. The IRS is not developing any other programs to require taxpayers to pre-certify for tax credits. The IRS is testing a potential certification requirement only after extensive analysis and review suggested that this approach may be effective for the EITC program. We are committed to data-driven decision making with the EITC as with other parts of the tax code the IRS administers.

4. In a report released last February, the General Accounting Office found that there are 27,000 private contractors registered with the Defense Department who owe more than $3 billion in unpaid taxes. Yet the Defense Department and the IRS had not used all of the tools at their disposal to collect the taxes from those companies. For example, under the Debt Collection Improvement Act, the IRS was entitled to levy up to 15 percent of each contract to offset federal tax debt. I am interested in what progress has been made on this front in the 5 months since the report was issued.

   Specifically, of the contractors cited by the GAO, can you tell me the number of contractors on whom the IRS has taken steps to impose levies for unpaid taxes since February?

   Response:

   The IRS has taken a number of steps to improve the effectiveness of the Federal Payment Levy Program (FPLP) in collecting unpaid taxes,

including taxes owed by Department of Defense (DoD) Contractors. In January 2004, to make a greater proportion of its collection inventory available for levy under the FPLP, the IRS removed the one-year waiting period for cases to enter the FPLP from the Collection Queue and also modified its treatment of low dollar cases in deferred status. Primarily as a result of this change, FMS reports that from January through June 2004, IRS made an additional 3.1 million tax debts totaling $28.9 billion available for levy compared to 680,061 tax debts totaling $5.1 billion added during the same period of the prior year. In addition, in January through June 2004, we have received 207 levy payments on DoD contractors totaling $2.4 million, compared to 43 payment totaling $323,000 during the same period of 2003. In July 2004, we removed blocks on Revenue Office inventory and certain accounts in the Automated Collection System. Effective January 2005, we will also remove blocks on certain Criminal Investigation cases. We estimate that the July 2004 and January 2005 changes will place additional tax debts totaling $26 billion in the FPLP. The completion of the IRS' plan to make additional debts available for the FPLP is the result of a one-time decrease in the IRS' existing inventory of delinquent tax debts. Making these additional tax debts available for the FPLP program increases the likelihood that these debts will be matched with payments to federal contractors and satisfied through levy prior to the expiration of the statute of limitations on collection or the cessation of payments to the contractor. In addition, the steps taken accelerate the availability of tax debts available for the FPLP will increase the likelihood that future tax debts of federal contractors will be matched and levied.

Of the $3 billion owed by the contractors cited by the GAO, how much delinquent revenue has been collected?

Response:

GAO reported that as of September 30, 2002, 27,100 entities registered in the DoD's Central Contractor Registration (CCR) database owed nearly $3 billion in unpaid taxes. It must be noted that these registrants have not necessarily been awarded a DoD contract. Companies register in the CCR in order to compete for a government contract. Although we can not specifically quantify dollars collected, as of June, 2004, the amount owed by these registrants totaled $1.086 billion. DoD has collected $6.63 million through the FPLP program, which started in December 2002, through September 2004 for the IRS. Of the $1.086 billion in delinquent taxes, approximately $638 million (59 percent) will be available for levy through the FPLP. The remaining 41 percent are excluded from FPLP for statutory or operational reasons. Statutory exclusions include cases in which:

- **The taxpayer has filed an Offer in Compromise:**
- **The taxpayer has entered into an Installment Agreement;**
- **The taxpayer has filed for bankruptcy protection;**
- **The taxpayer has not received their Collection Due Process (CDP) notice;**
- **The taxpayer has filed an Appeals Office protest or request for CDP hearing; or**
- **The taxpayer is located in a combat zone, which suspends IRS collection actions.**

Operational exclusions include cases in which (1) the taxpayer is under active criminal investigation; (2) has filed a claim or amended return that may result in a change in the amount of taxes owed; or (3) a determination has been made that the taxpayer had a financial hardship.

What specific steps has the IRS taken to coordinate with the Defense Department better in the future?

Response:

In March 2004, the Federal Contractor Tax Compliance (FCTC) task force, an interagency group with representatives of the Department of Defense (DOD), Defense Financial and Accounting Service (DFAS), General Services Administration (GSA), Office of Management and Budget (OMB), Internal Revenue Service (IRS), Department of Justice (DoJ), and Financial Management Service (FMS) was formed. The task force explored ways to maximize the tax debts available for levy; maximize the DOD payments available for levy; and to improve the effectiveness of the matching and levy processes. The FCTC report was recently completed and we will provide a copy to this Committee.

The FCTC has identified a number of administrative actions that could be taken immediately to improve the levy process. For example, through improved coordination with DoD and FMS, an earlier additional match of tax debts against the DoD contract obligation file has been implemented. This match will be conducted on a monthly basis. At the time a contract is awarded, DoD obligates funds. By matching the DoD obligation file against the FMS database of delinquent taxes, taxpayers who have active contracts with DoD can be identified and the CDP notice issued. By initiating the CDP notice soon after contract award, the IRS will be in a better position to levy most of the contractor payments without a delay. The task force will continue to meet on a periodic basis to oversee implementation of the recommendations and to provide a forum to coordinate future changes and actions to further improve the levy process.

DoD has provided 94% of its payments to the FPLP program for matching to the Treasury debt files. DoD plans to provide 100% of its payments by August 2005.

5. In March 2004, the Treasury Inspector General for Tax Administration reported that the IRS did not adequately notify the courts when convicted criminals did not comply with the terms of their sentences requiring the settlement of IRS tax liabilities.

   Have you determined why this reporting process broke down?

   Response:

   We have identified a variety of contributing factors and are addressing each of them. The IRS reorganization resulted in pervasive geographical realignments, the elimination of certain positions and the creation of new positions and job titles. These changes impacted key processes and coordination between CI and the newly created civil Operating Divisions. One of these key processes was civil action resolution, including conditional probation coordination.

   CI and the civil functions, particularly SB/SE, share joint responsibility in ensuring the facilitation of effective and efficient assessment and collection efforts. I have tasked both SBSE and CI with improving cross-functional coordination in a number of respects. This joint responsibility is particularly crucial as it pertains to conditional probation cases involving court ordered restitution. In these cases, CI has responsibility to timely forward the Judgment and Commitment Order, Special Agent Report and all other helpful public record information to SBSE so that the assessment and collection process can be initiated. Further, CI and Collection must jointly monitor these conditional probation cases on an ongoing basis because, in the event that the subject fails to fulfill the conditions of probation, CI must coordinate with Counsel and the Assistant United States Attorney to pursue possible revocation action.

   What specific steps have you taken to ensure that such situations are properly reported to the courts in the future?

   Response:

   On March 19, 2004, the Director, Operations Policy and Support forwarded a comprehensive memorandum to the CI Directors of Field Operations requiring each field office to review all sentenced and criminally closed cases between FY 2000 and the present. Additional guidance outlined management information system checks, closing

report procedures, and civil tax resolution coordination responsibilities. SBSE has coordinated with CI on this reconciliation process by having its Technical Services Section follow-up on any identified conditional probation cases with civil resolution potential. CI has also made improvements to their case management system to assist managers in their review and monitoring of conditional probation cases.

In addition, CI, SBSE, CT/Operating Division Counsel and DOJ representatives have held joint meetings to discuss such issues as the conditional probation and civil restitution processes. One area of particular concern is our difficulty in collecting taxes ordered to be paid as restitution by persons convicted of criminal tax crimes under Title 26. CI currently is exploring how it might improve the process for collecting court-ordered restitution. We are working with the Treasury Department to identify changes that may help us effectively address this problem and to:

- **Ensure persons convicted of criminal tax offenses are held responsible for the payment of tax liabilities stemming from the federal tax offenses for which they have been convicted.**
- **Ensure proper collection and accounting of court ordered restitution in tax cases.**
- **Increase the efficiency of the IRS in collecting these tax liabilities.**

We look forward to working with the Committee in the future on this important issue.

HEARING BEFORE THE U.S. SENATE

COMMITTEE ON FINANCE

July 21, 2004

Washington, DC

Pamela J. Gardiner
Acting Inspector General
Treasury Inspector General for Tax Administration

Chairman Grassley, Ranking Member Baucus, and distinguished Members of the Committee, I appreciate the opportunity to appear before you today to discuss the tax gap problem, what the Internal Revenue Service (IRS) is doing to address it, and additional actions that could be taken.

The Composition of the Tax Gap

In the past, the prevailing view was that the tax gap was primarily composed of unreported and delinquent taxes from the "underground economy." For example, self-employed contractors such as painters, housekeepers, and plumbers were suspected of failing to report and pay taxes on the cash payments they received. In addition, illegal activities, such as drug trafficking, were thought to be making large contributions to the tax gap.

However, it has recently become apparent that in addition to the problems with tax reporting and payment in those areas, there has been an ever-increasing problem with compliance both domestically and abroad. Reports of corporate corruption also point to a far greater tax gap problem than was originally suspected.

In recent years, the legal and accounting professions have also been identified as contributing to the overall tax gap problem by promoting illegal or questionable tax avoidance schemes. Increasing the bottom line has outweighed ethics and professional responsibility in far too many cases. Additionally, the increased globalization of our economy provides opportunities for corporations and individuals to avoid taxes using tools available in the worldwide marketplace. Offshore credit card schemes are just one example of a tool to hide taxable income in an offshore bank account.

These recent increases in participation in tax avoidance schemes and the promotion of them by highly-respected firms has evidently fueled a more cavalier attitude toward the tax system among the general population. Survey results recently released by the IRS Oversight Board indicated that from 1999 to 2003, the percentage of people who believe it is acceptable to cheat on their taxes grew from 11 percent to 17 percent, and almost one-third of young people age 18 to 24 were likely to feel that any amount of cheating on taxes was acceptable. This is an alarming trend. However, the survey also indicated that 95 percent of people believed it was "somewhat important" or "very important" for the IRS to ensure compliance by corporations and high-income individuals.

The Tax Gap—How Big Is It?

No one really knows the true size of the tax gap. In past years, the IRS used the Taxpayer Compliance Measurement Program (TCMP) to measure compliance levels among individual taxpayers and identify potential tax law changes to address the tax gap. However, the TCMP was discontinued in the late 1980's

due to concerns about its intrusiveness. The IRS has undertaken efforts to replace the TCMP with an initiative designed to measure compliance of both individuals and businesses. This initiative is called the National Research Program (NRP). However, the NRP has experienced delays, and initial data to update the individual tax return selection formulas will not be available until January 2006.

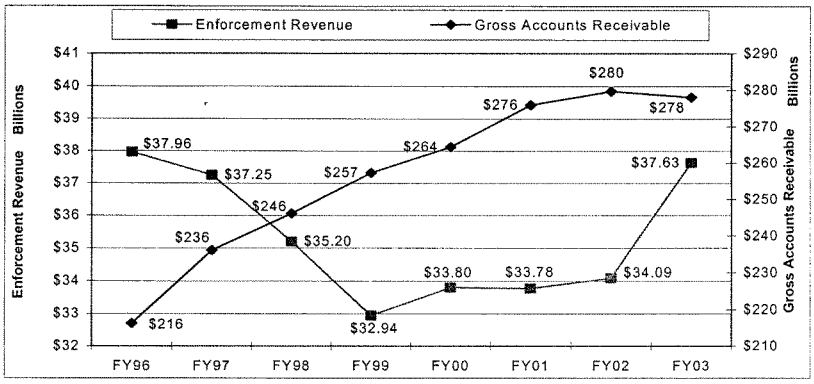
In the late 1990's, the IRS shifted its focus from enforcing tax compliance to improving customer service. This resulted in improvements in the customer service area, but enforcement actions were significantly reduced, and staffing levels in the enforcement areas decreased substantially.

As a result, the IRS estimates the annual gross tax gap (total tax liability for a given tax year less tax paid voluntarily and timely) increased from $282.5 billion in Tax Year (TY) 1998 to $310.6 billion in TY 2001. Subtracting late tax payments from that figure results in a net tax gap increase from $232.5 billion to $255.2 billion.

What Is the IRS Doing to Address the Tax Gap?

The IRS is making some progress in addressing certain components of the tax gap. For example, as the following chart shows, in Fiscal Year (FY) 2003, enforcement revenue collected increased by 10 percent after remaining fairly constant during the prior 3 years, and there were more collection actions in FY 2003 than in FY 2002. Additionally, after steadily rising for 6 years, the amount of gross accounts receivable was reduced slightly (by $1.67 billion) from FY 2002 to FY 2003. The IRS is taking a number of actions to improve its ability to react more quickly to an actual or potential tax debt. These actions include shortening the collection notice cycle and migrating toward a risk-based approach to collecting delinquent taxes.

Amounts of Enforcement Revenue Collected Compared to Growth in Gross Accounts Receivable



Source: IRS Enforcement Revenue Information System and Chief Financial Officer Financial Reports

Another objective of the IRS is to discourage and deter noncompliance within tax-exempt and government entities and the misuse of such entities by third-parties for tax avoidance. Examinations are currently underway of tax-exempt credit counseling organizations and abusive tax avoidance transactions involving tax-exempt organizations.

As part of its efforts to combat tax shelters, the IRS is expanding its partnership with state tax agencies to pursue abusive tax transactions and address other criminal activity. As of early June, the IRS Commissioner reported the IRS has shared 28,000 leads with states, and the IRS and states have uncovered tens of millions of dollars in previously unidentified abusive transactions during the early stages of this partnership effort. In addition, the IRS Commissioner has recently more than doubled the size and clarified the mandate of the Office of Professional Responsibility to help ensure attorneys, accountants, and tax practitioners abide by the standards and laws that apply to their professions.

Example of Tax Shelter Efforts - Combating Offshore Schemes

The IRS has begun addressing taxpayers' attempts to avoid taxes through the use of offshore techniques. Congressional witnesses have estimated that 1 to 2 million taxpayers avoid $40 to $70 billion in taxes annually using offshore bank accounts. The IRS developed the Offshore Credit Card Project (OCCP) to address this problem and made it a strategic priority for FYs 2003-2004. The OCCP uses information from the

transactions of credit cards issued from offshore banks to identify taxpayers evading taxes and the promoters of this type of scheme.

IRS results as of March 31, 2004, for this Project have been mixed. Although nearly $5 million in additional assessments[1] have been made on approximately 300 cases, the direct examiner cost associated with these cases is almost $1.5 million. This cost does not include the intensive labor costs associated with initiating these cases. In addition, the vast majority of the more than 3,000 completed cases have been closed without an assessment of any additional taxes.

Another IRS Project, called the Offshore Voluntary Compliance Initiative (OVCI), grew out of the OCCP and provided an opportunity for users of offshore accounts to come forward and pay back taxes, interest, and certain penalties but avoid fraud penalties or criminal prosecution. This initiative ran from January 14 to April 15, 2003.[2] The OVCI reflected attempts to bring taxpayers back into compliance quickly while simultaneously gathering more information about the promoters of these offshore schemes. As part of the request to participate in the OVCI, applicants were required to provide full details on those who promoted or solicited the offshore financial arrangement.

IRS results for the OVCI were more encouraging than those from the OCCP. In February 2004, the IRS reported this initiative had yielded over $170 million in taxes, interest, and penalties to the United States Treasury. The data the Treasury Inspector General for Tax Administration (TIGTA) reviewed indicated that the direct examiner costs associated with this project were only around $220,000. However, the data showed that even though the applicants voluntarily provided the tax information, over half of the completed cases had been closed without additional assessments.

What More Can Be Done To Address the Tax Gap?

Improving voluntary compliance rates is critical to the health of America's tax system. While the IRS is taking actions to address the tax gap and has a strategy focused on reducing it, the data models that this strategy is based on are over 15 years old. As a result, the IRS cannot be sure it is deploying its critical compliance resources to most effectively address the tax avoidance schemes that have arisen since these models were developed. Updated and reliable compliance data are critical to ensuring effective compliance planning and deployment of resources, as well as to providing justification to support legislative proposals designed to assist the IRS in addressing the tax gap.

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[1] This figure includes tax assessments only—associated penalty and interest assessments were not included.

[2] The deadline to come forward was April 15, 2003. However, there are still open OVCI cases in Examination's current inventory.

In recent years, TIGTA has made various recommendations to enhance the IRS' ability to identify nonfilers and assist in obtaining tax returns and payments. These recommendations address various components of the tax gap and could supplement the IRS' overall strategy to address it.

Withholding on Non-employee Compensation

One solution TIGTA believes would have a serious and quantifiable impact on compliance among the self-employed would be a legislative provision to mandate withholding on non-employee compensation payments, such as those provided to independent contractors. TIGTA has made recommendations to the IRS that it initiate a proposal for a legislative change in this area in two separate reports. The IRS has agreed to consider such a proposal. The Taxpayer Advocate has also recommended this step in her 2003 Annual Report issued to the Congress.

Research indicates that in 1998, 64 percent of the income tax gap and 40 percent of the employment tax gap was attributable to self-employed individuals. Later analyses indicate that these percentages have been growing. Because noncompliance in the self-employed population remains a significant component of the tax gap, TIGTA maintains that implementing a provision in this area could reduce the tax gap by billions of dollars.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors. For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TIN) for independent contractors. For TYs 1995 through 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately $204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records. This problem could be addressed by mandating that the payer and payee verify the TIN at the beginning of their relationship, but legislation would again be required.

Improving Compliance With Estimated Tax Payments

Estimated tax is the method used by individual taxpayers to pay taxes on non-wage income on a quarterly basis. About 12 million taxpayers made estimated tax payments totaling $183 billion for TY 2001. However, there is significant taxpayer noncompliance with estimated tax requirements. For each tax year from 1995 through 2000, between 5.7 million and 6.8 million individual taxpayers were assessed penalties for making

insufficient or late estimated tax payments. Many of these taxpayers also filed tax returns reporting unpaid taxes that resulted in the IRS having to take costly collection actions.

Revisions to the way the penalty is computed, legislative changes to require monthly payments, increases in the promotion of electronic payments, and issuance of a reminder notice to taxpayers who have paid estimated taxes in the past, could improve the compliance rate of these taxpayers.

Matching Documents to Verify Business Income

TIGTA has also identified improvements that should be implemented to improve compliance in business tax filing. For example, although individual wage earners that receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist.

The Government Accountability Office[3] recently reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000. Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance within the business tax universe.

Addressing Compliance in the Global Marketplace

Compliance among partnerships with foreign partners is another area that needs to be addressed. For example, the law requires that partnerships withhold taxes on certain income allocable to foreign partners. Tax is withheld on each foreign partner's distributive share of the income. Further action is needed to ensure that this withholding occurs and is accurate, and that refunds are only issued when the withholding is present.

Increasing the Examination Rate

Various studies have confirmed the connection between higher examination rates and better rates of voluntary compliance, even beyond that of those individuals examined. One study issued in 1990 projected that the indirect effects of examinations produced $6 out of every $7 in additional revenue. Another more recent study projected that doubling

[3] Formerly known as the General Accounting Office.

the examination rate would increase assessments and collections by $16.7 billion.

Although individual examination rates increased from FY 2000 to FY 2003, the vast majority of that increase is due to increases in correspondence examinations, which are likely to be much less effective in improving voluntary compliance of the general population than face-to-face examinations. The number of examinations of all corporate tax returns continuously decreased from FY 1997 to FY 2003, decreasing a total of 67 percent during that time period. In FY 1997, 1 out of 52 corporate returns filed was examined, and in FY 2003, 1 out of every 182 was examined.

Increasing Staffing in the Enforcement Functions

As stated earlier, staffing in the IRS' compliance areas has decreased significantly in the last few years. The Collection and Examination functions' combined enforcement staff declined from 25,000 at the beginning of FY 1996 to 16,000 at the end of FY 2003, a 36 percent decrease. In the Criminal Investigation (CI) function, Special Agent staffing at the end of FY 2003 was lower than in 3 of the last 4 years, and hiring efforts are struggling to keep pace with attrition. Staffing issues will become even more critical, as 45 percent of the currently employed Revenue Agents and Revenue Officers are eligible for retirement in the next 5 years.

The Administration's budget proposal for FY 2005 includes increased staffing for compliance functions, and the IRS Commissioner has indicated that some of the increase would be allocated to corporate compliance. Allocating training funds to less experienced employees will also be critical as highly-experienced employees retire from their positions.

Ensuring Individuals Sentenced for Tax Crimes Comply With Their Sentences

A recent outside study showed the activities of the IRS' CI function have a strong measurable impact on voluntary compliance. However, in 18 of 26 cases TIGTA reviewed in a recent audit, convicted criminals did not comply with the conditional terms that were imposed as part of the sentence. In 12 of those cases, the IRS did not notify the probation officers or the courts of this noncompliance. The IRS is taking action to improve the procedures in this area, and TIGTA believes that ensuring these actions are effective will send a clear message to the general public on the importance of complying with the tax laws.

In closing, I would like to reiterate the IRS has numerous significant efforts underway to address the various components of the tax gap. It is particularly critical that the IRS continue to obtain updated data from the NRP to enable it to revise the compliance data models, make more accurate forecasts of the extent of noncompliance, and ensure it uses its limited compliance resources in the most effective manner. TIGTA has recommended more actions which, if taken, could assist the IRS in its efforts. Finally, as has been stated numerous times, the complexity of the tax code affects both the compliance of the general population and the ability of the IRS to identify and take action on noncompliance.

STATEMENT OF

NICHOLAS P. GODICI

COMMISSIONER FOR PATENTS
UNITED STATES PATENT AND TRADEMARK OFFICE

HEARING ON

"BRIDGING THE TAX GAP"

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

JULY 21, 2004

INTRODUCTION

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

Thank you very much for inviting me to testify today on the patenting of business method inventions, and specifically on those business method patents concerning tax strategies and financial products, including banking, insurance, and investment products. As you know, patents in this emerging area of innovation are a topic of considerable interest and debate in many circles.[1] As has often been the case in the past with other emerging technologies, concerns have been raised about whether business methods should be patentable and whether business method patents will help or hinder innovation and commerce. More recently, attention has been drawn to those business method patents that involve tax strategies as well as their impact. Given the importance of these issues, particularly in light of our increasingly knowledge and information-based economy, I commend the Committee for holding this hearing.

I. U.S. PATENT SYSTEM

In order to understand the patentability of business method inventions, I believe it is necessary to first review the underpinnings of the U.S. patent system itself and the role of the United States Patent and Trademark Office (USPTO) in administering this system.

[1] Patents of this variety, "methods of doing business" have been awarded to inventors from companies large and small, including Citicorp, The Chase Manhattan Bank, Mellon Bank, Wachovia, Bank One, Merrill Lynch and Goldman-Sachs.

The basis for our patent system is found in Article 1, Section 8, Clause 8 of the Constitution, which provides that Congress shall have the power:

> **"To promote the progress of science and useful arts by securing for limited times to . . . inventors the exclusive right to their . . . discoveries."**

Following this Constitutional authority, our Founding Fathers designed an extremely flexible patent system based on principles that have proven remarkably suitable to 210 years of technological advancement. The uniformity and flexibility of the patenting standards of novelty, non-obviousness, adequacy of disclosure, and utility -- coupled with the incentives patents provide to invent, invest in, and disclose new technology -- have allowed millions of new inventions to be developed and commercialized. This has enhanced the quality of life for all Americans and helped fuel our country's transformation from a small, struggling nation to the most powerful economy in the world. Equally as impressive, the patent system has withstood the test of time. This is powerful evidence of the system's effectiveness in simultaneously promoting the innovation and dissemination of new technologies and the creation of new industries and jobs.

a. PATENTABILITY CRITERIA

In administering the U.S. patent laws, the USPTO takes its direction on what subject matter is patentable from Congress and our reviewing courts. The current Act that details the standards of patentability, the Patent Act of 1952, specifies four basic statutory requirements that must be met to obtain a patent: (1) the claimed invention must define eligible subject matter and have utility; (2) it must be novel; (3) it must not have been obvious to a person having ordinary skill in the art at the time the invention was made; and (4) it must be fully and unambiguously disclosed in the text of the patent application, so that the skilled practitioner would be able to practice the claimed invention without undue experimentation.

Prior to granting a patent, the USPTO examines each patent application to determine whether it meets these four criteria, as set forth in Title 35 of the U.S. Code. With respect to the first statutory requirement, 35 U.S.C. § 101 states that any person who "invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent..." subject to the conditions and requirements of the law. Thus, the threshold inquiry as to whether subject matter is eligible to receive patent protection is whether an invention is "new and useful" and whether it fits into one of the enumerated categories.

The courts have recognized the breadth of this statute. In the landmark case of **Diamond v. Chakrabarty**, 447 U.S. 303 (1980), the U.S. Supreme Court acknowledged that Congress intended the statutory subject matter under 35 U.S.C. 101 to include "anything

under the sun that is made by man." The Supreme Court also noted that there are limits to patentability. Indeed, in **Diamond v. Diehr**, 450 U.S. 175 (1981), the Court explicitly identified three specific areas of subject matter that are excluded from patent protection. These three areas are: (1) laws of nature, (2) natural phenomena and (3) abstract ideas. Thus, an invention directed toward a pure algorithm or manipulation of abstract ideas with no practical application is not patentable. The growth and importance of computers and the Internet have led to a significant increase in investment and development in computer-related processes, particularly with regard to electronic commerce. This has inevitably led to more individuals seeking patent protection in these areas. In response to this increased patent activity, a number of cases arose in the 1990s involving issues of defining the boundaries of patent eligibility. Accordingly, the Court of Appeals for the Federal Circuit (CAFC) rendered a series of decisions following the Supreme Court in **Diehr** and **Chakrabarty** that further defined what subject matter can and cannot be patented. I would like to briefly discuss these cases, which very clearly set forth the standards for patentability according to our patent law.

In the case of **In re Alappat**, 33 F.3d 1526 (Fed. Cir. 1994), the CAFC, sitting en banc, found that inventions that include mathematical formulas or algorithms are not unpatentable if they are practically applied. Thus, the mere presence of an algorithm within an invention does not exclude the entire invention from patentability. The key question to be answered is whether the claimed invention, when looked at "as a whole," is an abstract idea, such as a disembodied mathematical concept, or whether the invention produces a practical application, which achieves a "useful, concrete and tangible result."

Four years after **In re Alappat** came the most well-known case with regard to business methods: **State Street Bank and Trust Co. v. Signature Financial, Inc.**, 149 F.3d 1368 (Fed. Cir. 1998). The State Street case involved a patented data processing system that transformed data representing discrete dollar amounts into a final share price momentarily fixed for recording and reporting purposes. The Federal Circuit noted that a process, machine, manufacture, or composition of matter employing a law of nature, natural phenomenon, or abstract idea may be patentable subject matter even though a law of nature, natural phenomenon, or abstract idea would not, by itself, be entitled to such protection. As such, the court held that a machine programmed to transfer data which represents discrete dollar amounts into a final share price through a series of mathematical calculations does, in fact, constitute the practical application of a mathematical algorithm, formula, or calculation because it produced a "useful, concrete and tangible result." The final share price resulting from this process enabled investors and their brokers to make investment decisions for investment and tax advantage purposes.

It is important to note that the significance of **State Street** goes beyond its immediate holding. The Federal Circuit in State Street explicitly rejected the notion that a "business method" exception exists in United States patent law, thereby ending any notion that inventions deemed to be business methods, by whatever criteria, would be excluded from patentability on that basis alone. Thus, the **State Street** decision clarifies that an invention deemed to be a "business method" will be treated in the same manner as any

other method or process invention. In other words, the patent system is technology neutral and there shall be no disparate treatment for different categories of inventions. This was reaffirmed by the Federal Circuit court in 1999, where the court remanded the case of **AT&T Corp. v. Excel Communications, Inc.** back to the district courts and concluded that had the courts applied the proper analysis, they would have realized that the claimed telephone call tracking method falls comfortably within the "broad scope of patentable subject matter under § 101."

While **State Street** did not change United States law and practice, it did create a new awareness that business method claims could be patented. For example, in fiscal year 1998 there were less than 1500 filings in the U.S. classification area 705, which includes much of what is commonly known as computer-implemented "business method" inventions. By contrast, there were approximately 9,000 filings in fiscal year 2001 and approximately 7,400 filings in fiscal year 2003. It should be noted, however, that despite these increases, Class 705 filings represented only a small fraction (2.2%) of our total patent filings in fiscal year 2003. Moreover, the 479 patents that were granted in Class 705 last year constituted approximately one-quarter of one percent of all patents grants for the year. Today, the computer-implemented "business method" area includes business practices in many fields such as: health care management, insurance and insurance processing, reservation and booking systems, financial market analyses, point of sale systems, tax processing, inventory management, accounting, and financial management.

b. RESPONDING TO CONCERNS

While the courts have made it clear that inventions directed to business methods are patentable subject matter, some have suggested that an increase in the issuance of business method patents may stifle innovation and investment generally. Others are concerned that patents that have been awarded in these areas, while generally appropriate, may in certain cases be overly broad or not truly novel. These fears raise legitimate issues, and the USPTO has taken a number of steps to address these concerns.

In response to these concerns, in March of 2001, the USPTO announced a new Business Methods Patent Initiative. This program established a solid framework that provides the techniques necessary to cope with the ongoing challenges presented by the emerging area of business method patents. Accordingly, we have established enhanced partnerships with affected industries in order to have them educate our examiners so that we can take advantage of their knowledge and expertise in their fields. As part of this partnership, we hosted a Business Method Patents Roundtable on July 27, 2000, with members of industry and other interested parties, during which myriad issues regarding these patents were discussed. In addition, we convened our first meeting of the Business Methods Partnership on March 1, 2001. Since that time, the USPTO sponsors semi-annual Business Methods Partnership meetings with our customers, holding their last meeting on April 27, 2004. Through a fruitful exchange of ideas, these partnership meetings have proven beneficial to both our external users and our examination staff. The USPTO's

Business Methods Patent Initiative also includes specific features to bolster the quality of our patent searches. For example, we have defined a mandatory search template for all applications in the computer-implemented business methods area, including a classified U.S. patent document search and a full text search of U.S. patent documents, foreign patent documents with English language abstracts, and non-patent literature. To assist our examiners in finding pertinent prior art, we also have established "Electronic Information Centers" which provide examiners with access to over 1000 non-patent literature databases, over one-third of which contain business and financial information. As 18-month publication of patent applications has taken effect and as we identify with our industry partners more databases to search, the amount of published prior art available to examiners is also increasing.

As part of our Business Methods Patent Initiative, we also instituted a second-level review of all allowed applications in Class 705 by an additional experienced examiner beyond the examiner who would normally review the application before it could be granted. We also are continually enhancing the technical training for our examiners. For example, we revised our Examination Guidelines for Computer-Related Inventions and training examples for these inventions. These revisions were made in order to update patentability standards in light of the **State Street** and **AT&T** cases, which clarify that business methods should be treated like any other process claims.

Our examination guidelines and training materials specifically address the fact that merely automating a known human transaction process using well-known automation techniques is not patentable. Lastly, to handle the growing number of Class 705 filings, we also increased the number of examiners in this area from 17 in late 1997 to 106 today.

We believe that our Business Methods Patent Initiative and other concerted efforts in this regard have ensured the issuance of high quality business method and software patents. In fact, we are now beginning to see significant results in this regard. For example, our allowance rate in the affected areas of business method inventions has decreased since the time our Initiative was launched three years ago. It is worth noting from recent press reports that some of our customers believe we are being too restrictive in our examination, as evidenced by this reduced allowance rate.

On an additional note, I would also like to point out that the USPTO has been issuing method patents for over a century and a half. We have been issuing patents on methods of teaching since the mid-1800's, including a patent issued in 1864 for a method of teaching penmanship. Moreover, there have been a number of patents regarding innovations in the business and financial fields throughout the history of the USPTO. For example, in 1889, Herman Hollerith received a patent on a method for tabulating and compiling statistical information for a business. The patent he received helped his fledgling company to survive. Later, the company's name was changed to International Business Machine Corporation (IBM). Mr. Hollerith's patented method was probably the first patent issued regarding the automation of business or financial data, and it and the related punch cards were used until the birth of the personal computer.

c. CONGRESSIONAL ACTION

There is one additional important fact concerning this issue, namely that Congress acted promptly in response to the **State Street** decision to limit litigation in this area. In 1999, Congress enacted the landmark American Inventors Protection Act (AIPA) that included a special provision to limit litigation in this area. Congress established a limited "domestic prior user right" (35 USC § 273) specially directed at "methods of doing business." It is the belief of many that this narrowly tailored provision is a variety of tort reform that has been more than effective in warding-off frivolous patent infringement lawsuits and protecting the public. In fact, there are relatively few recorded infringement suits in the federal courts concerning solely business-method cases.

II. THE USPTO AND THE REEXAMINATION OF ISSUED PATENTS

As previously discussed, the USPTO confers property rights in the form of a patent grant to applicants who meet the previously described criteria established by Congress and pursuant to applicable case law. The essential role of a patent examiner is to make the determination regarding the grant of a patent by assessing all of the relevant evidence in light of these patentability criteria for an invention established under law.

An important check on patent quality relates to the occasions when new prior art (i.e., the relevant evidence bearing on patentability) becomes available that may bear on the validity of an issued patent. Often, this new evidence may be identified and submitted by a third party such as a commercial rival that wishes to challenge the patent's validity. In its wisdom, Congress established an administrative procedure for the USPTO to take a second look at an issued patent and consider questions of validity during the life of the patent. While this is an important quality check within the patent system, the USPTO has only a limited role in reconsidering patentability decisions after patents issue. The post-grant review of patent claims takes place before the USPTO under several circumstances, including:

(1) when a patentee files an application to reissue a patent to correct at least one error in the patent,
(2) when an applicant and a patentee claim the same invention and an interference is declared between the patentee and the applicant, and the applicant seeks judgment based on unpatentability of patent claims, and
(3) when a patent owner or third-party requests the reexamination of a patent.

Congress has incrementally added to the range of proceedings under the USPTO's jurisdiction under which third parties could invoke Office review of issued patents. It introduced *ex parte* reexamination in 1980, under which a third party could petition for reexamination of the patent.[2] In 1984, section 135 of the Patent Act was amended to allow issues of patentability, as well as priority, to be included in interference

[2] Pub. L. No. 96-517, § 1, 94 Stat. 3016 (1980).

proceedings.[3] In 1999, Congress, as part of the landmark patent reform, the AIPA, created *inter partes* reexamination, whereby the third party could participate in the reexamination proceeding and appeal to the USPTO's administrative Board of Patent Appeals and Interferences.[4] The AIPA's *Inter Partes* reexamination practice was expanded in 2002 to afford third parties the right to appeal to the U.S. Court of Appeals for the Federal Circuit.[5]

Through these amendments, the USPTO's role in helping guarantee the efficacy of the patent system after patent issuance has grown. However, none of these procedures alone, or collectively, have proven sufficient to optimize the USPTO's post-grant capability. Congress has labored to strike the right balance in creating an appropriate system that would permit the post-grant review of issued patents but would not lead to the harassment of independent inventors and small businesses. As part of the USPTO's 21st Century Strategic Plan, the Office is developing legislation to create a new procedure for the post-grant review of patents that would overcome many of the problems currently posed by litigation but yet prevent the harassment of independent inventors and small businesses.

III. THE 21ST CENTURY STRATEGIC PLAN

It is my pleasure to report to the Committee the Office's ongoing efforts to ensure the quality of the patent examination process. The USPTO has developed the 21st Century Strategic Plan in response to a congressional requirement.[6] The Strategic Plan was created after a rigorous top-to-bottom review of all USPTO operations, policies, and procedures. This resulting blueprint for modernizing the Office contains 37 initiatives that focus on quality, productivity, and e-government. As former Under Secretary James Rogan and Acting Under Secretary Jon Dudas have testified before Congress, patent quality is one of the most important, if not the foremost, goals of the agency.[7]

One notable example of a successful quality initiative is expansion of the "second-pair-of-eyes" review, previously discussed. As part of the Business Method Initiative, the Office required additional review of patent applications pending in the fields concerning business method patents. We found it beneficial to devote additional resources to these applications in areas of emerging technology. While this is a resource-intensive

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[3] Pub. L. No. 98-622, 98 Stat. 33831 (1984).

[4] Intellectual Property and Communications Omnibus Reform Act of 1999, S. 1948, Pub. L. No. 106-113 (1999).

[5] *21st Century Department of Justice Appropriations Authorization Act,* Pub. L. No. 107-273, 116 Stat. 1758, 1899-1906 § 13202 (2002).

[6] See 21st Century Department Of Justice Appropriations Authorization Act, Pub. L. No. 107-273, § 13104, 116 Stat. 1758 (Nov. 2, 2002).

[7] See *"United States Patent and Trademark Modernization Act of 2003" Hearing before the Subcomm. on Courts, the Internet and Intellectual Property*, 108th Cong. (2003) (Statement of James E. Rogan, Director, United States Patent and Trademark Office); *"Department of Commerce, Patent and Trademark Office" Hearing before the Subcomm. On Commerce, Justice, and State, the Judiciary, and Related Agencies*, 108th Cong. (2004) (Statement of Jon W. Dudas, Acting Director, United States Patent and Trademark Office).

initiative, as part of the Strategic Plan, we are also expanding the second pair of eyes to other areas of review.

The Strategic Plan is dedicated to improving the overall quality of the patents that we grant, not only during examination as is the case with the "second-pair-of-eyes" review, but also after a patent is granted. Creating a new procedure to permit the agency to review economically significant patents after they are granted based on the full participation of interested parties is also an important part of the Strategic Plan's goal to enhance patent quality.

Implementation of the majority of the Strategic Plan's thirty-seven initiatives is contingent upon adoption of changes in our fee system. That is why last year the Administration proposed as part of the USPTO's FY 2004 budget an increase in patent fees. These fee changes, which are contained in H.R. 1561, the "United States Patent and Trademark Office Fee Modernization Act of 2004," permit revisions in USPTO business practices that are necessary for the healthy functioning of the U.S. intellectual property system during the coming century. They raise the funds for essential technology and other investments that will modernize USPTO operations. The proposed fee changes will also benefit USPTO's user community by allowing applicants to evaluate the commercial value of their inventions and recover the cost of search and examination as the situation warrants. The Fee Bill is necessary for full-funding of the Strategic Plan and the quality initiatives.

The USPTO is committed to hiring high quality people who will make the best patent and trademark examiners. We are committed to certifying their knowledge and competencies throughout their careers. Furthermore, we are committed to focusing on quality in all aspects of the examination of patent and trademark applications. If additional resources are provided to the USPTO through the fee structure in H.R. 1561, we will be able to make even further progress on these and other initiatives outlined in the Strategic Plan to enhance the quality of patent and trademark examination. This will greatly benefit U.S. businesses and IP rights holders by limiting the need for costly litigation in the courts.

Further, we are grateful for Congress' consideration of the Administration's FY 05 budget request for the USPTO of $1.533 billion. This request is necessary for full-funding of our 21st Century Strategic Plan initiatives, including hiring additional examiners. The full request is also contingent on enactment of legislation, proposed by the Administration with the 2004 Budget, that increases patent and trademark fees by an estimated $219 million in FY 2005. Full-funding of the Strategic Plan should help facilitate stronger international cooperation and enforcement of intellectual property rights. In addition, it will enable us to carry out our core mission through the implementation of new initiatives dedicated to enhancing patent quality and by providing greater protection of assets of our innovators and entrepreneurs here at home.

IV. PATENTS VS. TRADE SECRETS

As the Committee considers this and other patent issues, we hope that it also acknowledges the importance of a strong patent system in protecting intellectual property and advancing innovation. State trade secret protection for innovative methods and processes is a complement to the patent system, but should not be considered a substitute. Maintaining the availability of patent protection offers significant benefits to inventors and society.

The history of the patent system demonstrates how it benefits the public. Throughout the history of the patent process, all information pertaining to the invention is disclosed upon the grant and publishing of the patent. Through the enactment of the AIPA, Congress established the practice of the early publication of a patent application at 18-months of pendency for most patents. This has helped speed the dissemination of information of new and useful inventions to the public. The hallmark of patents is that they are a form of intellectual property that results in the public disclosure of an invention, advancing the field of endeavor, and increasing the public storehouse of knowledge. In turn, the publication of patented inventions and patent applications offers greater access to these innovations for the public as well as compliance entities. One merely needs to visit the USPTO web site and they will discover one of the largest databases in the world that contains information on millions of U.S. patents.

Trade secret protection is an alternative to patent protection for an innovator. Because trade secret protection does not have a set term of expiration, and by definition does not disclose the nature of the innovation, it provides certain advantages for specific types of innovation, such as methods and processes. However, trade secrecy does not guarantee the inventor protection for any amount of time. Moreover, trade secrecy does not permit the public to build on the new knowledge that is protected. Patents do guarantee protection of the inventor for a limited period of time, and offer the public the further benefit of learning about the invention. The limited monopoly of patent protection was created within the Constitution in order to encourage innovators to share their discoveries. For purposes of the public benefit, patenting is thus the preferred method of protection for utility innovations. The patent process has greater transparency and can inform the public as well as compliance entities as to recent developments. Largely as a result of trade secrecy's non-preferred status, there are a number of problems for innovators when relying on trade secrecy to protect intellectual property.

It is important that inventors and companies have at their disposal patents in addition to trade secrets, since patents offer important advantages in many instances. For example, trade secrecy is a creature of state law; thus inventors face the challenge of protecting their intellectual property through a patchwork of a variety of state regimes. Moreover, trade secrecy generally requires contractual obligations and restrictions to bind the parties, which are often cumbersome. Overall, trade secrecy can result in more uncertainty and greater risk for the innovator and is often only effective if the product kept secret cannot be reverse engineered.

V. CONCLUSION

Mr. Chairman, the USPTO is very pleased with the results thus far of our Business Methods Patent Initiative and the implementation of the other initiatives contained in the 21st Century Strategic Plan. We will continue to closely monitor the situation in order to ensure the issuance of high quality business method patents. Over the past several years, there have been several Congressional oversight hearings in this area, and we are committed to continue to work with Congress in the future. In addition, if further administrative action is needed or warranted by modifications by the Courts, the USPTO will take appropriate action. We can assure that we will comply with the law and reject patent applications that attempt to claim monopolies in obvious or otherwise long-known methods of doing business, in the financial services realm, as in other fields.

Let me assure the Members of the Committee that we are committed to ensuring that our practices and policies promote the innovation and dissemination of new technologies. We are confident that the patenting of business method inventions is consistent with the law and with our practice, and we believe that any arbitrary restriction of patentability in this or other technologies would certainly have negative consequences for our country including causing deserving innovations to go unprotected and causing deserving investments to go unrewarded.

The overwhelming preponderance of evidence throughout the history of the U.S. patent system suggests that robust intellectual property protection supports, rather than impedes, innovation. Indeed, for over two hundred years our patent system has enabled American industry to flourish, creating countless jobs for our citizens. Advanced technologies have been -- and continue to be -- nurtured and developed in our nation to a degree that is unmatched in the rest of the world. In many instances, the availability of patent protection has been integral to these advancements. In this regard, the USPTO and the Administration look forward to continuing to work with you and the Members of the Committee to ensure that the U.S. patent system remains the envy of the world.

Thank you, Mr. Chairman.

U.S. SENATE COMMITTEE ON
Finance
SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN
http://finance.senate.gov

Opening Statement of Sen. Chuck Grassley
"Bridging the Tax Gap"
Wednesday, July 21, 2004

This hearing is to consider a serious subject: the tax gap and ways to close the tax gap. As members of the Finance Committee know, the tax gap is the difference between the amount of tax due and owing versus the amount actually collected.

Due to a number of factors, especially the war and increased spending, our nation is looking at deficits. At the same time the Administration and many in Congress do not want to increase the tax burden on the vast majority of honest citizens who pay their fair share of taxes.

Therefore, we must look at ways of dealing with the tax gap to bring revenues to the Treasury and fairness to the tax code. This is even more important as we look to the fall where we will hopefully have conferences concluding on several issues – each of them with significant demand for possible new revenue raisers.

In addressing the problem of the tax gap we have to recognize that we have finite resources and that we are not going to place a heavy burden on honest taxpayers. We must retain the proper balance of service and enforcement coupled with a respect for taxpayers' rights.

To achieve that, it is clear that we have to work smarter and more efficiently. We have to target limited resources where they will do the most good.

This hearing provides the Finance Committee an opportunity to consider both what the IRS is doing currently to address the tax gap and also learn about new ideas and innovations that are being implemented at the state level or being proposed by witnesses today.

STATEMENT OF THE CALIFORNIA FRANCHISE TAX BOARD
BEFORE THE
UNITED STATES SENATE FINANCE COMMITTEE
JULY 21, 2004

I. INTRODUCTION

Good morning, Mr. Chairman, Senator Baucus and Members of the Committee. My name is Debbie Langsea and I am testifying on behalf of California State Controller Steve Westly and the Franchise Tax Board (FTB). On their behalf, thank you for the opportunity to testify on California's efforts to combat the tax gap and tax shelters.

II. TAX GAP

The California income tax gap is approximately $6.5 billion a year.[1] Our tax gap is the difference between what taxpayers owe and what is voluntarily paid. The IRS estimates about 80 percent of the tax gap is attributable to the **underreporting** of income. The remaining 20 percent is attributable to the failure to file tax returns and underpayment of taxes.

Underreporting income includes failing to report income, hiding barter and cash transactions or minimizing taxable income through **abusive tax shelters**. My testimony will focus on abusive tax shelters and California's efforts to narrow this portion of the tax gap.

The tax gap is a chronic and inordinate challenge for tax administrators and is becoming a national epidemic. Although the tax system is fundamentally based on taxpayers voluntarily reporting the correct amount of tax, the opportunity to escape detection, underreport income, underpay taxes, and not get caught creates a behemoth challenge for federal and states governments alike.

California is increasing efforts to address the tax gap, collect additional revenues, and encourage future self-compliance by identifying unreported income, assessing or collecting owed taxes and considering other enforcement measures, such as, informant rewards patterned after federal provisions, identification of tax preparers who enable clients to underreport income and fraudulently claim tax credits, and identification of underground or suspicious activity information.

California is considering other alternatives that inhibit noncompliance, such as, increased penalties, misdemeanor program, identification of additional income sources, questionable wage withholding and other deterrent measures. Finally, we are seeking

[1] The tax gap is equivalent to about 10 percent of the California State General Fund for tax year 2002.

ways to modify public perception that help taxpayers voluntarily comply with tax laws and other educational measures.

III. TAX SHELTERS

A. California Voluntary Compliance Initiative (January 1, 2004 through April 15, 2004)

In April 2004, California reported over **$1.3 billion** in additional tax revenues from the Voluntary Compliance Initiative (VCI). These revenues were generated from about 1,200 taxpayers who filed amended returns reporting additional taxes from potentially abusive tax shelters. Of these taxpayers, 800 individuals reported approximately $900 million and 400 businesses reported close to $500 million. Based on these figures, VCI raised what was equivalent to $13 million a day or two times more money than any other amnesty program in U.S. history!

One of the authors of California's strongest tax shelter legislation, Assembly Majority Leader Dario Frommer (D-Glendale), stated, "Wealthy tax cheats have been stealing $600 million to $1 billion each year from our classrooms, public hospitals and police and fire stations. By combining the nation's toughest penalties for illegal tax shelters with an amnesty program, California has found the right carrot and stick to force rich scofflaws to pay the taxes they owe."[2]

1. Breakdown by VCI Options

VCI allowed taxpayers to elect either full or limited relief of penalties under one of the following options:

a. ***Right to File Future Claim for Refund:*** About 65 percent of VCI revenues came from taxpayers who reported additional tax but elected to protect their right to file a claim for refund **in the future**. These taxpayers remain subject to the accuracy related penalty.[3]
b. ***No Appeal Rights:*** About 25 percent of VCI revenues came from taxpayers who elected to forego their appeal rights and would not be subject to any tax shelter penalties including the accuracy related penalty.
c. ***Pending Federal Activity:*** About 7 percent of VCI revenues came from taxpayers who had pending federal activity and elected to protect their right to file a claim for refund in the future.
d. ***Filed Claim for Refund:*** The remaining 3 percent came from taxpayers who filed claims for refund and are subject to the accuracy related penalty.

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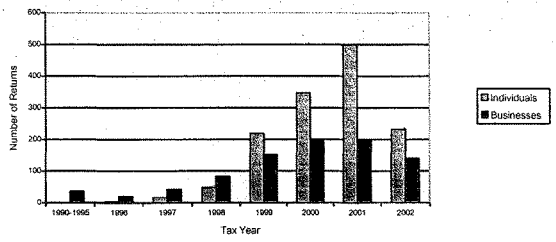
[2] News Release by Assembly Majority Leader Dario Frommer (D-Glendale) on April 26, 2004.
[3] California Revenue and Taxation Code Section 19164.

2. Breakdown by VCI Tax Years

Taxpayers filed over 2,200 VCI amended returns for tax years 1990 through 2002 (see Figure 1). Ninety percent of the revenues were attributable to tax years 1999 and subsequent. Individuals filed returns for tax years 1996 and subsequent while businesses filed returns for tax years 1990 and later. Some corporate taxpayers had pending federal audits on older years and were seeking relief from California tax shelter penalties.

Figure 1 Breakdown by VCI Tax Years



B. Events Leading Up to VCI

How *did* California receive the $1.3 billion in additional tax revenues?

You have heard testimony of the many egregious, tax-engineered and artificial transactions designed to thwart and undermine the tax system. The devastating effects of these transactions should not be underestimated.

In November 1999, the Acting Assistant Secretary for Tax Policy Jonathan Talisman testified before the House Committee on Ways. In his testimony on corporate tax shelters, Mr. Talisman stated that "if unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue loss we currently are experiencing in the corporate tax base."[4]

[4] Statement by Jonathan Talisman, Acting Assistant Secretary for Tax Policy, U.S. Dept. of the Treasury, in his Testimony Before the House Committee on Ways and Means Hearing on Corporate Tax Shelters, November 10, 1999. See also the Treasury Department's White Paper on "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals."

Five years later, lost tax revenues attributable to abusive tax shelters were staggering!

- Federal government lost about $85 billion over the last decade[5],
- States lost $10 to $17 billion due to corporate income shelters in 2001.[6]
- California lost $2.4 to $4 billion over the last four years.

Just one of the 31 IRS listed transactions generated about $6 billion in tax benefits for 5,000 participants. Of the 500 tax products produced by one major accounting firm, four products were sold to 350 people and generated $124 million in fees for that firm.

More disturbing was the rate that tax shelters were proliferated and marketed. For example:

- In December 1999, the IRS issued Notice 99-59 to curtail the Bond and Option Sales Strategies (BOSS). BOSS was designed and marketed by a major accounting firm to shelter gains through a complex series of sale, loan and dividend arrangements.
- By August 2000, the IRS issued Notice 2000-44 to crack down on variations of BOSS (Son of BOSS) designed to escape provisions of the 1999 IRS Notice. These BOSS variations were marketed by other accounting or legal firms and used short sales, digital options, and loan premiums.
- Although the IRS issued new regulations to deter such abuses in 2001 and 2003, promoters designed new strategies to escape application of the IRS notices and regulations and the Grandson of BOSS (using different financial instruments, such as, market linked deposits to create artificial tax losses) was born.

These new generations of tax shelters were devised and collaborated by tax professionals, utilized variations of complex schemes, buried in many layers of transactions and multiple entities to escape detection, packaged as generic tax products with boiler-plate legal and tax opinions for mass marketing, and sold to thousands of taxpayers to generate millions of dollars in fees.

Historically, government officials have reacted to meet these challenges by enacting legislation with more penalties or curtailments, incurring increased administrative costs to challenge seemingly unending new shelters, offering initiatives, or engaging in more enforcement measures to plug the leaky dam of lost tax revenues. But at every turn, tax officials were outgunned and outmaneuvered by promoters rewarded with millions of dollars in fees and taxpayers escaping millions in taxes.

State Controller Steve Westly stated, "The transactions we are seeing are so complicated that a typical taxpayer wouldn't dream them up. Financial experts are

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[5] U.S. General Accounting Office Report 04-104T "Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters".
[6] Reported by the Multistate Tax Commission at the Federation of Tax Administrators Annual Meeting in June 2004.

going to great lengths to devise complex deals and push them on taxpayers through their partners and even through seminars."[7]

C. California Targets Abusive Tax Shelters

Similar to other federal and states efforts, California strategies to combat abusive tax shelters focused on the following components:

- **Voluntary Compliance** to promote taxpayer compliance and to discourage the buying or selling of abusive tax shelter products.
- **Detection** to identify taxpayers who failed to participate in our Voluntary Compliance Initiative.
- **Enforcement Measures** to engage in tougher actions with taxpayers who continue to engage in abusive tax shelter transactions.

In 2001, California identified about 40 tax shelter cases. Within two years, this number quickly grew to over 600 tax shelter cases! California needed stronger voluntary compliance, detection, and enforcement measures to more effectively combat tax shelters. Current tax shelter laws were sorely inadequate to combat tax shelters at the federal and state levels.

California pursued other compliance efforts, such as, encouraging taxpayers to file amended returns and to participate in the IRS Offshore Voluntary Compliance Initiative (OVCI). By the end of 2002, it was readily apparent more drastic measures were needed due to the escalating number of tax shelters and budgetary deficits.

1. California Legislators Crack Down on Abusive Tax Shelters

As California considered legislative solutions to more effectively combat the escalating tax shelter phenomenon, Senator Charles E. Grassley (R-IA) introduced S.476 CARE Act of 2003[8] on February 27, 2003. Its tax shelter provisions provided desperately needed tools to more effectively combat abusive tax shelters.

The creation and proliferation of abusive tax shelters were running amok and tax officials were reduced to merely chipping away at the tip of an iceberg. These shelters provided a windfall for promoters, advisors, businesses and taxpayers who could well afford and benefited from engaging in abusive tax shelters. But the windfall came at the expense of the millions of Americans who voluntary complied with the tax laws. Without the appropriate legislative and administrative tools to effectively combat abusive tax shelters, both federal and state governments were fighting a losing battle to close the tax gap.

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[7] Statement by State Controller Westly in Press Release dated November 18, 2003.
[8] S.476, the CARE (Charity Aid, Recovery, and Empowerment) Act of 2003 108th Congress, first session) introduced on February 27, 2003 by Senator Charles E. Grassley (R-IA). See Title VII Revenue Provisions. Subtitle A Provisions Designed to Curtail Tax Shelters.

Due to the overwhelming number of tax shelter investments during the late 1990's[9] and the pending expiration of our statute of limitations, California raced against the clock to quickly move forward and enact its own state legislation. On October 2, 2003, California enacted SB 614 (introduced by Senators Cedillo and Burton) and AB 1601 (introduced by Assembly Member Frommer). The bills established over a dozen new or significantly increased penalties and curtailments, adopted federal disclosure and reporting requirements, and provided the **Voluntary Compliance Initiative** provisions.

2. **Publicity Efforts Ignite the California VCI Program**
   One key ingredient in the success of VCI was the publicity efforts with assistance from many key areas:
   a. Federal, other states and individuals challenging abusive tax shelters including U.S. Senate hearings, IRS initiatives and summons, individual lawsuits and other enforcement activities.
   b. News conferences conducted by State Controller Steve Westly and state legislators.
   c. Over a hundred news media articles and broadcasts, California press releases and tax newsletters.
   d. California Abusive Tax Schemes Symposium[10] and over 30 professional presentations.
   e. California websites provided information on the unprecedented tax shelter legislative provisions, we responded to a thousand public e-mails and phone calls, and mailed over 32,000 letters and publications to taxpayers, practitioners, and promoters.
   f. Staff testified at the U.S. Senate Permanent Subcommittee on Investigations Hearings on the U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals.[11]

3. **California Partners with Other Agencies**
   Another essential ingredient was the joint information sharing agreements with the IRS and many states or cities. In September 2003, California signed the IRS Memorandum of Understanding specifically targeting abusive tax shelters.[12] California received thousands of leads from the IRS and other sources on potential

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[9] The economic growth in capital gains and option income of $93 billion, $164 billion, $200 billion in 1998, 1999 and 2000 respectively. Some investors reduced or eliminated taxes aggressively during these tax years. In comparison, capital gains and option income took a sharp decline to $94 billion and $80 billion in 2001 and 2002, respectively.

[10] Abusive Tax Schemes Symposium conducted by California officials, Professor Joseph Bankman, Former IRS Deputy Commissioner (Small Business/Self-Employed Operating Division) Dale Hart, and other participants in Sacramento, California on July 15, 2003.

[11] Statement by Debra Petersen of the California Franchise Tax Board Before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs on November 18, 2003.

[12] Memorandum of Understanding between the Internal Revenue Service Small Business/Self Employed Division (SBSE) and 45 Other States, New York and Washington D.C. Concerning Abusive Tax Avoidance Transactions.

investors or promoters. These information exchange agreements were essential to avoid duplication of government efforts and to take a united approach combating abusive tax shelters.

In February 2004, California, New York and 45 other states and cities signed a States Memorandum of Agreement specifically targeting abusive tax shelters.[13] This agreement provides for the increased exchange of abusive tax shelter information including developing information on participants and promoters.

California was active on various federal and state task forces to improve communication and other enforcement activities on abusive tax shelters and other tax related matters. "Working together is often the most efficient way to enforce tax laws, and it is frequently the best way to help honest taxpayers deal with their multiple responsibilities."[14]

4. **California Detection Efforts: Identification of Abusive Tax Shelters**
   Since January 2004, we received over 300 boxes of information and are evaluating over 2,000 leads on tax shelters. We are currently matching this information against our databases for use in our enforcement efforts and to locate other tax shelter investors and promoters.

   In April 2004, the new reporting and registration requirements generated additional leads on potentially abusive tax shelter promoters and investors. Although some filings were filed as protective measures, there are many new leads and confirmation of other leads. Our new tax shelter registration rules expanded the requirements to register any listed transaction connected to California since February 28, 2000. Over 900 organizers filed registrations reporting tax shelter transactions from 1994 and located in the United States and other countries.

   Promoters must now automatically provide the name of investors for any listed transactions. This filing requirement generated information on over 7,000 investors who paid over $62 billion for listed transactions. Since California conformed to the federal disclosure requirements, taxpayers were required to disclose their participation in reportable transactions beginning on their 2003 tax return. Almost 800 taxpayers separately filed their disclosure and illuminated over 160 different possible reportable transactions.

5. **California Enforcement Efforts**
   Of the $1 billion in tax shelters under state audit, about half of the taxpayers participated in the California VCI. We are aggressively pursuing taxpayers who

[13] Memorandum of Agreement Pertaining to Abusive Tax Avoidance Transactions between 46 states, New York City and Washington D.C. in February 2004.
[14] Statement by Harley Duncan, Executive Director, Federation of Tax Administrators in the IRS Press Release IR-2004-77 "IRS and State Partnership Moves Forward to Improve Compliance and Service" dated June 7, 2004.

failed to participate and applying the increased or new tax shelter penalties. We continue to evaluate leads for potential investors and promoters for future enforcement activities.

a. **Insurance Companies**
In April 2004, we issued subpoenas on two major insurance companies suspected of issuing insurance policies covering potential adverse rulings for tax liabilities associated with abusive tax shelters. Subpoenas may require insurance companies to provide information, such as, names of clients who requested insurance policies and all supporting documentation associated with these requests. Currently, we received about nine boxes of information, issued a third subpoena on another insurance broker and expect to receive more information.

Proposed legislation (AB 1297 introduced by Assembly Majority Leader Frommer) would prohibit insurance companies from insuring or defending losses resulting from or in connection to an abusive tax shelter. Such policies would be null and void and require return of premiums to the policyholder. This bill establishes a penalty against the policyholder equal to 75% of the proceeds received from any insurance policy or other financial protection product related to abusive tax shelters.

b. **Abusive Tax Shelter Task Force**
California continues to dedicate resources including plans to establish an Abusive Tax Shelter Task Force to coordinate increased tax shelter activities, such as, audit engagements, issuance of subpoenas, assertion of all appropriate penalties, enforce reporting requirements for promoters and investors, seek injunctions against promoters, and use consultants to provide financial products and other industry expertise.

IV. RECOMMENDATIONS

Despite the successful efforts combating abusive tax shelters obtained by federal and states government, the following are some recommendations essential if we are to effectively address the tax gap and abusive tax shelters:

A. Congress should pass tax shelter legislation.

The abusive nature of tax shelters is a nationwide problem that states cannot manage solely by improving state laws. There must be corresponding consequences at the federal level to make any meaningful dent in the overall effort to combat abusive tax shelters. California's passage of ideas proposed at the federal level illustrates tax administrators can influence noncompliant behavior if the right level of consequences exist.

B. **Congress should encourage the AICPA to follow the SEC's interpretation of prohibited contingency fee transactions and the states should have uniform restrictions on contingency fees consistent with the SEC's interpretation.**

The AICPA's interpretation under Rule 302 regarding contingency fees is too broad and should be more narrowly construed consistent with the SEC's interpretation of this same language. The AICPA's definition of contingency fee in its Code of Professional Conduct, Rule 302, is identical to the definition used by the SEC in its regulations discussing Qualifications of Accountants (17 CFR 210.2-01(f)(10)). Both rules state:

> Contingent fee means, except as stated in the next sentence, any fee established for the sale of a project or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered

While both regulatory agencies use the same definition, the AICPA's interpretation and examples of what constitutes a prohibited contingency fee differs significantly as explained in the letter sent from Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, to Bruce P. Webb, Chair of the Professional Ethics Executive Committee for the AICPA, dated May 21, 2004. The AICPA's interpretation states that:

> A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns.

Mr. Nicolaisen stated in his letter that the exception to the definition of contingency fee is not based on whether the accountant reasonably expects a government agency to consider issues with respect to its audit client. Rather, the exception applies only when the determination of the fee is taken out of the hands of the accounting firm and its audit client and is made by a body that will act in the public interest.

Mr. Nicolaisen's letter cites an example of a prohibited fee arrangement:

> ... For example, as discussed in the Proposing Release, an auditor might undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. Fees for such services might be based on a percentage of the tax

> credits generated, a base fee plus a percentage of tax credits generated over a pre-determined base amount, or a base fee plus a "value added" amount to be added to the base fee. In that case, the accounting firm's economic benefit will be greater if the tax credits are maximized. ***Because this interest (in the economic benefit) is inconsistent with acting independently in assessing the accuracy of the impact on the income tax accounts and financial statements of the tax credits, those kinds of fee arrangements are prohibited under the final rule...***

We have often seen an accounting firm base its fee upon the tax benefits derived. When this occurs, the firm has an incentive to over inflate the tax benefits. In support, we have seen claim for refunds filed reporting aggressive tax positions claiming credits for property and other expenditures that are clearly not qualified and appear to be claimed merely as a means to increase fees for the firm. The taxpayer and the accounting firm play audit roulette in the hopes of being sustained on some or all of the highly aggressive, and, in some cases, completely erroneous positions. We have seen firms claim tax benefits for years prior to California's enactment of statutes granting those benefits. We are aware of firms that make it a policy to bypass state prohibitions on contingency fees by issuing their contingent fee engagement letters in a state that permits contingent fees. Accordingly, state uniformity in defining and interpreting contingency fees is imperative to addressing the abuses.

C. **Congress should fund the IRS's tax gap and abusive tax shelter compliance and enforcement efforts at an aggressive level in the long term to address the current level of abusive transactions and common tax gap issues, and to deter future noncompliance.**

Successfully combating abusive transactions set up by some of the most brilliant minds in the legal and accounting communities requires staff with extensive training, experience, and knowledge. If we increase the likelihood of detection and prosecution, we decrease the taxpayer's benefits of playing the audit roulette.

In determining IRS funding levels, consideration should be given to providing funds to hire industry expert witnesses and outside consultants. Combating highly technical financial transactions requires specialized skills and the flexibility to hire the best person for the worst situation.

Specific funding should be provided for increased coordination and assistance between the IRS and the states at a technical level. Overall tax enforcement is increased if state and federal activities complement each other, but these requires that joint administration be given a priority, rather than an auxiliary role.

Finally, eighty percent of the tax gap is made up of taxpayers who underreport their income. Therefore, increased funding for enhanced information reporting, increased education, and stepped up enforcement efforts are key to addressing the tax gap.

D. **The SEC rules adopted pursuant to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") have proven effective in curbing similar non-tax corporate abuses. We believe these rules should be amended as necessary to specifically address abusive tax shelters consummated by publicly traded corporations. We further believe that additional legislation should be adopted to apply similar laws to privately held companies engaging in abusive tax shelters. These recommendations are summarized below:**

Ban sale of tax shelters to financial audit clients. Section 201 of Sarbanes-Oxley enumerates certain nonaudit services auditors cannot perform at the same time as the audit under any circumstances. The SEC rules adopted pursuant to Section 201 of Sarbanes-Oxley do not give definitive guidance on how audit committees should determine whether a tax service is an allowable activity. The rules provide that CPA firms are permitted to provide tax minimization services to audit clients, except for "transactions that have no business purpose other than tax avoidance."[15] These SEC auditor independence rules have proven entirely ineffective in curbing corporate tax shelter abuses due to the lack of unambiguous guidance identifying specific indicia of transactions having no business purpose.

We believe Congress should amend Section 201 of Sarbanes-Oxley to ban the sale of tax shelters to audit clients (including listed and reportable transactions or those reasonable likely to be characterized as such in the future). U.S. Senator Carl Levin has introduced such legislation. This legislation should also prohibit audit firms from "signing off" on tax shelter transactions if the audit firm participates in the sale of the same or substantially similar tax shelters to other parties.

Financial statement disclosure of tax shelters. SEC rules adopted pursuant to Sarbanes-Oxley Section 401 require publicly traded corporations to disclose certain off-balance sheet transactions that have a material impact on financial statements. We believe that Congress should adopt similar legislation to require financial statement disclosure of certain tax shelter transactions, particularly listed and reportable transactions. Companies are reluctant to make such financial statements disclosures principally because they believe this will diminish their ability to "play the audit lottery." The IRS has the authority to obtain audit work papers relating to a company's tax accrual. In 2002, the IRS announced its intention to request such work papers as necessary to combat abusive tax shelters. SEC rules adopted pursuant to Section 802

[15] The rules the SEC originally proposed had listed "formulation of tax strategies (tax shelters) designed to minimize a company's tax obligations" as a prohibited activity. The AICPA provided comments to the proposed rules extolling the virtues of tax-minimization strategies (i.e., lower cost of capital, increased free cash flow and funds for dividend distributions, increased after tax earnings per share, and other increased value for a corporation's stockholders). The AICPA suggested that audit firms be allowed to provide tax-minimization services to audit clients, except for transactions with no business purpose other than tax avoidance (unless consistent with applicable tax laws). The rules the SEC issued as final substantially adopted the AICPA recommendation.

of Sarbanes-Oxley requires public companies to retain records relevant to the audit and review of financial statements, including information associated with the tax accrual.

CEO/CFO responsibility for tax shelters disclosures. SEC rules adopted pursuant to Sections 302 of Sarbanes-Oxley require certain CEO and CFO certifications with respect to the financial statements disclosures of publicly traded corporations. We believe that these certification rules should provide unambiguous guidance with respect to their application to tax shelters. Section 1001 of Sarbanes-Oxley provides that it is the sense of the Congress that the Federal income tax return of a publicly traded corporation should be signed by the CEO of such corporation. With respect to all corporations, public and private alike, we believe that Congress should require CEO or CFO signature or certification with respect to the disclosure of all transactions and other material facts relevant to the filing of a corporate tax return.

Expand application of obstruction provisions. Sections 802 and 1102 of Sarbanes Oxley make it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine. We believe that legislation may be required to adopt similar statutory provisions specifically applicable to the documentary evidence related to corporate tax shelters consummated by public and private companies. Application of such a provision should be reserved for the most egregious of conduct. Hopefully, the mere existence of such authority unambiguously defining the targeted conduct and associated penalties may be sufficient to increase the perceived risk of prosecution to adequately deter such misconduct.

E. **Adopt proposed changes to Circular 230.**

The proposed changes to Circular 230 enhance the effectiveness of the professional ethics provisions, include critical elements necessary to address abusive tax shelters, and establish common rules relevant to all preparers covered by Circular 230. Proposed changes include:

1. **Applies to all preparers.** Adoption of "Best Practices" including:
    - Clear communication regarding scope of advice or assistance rendered.
    - Establishing facts, *including* evaluation of reasonableness of any assumptions or representations.
    - Relating law to the facts.
    - Arriving at a supportable conclusion.
    - Advising client of all conclusions.

2. **Applies only to preparers issuing abusive tax avoidance transaction opinions** including "more likely than not" and marketed opinions.
    - Abusive tax avoidance transactions are any plan, arrangement, etc. used to avoid or evade taxes.

- Proposed changes require those who write opinion letters to be fully aware of ***ALL*** facts and circumstances surrounding the transaction rather than just a piece of the transaction. Changes require the opinion author to:
  - Identify and consider ***all*** relevant facts and not rely on any unreasonable assumptions and representations.
  - Relate applicable law to the facts.
  - Consider ***all*** federal tax issues and reach supportable conclusion.
  - Provide ***overall*** conclusion and statement as to why conclusion was reached, or if unable to provide overall conclusion, state and indicate why.
  - Disclose to the taxpayer their relationship with the promoter or other practitioners involved in the transaction including information on compensation arrangements and referral agreements.
  - Disclose that their opinion may not be sufficient for the taxpayer to rely on to avoid the accuracy related penalty.
  - State that the taxpayer should seek advise from their own tax advisor.
- If the opinion is limited in scope, the writer must disclose other issues that may exist that could effect the tax treatment discussed in the opinion.

V. CLOSING COMMENTS

We are far from completely closing the tax gap. We continue to encounter challenges thwarting our ability to effectively combat abusive tax shelters. As soon as one abusive tax shelter is identified, others are created to take its place.

State Controller Steve Westly stated, "The huge success of our amnesty program shows that government can think outside the box. We must collect the taxes already owed to California before we consider raising taxes or cutting services."[16] But, Westly also added, "We've climbed out of the revenue quicksand, but we're not out of the woods."[17]

Thank you.

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[16] Press Release by State Controller Westly on April 22, 2004.
[17] Press Release by State Controller Westly on May 6, 2004.

Senate Finance Committee:

In response to the Committee's inquiry regarding issued and pending patents concerning business methods involving tax strategies, the USPTO staff searched our electronic database. As you know, the USPTO has issued more than 6 million patents over the past 210 years. Here are the results:

(1) The front page of 24 issued patents.
(2) The front page of 50 published pending patent applications.

The full text of the patents and applications is available online at http://www.uspto.gov/.

US005206803A

United States Patent [19]

Vitagliano et al.

[11] Patent Number: 5,206,803

[45] Date of Patent: Apr. 27, 1993

[54] SYSTEM FOR ENHANCED MANAGEMENT OF PENSION-BACKED CREDIT

[76] Inventors: Francis M. Vitagliano, 117 Revere St., Boston, Mass. 02114; Franco Modigliani, 25 Clark St., Belmont, Mass. 02178

[21] Appl. No.: 670,060

[22] Filed: Mar. 15, 1991

[51] Int. Cl.[5] G06F 15/30

[52] U.S. Cl. 364/408; 364/401

[58] Field of Search ..... 364/401, 408, DIG. 1, 364/DIG. 2

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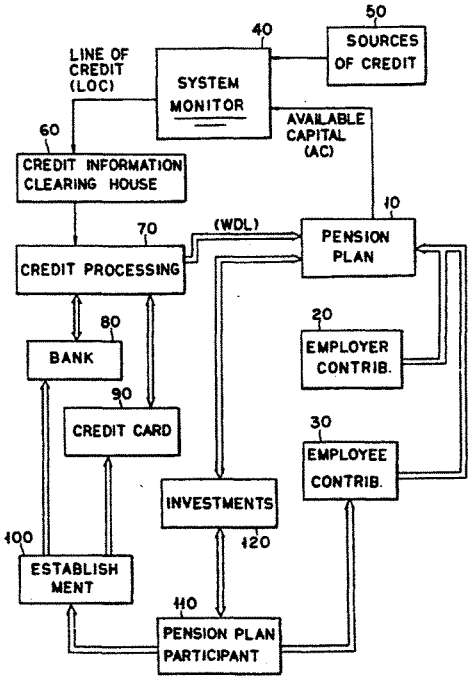
Primary Examiner—Roy N. Envall, Jr.
Assistant Examiner—A. Bodendorf
Attorney, Agent, or Firm—Hopgood, Calimafde, Kalil, Blaustein & Judlowe

[57] ABSTRACT

A data processing pension plan monitor is directed specifically to the management and controlled access of pension-backed credit. This system permits pension plan participants to establish a line of credit (LOC), based on their vested interest in a sponsored pension plan. This LOC is thereafter systematically applied to a plurality of accounts, each permitted selected credit card and/or check writing privileges.

The present invention balances credit access with long term pension requirements. The charges associated with the credit accessed are paid back to the pensioner, thereby retaining certain tax deferred privileges while permitting access to the accumulated funds.

3 Claims, 3 Drawing Sheets



US005870720A

United States Patent [19]

Chusid et al.

[11] Patent Number: 5,870,720

[45] Date of Patent: Feb. 9, 1999

[54] **METHOD FOR IMPLEMENTING A RESTRUCTURING EXCHANGE OF AN EXCESSIVE UNDIVIDED DEBT**

[76] Inventors: **Candee B. Chusid**, 404 E. 66th St., New York, N.Y. 10021; **Julia M. Whitehead**, 9 E. 96th St., New York, N.Y. 10128

[21] Appl. No.: **260,211**

[22] Filed: **Jun. 15, 1994**

[51] **Int. Cl.**[6] **G06F 17/60**

[52] **U.S. Cl.** **705/38**; 705/35

[58] **Field of Search** 364/408, 401; 705/35, 38, 30

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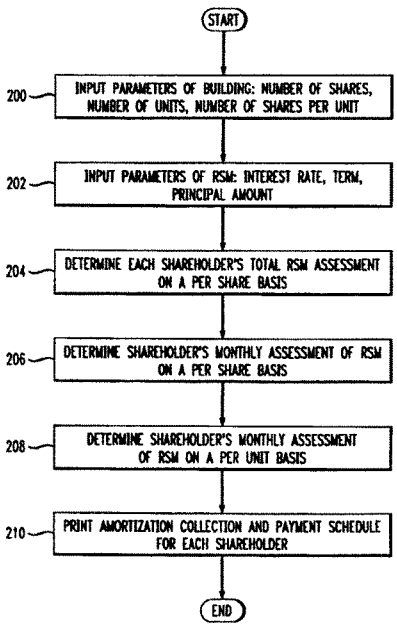
Primary Examiner—Edward R. Cosimano
Assistant Examiner—Barton L. Bainbridge
Attorney, Agent, or Firm—Sofer & Haroun, LLP

[57] **ABSTRACT**

A method for restructuring an excessive underlying mortgage in excess of its current market value so that the value of the restructured underlying mortgage and the property to which it attaches exceeds the values prior to the restructuring. The method determines an existing underlying mortgage utilizing parameters which include a principal amount, a maturity date, an interest rate and payment periods. Thereafter, a first market value mortgage portion, which is substantially equal to the current mortgage value of the existing mortgage, and a second excess portion, which is the difference between the remaining principal balance of the existing underlying mortgage and the first market value portion, is determined. As such, the existing underlying mortgage is transferred into or replaced by the first market value portion and the second excess portion so that the principal of the remaining underlying mortgage is, in a most preferred form of the invention, substantially the same as the total of the principals of the first market value portion and the second excess portion. Thereafter, each shareholder's amount and percentage of liability in respect of the assessment in accordance with the number of shares owned by each shareholder is calculated.

11 Claims, 6 Drawing Sheets



US005907828A

United States Patent [19]

Meyer et al.

[11] Patent Number: 5,907,828

[45] Date of Patent: *May 25, 1999

[54] **SYSTEM AND METHOD FOR IMPLEMENTING AND ADMINISTERING LENDER-OWNED CREDIT LIFE INSURANCE POLICIES**

[76] Inventors: **Bennett S. Meyer**, 8205 Westminster Rd., Elkins Park, Pa. 19117; **William D. Chatfield**, 5 East Buck Rd., Downington, Pa. 19335

[*] Notice: This patent issued on a continued prosecution application filed under 37 CFR 1.53(d), and is subject to the twenty year patent term provisions of 35 U.S.C. 154(a)(2).

[21] Appl. No.: **08/578,307**

[22] Filed: **Dec. 26, 1995**

[51] **Int. Cl.**[6] **G06F 17/60**

[52] **U.S. Cl.** **705/4**; 705/35; 705/38

[58] **Field of Search** 395/204, 235; 705/4, 35, 38

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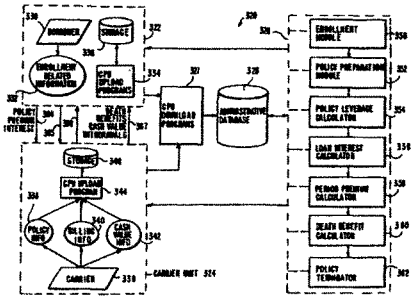
Primary Examiner—Emanuel Todd Voeltz
Assistant Examiner—William N. Hughet
Attorney, Agent, or Firm—Douglas P Dreyer

[57] **ABSTRACT**

The invention relates to a system for analyzing and managing at least one lender owned life insurance policy on behalf of a lender to improve loan profitability, achieve investment results from the COLI, and to prevent investment loss as a result of adverse tax law changes. The system tracks mortgage balances, applies vesting schedules, determines appropriate face amounts, policy loan amounts and/or cash withdrawals to maximize return on investment for the lender. The system also reacts to adverse changes in the tax laws by adjusting the form of the insurance policy to a term policy with an increased face value and terminating the policy. Termination of the policy involves additional cash withdrawals which are used to pay back policy loans. The system further illustrates past and future performance of the policy based upon assumptions of tax law changes. Finally, the system monitors and administers the MCPP program on an ongoing basis.

20 Claims, 7 Drawing Sheets



US005946668A

United States Patent [19]

George

[11] Patent Number: 5,946,668

[45] Date of Patent: *Aug. 31, 1999

[54] **SYSTEM AND METHOD FOR FUNDING A HOME INVESTMENT TRUST**

[75] Inventor: **J. Dean George**, 32-A Hilten Pl., Greensboro, N.C. 27409

[73] Assignee: **J. Dean George**, Greensboro, N.C.

[*] Notice: This patent issued on a continued prosecution application filed under 37 CFR 1.53(d), and is subject to the twenty year patent term provisions of 35 U.S.C. 154(a)(2).

[21] Appl. No.: **08/543,851**

[22] Filed: **Oct. 12, 1995**

[51] **Int. Cl.**[6] **G06F 17/60**; G06F 157/00

[52] **U.S. Cl.** **705/38**; 705/36; 705/31

[58] **Field of Search** 395/201, 230, 395/231, 235, 236, 238, 240, 234, 219; 705/1, 30, 31, 35, 36, 38, 40, 34, 19; 235/375, 376, 379

[56] **References Cited**

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5,832,461	11/1998	Leon et al.	705/35
5,852,811	11/1998	Atkins	705/36
5,864,828	1/1999	Atkins	705/38

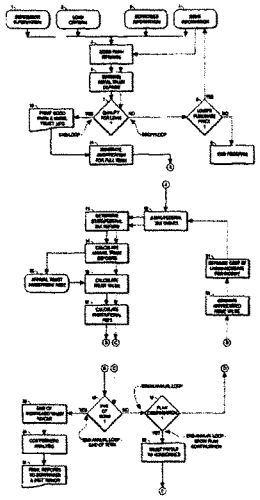
Primary Examiner—Joseph Thomas

Attorney, Agent, or Firm—Rhodes Coats & Bennett, L.L.P.

[57] **ABSTRACT**

A system and method for funding a home investment trust program to provide for home mortgage payments to pay for a home throughout the mortgage period, a first trust fund and a cash-out amount payable during the mortgage period useable for college expenses, and a second trust fund payable at the end of the mortgage period for retirement, wherein funding for the trust comes substantially from income tax savings associated with deducting interest paid on a home mortgage. The invention includes determining the purchaser's tax liability and any tax refund or reduction due to the deduction attributable to interest paid on the home mortgage. The latter amount is systematically deposited into a trust fund. At a point during the mortgage period, the home maybe refinanced in a manner allowing the homeowner to "cash-out" part of the equity build-up. After refinancing, the homeowner will continue funding another trust with income tax deductions attributable to the interest paid on the home mortgage.

17 Claims, 7 Drawing Sheets



US005966693A

United States Patent [19]

Burgess

[11] **Patent Number: 5,966,693**

[45] **Date of Patent: Oct. 12, 1999**

[54] **METHOD FOR COMBINING LOAN WITH KEY EMPLOYEE LIFE INSURANCE**

[75] Inventor: **Duane Burgess**, Indianapolis, Ind.

[73] Assignee: **Money Accumulation Programs, Inc.**, Indianapolis, Ind.

[21] Appl. No.: **08/643,966**

[22] Filed: **May 7, 1996**

[51] **Int. Cl.**[6] **G06F 17/60**

[52] **U.S. Cl.** **705/4**; 705/38; 705/1; 707/104

[58] **Field of Search** 705/4, 35, 30, 705/38, 1; 707/104

[56] **References Cited**

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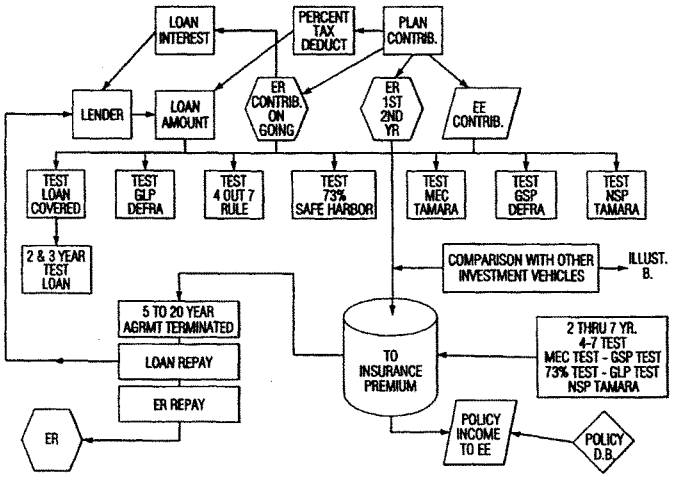
Primary Examiner—Emanuel Todd Voeltz
Assistant Examiner—Raquel Alvarez
Attorney, Agent, or Firm—Eckert Seamans Cherin & Mellott, LLC

[57] **ABSTRACT**

A leveraged whole or universal life insurance plan is administered using a computer processing method to ensure lender security, accumulation of value to an employee, and minimum tax exposure. The employer borrows in installments to partly cover insurance premiums on a policy owned by the employee, and pays interest on the loan for the life of the plan. The employee also pays part of the premiums, and collaterally assigns the policy as security for repayment of the loan. As the insurance policy appreciates in value, premiums decrease. The employee can pay down the loan and eventually eliminate premium payments, or can borrow against the policy for tax-free retirement income. The excess of the death benefit over any loan principal remaining upon the death of the employee is a tax-free payment to the employee's beneficiaries. The computerized method includes storing parameters of insurance policies and loan agreements in a computer memory, over ranges of possible death benefits, cash values, loan principals, and incremental payments over a span of years. Employee factors are quantified and input to the computer processor, which is programmed to integrate the employee factors with the insurance and loan terms to select an integrated loan/insurance arrangement to schedule payments to meet maximum contributions and retirement and life expectancy expectations. The processor adjusts incremental payments from the employer and the employee to ensure sufficient collateral and to comply with tax regulations that are unfavorable to certain front-loaded payment schedules.

5 Claims, 3 Drawing Sheets



US005991744A

United States Patent [19]

DiCresce

[11] Patent Number: 5,991,744

[45] Date of Patent: Nov. 23, 1999

[54] **METHOD AND APPARATUS THAT PROCESSES FINANCIAL DATA RELATING TO WEALTH ACCUMULATION PLANS**

[75] Inventor: **Gary P. DiCresce**, Saratoga Springs, N.Y.

[73] Assignee: **Gary P. DiCresce & Associates**, Saratoga Springs, N.Y.

[21] Appl. No.: **08/962,457**

[22] Filed: **Oct. 31, 1997**

[51] **Int. Cl.**[6] **G06F 17/60**; G06F 19/00

[52] **U.S. Cl.** **705/36**; 705/4; 705/35

[58] **Field of Search** 705/4, 35, 36

[56] **References Cited**

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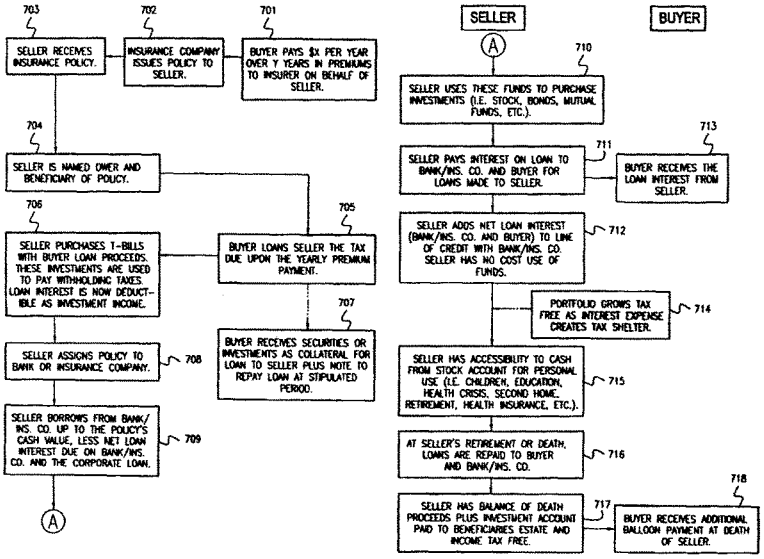
Primary Examiner—Allen R. MacDonald
Assistant Examiner—James W. Myhre
Attorney, Agent, or Firm—Robert S. Babayi; Burns Doane Swecker & Mathis

[57] **ABSTRACT**

A digital computer produces data corresponding to results of different financial plans. Contribution data corresponding to contributions to an account created under the plan are entered into the digital computer. The digital computer produces data representing after tax cost of interest for cash value loan amounts corresponding to cumulative cash values of an insurance contract issued based on the contribution. Then, the digital computer outputs data representing investment income derived from the cash value loan amounts less after tax cost of interest to a display device.

46 Claims, 12 Drawing Sheets



US006009402A

United States Patent [19]

Whitworth

[11] Patent Number: 6,009,402

[45] Date of Patent: Dec. 28, 1999

[54] **SYSTEM AND METHOD FOR PREDICTING, COMPARING AND PRESENTING THE COST OF SELF INSURANCE VERSUS INSURANCE AND FOR CREATING BOND FINANCING WHEN ADVANTAGEOUS**

[76] Inventor: **Brian L. Whitworth**, 20433 Seaboard Rd., Malibu, Calif. 90265

[21] Appl. No.: **08/901,762**

[22] Filed: **Jul. 28, 1997**

[51] **Int. Cl.**[6] **G06F 17/60**

[52] **U.S. Cl.** **705/4**; 705/400

[58] **Field of Search** 705/1, 4, 36, 400

[56] **References Cited**

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4,752,877	6/1988	Roberts et al.	705/35
5,590,037	12/1996	Ryan et al.	705/4
5,712,984	1/1998	Hammond et al.	705/4

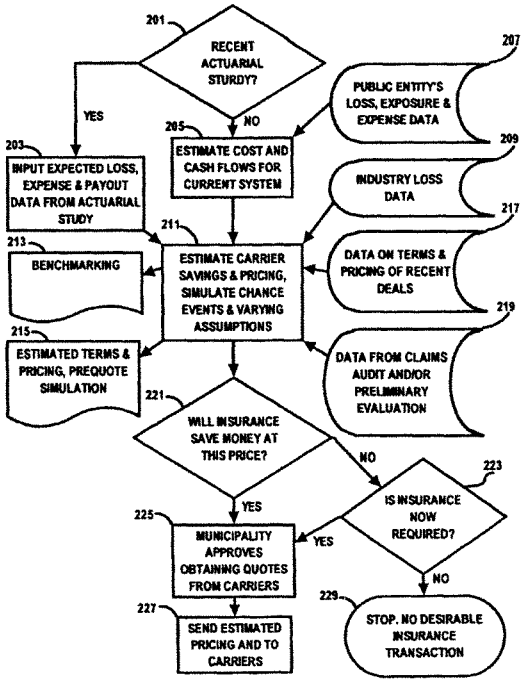
Primary Examiner—Edward R. Cosimano

Attorney, Agent, or Firm—Oppenheimer Wolff & Donnelly LLP

[57] **ABSTRACT**

A system and method for predicting, comparing, and presenting the cost of self insurance versus insurance for property, casualty, or employee benefit liabilities, and for creating bond financing when advantageous. For a self insured entity, the cost of insurance is estimated by reviewing available data from actuarial studies, claims audits, loss runs, similar self insureds, recent similar insurance deals and rating agencies. These preliminary pricing estimates are used to decide if pursuing insurance is likely to provide savings to the self insured. Suggested pricing estimates are also provided to facilitate marketing the program to insurance carriers. If a carrier offers an insurance program which provides savings and the insured entity requires bond financing, the system is adapted to calculate bond payments based on budget constraints or claims payout patterns.

69 Claims, 42 Drawing Sheets



US006064986A

United States Patent [19]

Edelman

[11] **Patent Number: 6,064,986**

[45] **Date of Patent: *May 16, 2000**

[54] **COMPUTER ASSISTED AND/OR IMPLEMENTED PROCESS AND ARCHITECTURE FOR CUSTOMER ACCOUNT CREATION, MAINTENANCE AND ADMINISTRATION FOR AN INVESTMENT AND/OR RETIREMENT PROGRAM**

[75] Inventor: **Fredric M. Edelman**, Great Falls, Va.

[73] Assignee: **Edelman Financial Services, Inc.**, Fairfax, Va.

[*] Notice: This patent is subject to a terminal disclaimer.

[21] Appl. No.: **09/233,169**

[22] Filed: **Jan. 19, 1999**

Related U.S. Application Data

[63] Continuation-in-part of application No. 08/936,020, Sep. 23, 1997.

[51] **Int. Cl.**[7] **G06F 19/00**

[52] **U.S. Cl.** **705/36**; 705/35; 705/37; 705/40

[58] **Field of Search** 705/35, 36, 40, 705/37

[56] **References Cited**

U.S. PATENT DOCUMENTS

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4,752,877	6/1988	Roberts et al.	705/35
4,953,085	8/1990	Atkins	705/36
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5,644,727	7/1997	Atkins	705/40
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5,852,811	12/1998	Atkins	705/36
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5,875,437	2/1999	Atkins	705/40

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Edelman, Ric. "The New Rules of Money" 1998. No Mo.

Primary Examiner—Allen R. MacDonald

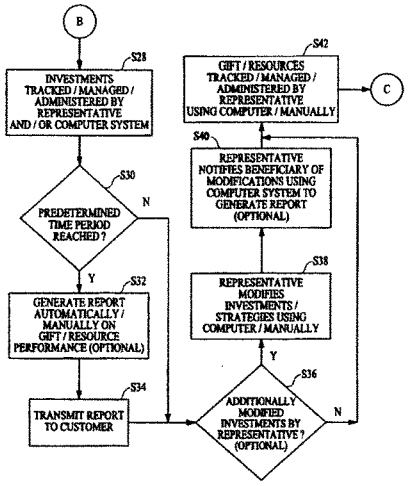
Assistant Examiner—Jagdish Patel

Attorney, Agent, or Firm—Irah H. Donner; Pepper Hamilton LLP

[57] **ABSTRACT**

A computer program product, system or process administer or assist in the administration of resources of a customer for the benefit of a beneficiary. The process includes receiving a request from the customer to administer the resources in accordance with predetermined criteria, and storing customer related data associated with the customer. A network of service providers is formed to assist in the administration of the resources for the customer and provide a variety of economic and/or administrative features and benefits, using a computer.

19 Claims, 28 Drawing Sheets



US006078899A

United States Patent [19]

Francisco et al.

[11] Patent Number: 6,078,899

[45] Date of Patent: *Jun. 20, 2000

[54] **POINT OF SALE TAX REPORTING AND AUTOMATIC COLLECTION SYSTEM WITH TAX REGISTER**

[76] Inventors: **Paul A. Francisco**, 101 Norwood Ave., Loch Arbour, N.J. 07711; **Frederick J. Petschauer**, 402 10th Ave., Belmar, N.J. 07719

[*] Notice: This patent is subject to a terminal disclaimer.

[21] Appl. No.: **09/139,265**

[22] Filed: **Aug. 25, 1998**

Related U.S. Application Data

[63] Continuation of application No. 08/438,890, May 10, 1995, Pat. No. 5,799,283.

[51] **Int. Cl.**[7] **G06F 17/60**

[52] **U.S. Cl.** **705/19**; 705/31; 705/16

[58] **Field of Search** 705/19, 31, 16

[56] **References Cited**

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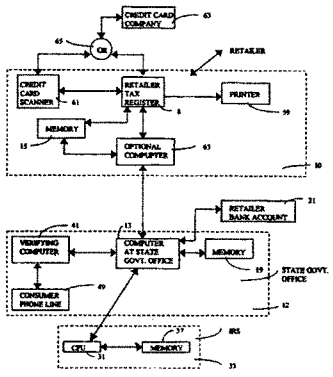
5,774,872	6/1998	Golden et al.	705/19
5,799,283	8/1998	Francisco et al.	705/19

Primary Examiner—Allen R. MacDonald
Assistant Examiner—Ahiba Robinson-Boyce
Attorney, Agent, or Firm—Nixon & Vanderhye P.C.

[57] **ABSTRACT**

A point of sale tax reporting and automatic collection system including a smart tax register located at a retailer location. The retailer smart register processes consumer transactions and calculates the amount of sales tax due the retailer by the consumer for each transaction. Following the transaction, the consumer requests and is give a tax paid receipt. After the sales tax is paid to the retailer by the consumer, the register either immediately or periodically forwards the amount of the transaction and the amount of sales tax collected by the retailer to a computer and memory located at a remote location (e.g. state government taxing authority). The computer and memory receive and store the retailer's transaction and sales tax information, and report same to the Internal Revenue Service at least once a year. After receiving the retailer's sales tax information, the computer accesses and debits an account belonging to the retailer, the amount debited corresponding to the amount of sales tax collected by the retailer. In sum, the system automatically reports all retailer transactions and sales tax collected by retailers from consumers to local and federal government authorities and then automatically collects the sales tax amounts from retailer accounts so as to prevent retailers from turning over the collected sales tax. A tax paid receipt is given to each consumer as evidence that the tax paid will be turned over to the proper authorities.

17 Claims, 6 Drawing Sheets



US006085174A

United States Patent [19]

Edelman

[11] **Patent Number: 6,085,174**

[45] **Date of Patent: Jul. 4, 2000**

[54] **COMPUTER ASSISTED AND/OR IMPLEMENTED PROCESS AND ARCHITECTURE FOR ADMINISTERING AN INVESTMENT AND/OR RETIREMENT PROGRAM**

[76] Inventor: **Ric Edelman**, 12450 Fair Lakes Cir., Suite 200, Fairfax, Va. 22033

[21] Appl. No.: **08/936,020**

[22] Filed: **Sep. 23, 1997**

[51] **Int. Cl.**[7] **G06F 17/60**

[52] **U.S. Cl.** **705/36**; 705/37; 705/38; 705/35

[58] **Field of Search** 705/36, 37, 38, 705/35, 40; 283/57

[56] **References Cited**

U.S. PATENT DOCUMENTS

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4,376,978	3/1983	Musmanno	705/36
4,722,055	1/1988	Roberts	705/36
4,752,877	6/1988	Roberts et al.	705/36
4,953,085	8/1990	Atkins	705/36
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5,689,649	11/1997	Altman et al.	705/36
5,775,734	7/1998	George, Jr.	283/57
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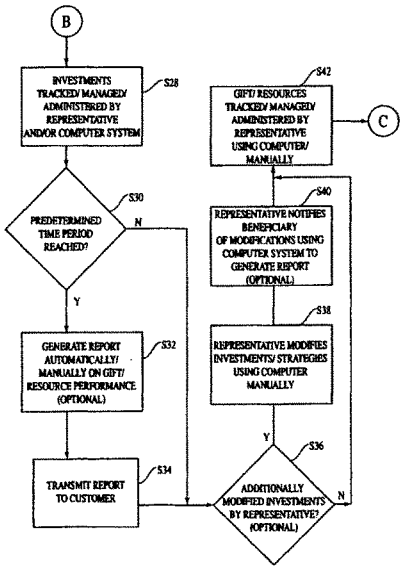
Primary Examiner—Allen R. MacDonald
Assistant Examiner—Jagdish Patel
Attorney, Agent, or Firm—Irah H. Donner; Pepper Hamilton LLP

[57] **ABSTRACT**

A computer program product stores computer instructions therein for instructing a computer to perform a process of administering or assisting in the administration of resources of a customer for the benefit of a beneficiary. The program product includes a recording medium readable by the computer, and computer instructions stored thereon instructing the computer to perform the process. The instructions and the process include receiving a request from the customer to administer the resources in accordance with predetermined criteria, and storing customer related data associated with the customer. The instructions and process also include determining a predetermined period of time based on an age of the beneficiary at which withdrawals do not incur a tax penalty, and administering the resources in an annuity investment growing tax deferred in accordance with withdrawal criteria, and preventing withdrawal of the resources responsive to the withdrawal criteria.

13 Claims, 22 Drawing Sheets



US006115697A

United States Patent [19]

Gottstein

[11] Patent Number: 6,115,697

[45] Date of Patent: Sep. 5, 2000

[54] **COMPUTERIZED SYSTEM AND METHOD FOR OPTIMIZING AFTER-TAX PROCEEDS**

[75] Inventor: **David Richard Gottstein**, Anchorage, Ak.

[73] Assignee: **Dynamic Research Group**, Anchorage, Ak.

[21] Appl. No.: **09/253,453**

[22] Filed: **Feb. 19, 1999**

[51] **Int. Cl.**[7] **G06F 17/00**

[52] **U.S. Cl.** **705/35**; 705/36

[58] **Field of Search** 705/35–37, 39, 705/31

[56] **References Cited**

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5,802,501	9/1998	Graff .	
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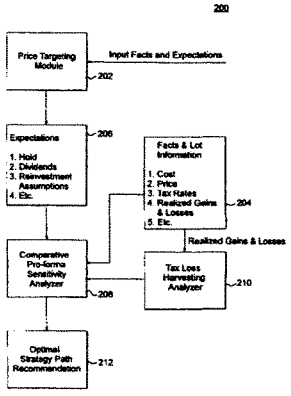
Primary Examiner—Melanie A. Kemper

Attorney, Agent, or Firm—Brown Raysman Millstein Felder & Steiner LLP

[57] **ABSTRACT**

A computerized system and method process financial securities and instruments to accurately determine and optimize the after-tax proceeds an investor could expect to have at the end of a holding period for each of a set of investment strategies and determines an optimal strategy for maximizing such after-tax proceeds. The computerized system and method receive tax and investment data, user-customized investment expectations, and financial adviser-based investment expectations at a processor; perform tax loss harvesting analysis on the user-customized investment expectations and the financial adviser-based investment expectations over a dynamic taxation time range using a predetermined software program; perform comparative pro-forma tax sensitivity analysis of the tax and investment data and the analyzed investment expectations using the predetermined software program; and determine and output an optimal after-tax investment strategy path from a plurality of investment strategy paths over the dynamic taxation time range using the predetermined software program to optimize the after-tax proceeds from the plurality of investment strategies. The predetermined software program may include a spreadsheet program.

26 Claims, 19 Drawing Sheets



US006161096A

United States Patent [19]

Bell

[11] **Patent Number: 6,161,096**

[45] **Date of Patent: Dec. 12, 2000**

[54] **METHOD AND APPARATUS FOR MODELING AND EXECUTING DEFERRED AWARD INSTRUMENT PLAN**

[76] Inventor: **Lawrence L. Bell**, 18 Farmington Ct., Chevy Chase, Md. 20815

[21] Appl. No.: **09/177,131**

[22] Filed: **Oct. 22, 1998**

[51] **Int. Cl.**[7] **G06F 17/60**

[52] **U.S. Cl.** **705/4**; 705/35; 705/36; 705/1

[58] **Field of Search** 705/4, 36, 40, 705/35, 37, 38, 39, 1

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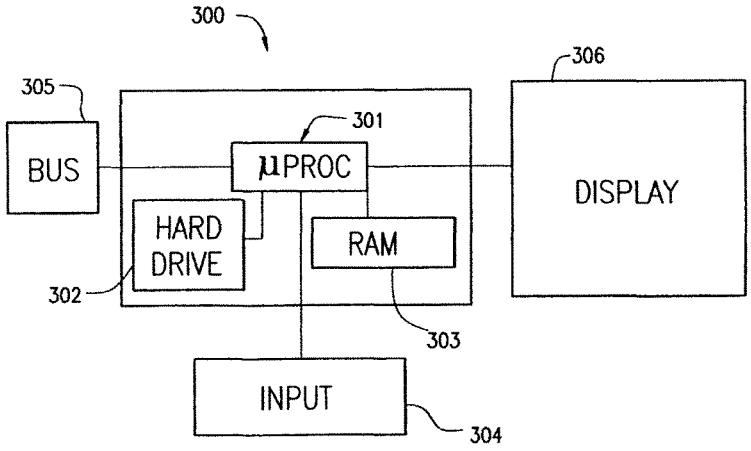
Primary Examiner—Allen R. MacDonald
Assistant Examiner—Anne Teitelbaum
Attorney, Agent, or Firm—Dickstein Shapiro Morin & Oshinsky LLP

[57] **ABSTRACT**

A method and apparatus for deferred award instrument plan by identifying at least one participant in the deferred award plan, retrieving financial data related to stock options corresponding to the identified participant, computing a spread associated with the retrieved stock options, establishing a rabbi trust with the spread, determining whether a life insurance policy has been purchased by the participant, determining whether a split dollar agreement has been executed, monitoring and paying at least one premium for the life insurance policy and notifying the participants that a payment associated with the life insurance policy has been paid.

8 Claims, 5 Drawing Sheets



US006167384A

United States Patent [19]

Graff

[11] Patent Number: 6,167,384

[45] Date of Patent: Dec. 26, 2000

[54] **AUGMENTED SYSTEM AND METHODS FOR COMPUTING TO SUPPORT FRACTIONAL CONTINGENT INTERESTS IN PROPERTY**

[75] Inventor: **Richard A. Graff**, Chicago, Ill.

[73] Assignee: **Graff/Ross Holdings**, Chicago, Ill.

[21] Appl. No.: **09/145,341**

[22] Filed: **Sep. 1, 1998**

[51] **Int. Cl.**[7] **G06F 15/30**

[52] **U.S. Cl.** **705/35**; 705/1

[58] **Field of Search** 705/35, 36, 1

[56] **References Cited**

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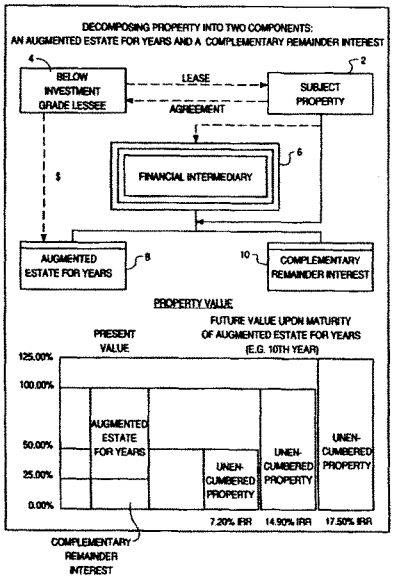
Primary Examiner—Allen R. MacDonald
Assistant Examiner—Susanna Meinecke-Diaz
Attorney, Agent, or Firm—Peter K. Trzyna, Esq.

[57] **ABSTRACT**

A computer system, and methods for making and using it, for changing digital electrical signals to generate a valuation of a fractional interest in a contingent interest in property, the computer apparatus including: an input device operable for converting input data representing property into input digital electrical signals representing the input data; a digital electrical computer having a processor, the processor electrically connected to the input device to receive the input digital electrical signals, the processor programmed to change the input digital electrical signals to produce modified digital electrical signals representing a valuation of a fractional interest in a contingent interest in the property associated with at least one lease default condition for the property; a memory electrically connected to the processor, and wherein: the processor manipulates further digital electrical signals to generate at least one document for the contingent interest by inserting the valuation in preexisting text data obtained from the memory; and an output device electrically connected to the processor to print the document.

17 Claims, 17 Drawing Sheets



US006192347B1

(12) **United States Patent**
Graff

(10) **Patent No.: US 6,192,347 B1**
(45) **Date of Patent: *Feb. 20, 2001**

(54) **SYSTEM AND METHODS FOR COMPUTING TO SUPPORT DECOMPOSING PROPERTY INTO SEPARATELY VALUED COMPONENTS**

(75) Inventor: **Richard A. Graff**, Chicago, IL (US)

(73) Assignee: **Graff/Ross Holdings**, Chicago, IL (US)

(*) Notice: Under 35 U.S.C. 154(b), the term of this patent shall be extended for 0 days.

This patent is subject to a terminal disclaimer.

(21) Appl. No.: **09/134,451**

(22) Filed: **Aug. 14, 1998**

Related U.S. Application Data

(63) Continuation-in-part of application No. 08/181,632, filed on Jan. 12, 1994, now Pat. No. 5,802,501, which is a continuation-in-part of application No. 07/967,644, filed on Oct. 28, 1992, now abandoned.

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/31; 705/35; 705/38

(58) **Field of Search** 705/4, 30, 31, 705/35, 36, 38

(56) **References Cited**

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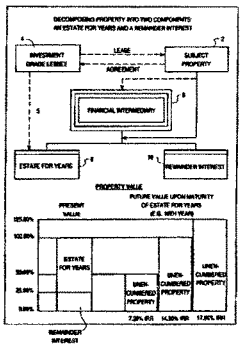
Primary Examiner—James P. Trammell
Assistant Examiner—Nicholas David Rosen
(74) *Attorney, Agent, or Firm*—Peter K. Trzyna, Esq.

(57) **ABSTRACT**

A computer system, and methods for making and using it, for manipulating digital electrical signals to produce an illustration of a decomposition of property into separately valued components. The computer system includes a digital electrical computer controlled by a processor. There is a first logic means controlling the processor in manipulating digital electrical signals representing input data to the computer, the input data characterizing at least two components decomposed from the property, the manipulating including transforming the digital electrical signals into modified digital electrical signals representing respective values for each of the components, the values being computed to reflect taxation for the components. Input means is coupled to the computer and operable for converting the input data into the digital electrical signals and communicating the digital electrical signals to the computer. Output means is coupled to receive the modified digital electrical signals from the computer and to converting the modified digital electrical signals representing the respective values into an illustration of the computed respective prices. The property can be real estate or tax-exempt securities.

128 Claims, 17 Drawing Sheets



US006292788B1

(12) **United States Patent**
Roberts et al.

(10) **Patent No.: US 6,292,788 B1**
(45) **Date of Patent: Sep. 18, 2001**

(54) **METHODS AND INVESTMENT INSTRUMENTS FOR PERFORMING TAX-DEFERRED REAL ESTATE EXCHANGES**

(75) Inventors: **Neal Roberts**, Santa Monica; **Michael Franklin**, Carlsbad, both of CA (US); **Charles Runnels**, Scottsdale, AZ (US); **James Andrews**, Los Angeles, CA (US)

(73) Assignee: **American Master Lease, L.L.C.**, Los Angeles, CA (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/205,633**

(22) Filed: **Dec. 3, 1998**

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/35; 705/37; 705/38

(58) **Field of Search** 705/36, 37, 38, 705/39, 35

(56) **References Cited**

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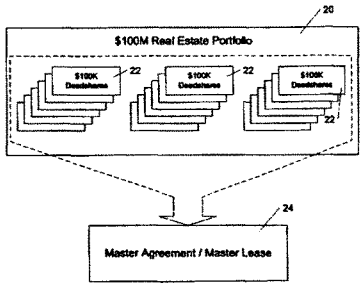
Primary Examiner—Vincent Millin
Assistant Examiner—Pedro Kanof
(74) *Attorney, Agent, or Firm*—Fish & Neave; Nicola A. Pisano

(57) **ABSTRACT**

Methods and investment instruments for investing in real estate are described wherein a portfolio of investment real estate is divided into a plurality of tenant-in-common deeds of predetermined denominations, and which are subject to a master agreement and master lease to form "deedshares." Holders of the deedshares receive a guaranteed income stream from the master lease and yearly depreciation, without having to maintain or manage the real estate. The holders of deedshares are subject, under the master agreement, to a mechanism that enables the master tenant to purchase, or arrange for the purchase of the deedshares at fair market value (or some other calculable value) at the end of a specified term. Because the deedshares qualify as interests in investment real estate, they are eligible for tax-deferred treatment under §1031 of the Internal Revenue Code.

41 Claims, 5 Drawing Sheets



US006381585B1

(12) **United States Patent**
Maples et al.

(10) **Patent No.: US 6,381,585 B1**
(45) **Date of Patent: *Apr. 30, 2002**

(54) **METHOD AND APPARATUS FOR ADMINISTERING A SHARE BOND**

(76) Inventors: **Durham Russell Maples**, 1507 Park Cir., Camden, SC (US) 29020; **Herman Russell Anderson**, 1113 Second St., Gulfport, MS (US) 39501

(*) Notice: This patent issued on a continued prosecution application filed under 37 CFR 1.53(d), and is subject to the twenty year patent term provisions of 35 U.S.C. 154(a)(2).

Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/071,878**

(22) Filed: **May 4, 1998**

(51) **Int. Cl.**[7] **G06F 17/00**
(52) **U.S. Cl.** **705/36**; 705/35
(58) **Field of Search** 705/36, 35

(56) **References Cited**

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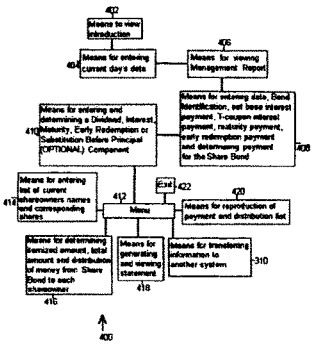
Primary Examiner—James P. Trammell
Assistant Examiner—Pierre E. Elisca

(57) **ABSTRACT**

A method and apparatus for enhancing the stock of a business entity by joining the shares of stock to non-investment bonds at no cost, no loss financially to any current and/or future shareowner with any principal or issue price is zero, unpaid or paid by any means other than any current and/or future shareowner paying any money or property for the bonds. The enhancement that is derived from this joining is called a Share Bond (28) which has increased investment security, guaranteed monetary benefits for the shareowners that are administered by the data processing system provided by the invention. This includes the joining, updating of information, calculating payments and distribution of the Share Bond benefits.

5 Claims, 6 Drawing Sheets

Microfiche Appendix Included
(3 Microfiche, 66 Pages)



US006542875B1

(12) **United States Patent**
Mulvihill et al.

(10) **Patent No.: US 6,542,875 B1**
(45) **Date of Patent: Apr. 1, 2003**

(54) **CHARITABLE AND PUBLIC FUNDING USING TAX CREDITS AND PASSIVE LOSSES**

(75) Inventors: **Steven Mulvihill**, Elmhurst, IL (US); **Patricia A. Teplan**, Itasca, IL (US); **Geraldine K. Ryan**, Chicago, IL (US); **John M. Ryan**, Littleton, CO (US)

(73) Assignee: **Arcon Capital, LLC**, Lombard, IL (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/377,574**

(22) Filed: **Aug. 19, 1999**

Related U.S. Application Data

(60) Provisional application No. 60/097,407, filed on Aug. 21, 1998.

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/35**; 705/30; 705/39
(58) **Field of Search** 705/30, 35, 39

(56) **References Cited**

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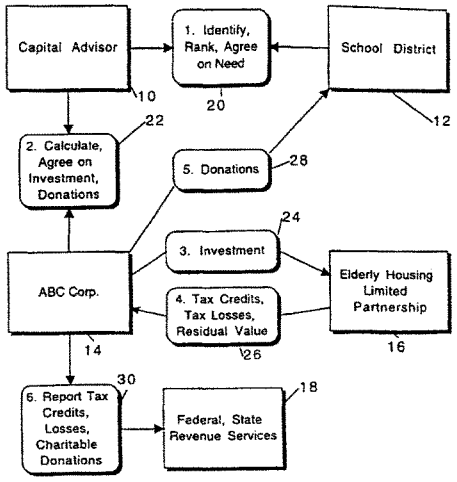
Primary Examiner—Vincent Millin
Assistant Examiner—Jagdish N Patel
(74) *Attorney, Agent, or Firm*—Chapman and Cutler

(57) **ABSTRACT**

Limited partnerships formed for specified public purposes, such as qualified low-income and elderly housing construction and services, are federally tax advantaged. In accordance with the present invention, tax credits and/or passive losses are leveraged by being directed into a method of funding charitable works, for instance school construction projects. A $1 million investment in a qualifying tax credit and/or passive loss plan, with recoupment of the investment after 13 years, will return 8.05% after taxes over 13 years if 50% of the tax credit amounts are donated to a qualified charity or public entity; this results in a net benefit to the donor of $1,759,450 and a total contribution to the charitable entity of $615,000. That contribution can, in accordance with the invention, fund the issuance and retirement of municipal bonds secured principally by the contribution, sufficient for a school construction project of about $500,000.

10 Claims, 3 Drawing Sheets



US006567790B1

(12) **United States Patent**
Slane

(10) **Patent No.: US 6,567,790 B1**
(45) **Date of Patent: May 20, 2003**

(54) **ESTABLISHING AND MANAGING GRANTOR RETAINED ANNUITY TRUSTS FUNDED BY NONQUALIFIED STOCK OPTIONS**

(75) Inventor: **Robert C. Slane**, Maitland, FL (US)

(73) Assignee: **Wealth Transfer Group, L.L.C.**, Altamont Springs, FL (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/453,364**

(22) Filed: **Dec. 1, 1999**

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(58) **Field of Search** 705/36, 35, 37

(56) **References Cited**

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Title 26—Internal Revenue Code, Subtitle A, Chapter 1, Subchapter P, Part V, Subpart A, Sec. 1274, Jan. 26, 1998.

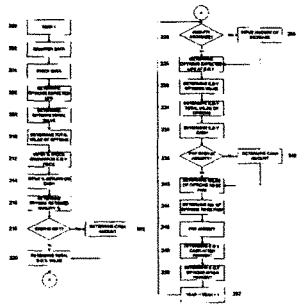
(List continued on next page.)

Primary Examiner—Robert P. Olszewski
Assistant Examiner—Andrew J. Fischer
(74) *Attorney, Agent, or Firm*—Moore & Van Allen PLLC; Matthew W. Witsil; Dominic J. Chiantera

(57) **ABSTRACT**

An estate planning method for minimizing transfer tax liability with respect to the transfer of the value of stock options from a holder of stock options to a family member of the holder. The method comprises establishing a Grantor Retained Annuity Trust (GRAT) funded with nonqualified stock options. The method maximizes the transfer of wealth from the grantor of the GRAT to a family member by minimizing the amount of estate and gift taxes paid. By placing the options outside the grantor's estate, the method takes advantage of the appreciation of the options in said GRAT. In one embodiment the method also maximizes the amount transferred to the family member by keeping as many of the options as possible in the GRAT until immediately prior to the termination of the GRAT, when the grantor substitutes an equivalent value of assets into the GRAT for the remaining options, and then exercises the options. The method is used for evaluation purposes in establishing the GRAT, and responds to a variety of grantor-selected options. An Irrevocable Life Insurance Trust (ILIT) may also be established to provide life insurance should the grantor die before the termination of the GRAT. If the GRAT continues until its natural termination date the ILIT will receive the assets of said GRAT and may purchase further life insurance on the grantor.

25 Claims, 5 Drawing Sheets



US006578016B1

(12) **United States Patent**
Trankina et al.

(10) **Patent No.: US 6,578,016 B1**
(45) **Date of Patent: Jun. 10, 2003**

(54) **TAX ADVANTAGED TRANSACTION STRUCTURE (TATS) AND METHOD**

(76) Inventors: **Timothy Joseph Trankina**, 110 Nature Mill Ct., Alpharetta, GA (US) 30022; **James Dominic Terlizzi**, 750 Pine Chase Ct., Wellington, FL (US) 33414

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/475,826**

(22) Filed: **Dec. 30, 1999**

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/39**
(58) **Field of Search** 705/39

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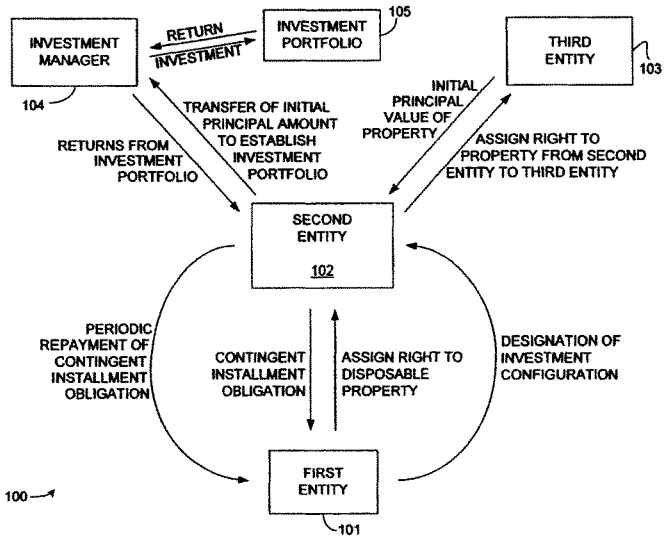
Primary Examiner—Kenneth R. Rice
(74) *Attorney, Agent, or Firm*—Foley & Lardner

(57) **ABSTRACT**

A tax advantage transaction structure (TATS) and method directs that a first entity assigns disposable property it owns to a second entity in exchange for a contingent installment obligation. The disposable property is further assigned by the second entity to a third entity in exchange for monetary proceeds. Second entity then causes an investment manager to invest the monetary proceeds in an investment portfolio containing financial securities selected by the first entity. Returns on the investment portfolio are transferred to the second entity and are thereafter paid to first entity in periodic installments in satisfaction of the contingent installment obligation.

46 Claims, 11 Drawing Sheets



US006601033B1

(12) **United States Patent**
Sowinski

(10) **Patent No.: US 6,601,033 B1**
(45) **Date of Patent: Jul. 29, 2003**

(54) **POLLUTION CREDIT METHOD USING ELECTRONIC NETWORKS**

(76) Inventor: **Richard F. Sowinski**, 996 Arnold Dr., Martinez, CA (US) 94553

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 442 days.

(21) Appl. No.: **09/696,152**

(22) Filed: **Oct. 24, 2000**

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/1**; 705/37; 705/52
(58) **Field of Search** 705/1, 52, 30–32, 705/37; 123/325, 434; 422/900; 110/345; 60/274

(56) **References Cited**

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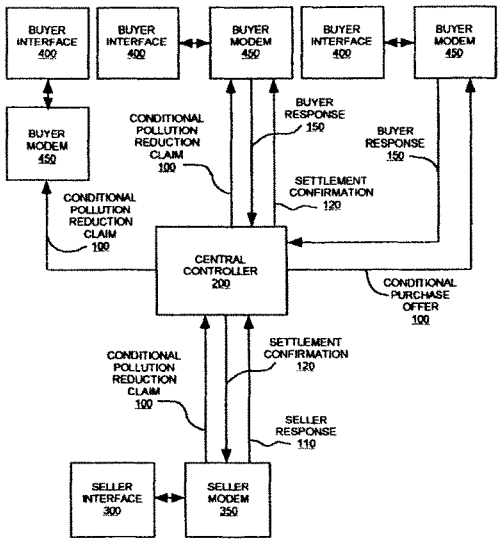
Primary Examiner—James P. Trammell
Assistant Examiner—Mary Cheung
(74) *Attorney, Agent, or Firm*—Harold D. Messner

(57) **ABSTRACT**

The present invention is a method and apparatus for effectuating commerce in claimant-driven individual pollution credits which allows gas utility consumers to claim pollution credit when reducing their pollution levels while employing energy efficiency measures, which has value. Such reduced pollution credit is given value by a third-party, thus, individuals, government agencies and related parties, working in concert with a third-party identify the need, establish ownership, calculate the pollution credit value, and create a new market that has economic value and environmental benefit.

16 Claims, 20 Drawing Sheets



US006609111B1

(12) **United States Patent**
Bell

(10) **Patent No.: US 6,609,111 B1**
(45) **Date of Patent: Aug. 19, 2003**

(54) **METHOD AND APPARATUS FOR MODELING AND EXECUTING DEFERRED AWARD INSTRUMENT PLAN**

(76) Inventor: **Lawrence L. Bell**, 18 Farmington Ct., Chevy Chase, MD (US) 20815

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 64 days.

(21) Appl. No.: **09/690,891**

(22) Filed: **Oct. 18, 2000**

Related U.S. Application Data

(63) Continuation-in-part of application No. 09/177,131, filed on Oct. 22, 1998, now Pat. No. 6,161,096.

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/1; 705/4; 705/35; 707/104.1

(58) **Field of Search** 705/36, 1, 40, 705/30, 35, 37, 38; 707/104.1

(56) **References Cited**

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(List continued on next page.)

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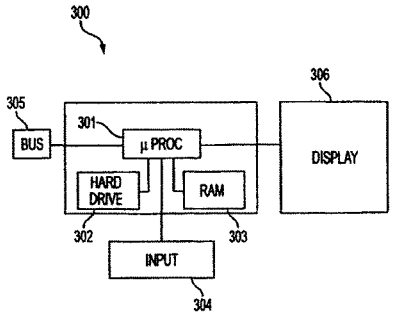
(74) *Attorney, Agent, or Firm*—Dickstein Shapiro Morin & Oshinsky LLP

(57) **ABSTRACT**

The present invention is directed to the administration of various deferred compensation programs that can effectively reduce an individual's income or estate tax by assisting a company in the identification of appropriate employees, and through the use of a novel modeling method and apparatus to implement a deferred compensation program through a novel Rabbi Trust maintenance plan that permits the employees to benefit from their deferred compensation (such as stock options or life insurance benefits), while having a minimal financial impact on the company.

10 Claims, 6 Drawing Sheets



US006625582B2

(12) **United States Patent**
Richman et al.

(10) **Patent No.: US 6,625,582 B2**
(45) **Date of Patent: Sep. 23, 2003**

(54) **METHOD AND SYSTEM FOR CONVERTING A DESIGNATED PORTION OF FUTURE SOCIAL SECURITY AND OTHER RETIREMENT PAYMENTS TO CURRENT BENEFITS**

(75) Inventors: **Richard Paul Richman**, Greenwich, CT (US); **Craig Singer**, Bedford Corners, NY (US)

(73) Assignee: **Richman/Singer Venture**, Greenwich, CT (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/267,255**

(22) Filed: **Mar. 12, 1999**

(65) **Prior Publication Data**

US 2002/0161681 A1 Oct. 31, 2002

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/39

(58) **Field of Search** 705/35

(56) **References Cited**

U.S. PATENT DOCUMENTS

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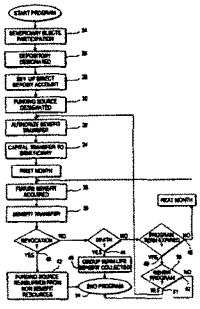
Primary Examiner—V. Millin
Assistant Examiner—Charles R. Kyle
(74) *Attorney, Agent, or Firm*—Kramer Levin Naftalis & Frankel LLP

(57) **ABSTRACT**

A system and method for a beneficiary of Social Security payments or other retirement payments to access present value of future benefits to meet current financial and other objectives is provided. A financial institution is designated to be a direct depository and a disbursement agent for disbursing, at the direction of the beneficiary predetermined portions of retirement payments to a funding source or asset or service provider in exchange for access to capital or the acquisition of an asset or service by the beneficiary in an amount or having a value at least in part based on present value of a designated portion of future retirement payments. In the event of the premature termination of the beneficiary's participation in the program, the funding source or asset or service provider may seek reimbursement of a specified amount relating to the capital or asset or service it made available to the beneficiary, but not from subsequent retirement payments. In the event that the beneficiary dies during the term of the program, the funding source or asset or service provider are precluded from looking to a surviving spouse's share of remaining retirement payments, or from the beneficiary's estate, for reimbursement of any sustained loss, nor can it have any remaining interest in any asset acquired or service obtained by the beneficiary under the program. The funding source or asset or service provider can insure against the risk by purchasing group term life insurance in its favor covering all beneficiaries participating in the program.

34 Claims, 3 Drawing Sheets



US006687681B1

(12) **United States Patent**
Schulz et al.

(10) **Patent No.: US 6,687,681 B1**
(45) **Date of Patent: Feb. 3, 2004**

(54) **METHOD AND APPARATUS FOR TAX EFFICIENT INVESTMENT MANAGEMENT**

(75) Inventors: **David W. Schulz**, Mequon, WI (US); **John M. Blaser**, Mequon, WI (US); **Daniel Patrick Brown**, Wauwatosa, WI (US); **Todd Hanson**, Thiensville, WI (US)

(73) Assignee: **Marshall & Ilsley Corporation**, Milwaukee, WI (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

(21) Appl. No.: **09/322,412**

(22) Filed: **May 28, 1999**

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/36**; 705/37
(58) **Field of Search** 705/36, 37, 35, 705/39

(56) **References Cited**

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Chase (Manhattan Private Bank)—Vogel Consulting Group, S.C., Chase Tax–Efficient Portfolio (TEP), pp. 5–11, Dec. 5, 1998.

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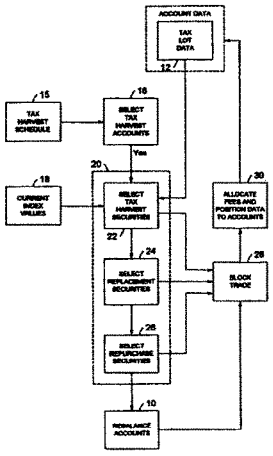
Primary Examiner—Richard Chilcot
(74) *Attorney, Agent, or Firm*—Reinhart Boerner Van Deuren s.c.

(57) **ABSTRACT**

A method and apparatus for automatically managing investment portfolios to substantially track a selected index and to automatically harvest tax losses is disclosed. Preferably, the system comprises an accounting system for maintaining tax lot information for individual accounts, an optimization system for rebalancing each account to substantially model the index and for harvesting tax losses, and a trading system for executing trades. Each investor owns the securities in his account, and therefore, harvested losses can be used to offset capital gains. The period between successive optimization procedures is selected to avoid application of the internal revenue service wash sale rules.

18 Claims, 3 Drawing Sheets



US006760709B2

(12) **United States Patent**
Graff

(10) **Patent No.: US 6,760,709 B2**
(45) **Date of Patent: *Jul. 6, 2004**

(54) **AUGMENTED SYSTEM AND METHODS FOR COMPUTING TO SUPPORT FRACTIONAL CONTINGENT INTERESTS IN PROPERTY**

(75) Inventor: **Richard A. Graff**, Chicago, IL (US)

(73) Assignee: **Graff-Ross Holdings**, Chicago, IL (US)

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 0 days.

This patent is subject to a terminal disclaimer.

(21) Appl. No.: **09/742,495**

(22) Filed: **Dec. 20, 2000**

(65) **Prior Publication Data**

US 2003/0069817 A1 Apr. 10, 2003

Related U.S. Application Data

(63) Continuation of application No. 09/145,341, filed on Sep. 1, 1998, now Pat. No. 6,167,384.

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/1

(58) **Field of Search** 705/1, 35, 36

(56) **References Cited**

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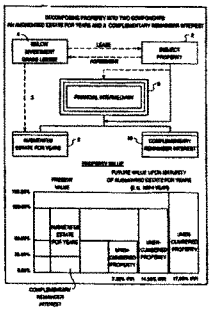
Primary Examiner—Susanna Meinecke-Diaz
(74) *Attorney, Agent, or Firm*—Peter K. Trzyna, Esq.

(57) **ABSTRACT**

A computer system, and methods for making and using it, for changing digital electrical signals to generate a valuation of a fractional interest in a contingent interest in property, the computer apparatus including: an input device operable for converting input data representing property into input digital electrical signals representing the input date; a digital electrical computer having a processor, the processor electrically connected to the input device to receive the input digital electrical signals, the processor programmed to change3 the input digital electrical signals to produce modified digital electrical signals representing a valuation of a fractional interest in a contingent interest in the property associated with at least one lease default condition for the property; a memory electrically connected to the processor; and wherein the processor manipulates further digital electrical signals to generate at least one document for the contingent interest by inserting the valuation in pre-existing text data obtained from the memory; and an output device electrically connected to the processor to print the document.

202 Claims, 17 Drawing Sheets



US 20030105700A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105700 A1**

Brown et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **METHOD AND APPARATUS FOR ESTABLISHING AND ADMINISTERING A WEALTH TRANSFER PLAN**

(75) Inventors: **Michael D. Brown**, Irvine, CA (US); **Jonathan G. Blattmachr**, Garden City, NY (US)

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(73) Assignee: **Spectrum Group Investments, LLC**

(21) Appl. No.: **10/043,989**

(22) Filed: **Jan. 9, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/337,758, filed on Dec. 3, 2001.

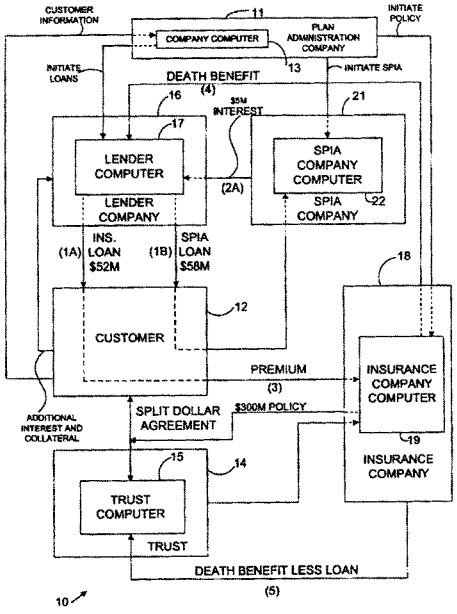
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/38

(57) **ABSTRACT**

A system and method for the efficient transfer of wealth is disclosed. The system comprises a transferor having wealth and a transferee intended to be the recipient of transferred wealth. The transferee may be a trust. An insurance policy purchased by the transferee is subject to a split-dollar agreement by which the death benefit of the policy is assigned to a the transferor in exchange for payment of at least the death-benefit portion of the premiums. When sufficient premiums have been paid to effectuate the policy for the life of the insured, the split-dollar agreement may be canceled, reverting full ownership in the policy to the transferee.



US 20030105697A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105697 A1**

Griffin et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **SYSTEMS AND METHODS FOR RULE-BASED LOT SELECTION OF MUTUAL FUNDS**

(76) Inventors: **Theresa McGuire Griffin**, Hingham, MA (US); **Lisa-Marie Ardita**, Holbrook, MA (US); **John Andrews**, Duxbury, MA (US); **Barbara Donahue**, Watertown, MA (US); **John D. Fitch**, Framingham, MA (US); **John Mahoney**, Middleton, MA (US)

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(21) Appl. No.: **09/999,512**

(22) Filed: **Oct. 25, 2001**

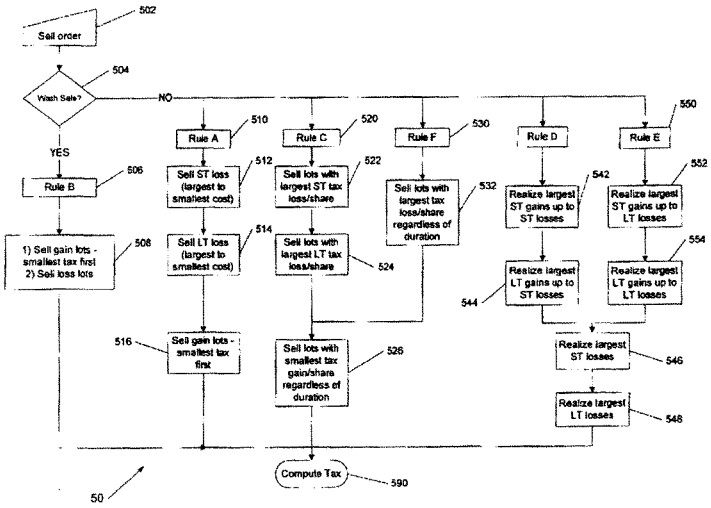
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

A computer-based system and method is disclosed that allow a custodian or fund accounting agent of a mutual fund to select lots in the portfolio inventory based on predefined rules to maximize the fund's after tax return. If no rule is stipulated, the process automatically compares tax consequences for possible combinations of buy and sell lots of a security under the various business rules and selects the rule for the particular trade that results in the most favorable tax for the fund.



US 20020198797A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0198797 A1**

Cooper et al. (43) **Pub. Date: Dec. 26, 2002**

(54) **METHOD FOR ASSESSING EQUITY ADEQUACY**

(76) Inventors: **Christine M. Cooper**, Hornchurch Essex (GB); **Mike Gulkewicz**, Canton, MI (US); **Mario Spivak**, Ann Arbor, MI (US); **Mark Turner**, West Bloomfield, MI (US); **Neil Schloss**, West Bloomfield, MI (US); **Paul Duncan McCarthy**, Ann Arbor, MI (US); **Ron Alan Pollard**, Novi, MI (US); **Yong Yang**, Ann Arbor, MI (US)

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(21) Appl. No.: **09/681,902**

(22) Filed: **Jun. 22, 2001**

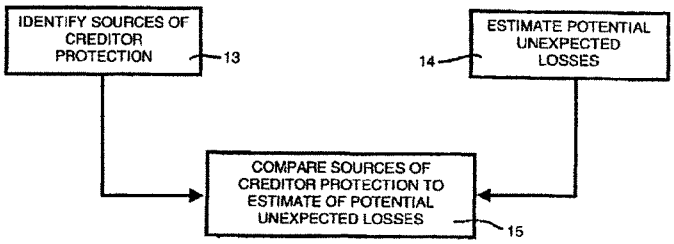
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

Risk-based method for assessing an automotive finance company's equity adequacy wherein sources of creditor protection comprises equity, reserves, net deferred tax liability in the event of an overall loss, future tax liability and lifetime profits. Potential unexpected worst-case losses for each of a plurality of exposures is estimated with 99.9% confidence and compared with the company's creditor protection to demonstrate the company's equity adequacy.



US 20020194136A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0194136 A1**

Sullivan et al. (43) **Pub. Date: Dec. 19, 2002**

(54) **HEDGING EMPLOYEE STOCK OPTIONS**

(76) Inventors: **Colleen Sullivan**, Chicago, IL (US); **Joseph Klein**, Chicago, IL (US); **Joseph Kelly**, Chicago, IL (US)

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Chicago, IL 60601 (US)

(21) Appl. No.: **10/126,756**

(22) Filed: **Apr. 19, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/285,660, filed on Apr. 20, 2001.

Publication Classification

(51) **Int. Cl.**[7] **H04K 1/00**; H04L 9/00; G06F 17/60

(52) **U.S. Cl.** **705/64**

(57) **ABSTRACT**

The present disclosure creates an efficient process, from both a regulatory and tax perspective, for individuals to hedge employee stock options. First, the present disclosure provides that no margin is required for a listed call option written on an equity security when the account holds a "long" position in a vested employee stock option which can be immediately exercised without restriction (not including the payment of money) to purchase an equal or greater quantity of the security underlying the listed option provided that the vested employee stock option does not expire before the short listed call option, and provided that the amount (if any) by which the exercise price of the vested employee stock option exceeds the exercise price of the short listed call option is held in or deposited to the account. Second, the present disclosure makes it possible to treat the return on a listed option or over-the-counter option hedge of vested or unvested employee stock options as ordinary instead of capital, thus avoiding the mismatch with the employee stock options' ordinary return and the potential capital loss on the listed option or over-the-counter option hedge. This disclosure treats any losses arising on a closing transaction with respect to the short listed call option as ordinary losses, provided the optionee makes a valid hedging election pursuant to Internal Revenue Code Section 1221(a)(7).

US 20020178039A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0178039 A1**

Kennedy (43) **Pub. Date: Nov. 28, 2002**

(54) **ACCELERATED TAX REDUCTION PLATFORM**

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(21) Appl. No.: **10/153,093**

(22) Filed: **May 22, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/292,652, filed on May 22, 2001.

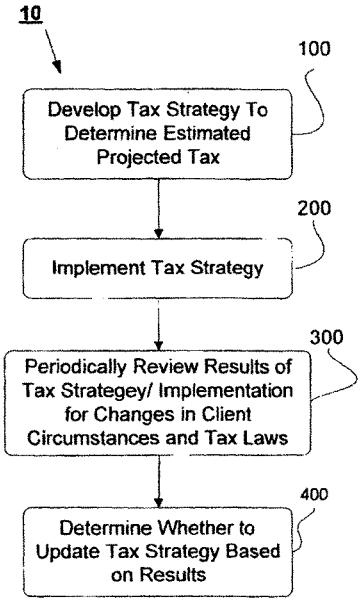
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/7**; 705/31

(57) **ABSTRACT**

Methods and systems are disclosed for reducing a tax burden, one such method including: developing a tax strategy to determine an estimated projected tax, implementing the tax strategy, reviewing results of the implemented tax strategy for changes in taxpayer circumstances and tax laws, determining whether to update the tax strategy based on the reviewed results. Developing the tax strategy may include: collecting taxpayer information, processing the collected information to determine a suggested tax strategy, and determining action items to implement the suggested tax strategy. Implementing the tax strategy may include: developing a list of specific steps to implement the action items, and determining a timeline for performing the specific steps. A system for selecting appropriate business entities based on taxpayer circumstances is also disclosed. The invention also discloses computer programs and systems for reducing a tax burden.



US 20020174017A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0174017 A1**

Singh et al. (43) **Pub. Date: Nov. 21, 2002**

(54) **DEVELOPING PROPERTY TAX DATA**

(76) Inventors: **Somesh Singh**, Houston, TX (US); **Giridhar Iyer**, Houston, TX (US)

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(21) Appl. No.: **09/862,779**

(22) Filed: **May 21, 2001**

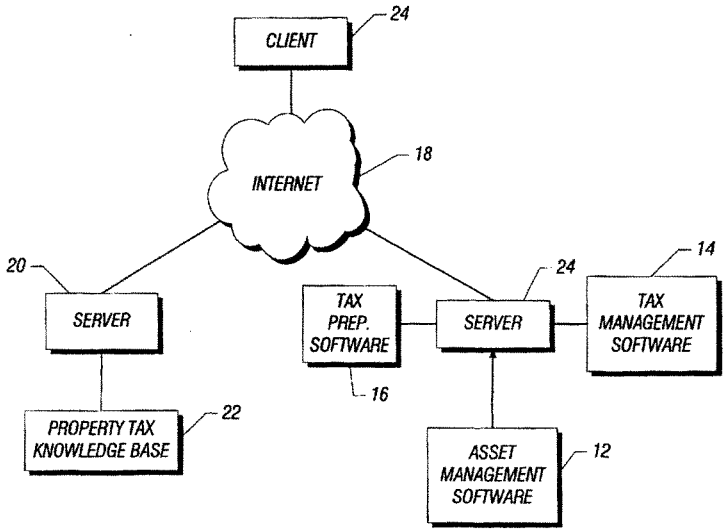
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/19**

(57) **ABSTRACT**

Property tax data may be mined from existing asset databases. These databases commonly do not communicate with other databases since they are developed for specialized purposes. By mining tax sensitive data from the databases, tax management software may develop information for property tax compliance or tax planning purposes. For example, information about property tax exemptions and possible exclusions may be mined from the data together with information about the assets' location which may be important to allocating assets to particular tax jurisdictions.



US 20020161684A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0161684 A1**

Whitworth (43) **Pub. Date: Oct. 31, 2002**

(54) **METHOD OF CREATING NEW SECURITIES FROM EQUITIES: SEPARATELY TRADABLE REGISTERED INDEPENDENT DIVIDEND AND EQUITY SECURITIES ("STRIDES")**

(76) Inventor: **Brian L. Whitworth**, Malibu, CA (US)

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(21) Appl. No.: **09/844,972**

(22) Filed: **Apr. 27, 2001**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Methods are disclosed for creating new types of securities, including equity dividend strips, equity dividend strip futures, equity dividend strip options, new index fund stocks, new mutual fund investments, and related securities are created in consideration of the cash dividends paid by companies issuing the original stock. Similar financial products are created for nondividend paying stock.

Additionally, the principles of the present invention can be employed to provide new corporate financing methods which make use of the aforementioned securities. An example of such a new method is the issuance of original common stock with a detachable dividend strip.

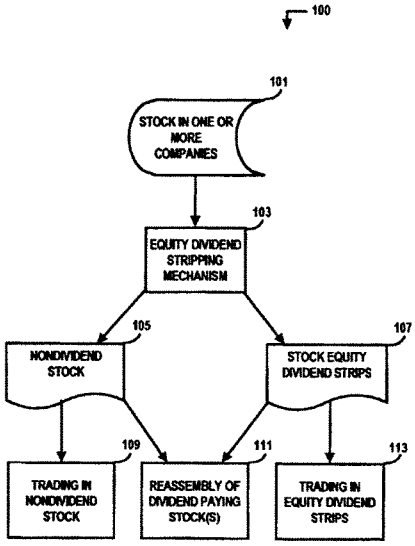
Purchase both and put the dividend strip into your retirement account.

Purchase both and donate the dividend strip to charity.

Give the dividend strip to a minor child, or a child in college.

The stock does not need to be paying dividends at the time the dividend strip is created. The dividend strip covers all future dividends, even if there are none now.

Investors can set dividend policy themselves, as long at the constraint is met: total dividends paid by company=total dividend received by security holders. Many security holders will have only stripped stock, or only stripped dividend.



US 20020161682A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0161682 A1**

Ewing et al. (43) **Pub. Date: Oct. 31, 2002**

(54) **COMPUTERIZED SYSTEM AND METHOD USED IN FINANCIAL AND RETIREMENT PLANNING**

(76) Inventors: **Anton A. Ewing**, Phoenix, AZ (US); **William Everts**, Phoenix, AZ (US)

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(21) Appl. No.: **09/793,450**

(22) Filed: **Feb. 27, 2001**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

This invention is directed to a computer-implementable process for calculating financial retirement needs or whether a future financial needcan be met based on current financial vehicles, through the use of multiple categories or classes of assets. The main reason that different categories or classes of assets are employ is due to different treatments of each class or financial vehicle under the US Tax Code.

US 20020161681A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0161681 A1**

RICHMAN et al. (43) **Pub. Date: Oct. 31, 2002**

(54) **METHOD AND SYSTEM FOR CONVERTING A DESIGNATED PORTION OF FUTURE SOCIAL SECURITY AND OTHER RETIREMENT PAYMENTS TO CURRENT BENEFITS**

(76) Inventors: **RICHARD PAUL RICHMAN**, GREENWICH, CT (US); **CRAIG SINGER**, BEDFORD CORNERS, NY (US)

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(*) Notice: This is a publication of a continued prosecution application (CPA) filed under 37 CFR 1.53(d).

(21) Appl. No.: **09/267,255**

(22) Filed: **Mar. 12, 1999**

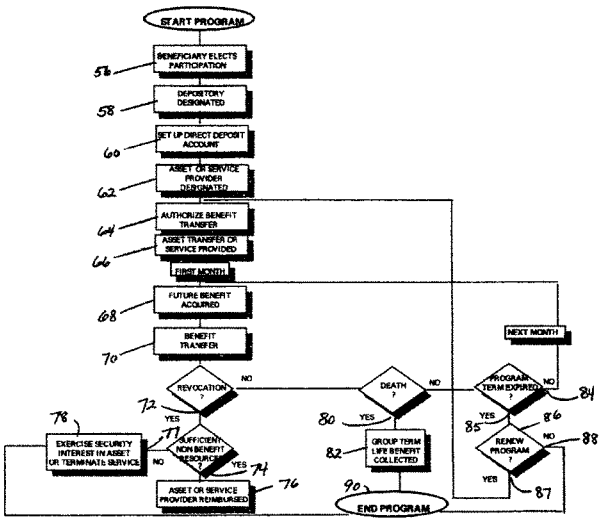
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/35

(57) **ABSTRACT**

A system and method for a beneficiary of Social Security payments or other retirement payments to access present value of future benefits to meet current financial and other objectives is provided. A financial institution is designated to be a direct depository and a disbursement agent for disbursing, at the direction of the beneficiary predetermined portions of retirement payments to a funding source or asset or service provider in exchange for access to capital or the acquisition of an asset or service by the beneficiary in an amount or having a value at least in part based on present value of a designated portion of future retirement payments. In the event of the premature termination of the beneficiary's participation in the program, the funding source or asset or service provider may seek reimbursement of a specified amount relating to the capital or asset or service it made available to the beneficiary, but not from subsequent retirement payments. In the event that the beneficiary dies during the term of the program, the funding source or asset or service provider are precluded from looking to a surviving spouse's share of remaining retirement payments, or from the beneficiary's estate, for reimbursement of any sustained loss, nor can it have any remaining interest in any asset acquired or service obtained by the beneficiary under the program. The funding source or asset or service provider can insure against the risk by purchasing group term life insurance in its favor covering all beneficiaries participating in the program.



US 20020138384A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0138384 A1**

Malackowski et al. (43) **Pub. Date: Sep. 26, 2002**

(54) **SYSTEM FOR AND METHOD OF RISK MINIMIZATION AND ENHANCED RETURNS IN AN INTELLECTUAL CAPITAL BASED VENTURE INVESTMENT**

(76) Inventors: **James E. Malackowski**, Chicago, IL (US); **David A. Kennedy**, Marietta, GA (US); **Roger L. May**, Fennville, MI (US)

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(21) Appl. No.: **09/814,547**

(22) Filed: **Mar. 22, 2001**

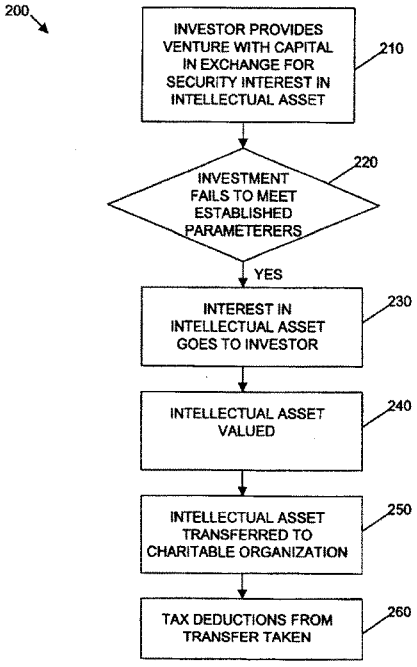
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/35

(57) **ABSTRACT**

The disclosure relates to an investment risk minimization system involving a venture capital investor and a venture needing investment from the venture capital investor. In such a system, an exemplary method can include providing an investment to a venture having an intellectual asset, and receiving a security interest in the intellectual asset. The security interest secures an ownership right upon failure by the venture to meet established parameters. Further, if the venture receiving the investment fails to meet the established parameters, the method includes obtaining an ownership interest in the intellectual asset, valuing the intellectual asset, and transferring the intellectual asset to a charitable organization.



US 20020111815A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0111815 A1**

Smith (43) **Pub. Date: Aug. 15, 2002**

(54) **SYSTEM AND METHOD FOR ENABLING USERS OF GAMING ACTIVITIES TO AUTOMATE THEIR TAX DEDUCTIBLE AND CHARITABLE CONTRIBUTIONS**

(75) Inventor: **Gordon James Smith**, Rochester, MN (US)

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(73) Assignee: **International Business Machines Corporation**

(21) Appl. No.: **09/781,010**

(22) Filed: **Feb. 9, 2001**

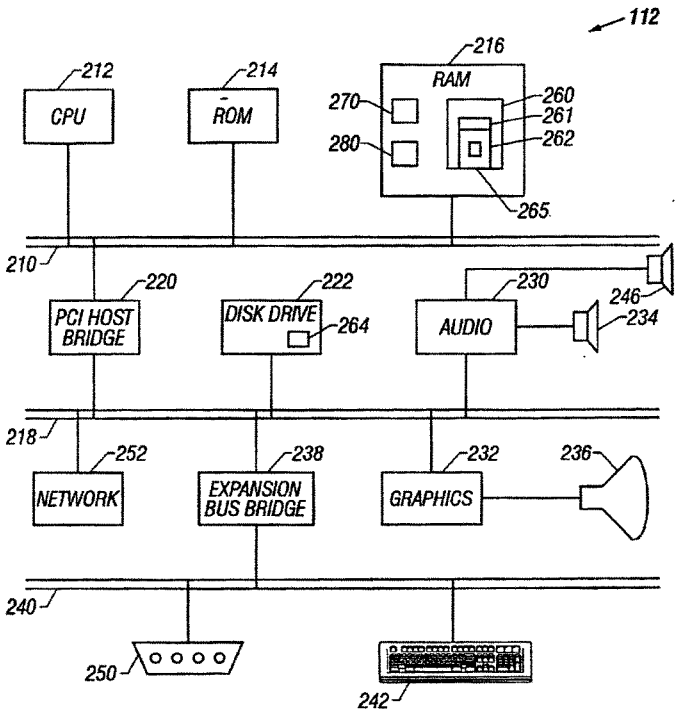
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/1**

(57) **ABSTRACT**

A business method and system for making charitable contributions allows users of gaming systems, such as games of chance, to automatically improve their odds of winning or potential payout amount. The system enables gaming system users to designate a portion of their funds or net proceeds from gaming activities to be donated to charity of their choice. The donations are automatically made and funded to authorized charities or non-profit organizations and the balance of the net proceeds are distributed to the players. In addition, the system also complies with any Internal Revenue Service reporting that is required by law.



US 20020087365A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0087365 A1**

Kavanaugh (43) **Pub. Date: Jul. 4, 2002**

(54) **SYSTEM FOR FUNDING, ANALYZING AND MANAGING LIFE INSURANCE POLICIES FUNDED WITH ANNUITIES**

(76) Inventor: **Bart Kavanaugh**, Manhattan Beach, CA (US)

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(21) Appl. No.: **09/986,670**

(22) Filed: **Nov. 9, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/246,755, filed on Nov. 9, 2000. Non-provisional of provisional application No. 60/286,344, filed on Apr. 26, 2001.

Publication Classification

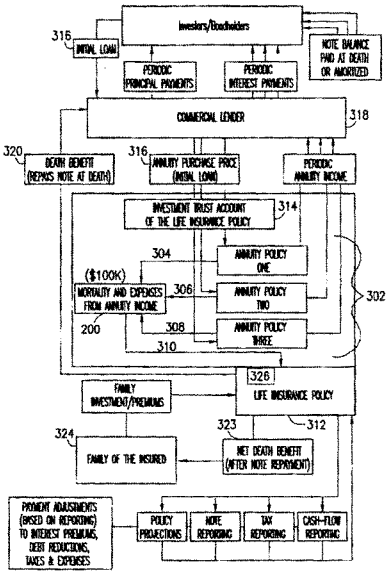
(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

The invention relates to a program that administers a method of funding life insurance policies using annuities that are purchased at least in part using borrowed money, using business and trust structures to reduce and/or eliminate tax. This investing can be done either directly by the policy or through the trust and/or other business entity. As an internal investment of the insurance policy the income generated by the annuity and the inside build-up are non-income taxable to the owner of the policy. The resulting death benefits will also be non-income taxable to the beneficiary.

Embodiment One



US 20020077955A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0077955 A1**

Ramm (43) **Pub. Date: Jun. 20, 2002**

(54) **FULL MATURITY OPTION BOND FUND**

(76) Inventor: **Henry L. Ramm**, Seabrook, TX (US)

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(21) Appl. No.: **09/738,414**

(22) Filed: **Dec. 15, 2000**

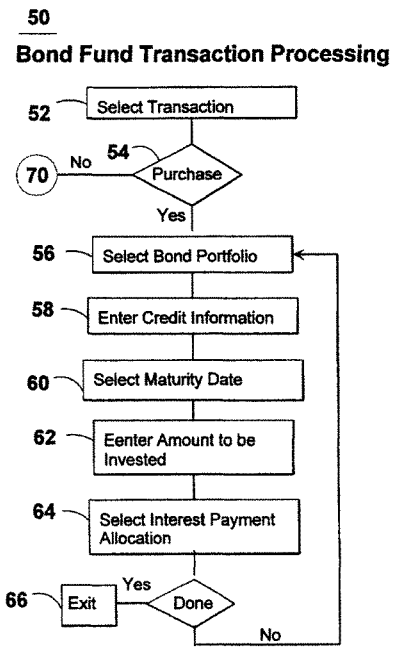
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/37**

(57) **ABSTRACT**

The invention is a full maturity option bond fund that provides a bond fund wherein the investors have the option of specifying maturity dates for their investment that coincide with the maturity date of a debt securities held by the bond fund manager. Whereby the investor having held his bond fund investment until the debt security matures receives the full face value of the original investment. The invention also allows the investor to receive a cash credit for interest received relative to each maturity date selected less fund fees. The interest could be withdrawn as cash or reinvested in the fund at a selected maturity date.



US 20020059127A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0059127 A1**

Brown et al. (43) **Pub. Date: May 16, 2002**

(54) **METHOD AND APPARATUS FOR TAX EFFICIENT INVESTMENT MANAGEMENT**

(76) Inventors: **Daniel P. Brown**, Wauwatosa, WI (US); **David W. Schulz**, Mequon, WI (US)

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(21) Appl. No.: **10/051,893**

(22) Filed: **Jan. 18, 2002**

Related U.S. Application Data

(63) Continuation-in-part of application No. 09/322,412, filed on May 28, 1999.

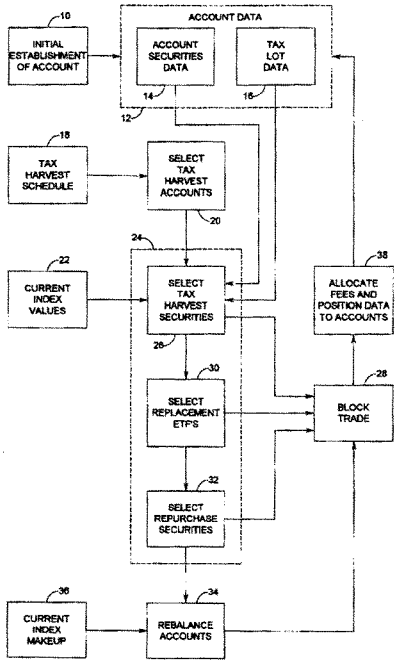
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/37

(57) **ABSTRACT**

A method and apparatus for automatically managing investment portfolios is disclosed which substantially tracks a selected index and automatically harvests tax losses. The system includes an accounting system for maintaining tax lot information for individual accounts, an optimization system for rebalancing each account to substantially model the index and for harvesting tax losses, and a trading system for executing trades. Each investor owns the securities in his/her account, and therefore, harvested losses can be used to offset capital gains. Securities sold to harvest tax losses are repurchased at a later time selected to avoid application of the Internal Revenue Service wash sale rules, with exchange traded funds (ETF's) from the same technological sector as the securities being sold to harvest tax losses being used as temporary replacement securities for the portfolios.



US 20020013754A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0013754 A1**

Frank et al. (43) **Pub. Date: Jan. 31, 2002**

(54) **FINANCIAL OPTIMIZATION SYSTEM AND METHOD**

(76) Inventors: **Glenn Frank**, Burlington, MA (US); **Jay Whittaker**, Wellesley Hills, MA (US)

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(21) Appl. No.: **09/825,426**

(22) Filed: **Apr. 3, 2001**

Related U.S. Application Data

(63) Continuation-in-part of application No. 09/346,602, filed on Jul. 2, 1999, now Pat. No. 6,240,399. Non-provisional of provisional application No. 60/194,158, filed on Apr. 3, 2000.

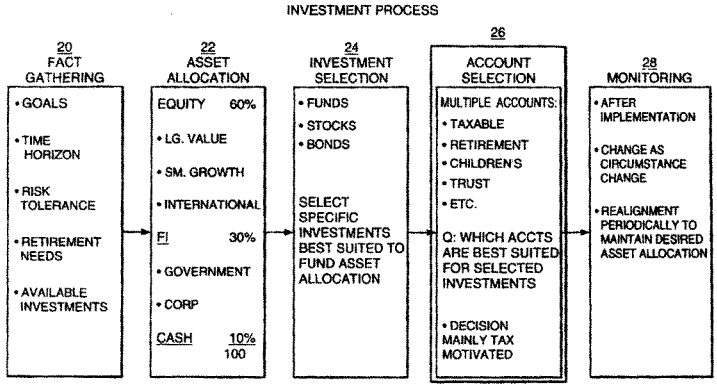
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

An improved investment optimizing system and method. Once an investor or investment advisor determines the appropriate asset allocation and that there are both taxable accounts and tax-deferred or tax-free investment accounts, the invention will optimize/maximize the investor's ending after-tax asset accumulation, which is the objective of all investors. This is accomplished by allocating the chosen investment vehicles between the taxable and tax-deferred accounts in an optimum way. The invention runs on a computer system and searches for an allocation which results in a maximal return. Intelligent heuristics measure increased performance based on different asset allocations.



US 20020013750A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0013750 A1**

Roberts et al. (43) **Pub. Date: Jan. 31, 2002**

(54) **METHODS AND INVESTMENT INSTRUMENTS FOR PERFORMING TAX-DEFERRED REAL ESTATE EXCHANGES**

(75) Inventors: **Neal Roberts**, Santa Monica, CA (US); **Michael Franklin**, Carlsbad, CA (US); **Charles Runnels**, Scottsdale, AZ (US); **James Andrews**, Los Angeles, CA (US)

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(73) Assignee: **American Master Lease, L.L.C.**, Los Angeles, CA

(21) Appl. No.: **09/956,372**

(22) Filed: **Sep. 17, 2001**

Related U.S. Application Data

(63) Continuation of application No. 09/205,633, filed on Dec. 3, 1998, now Pat. No. 6,292,788.

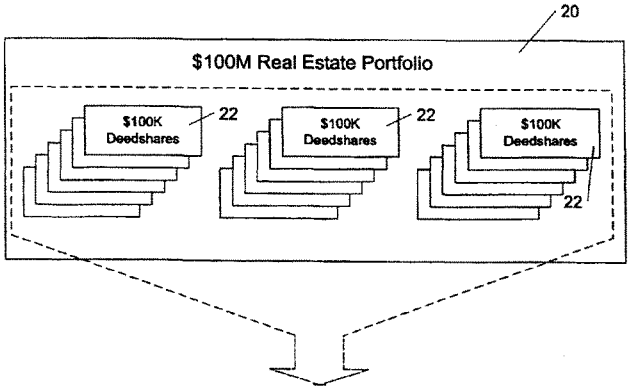
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/36; 705/37

(57) **ABSTRACT**

Methods and investment instruments for investing in real estate are described wherein a portfolio of investment real estate is divided into a plurality of tenant-in-common deeds of predetermined denominations, and which are subject to a master agreement and master lease to form "deedshares." Holders of the deedshares receive a guaranteed income stream from the master lease and yearly depreciation, without having to maintain or manage the real estate. The holders of deedshares are subject, under the master agreement, to a mechanism that enables the master tenant to purchase, or arrange for the purchase of the deedshares at fair market value (or some other calculable value) at the end of a specified term. Because the deedshares qualify as interests in investment real estate, they are eligible for tax-deferred treatment under §1031 of the Internal Revenue Code.



US 20020010674A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0010674 A1**

Kent (43) **Pub. Date: Jan. 24, 2002**

(54) **METHOD OF PROVIDING TAX CREDITS AND PROPERTY RENTAL AND PURCHASE**

(76) Inventor: **Carl E. Kent**, Fridley, MN (US)

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(21) Appl. No.: **09/843,191**

(22) Filed: **Apr. 26, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/224,198, filed on Aug. 9, 2000. Non-provisional of provisional application No. 60/207,492, filed on May 26, 2000.

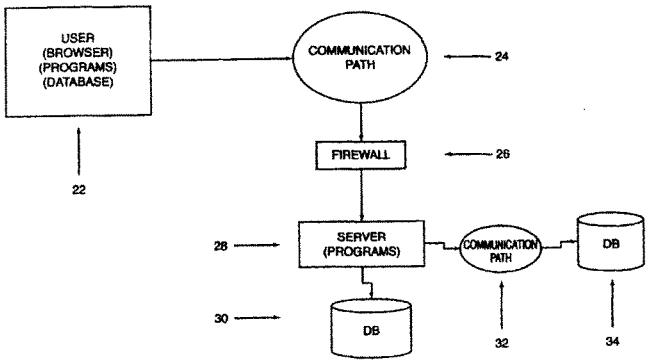
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/37**; 705/14; 705/26

(57) **ABSTRACT**

The present invention offers a comprehensive distribution system for tax credits and property rental and purchase, that allows corporate, institutional, and individual investors to compete for the purchase of tax credits attached to real estate offered by the issuer, by facilitating tax credit trading into specialized markets, and allows prospective renters and purchasers to search through available single family and multi-family dwellings, and do business with the seller/owner.



US 20020004771A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0004771 A1**

McCain (43) **Pub. Date: Jan. 10, 2002**

(54) **EMPLOYEE DEFERRED INCOME SYSTEM AND METHOD**

(76) Inventor: **Amos Eugene McCain**, Miami, FL (US)

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(21) Appl. No.: **09/865,410**

(22) Filed: **May 25, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/206,962, filed on May 25, 2000.

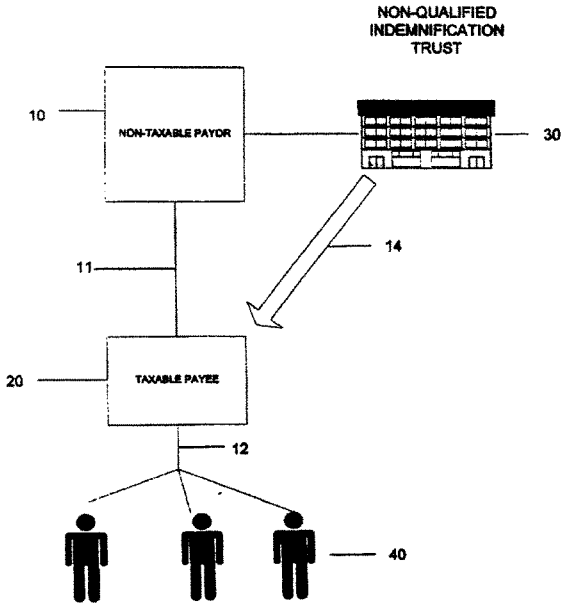
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

The present invention provides a system and method for setting up an employee deferred income plan that may preferably be utilized for various purposes such as to delay taxation of the deferred amounts, to avoid inclusion of the deferred amounts in the income of the employer, to avoid the possibility that the employer's creditors can obtain the deferred amount, and to permit any percentage of the employees income to be deferred. The plan provides that a taxable employer has an agreement with a non-taxable entity regarding income due to the taxable employer from the non-taxable entity. Under the agreement, the non-taxable entity or an agent thereof will remit to an indemnification trust fund an amount equal to the employee's elected deferred amount in order to indemnify the taxable employer for the deferred amount which the taxable employer has promised to pay the employee upon the occurrence of a payable event. In a preferred embodiment, the entire balance of the undistributed corpus of the deferral account is subject to a risk of forfeiture for the entire payout period, as periodic payable events occur over time, thereby dissipating the account assets to zero.



US 20010056391A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2001/0056391 A1**

Schultz (43) **Pub. Date: Dec. 27, 2001**

(54) **METHOD AND APPARATUS FOR MANAGING AND OPTIMIZING STOCK OPTIONS**

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(21) Appl. No.: **09/759,337**

(22) Filed: **Jan. 16, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/176,032, filed on Jan. 14, 2000.

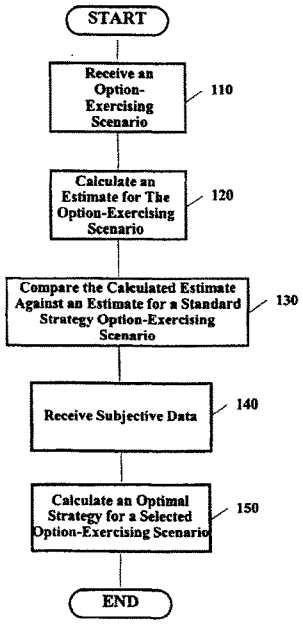
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**; 705/26; 705/37

(57) **ABSTRACT**

The present invention relates to stock options, and more specifically to a method and system for managing and optimizing stock options via a communications network. In an embodiment of the present invention, a method of optimizing the value of stock option grants using a communications network includes: receiving an option-exercising scenario for a stock option grant; calculating an estimate for the option-exercising scenario for the stock option grant; comparing the estimate for the option-exercising scenario for the stock option grant against an estimate based on a standard strategy option-exercising scenario; and calculating an optimal strategy to maximize the value of the stock option grant based on one of the estimate for the to option-exercising scenario for the stock option grant and the estimate based on the standard strategy option-exercising scenario.



US 20010049612A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2001/0049612 A1**

Davis (43) **Pub. Date: Dec. 6, 2001**

(54) **SURVIVOR'S BENEFIT PLAN**

(75) Inventor: **Philip T. Davis**, Danbury, CT (US)

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(21) Appl. No.: **09/853,566**

(22) Filed: **May 10, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/203,521, filed on May 10, 2000.

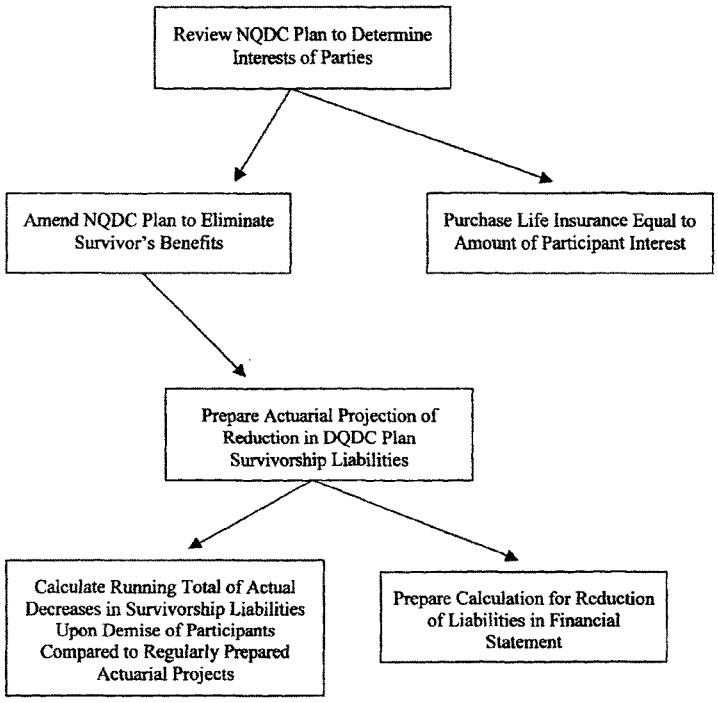
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

A method for providing deferred compensation to an employee's beneficiary is disclosed, whereby the benefit takes the form of insurance policy proceeds payable to an employee's beneficiary, and wherein the deferred compensation is paid to the beneficiary in an income and estate tax free manner.



US 20010037275A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2001/0037275 A1**

Johnson et al. (43) **Pub. Date: Nov. 1, 2001**

(54) **SYSTEM AND METHOD FOR GIVING APPRECIATED ASSETS**

(75) Inventors: **Donald Edward Johnson**, Belmont, MA (US); **Duane Allen Steward**, Orlando, FL (US)

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(73) Assignee: **AssetStream Corp.**, 400 Unicorn Park Dr., Woburn, MA (US)

(21) Appl. No.: **09/767,031**

(22) Filed: **Jan. 22, 2001**

Related U.S. Application Data

(63) Non-provisional of provisional application No. 60/177,722, filed on Jan. 21, 2000.

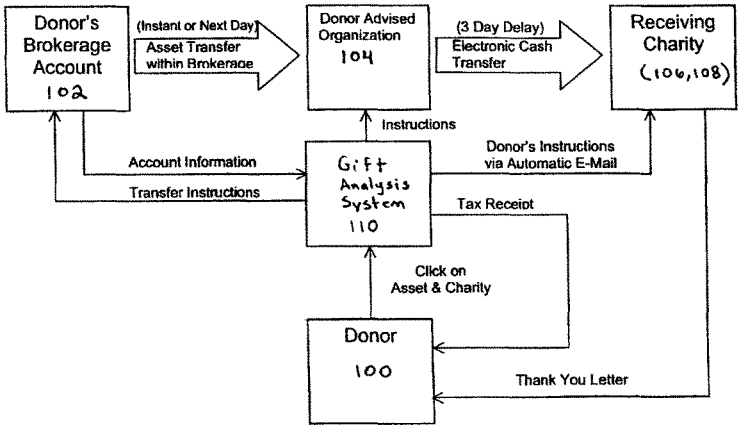
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Giving appreciated assets is accomplished by analysis and processing for tax-advantaged asset transfer to charity. Easy access to sophisticated evaluation tools for choosing gifts that maximize tax-efficient giving; fully automated transfer mechanism for giving appreciated assets on a continuing basis (e.g., monthly or quarterly); speed of transfer; "point, click and give" ease of transferring assets to charity; removal of wealth barriers in the area of asset gifting; back-office support for the transfer of assets to charities and donor advised organizations; and an ability to gift unrealized gains (while keeping 100% of the basis) through currently existing hedge funds is provided.



US 20010011223A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2001/0011223 A1**

BURKE (43) **Pub. Date: Aug. 2, 2001**

(54) **SYSTEM, METHOD AND APPARATUS FOR PROVIDING AN EXECUTIVE COMPENSATION SYSTEM**

(76) Inventor: **THOMAS W. BURKE**, DALLAS, TX (US)

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(*) Notice: This is a publication of a continued prosecution application (CPA) filed under 37 CFR 1.53(d).

(21) Appl. No.: **09/167,633**

(22) Filed: **Oct. 6, 1998**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**; 705/35

(57) **ABSTRACT**

The present invention provides a system, method and apparatus for providing an executive compensation system having a first entity, a money lender, and an insurer. The first entity receives a taxable sum of money from a second entity, which owes the taxable sum of money to a person. The first entity provides one or more periodic payments to the person until the person dies, wherein the one or more periodic payments determined from the taxable sum of money and the person's life expectancy. The money lender loans a non-taxable sum of money to the person and in return receives one or more periodic interest payments from the person. The non-taxable sum of money is determined from a fixed rate of interest and the one or more periodic interest payments that are substantially equivalent to the one or more periodic payments. The insurer provides a life insurance policy for the person's life such that the life insurance policy pays a death benefit substantially equivalent to the non-taxable sum of money.

US 20030105691A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105691 A1**

Brown et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **METHOD AND APPARATUS FOR TRANSFERRING WEALTH**

(75) Inventors: **Michael D. Brown**, Irvine, CA (US); **Jonathan G. Blattmachr**, Garden City, NY (US)

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(73) Assignee: **Spectrum Group Investments, LLC**

(21) Appl. No.: **10/043,990**

(22) Filed: **Jan. 9, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/337,758, filed on Dec. 3, 2001.

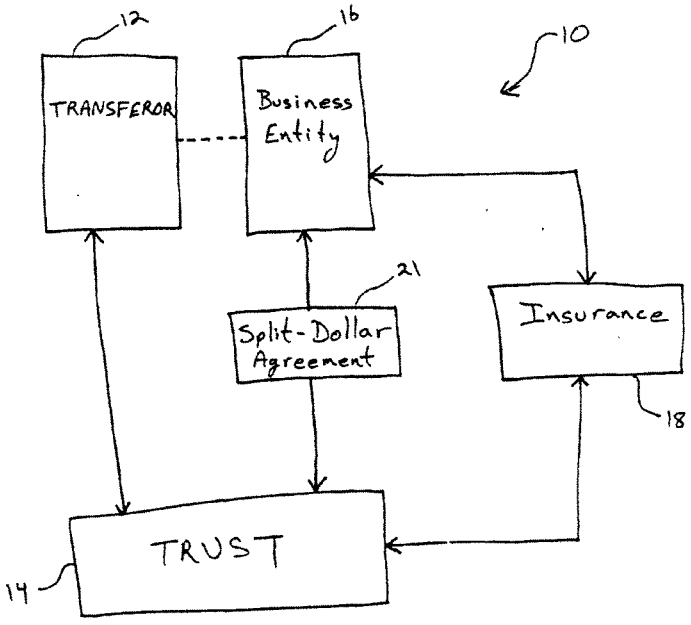
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

A system and method for the efficient transfer of wealth is disclosed. The method comprises gathering information on the amount of wealth to be transferred from a transferor to a transferee; determining the amount of life insurance premium for an insurance policy on the life of an insured individual to be substantially equal to the amount of the wealth to be transferred; and appraising a present value of a cash value of the insurance policy. The policy comprises a cash value and a term benefit. The transferee owns the term benefit, and an entity owns said cash value. The entity may be owned by the transferor. The appraising is based on a mortality risk of the insured individual and a value of the cash value during each year of a projected life of the insured individual, so that an appraised value of the cash value is obtained as a basis for a sale price of the cash value, whereby the wealth may be transferred to the transferee as the cash value.



US 20030105690A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105690 A1**

Brown et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **METHOD AND APPARATUS FOR ESTABLISHING AND ADMINISTERING A CHARITABLE GIFT TRANSFER PLAN**

(75) Inventors: **Michael D. Brown**, Irvine, CA (US); **Jonathan G. Blattmachr**, Garden City, NY (US)

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(73) Assignee: **Spectrum Group Investments, LLC**

(21) Appl. No.: **10/043,988**

(22) Filed: **Jan. 9, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/337,758, filed on Dec. 3, 2001.

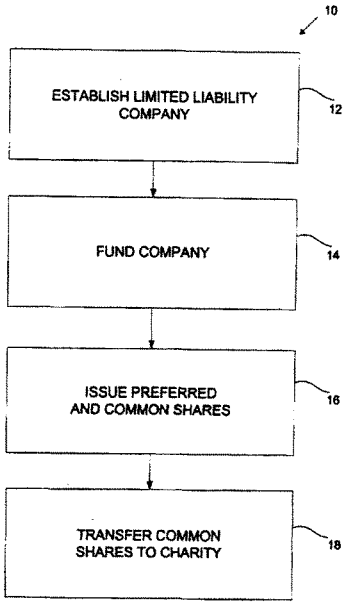
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/1

(57) **ABSTRACT**

A system and method for the efficient transfer of a gift to a charity is disclosed. One embodiment of the system and method implements a charitable gift transfer plan comprising causing the issuance of common and preferred shares from a business entity such as a limited liability company. The common shares are then donated to the charity. A life insurance policy and a single-premium immediate annuity are purchased through the business entity. The purchases may be funded through a loan from a lender company. The payments from the annuity may be partially used to pay the interest on the loan, with the remainder being directed to the charity through the business entity. The death benefit of the life insurance policy is assigned to the owner of the preferred shares and may be used to retire the loan upon the death of the insured.



US 20030105652A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105652 A1**

Arena et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **SYSTEM, METHOD, AND COMPUTER PROGRAM PRODUCT FOR MANAGING AN INVESTMENT TO INCREASE THE AFTER-TAX DEATH BENEFIT OF THE INVESTMENT**

(76) Inventors: **Robert Arena**, Farmington, CT (US); **Robert O'Donnell**, Harwinton, CT (US); **Robert Schwartz**, West Granby, CT (US); **N. David Kuperstock**, Woodbridge, CT (US); **Tim Paris**, Guilford, CT (US); **Robert Leach**, Weston, CT (US); **Jacob Herschler**, Southport, CT (US); **Mike Morrell**, Shelton, CT (US); **Fiona Jackman-Ward**, Stratford, CT (US)

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(21) Appl. No.: **10/121,908**

(22) Filed: **Apr. 12, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/283,718, filed on Apr. 13, 2001.

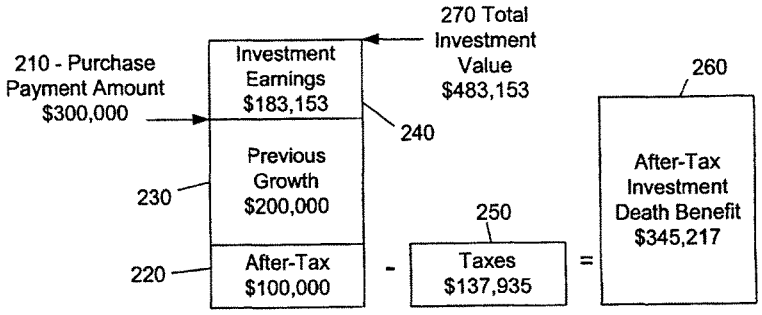
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

A system, method, and computer program product for managing an investment to increase the after-tax death benefit of the investment received by the beneficiaries, the system comprising a processor, a memory, and a computer program stored in the memory. The computer program receives and stores information relating to an investment and periodically assesses the value of the investment. The computer program then determines an insurance premium that will provide a death benefit based on the assessed value of the investment. Next, the computer program collects or otherwise receives information of receipt of the insurance premium. In the preferred embodiment, the insurance premium provides a life insurance death benefit of forty percent (40%) of the assessed value of the investment. Because the maximum federal tax on the investment is approximately thirty-six percent (36%) of the investment value, even if the investment were purchased with appreciated assets, the life insurance death benefit ensures that the beneficiaries receive an after-tax death benefit that is substantially equal to or greater than the pre-tax value of the investment.



US 20030065616A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0065616 A1**

O'Donnell, JR. (43) **Pub. Date: Apr. 3, 2003**

(54) **CONSUMER REFUND DEFERRED PROVIDER PAYMENT ELECTIVE TAX-DEFERRED SAVINGS INSTRUMENT BUSINESS METHOD**

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(21) Appl. No.: **10/232,876**

(22) Filed: **Aug. 30, 2002**

Related U.S. Application Data

(63) Continuation-in-part of application No. 09/593,498, filed on Jun. 14, 2000.

(60) Provisional application No. 60/139,571, filed on Jun. 16, 1999.

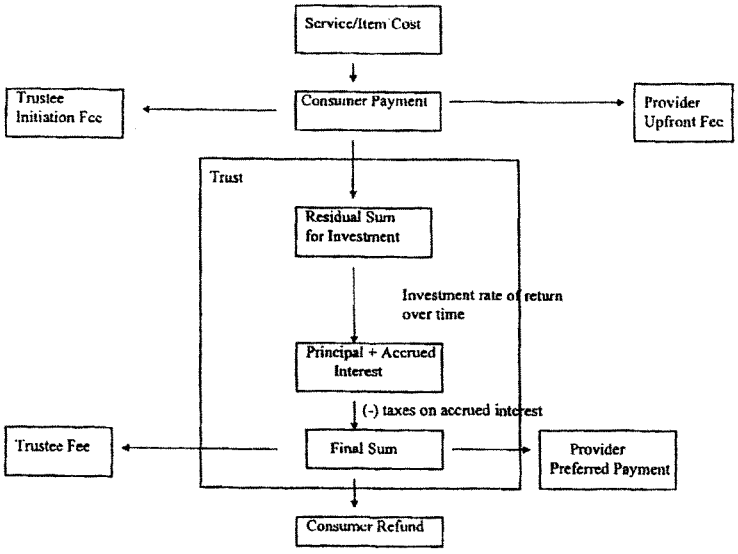
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/39**; 705/40

(57) **ABSTRACT**

A method of purchasing a product or service in which a tax-deferred savings instrument is used to provide for a full or partial refund to the consumer, while also proving a partially deferred or totally deferred payment to the provider of the service or product to the consumer. The method utilizes a computer system executing a computer program which can provide a full definition of the required tax-deferred savings instrument by solving after solving a set of equations which can be used to calculate a number of unknown variables upon the insertion of certain known variables into the computer program.



US 20030040941A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0040941 A1**

Whitworth (43) **Pub. Date: Feb. 27, 2003**

(54) **METHOD OF CREATING AUTHORIZED, TAX EXEMPT MUNICIPAL BONDS USED TO REPLACE A LIABILITY WITH INSURANCE**

(76) Inventor: **Brian L. Whitworth**, Malibu, CA (US)

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(21) Appl. No.: **09/935,818**

(22) Filed: **Aug. 23, 2001**

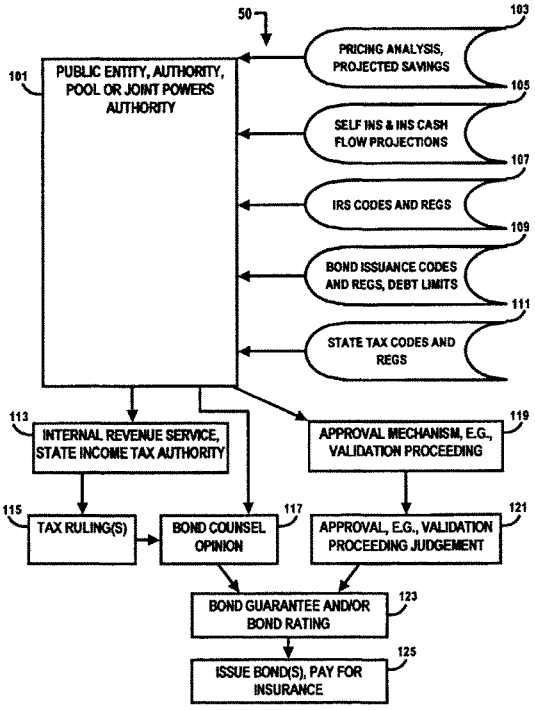
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

This application describes certain procedures for obtaining tax exempt status for interest paid on municipal bonds used to pay insurance premiums, approval procedures for bond issuance, and obtaining bond guarantees and ratings on bonds used to pay for insurance or finance a departure from self insurance or noninsurance.



US 20030033172A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0033172 A1**

Menke (43) **Pub. Date: Feb. 13, 2003**

(54) **METHOD AND SYSTEM FOR COVERTING AN ANNUITY FUND TO A LIFE INSURANCE POLICY**

(76) Inventor: **Robert Menke**, Terra Verde, FL (US)

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(21) Appl. No.: **09/927,748**

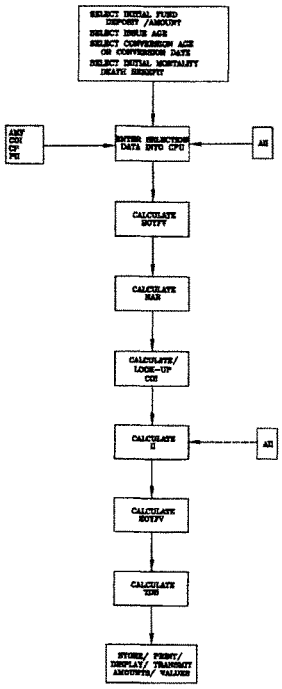
(22) Filed: **Aug. 10, 2001**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

A method and system for converting an annuity fund to a life insurance policy at a predetermined conversion date comprising the following steps: establishing an annuity fund including selecting an initial predetermined value and purchasing an annuity for the initial predetermined value, establishing an irrevocable life insurance conversion plan including selecting the predetermined conversion date, selecting a predetermined mortality death benefit at the predetermined conversion date and purchasing a guaranteed insurability option to guarantee the availability of the predetermined mortality death benefit at the predetermined conversion date, accruing investment income within the annuity fund on a tax deferred basis until the predetermined conversion date, converting the annuity fund to the life insurance policy with the predetermined mortality death benefit at the predetermined conversion date, accruing income within the life insurance policy until the death of the owner of the life insurance policy and disbursing the death benefit to the beneficiary at the death of the owner of the life insurance policy.



US 20030018576A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0018576 A1**

Zuckerbrot et al. (43) **Pub. Date: Jan. 23, 2003**

(54) **RISK EVALUATION SYSTEM AND METHOD**

(75) Inventors: **Kenneth Zuckerbrot**, New York, NY (US); **Jeffrey D. Mamorsky**, Greenwich, CT (US); **Robert T. Bossart**, Rockville Center, NY (US)

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(73) Assignee: **BOMAZU, LLC**, New York, NY

(21) Appl. No.: **10/178,776**

(22) Filed: **Jun. 25, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/300,729, filed on Jun. 25, 2001.

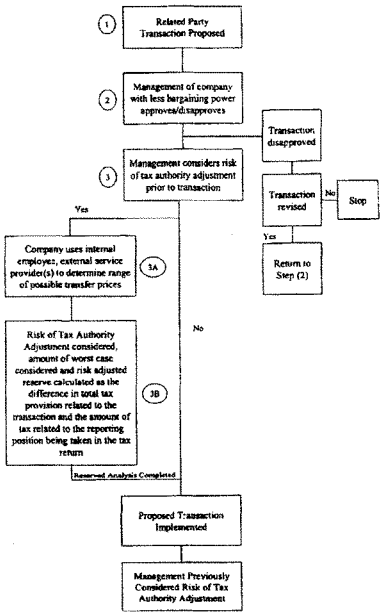
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/38**

(57) **ABSTRACT**

Disclosed is a method for increasing earnings per share for a taxpayer without revealing attorney-client or work product privileged information. In one embodiment, the method includes the steps of: determining a tax reserve amount in connection with a transfer pricing transaction in a tax period; reserving a tax reserve for financial statement purposes, the amount of the tax reserve being equal to the determined tax reserve amount; obtaining an insurance product from an insurer, the insurance product insuring a portion of the tax reserve amount and being issued by the insurer without the insurer reviewing attorney-client or work product privileged information; and reversing to income, for financial statement purposes, the tax reserve amount that is insured by the insurance product. In another embodiment, the invention provides a method for determining whether an application to insure a given amount in connection with a transfer pricing transaction for a given taxation period constitutes an insurable risk.



US 20020198805A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2002/0198805 A1**

Burkhardt (43) **Pub. Date: Dec. 26, 2002**

(54) **METHOD AND APPARATUS FOR OPTIMIZING TAXES IN A TRANSACTION**

(76) Inventor: **Roger Burkhardt**, Irvington, NY (US)

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(21) Appl. No.: **10/155,848**

(22) Filed: **May 24, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/293,245, filed on May 24, 2001.

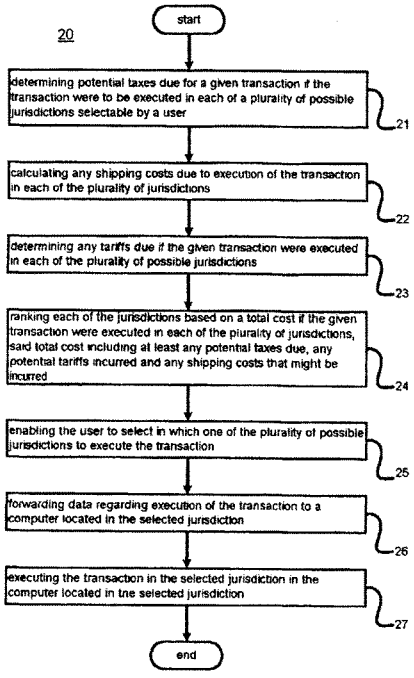
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

A method and apparatus optimizes tax treatment of business transactions by determining in advance the taxes that would be due in each of several possible jurisdictions. Once the tax results are presented to the user, the user can select in which jurisdiction to execute the transaction. Once the jurisdiction is selected, information regarding execution of the transaction is forwarded to a computer located in the selected jurisdiction and the transaction is then executed in the computer in the selected jurisdiction. The method and apparatus help conduct business transactions electronically over an internationally operated distributed computer network, such as the Internet, and execute the transaction in a jurisdiction selected to minimize the taxes while transferring the money and assets, rights or liabilities from the parties in jurisdictions in which the money and assets, rights or liabilities are located.



US 20040024677A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0024677 A1**

Wallman (43) **Pub. Date: Feb. 5, 2004**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

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(21) Appl. No.: **10/627,626**

(22) Filed: **Jul. 28, 2003**

Related U.S. Application Data

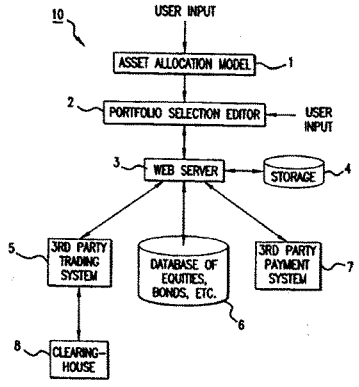
(60) Division of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation-in-part of application No. 09/038,158, filed on Mar. 11, 1998.

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**
(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual find. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



US 20040019506A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0019506 A1**

Struchtemeyer et al. (43) **Pub. Date: Jan. 29, 2004**

(54) **METHOD AND SYSTEM FOR GENERATING ENDOWMENT FOR A TAX-EXEMPT ORGANIZATION**

(76) Inventors: **Brian P. Struchtemeyer**, Columbia, MO (US); **Ralph E. Struchtemeyer**, Hartsburg, MO (US); **Melissa K. Struchtemeyer**, Hartsburg, MO (US)

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(21) Appl. No.: **10/201,421**

(22) Filed: **Jul. 23, 2002**

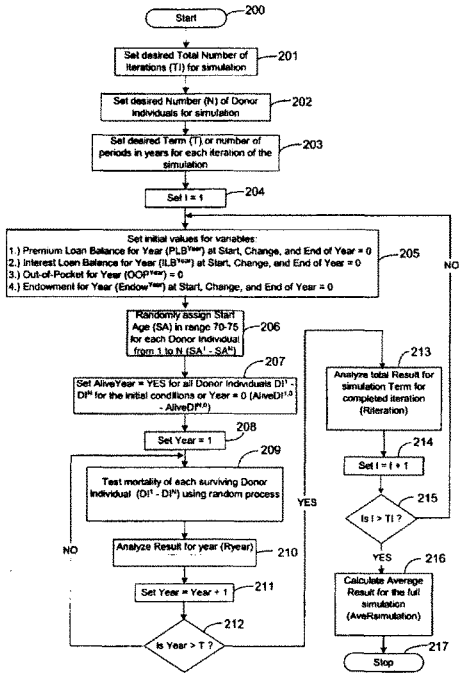
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

A program for generating new endowment for a tax-exempt organization. Life insurance policies are purchased for a group of suitable donor individuals, with the tax-exempt organization as the beneficiary. A finance company lends money to the tax-exempt organization in amounts sufficient to pay the annual life insurance premiums, and a secondary bank lends further money to the tax-exempt organization to cover the interest that accumulates annually on the premium loans. Upon the death of a donor individual, the policy death benefit is used in several ways: a predetermined fixed amount is set aside and used to pay the interest loan; a predetermined priority portion of the remainder is used to pay the premium loans; and, after the premium loans have been paid in full, any remaining balance is accumulated as new endowment. A Monte Carlo simulation is used to predict the program's performance.



US 20040002908A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0002908 A1**

James (43) **Pub. Date: Jan. 1, 2004**

(54) **METHOD OF INCREASING RETURN TO OWNERS OF INCOME PROPERTY WITH INTENT TO REACH ULTIMATE GOAL OF ZERO MORTGAGE DEBT WITHOUT MAJOR FINANCIAL STRESS**

(76) Inventor: **Arthur James**, Marina Del Rey, CA (US)

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Scarsdale, NY 10583 (US)

(21) Appl. No.: **10/183,280**

(22) Filed: **Jun. 26, 2002**

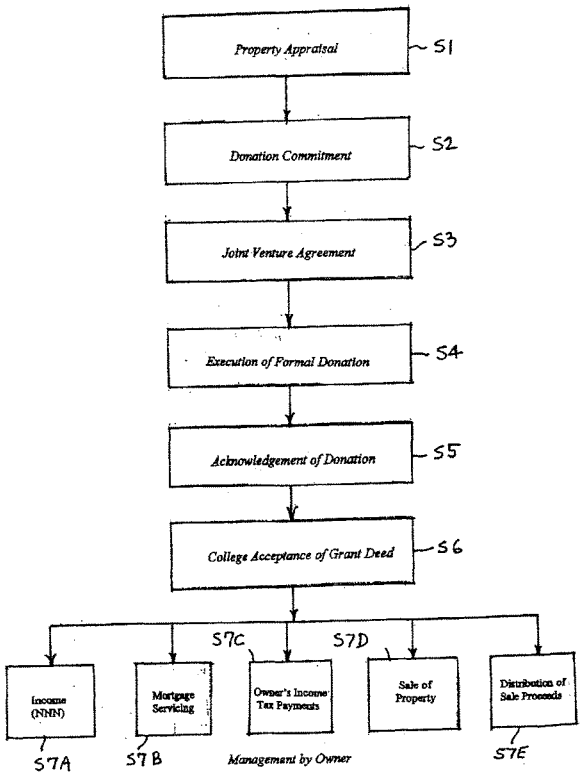
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/1

(57) **ABSTRACT**

A method of partially transferring non-cash equity in income property with lease income servicing mortgage debt to a tax-exempt educational institution while providing the advantage of being able to withstand major taxes in the later years of a mortgage while assisting in achieving most owners' goals of obtaining debt-free free property.



US 20030212622A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0212622 A1**

Wallman (43) **Pub. Date: Nov. 13, 2003**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

(76) Inventor: **Steven M.H. Wallman**, Great Falls, VA (US)

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(21) Appl. No.: **10/440,142**

(22) Filed: **May 19, 2003**

Related U.S. Application Data

(63) Continuation of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation-in-part of application No. 09/038,158, filed on Mar. 11, 1998.

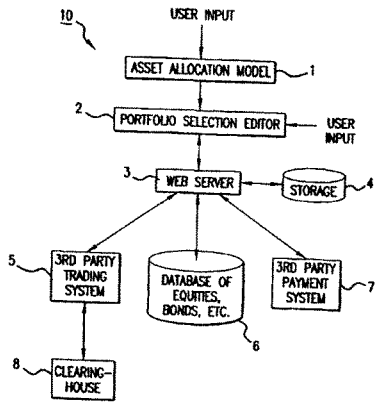
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual fund. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



US 20030208432A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0208432 A1**

Wallman (43) **Pub. Date: Nov. 6, 2003**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

(76) Inventor: **Steven M.H. Wallman**, Great Falls, VA (US)

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(21) Appl. No.: **10/435,591**

(22) Filed: **May 12, 2003**

Related U.S. Application Data

(60) Division of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation-in-part of application No. 09/038,158, filed on Mar. 11, 1998.

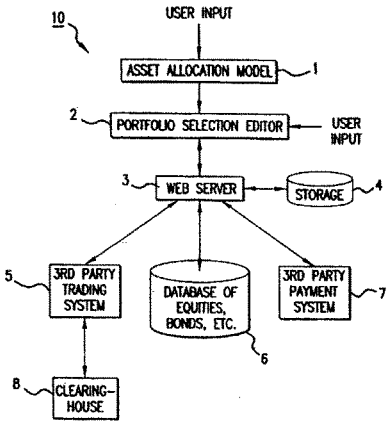
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual fund. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



US 20030195827A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0195827 A1**

Lichtig, III (43) **Pub. Date: Oct. 16, 2003**

(54) **METHOD OF DOING BUSINESS INVOLVING CONVERSION OF TRADITIONAL INDIVIDUAL RETIREMENT ACCOUNT TO A ROTH INDIVIDUAL RETIREMENT ACCOUNT**

(76) Inventor: **Edwin Lichtig III**, Lafayette, CA (US)

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(21) Appl. No.: **10/123,703**

(22) Filed: **Apr. 15, 2002**

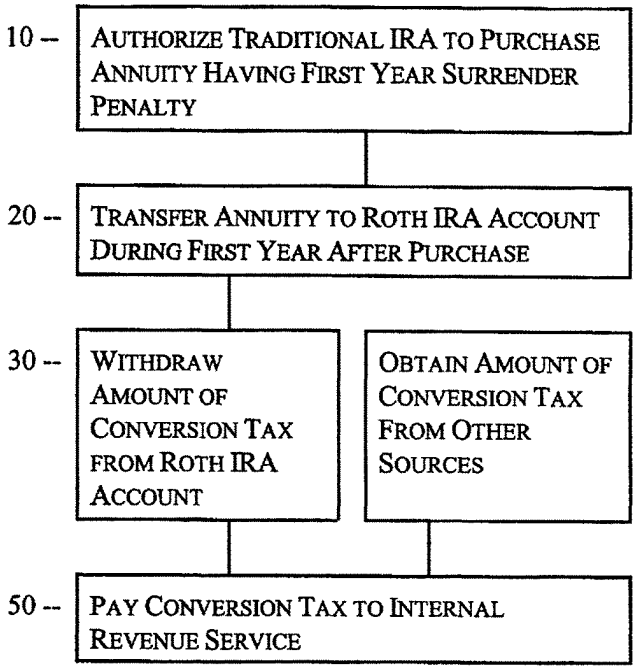
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

A traditional IRA is first used to purchase an annuity, and then some months later, the traditional IRA is converted into a Roth IRA. Because of the penalty associated with the surrender of the annuity, the fair market value of the annuity transferred to the Roth IRA is discounted from the face value of the annuity, thus decreasing the federal income tax payable as a result of converting the traditional IRA to a Roth IRA. This method of doing business also contemplates the use of other assets similar in some ways to an annuity, such as long term real estate partnerships, that feature a long term surrender period, and an initial surrender penalty.



US 20030139992A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0139992 A1**

Flanery (43) **Pub. Date: Jul. 24, 2003**

(54) **METHOD OF CREATING FINANCIAL STRUCTURE FOR DELIVERING A TAX FAVORED FINANCIAL POSITION**

(76) Inventor: **Patrick Flanery**, Scottsdale, AZ (US)

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(21) Appl. No.: **10/054,505**

(22) Filed: **Jan. 22, 2002**

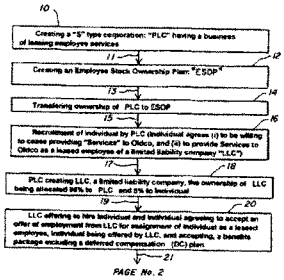
Publication Classification

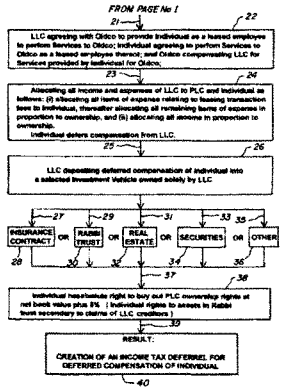
(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

A multiple-step method of deferring compensation of an individual, with concurrent deferral of payment of income tax. The method of the invention is especially important, helpful, and applicable to a highly compensated individual.





US 20030139987A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0139987 A1**

Flanery (43) **Pub. Date: Jul. 24, 2003**

(54) **METHOD OF CREATING FINANCIAL STRUCTURE FOR DELIVERING A TAX FAVORED FINANCIAL POSITION**

(76) Inventor: **Patrick Flanery**, Scottsdale, AZ (US)

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(21) Appl. No.: **10/054,593**

(22) Filed: **Jan. 22, 2002**

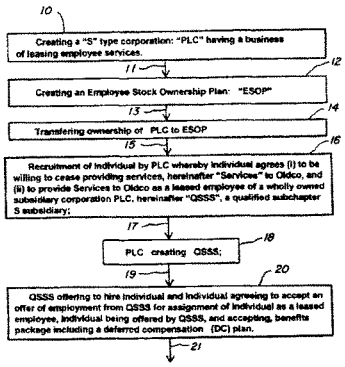
Publication Classification

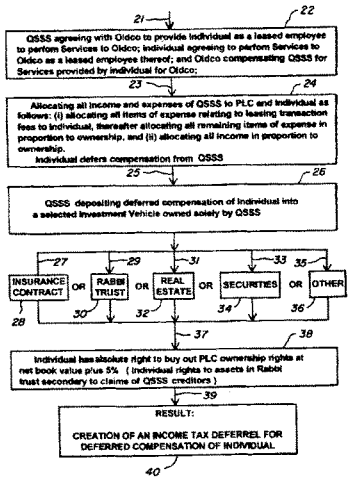
(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

A multiple-step method of deferring compensation of an individual, with concurrent deferral of payment of income tax. The method of the invention is especially important, helpful, and applicable to a highly compensated individual.





US 20030130939A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0130939 A1**

Brown et al. (43) **Pub. Date: Jul. 10, 2003**

(54) **WEALTH TRANSFER PLAN USING IN KIND LOAN REPAYMENT WITH TERM INSURANCE PROTECTION**

(75) Inventors: **Michael D. Brown**, Irvine, CA (US); **Jonathan G. Blattmachr**, Garden City, NY (US)

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(73) Assignee: **Spectrum Group Investments, LLC**

(21) Appl. No.: **10/043,991**

(22) Filed: **Jan. 9, 2002**

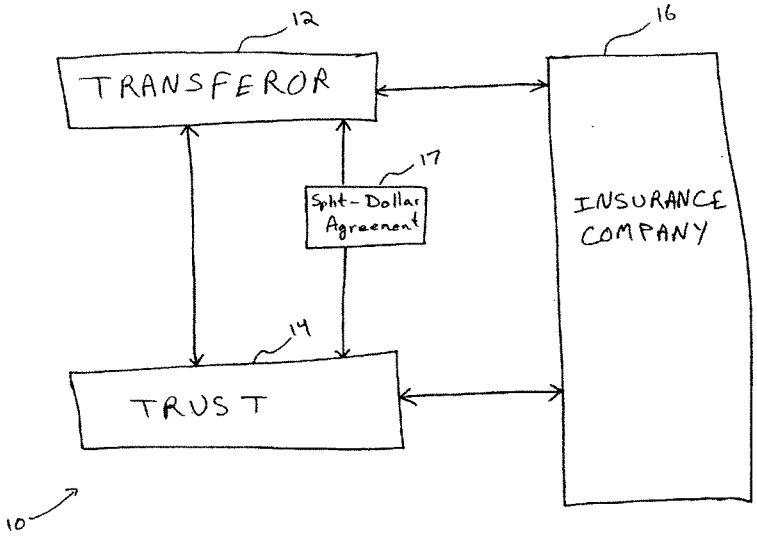
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/39**

(57) **ABSTRACT**

A system and method for the efficient transfer of wealth is disclosed. The system and method implement a plan for the efficient transfer of wealth. The disclosed embodiments include a company computer for gathering information on the amount of wealth to be transferred from a transferor. An amount is determined to be transferred from the transferor to a transferee in the form of a loan. According to the plan, an insurance policy having a term benefit is purchased by the transferee, and the term benefit is assigned to the transferor as an economic benefit which is credited towards the loan. The economic benefit may be determined according to, for example, published IRS Table PS58. The economic benefit may be significantly greater than the actual cost of the policy, with the spread being effectively transferred to the transferee.



US 20030105701A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2003/0105701 A1**

Brown et al. (43) **Pub. Date: Jun. 5, 2003**

(54) **APPARATUS AND METHOD FOR IMPLEMENTING AND/OR ADMINISTERING A WEALTH TRANSFER PLAN**

(76) Inventors: **Michael D. Brown**, Irvine, CA (US); **Jonathan G. Blattmachr**, Garden City, NY (US)

Correspondence Address:
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(21) Appl. No.: **10/125,914**

(22) Filed: **Apr. 18, 2002**

Related U.S. Application Data

(60) Provisional application No. 60/337,758, filed on Dec. 3, 2001.

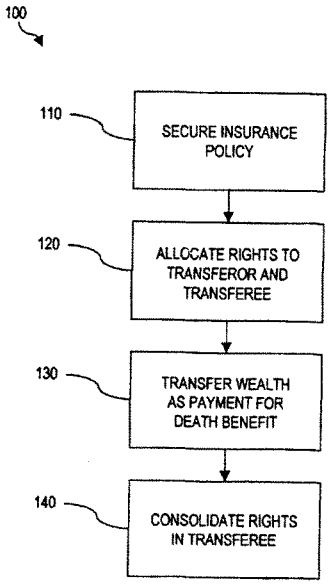
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

An apparatus and method for the efficient transfer of wealth is disclosed. The method comprises a transferee securing an insurance policy having a death benefit component and a cash value component on the life of an insured. The death benefit proceeds are to be paid out at the death of the insured. A transferor obtains a loan having a principal and an interest. The principal of the loan is to be paid with the death benefit proceeds from the insurance policy. The proceeds from the loan are used to directly or indirectly obtain an income-generating investment instrument that produces periodic income. The periodic income is used to pay the interest of the loan. Rights to the death benefit component are allocated to the transferor and rights to the cash value component are allocated to a transferee. The insurance policy is funded directly or indirectly with proceeds from the loan as payment for rights to the death benefit component.



US 20040138972A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0138972 A1**

Mendelsohn (43) **Pub. Date: Jul. 15, 2004**

(54) **METHOD OF DISPOSING OF ARTWORK FOR FINANCIALLY BENEFITING CHARITABLE ORGANIZATIONS**

(76) Inventor: **Michael Mendelsohn,** Hastings-on-Hudson, NY (US)

Correspondence Address:
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(21) Appl. No.: **10/342,903**

(22) Filed: **Jan. 15, 2003**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

The present invention generally relates to a system and method for disposing of an art collector's artwork in a manner which financially benefits charitable organizations. More particularly, the system and method of the present invention combines a variety of financing techniques and strategies create endowment funds for charitable organizations. In particular, the method of the present invention combines the concepts of donating art to related-use organization, fractional gifting of the artwork, gifting of related charitable tax deductions, and gifting of life insurance and financed premiums to other charitable organizations. The method of the present invention creates a "dual legacy", assisting many charities in establishing present and future endowment funding.

US 20040122755A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0122755 A1**

Bates et al. (43) **Pub. Date: Jun. 24, 2004**

(54) **METHOD FOR FINANCING BUSINESS EXPENSES**

(76) Inventors: **Ernest A. Bates**, Napa, CA (US); **Craig Tagawa**, Vallejo, CA (US)

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(21) Appl. No.: **10/325,329**

(22) Filed: **Dec. 19, 2002**

Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**

(57) **ABSTRACT**

A method for financing a business expense comprising a method of tax-exempt financing that may be classified as an operating lease pursuant to Generally Accepted Accounting Principles in the United States of America at the time of the invention.

US 20040111300A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0111300 A1**

Callen et al. (43) **Pub. Date: Jun. 10, 2004**

(54) **TAX WITHHOLDING ON EMPLOYEE TERMINATION BENEFITS**

(76) Inventors: **Brock W. Callen**, Chilmark, MA (US); **Hope C. Callen**, Chilmark, MA (US)

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(21) Appl. No.: **10/152,051**

(22) Filed: **May 20, 2002**

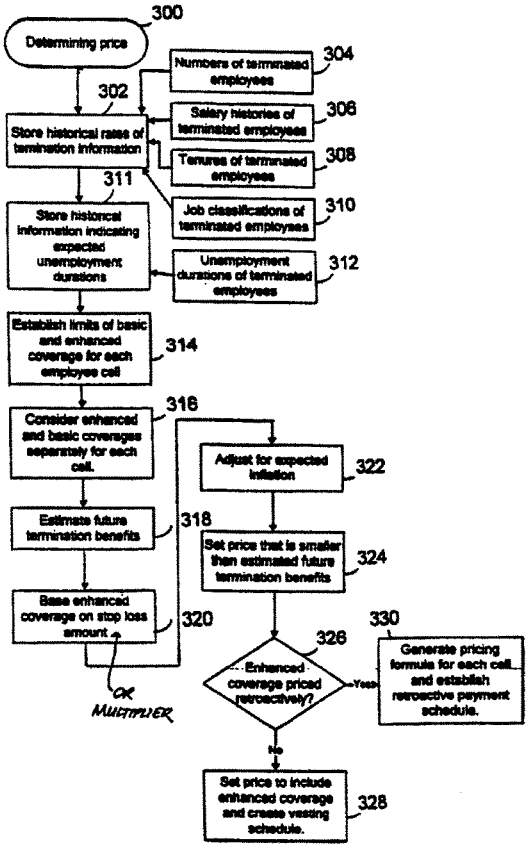
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

Termination benefits to employees are paid under an insurance product owned by an employer of the employees, federal or state unemployment taxes are not withheld from the paid termination benefits.



US 20040098327A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0098327 A1**

Seaman (43) **Pub. Date: May 20, 2004**

(54) **CONTINGENT CONVERTIBLE SECURITIES INSTRUMENT AND METHOD OF PROVIDING, TRADING AND USING THE SAME**

(76) Inventor: **David A. Seaman**, Short Hills, NJ (US)

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(21) Appl. No.: **10/293,491**

(22) Filed: **Nov. 14, 2002**

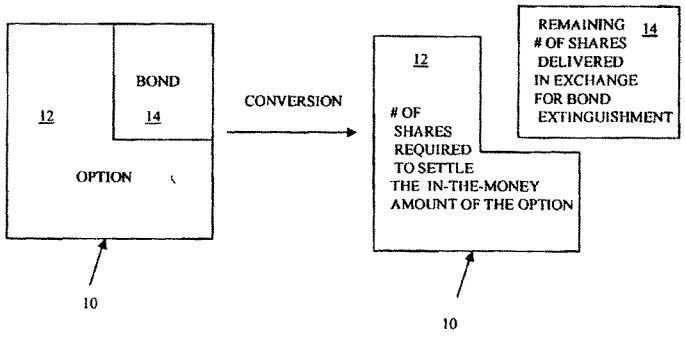
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

A contingent convertible financial instrument which includes a bond portion and an embedded option portion. The bond portion is redeemable at a maturity date similar to a traditional bond. The embedded option portion is exercisable, within a specified time period after the value of the shares of stock reaches a target value, for shares of stock in the entity issuing the bond portion in an amount equal to the difference between an early exercise value and a value of the stock on the date that the embedded option portion is exercised. In contrast to traditional convertible bonds, the exercising of the embedded option portion does not extinguish the bond portion. Methods of providing, trading and using such a convertible financial instrument are also described.



US 20040078244A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0078244 A1**

Katcher (43) **Pub. Date: Apr. 22, 2004**

(54) **SECTOR SELECTION INVESTMENT OPTION IN A VARIABLE INSURANCE PRODUCT**

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(21) Appl. No.: **10/273,941**

(22) Filed: **Oct. 18, 2002**

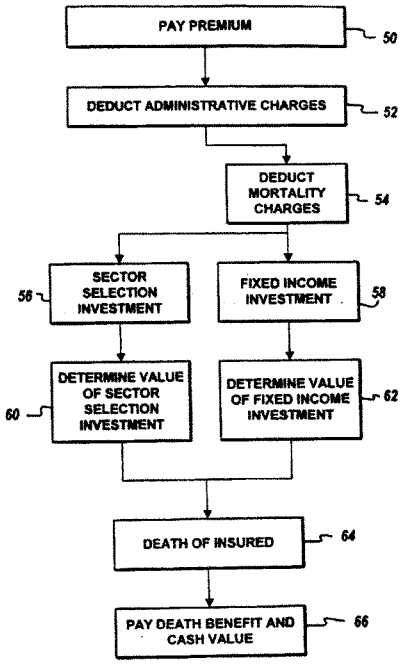
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

The present invention provides a combination of the investment methodology known as sector rotation with tax-advantaged investment products, particularly, variable annuity and variable life insurance products and combination insurance products. The sector rotation methodology is implemented through purchase of appropriate funds, such as equity mutual funds, exchange traded funds, or index funds which are available through such variable annuity and variable life insurance products and combination insurance products, and such funds being determined by an asset allocation or style-driven model created by an insurance company or investment adviser. In one embodiment, the sector rotation methodology is implemented through a fund of funds approach.



US 20040059609A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0059609 A1**

Chatlain et al. (43) **Pub. Date: Mar. 25, 2004**

(54) **SYSTEM AND METHODS FOR TRACKING THE RELATIVE INTERESTS OF THE PARTIES TO AN INSURANCE POLICY**

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(21) Appl. No.: **10/252,224**

(22) Filed: **Sep. 23, 2002**

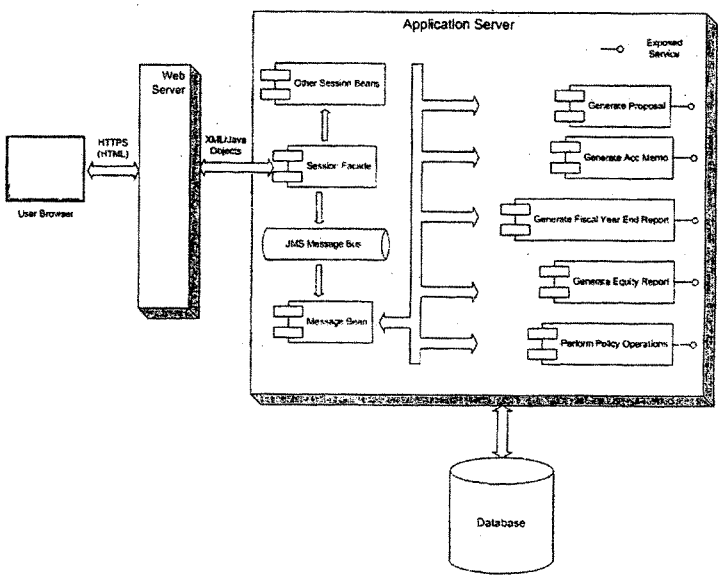
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/4**

(57) **ABSTRACT**

Systems and processes are provided for projecting, tracking and assessing the performance of and relative interests of the parties to one or more cooperatively-funded insurance policies, such as split-dollar or jointly-owned life insurance policies. Certain embodiments can also optimize the structure and function of existing insurance policies. Input data regarding actual and potential parties to an insurance contract, regulatory considerations, as well as the objectives that the parties intend to achieve, is used to propose, create, track, maintain, and implement an insurance policy or a group insurance plan. The input data is communicated to an enterprise platform via a web server. The enterprise platform includes applications which process the data. Data processing functions performed include proposal and policy generation, policy reevaluation and re-proposal, policy conversion, and report generation. The systems and processes optimize achievement of policy objectives and minimize tax consequences under applicable tax codes.



US 20040039675A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0039675 A1**

Wallman (43) **Pub. Date: Feb. 26, 2004**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

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(21) Appl. No.: **10/627,646**

(22) Filed: **Jul. 28, 2003**

Related U.S. Application Data

(60) Division of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation-in-part of application No. 09/038,158, filed on Mar. 11, 1998.

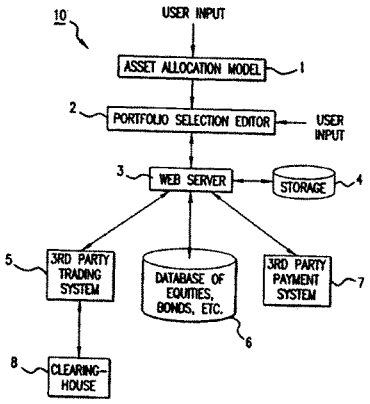
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual fund. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



US 20040034585A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0034585 A1**

Saunders (43) **Pub. Date: Feb. 19, 2004**

(54) **CHARITABLE DONATION SYSTEM INTEGRATED WITH BROKERAGE ACCOUNT**

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(21) Appl. No.: **10/642,471**

(22) Filed: **Aug. 14, 2003**

Related U.S. Application Data

(60) Provisional application No. 60/403,602, filed on Aug. 14, 2002.

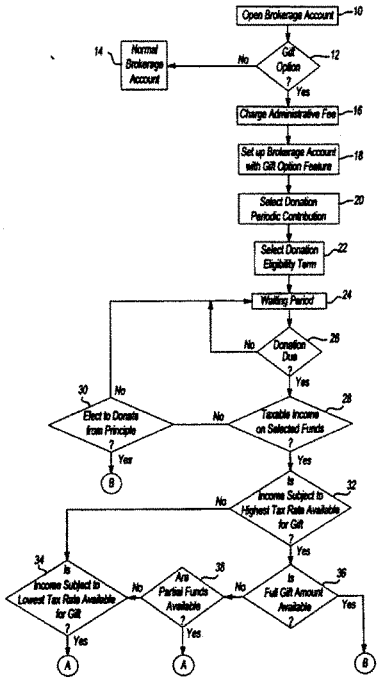
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/35**; 705/31

(57) **ABSTRACT**

A systematic method of making donations to charities from investment income is provided. Mutual fund investors and other investors are provided with an option to designate that a gift to a charity is to be paid from the brokerage account. The gift may be of a fixed amount or of a percentage of investment income, or may be limited to a portion of investment income that is taxed at the highest tax rate for the investor. The mutual fund or investment management entity may receive compensation in the form of an administrative fee that may be a set annual amount or a percentage of gifts made.



US 20040024679A1

(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0024679 A1**

Wallman (43) **Pub. Date: Feb. 5, 2004**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

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(21) Appl. No.: **10/627,921**

(22) Filed: **Jul. 28, 2003**

Related U.S. Application Data

(60) Division of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation-in-part of application No. 09/038,158, filed on Mar. 11, 1998.

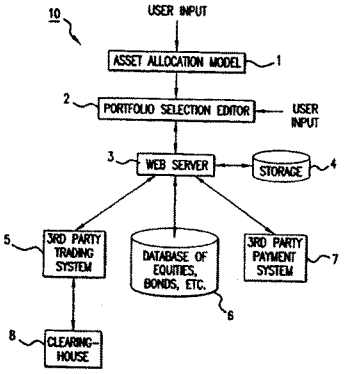
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual fund. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



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(19) **United States**

(12) **Patent Application Publication** (10) **Pub. No.: US 2004/0024678 A1**

Wallman (43) **Pub. Date: Feb. 5, 2004**

(54) **METHOD AND APPARATUS FOR ENABLING INDIVIDUAL OR SMALLER INVESTORS OR OTHERS TO CREATE AND MANAGE A PORTFOLIO OF SECURITIES OR OTHER ASSETS OR LIABILITIES ON A COST EFFECTIVE BASIS**

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(21) Appl. No.: **10/627,873**

(22) Filed: **Jul. 28, 2003**

Related U.S. Application Data

(60) Division of application No. 09/139,020, filed on Aug. 24, 1998, now Pat. No. 6,601,044, which is a continuation of application No. 09/038,158, filed on Mar. 11, 1998.

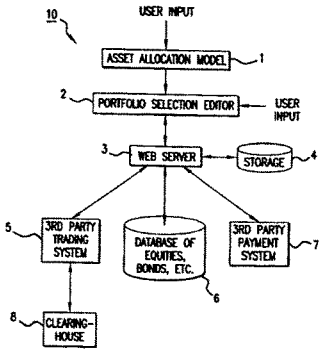
Publication Classification

(51) **Int. Cl.**[7] **G06F 17/60**

(52) **U.S. Cl.** **705/36**

(57) **ABSTRACT**

Smaller investors can create and manage on a cost-effective basis a complex portfolio of securities using a mechanism that enables the investor to provide to the system the investor's preferences regarding his portfolio, to generate a portfolio, including fractional shares, that reflects the investor's preferences. The system then permits aggregation of the orders, and netting of orders, generated by multiple investors at various times during the day for execution. In addition, the structure of the computer-based system of the present invention allows its cost to be based on access to or usage of the system (such as a monthly fee) as opposed to by securities orders entered into the system as per common brokerage. The result is that the investor can create a portfolio of directly owned securities with attributes, such as diversification, similar to a mutual fund. As compared with the problems with existing systems, the computer-based system of the present invention provides complete control for the investor over what securities can be selected, and in what weights and amounts, as well as control over the tax effects of purchases or sales of the securities comprising the portfolio, preventing the investor from being presented with unwanted taxable effects due to discretionary sales transactions of fund managers. In addition, the computer-based system of the present invention provides all the information necessary to monitor and manage tax effects and capability to sell or buy the individual securities in his portfolio to obtain desired tax benefits, all shareholder rights with respect to each security in the portfolio to the investor and full ownership and control over all investment, voting and other decisions regarding such securities. The computer-based system of the present invention also allows for parameters to be set with respect to a portfolio to ensure that it stays within certain diversification or risk limits. Furthermore, the computer-based system of the present invention provides direct control over the charges and expenses that will be incurred, and the possibility of making multiple intra-day investment decisions by the investor, if he wishes. Moreover, the computer-based system of the present invention provides control over all factors in the portfolio and modification of them as the investor sees fit.



Testimony
of
Robert M. Morgenthau
District Attorney of New York County
before the
United States Senate
Committee on Finance
July 21, 2004

I appreciate the opportunity to testify before this distinguished committee about some of the money laundering and tax evasion schemes we see at the New York County District Attorney's Office. These cases run the gamut from simple tax frauds to international money laundering with links to international terrorism. Our experience shows that, if we intend to put a dent in large scale tax evasion and the financing of other criminal activities, we need to tighten the controls on the U.S. money system considerably.

In the past year, my office has convicted four New York stockbrokers of laundering more than three-quarters of a million dollars in profits from fraudulent stock deals through offshore credit card accounts to avoid New York City, State and federal taxes. More than $1.6 million from the stock fraud was paid to the brokers, over a two-year period, into accounts at the Leadenhall Bank & Trust in Nassau the Bahamas. The brokers, who have since been barred from the securities industry, withdrew $790,000, using MasterCard debit cards at ATM machines in New York City and Atlantic City, New Jersey, among other places.

Only last week, we convicted a New York doctor for evading taxes on $300,000 of income, $126,000 of which he put into an account at Leadenhall in the form of checks, ostensibly in payment of rent for his office. In fact, he owned the building in which he had his office. Like the crooked brokers, the doctor used a MasterCard to withdraw money at ATMs and to make purchases with the offshore funds. The doctor also used offshore accounts and a shell company to shelter another $76,000 of the income he failed to report.

Regrettably, these are not isolated cases. My office's investigation has disclosed that 115, 000 separate offshore MasterCard accounts were used in the New York, New Jersey and Connecticut area in a single year, 2001. The MasterCards were used in 2001 to access over $100 million deposited in banks located in at least 17 tax haven jurisdictions, including the Bahamas, Barbados, Belize and the Cayman Islands. It is highly unlikely that U.S. taxes were paid on any of this money. These figures - from just one of the major credit card companies - suggest that there is enormous wealth being hidden offshore by U.S. citizens that is neither being reported nor taxed.

In fact, as of December 2003, there was over 1 trillion in U.S. dollars on deposit in banks in the Cayman Islands alone. This staggering amount of money – reflecting an increase of about $500 million over the past five years – is twice the amount that is currently on deposit in all the banks in New York City and more than double the annual budget of the United States Department of Defense. The Caymans boasts that there were a total of 349 banks licensed there at the end of 2003, including 43 of the 50 largest banks in the world. Not surprisingly, a substantial portion of the dollar deposits in the Caymans is booked to subsidiaries and branches of banks in the United States.

Although some money may be in the Caymans and other tax havens for legitimate purposes, there is no doubt that much of it is deposited there to avoid taxes and responsible regulation in the United States and other developed countries. It is no coincidence that the Caymans, widely known for its strict bank and corporate secrecy laws, has figured in many recent major financial scandals. Enron Corporation, for example, used 441 Cayman affiliates to hide $2.9 billion in losses. Parmalat Finanziaria used Cayman subsidiaries to falsely claim $4.9 billion in bank deposits that it did not have. The Caymans was also the nominal home of Long Term Capital, the giant hedge fund that collapsed in 1998.

One reason so much in potential tax revenue is being lost to offshore tax evasion and fraud is that ATMs, electronic transfers and the Internet have made it easier to take advantage of the strict bank and corporate secrecy provided by the Caymans and other tax havens. Today, anyone who wishes to deposit cash offshore can open a bank account, accessible by credit card, and even charter a shell company in a tax haven, simply by logging on to the Internet. It has been estimated that offshore tax frauds alone cost the U.S. government about $70 billion in tax revenues every year. Considering the revenues lost to state and local governments, the amount lost is actually much higher.

In the course of tracing money deposited into the correspondent bank for Leadenhall Bank & Trust (the Bahamas bank used in the offshore credit card scam) my office came across Beacon Hill Service Corporation. Beacon Hill was an unlicensed money transmitting business, run out of offices on the seventh floor of a midtown Manhattan office building. It had about a dozen employees. Beacon Hill was open for business from 1994 to February 2003, when we executed a search warrant on the premises. In the last six years of its operation, this small company moved $6.5 billion, by wire transfers alone, through the 40 accounts it maintained at a major New York bank. This does not include checks, payable-through drafts or cash transactions. Beacon Hill was convicted in February 2004 of operating as a money transmitter without a license.

We can reasonably conclude that very little, if any, of this money was moved through Beacon Hill for legitimate purposes. Legitimate clients moving that amount of money would have dealt directly with a bank, rather than pay the extra fees required to deal with Beacon Hill. What the clients got for the extra money they paid is secrecy. Because Beacon Hill did not keep proper records and because of the nature of its clients – which included numerous offshore shell corporations and "casas de cambio," or exchange houses, in Brazil and Uruguay – it is nearly impossible to identify the real parties in interest behind Beacon Hill's transactions or to trace the money through these accounts. Some of the money was no doubt

linked to narcotics traffickers from South America. Records also show that Beacon Hill transmitted $31.5 million to accounts in Pakistan, Lebanon, Jordan, Dubai, Saudi Arabia and elsewhere in the Middle East.

Among the foreign authorities that have contacted the New York County District Attorney's Office about the Beacon Hill accounts are Brazilian prosecutors and police and representatives of a special commission established in Brazil to investigate the movement of some $30 billion out of Brazil. The $30 billion is thought to be the proceeds of official corruption, government fraud, organized crime activities and weapons and narcotics trafficking. At least $200 million of this money – funds alleged to belong to a prominent public official in Brazil – moved through Beacon Hill's accounts.

Commercial check cashing businesses are another major vehicle for money laundering and tax fraud schemes. In a typical scheme, a business will write checks to vendors or suppliers for purported business purchases and then cash them at a commercial check casher. The business person then has the use of the cash, which is never reported as personal income, and the benefit of a phony tax deduction.

In May of this year, the District Attorney's Office concluded an investigation of medical management and supply companies which evaded taxes by cashing customers' checks through Manhattan commercial check cashers. We convicted six individuals of using check cashers to evading taxes on a total of $41 million that never appeared on the company books and was never reported on tax returns. In another recent case we convicted 11 companies of evading $4.4 million in income through a check casher.

In a long-running securities fraud case, my office convicted 43 brokers from the securities firm, Meyers Pollock Robbins. Among other schemes, the Meyers Pollock brokers generated fictitious sales between offshore shell corporations in the Isle of Man in so-called "pump and dump" operations. Millions of dollars earned

offshore every year in these frauds were wired to the bank account of City Check Cashing, once a major check-cashing business in the New York metropolitan area. A bagman paid by Meyers Pollock would arrange to pick up the cash from the check casher and deliver it to the crooked brokers in New York and elsewhere.

Commercial check cashing is big business. City Check Cashing did $175 million in business every year; another notorious New York operation cashed $250 million in checks a year.

Like any other U.S. businesses, check cashers and money transmitters need access to the U.S. banking system to transmit funds. For that reason, we rightly expect our banks to be the first line of defense against the abuse of the system for tax evasion and other illegal purposes. Of course, the Patriot Act requires them to perform that function by, among other things, taking measures to know their customers, and in some instances their customers' customers. However, our experience at the District Attorney's Office shows that, all too often, banks are failing to live up to these obligations.

One case in point concerns the major New York bank where Beacon Hill maintained its accounts. In the course of its nine year relationship with Beacon Hill, the bank ignored numerous red flags for money laundering: many of Beacon Hill's clients were themselves in the business of moving money in South America, and the identities of their customers were unknown to the bank. Other clients were offshore shell corporations. Documents often identified the ultimate beneficiaries of transfers only as a "customer" or "valued customer." A large portion of Beacon Hill's business was run out of a pooled account which served many customers, making it impossible to connect deposits to transfers out of the account. The London office of the New York bank had shut down Beacon Hill's accounts in 1994, and Beacon Hill did not have a license to operate in the State of New York. In this case, the bank's New York compliance department completely fell down on the job.

A related investigation disclosed that a branch of Hudson United Bank in Manhattan was conducting an international money service business through certain accounts it had purchased from the Federal Deposit Insurance Corporation, following the liquidation of the Connecticut Bank of Commerce. This business had a high risk for money laundering. In a 16 month period, $1.4 billion dollars flowed through these accounts, some of it transmitted on behalf of foreign exchange houses and black market currency dealers from South America. Pursuant to a settlement my office reached with Hudson United in March, the bank has initiated significant anti-money laundering and compliance reforms and closed the international money service business at its Manhattan branch.

Our investigation is continuing into other banks in Manhattan that are providing similar money transmittal services with little apparent regard for the type of activities – including international terrorism – they may be facilitating. In the course of our banking investigations, we have seen millions of dollars transmitted on behalf of parties from the tri-border region of Brazil, Argentina and Paraguay, which is notorious for supplying funds to terrorist groups in the Middle East. We have also seen substantial amounts transferred from shell companies in the British Virgin Islands to a Middle Eastern bank long suspected of funding Hizballah and other terror groups. In other cases, we are investigating systematic frauds being committed by ethnic groups from the Middle East and the Asian sub-continent; the proceeds from these crimes are being sent back to their home countries, and some of the proceeds are clearly earmarked for terrorist activities.

The banks need to do a better job. Some oversight failures at the banks may be due to ignorance or simple negligence. But it is difficult to discount the influence of the considerable fees that banks can earn through the international money transmittal business. In one case currently under investigation, a major U.S. bank brought in revenues of $280 million, in just one year, from its relationship with a large South American money service business. It is not unreasonable to believe that, in many cases, self-interest has played a role in the banks' overlooking suspicious activities, which if scrutinized, might require them to shut down the

accounts involved. Obviously, it is important for banks to look beyond the fees they earn and to get serious about know your customer requirements. Regulators must get tougher on those institutions that fail to live up to their obligations.

Criminal investigations and prosecutions are not a substitute for the application of strict anti-money laundering procedures at U.S. banks. Even under the best conditions, law enforcement will have only limited success in combating money laundering and related crimes, such as tax evasion. We see only a small number of the crimes that actually occur, and the time and resources needed to mount a successful prosecution limit the number of cases we can handle. There are also many obstacles to successful criminal investigations in this area, especially when money moves internationally.

Records of our domestic financial institutions are often incomplete and are seldom sufficient in themselves to prove international crimes. Beacon Hill, for example, kept no record linking deposits into its accounts with withdrawals. And, surprisingly, in the investigation of the offshore credit cards, we found that MasterCard kept no record of the identity of its cardholders; each credit card account was identified only by number. The sole repository of customer identifying information was Leadenhall Bank & Trust in the Bahamas and other banks in secrecy jurisdictions.

In general, obtaining records from foreign jurisdictions is a frustrating process. Mutual Legal Assistance Treaties [MLATs] are effective only when foreign law enforcement authorities and financial institutions wish to be cooperative, which is seldom the case with the tax havens. Many MLATs do not provide for the exchange of information in tax cases; and may provide only for disclosure to federal authorities, leaving state and local prosecutors out in the cold. This is particularly short-sighted on the part of the United States government, as state and local prosecutors handle 98 per cent of the criminal cases that are prosecuted in this country.

The MLAT process is also painfully slow; it routinely takes six months to a year to successfully subpoena records from a foreign jurisdiction. In a current investigation, my office has been waiting for bank records requested by treaty from Shanghai, China for nearly two years. As you can imagine, when the same funds have been transmitted through multiple jurisdictions, the MLAT process may take so long as to be useless.

There has been improvement in the attitude of some foreign jurisdictions over the years. For example, we have had excellent cooperation from the Channel Islands, Jersey and Guernsey, and the Isle of Man, in several cases. To assist our investigation of the role of J.P. Morgan Chase and Citigroup in the Enron collapse, the Attorney General and the Financial Services Commission in the Isle of Jersey were able to arrange for our investigators to obtain records and interview witnesses concerning the offshore entities used by Chase; this was all done pursuant to Jersey law in response to a letter of request sent directly to the Jersey authorities. In another recent investigation, we even got help from some private lawyers in the Caymans, who were eager to do what they could to create a more favorable image for that jurisdiction.

This sort of expeditious access to foreign evidence should be the rule rather than the exception in an age when access to foreign banks and offshore entities in financial transactions is becoming routine. Hopefully, the Patriot Act, by requiring foreign banks with correspondent accounts in the U.S. to appoint an agent for service of process in this country, will help to circumvent some of the current complexities and obstacles in the MLAT process, as it applies to foreign banks. The federal government and the other G-8 nations need to put more pressure on the offshore tax havens to allow access to banking and corporate records on a reasonable basis. Jurisdictions that refuse to act responsibly should be denied access to the U.S. money system. A tougher stance against secrecy in the tax havens would be a great help to law enforcement and would, in the long run, significantly increase U.S. tax revenues.

Vigorous law enforcement is nowhere more important than in the area of tax fraud and evasion. As Justice Oliver Wendell Holmes said, "Taxes are what we pay for a civilized society." We all benefit from the money expended on vital infrastructure, national defense and security, and the other costs of government, which are increasing every year. For example, it is estimated that the costs to the cities of New York and Boston of providing security at this year's Republican and Democratic party conventions will exceed $125 million, much of which will be subsidized by the federal government. Every citizen should a pay a fair share of the taxes that support these expenditures.

Regrettably, not everyone sees it that way. In some quarters, evasion has become the norm. In a continuing investigation of tax cheating in the sale of fine art, my office has convicted more than a dozen dealers in fine art of colluding with customers to avoid sales taxes by falsely reporting transactions as out of state sales. In the past two years, we have collected $24.6 million in back sales and use taxes and fines in the fine art industry alone. Actually, a partner at a major accounting firm told me that this figure is low – that the back taxes paid as a consequence of this investigation probably exceed $100 million.

Although investigating these cases is difficult and time-consuming, it is important that we undertake them. In a democratic society such as ours, where we rely largely on voluntary compliance with the tax laws, the tax system must not only be fair, it must be perceived to be fair. People will pay their taxes so long as they believe others are also paying their share. For that reason, tough enforcement against those who do not pay is essential.

Of course, criminal enforcement is only part of the solution to keeping tax evasion and fraud in check. Enforcement by the Internal Revenue Service as well as

state and local tax authorities is equally important. And the work of the Congress in making certain the U.S. Tax Code allocates the tax burden fairly is also critical.

In recent years, we have seen one interest group after another seeking to take unfair advantage by manipulating provisions of our tax laws. I know members of this committee have done some important work in regard to corporate tax inversions, which have come into vogue in recent years. As it happens, the chairman of a major U.S. company who is currently under indictment in Manhattan for a corporate fraud boasted that he saved his company $400 million in taxes by establishing a nominal headquarters for the company in Bermuda. Corporate inversions and other major tax dodges – such as so-called "skimming" practices which reduce corporate profits onshore and abusive tax shelters – not only deprive the federal government of needed tax revenues, but also reduce revenues in New York and other states which have tax systems tied to the federal system.

Addressing these inequities is as important as any other step we can take to increase confidence in the tax system. If we want to minimize the financial burden on honest taxpayers, we must ensure that every U.S. citizen and corporation pays a fair share of taxes.

TESTIMONY
of

NINA E. OLSON
NATIONAL TAXPAYER ADVOCATE

before the
SENATE COMMITTEE ON FINANCE

on
THE TAX GAP AND TAX SHELTERS

21 JULY 2004

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Mr. Chairman, Senator Baucus, and members of the Committee, thank you for inviting me to testify here today on approaches to reducing the tax gap. I commend the Committee and Commissioner Everson for their efforts in highlighting this issue. The tax gap has dogged tax administration since its inception. The good news is that, to the best of our knowledge, the taxpaying public pays approximately 85 percent of the taxes it owes. The bad news is that the taxpaying public does not pay approximately 15 percent of taxes due.[1]

I. THE SIGNIFICANCE OF THE TAX GAP TO MOST TAXPAYERS

The tax gap has real victims. Individuals and businesses that evade tax impose a significant burden on those who comply with their tax obligations. If we divide the 2001 net tax gap estimate of $255 billion by 130 million individual taxpayers,[2] we can see that each of those taxpayers in 2001 paid, on average, an extra $2,000 to subsidize the unwillingness or inability of some taxpayers to pay their fair share.

As the National Taxpayer Advocate – the advocate for *all* taxpayers as well as specific taxpayers – I am concerned about the economic and social costs that this noncompliance imposes. In fact, in my 2003 Annual Report to Congress, I identified the tax gap as the most serious problem facing taxpayers, after the AMT. It comes down to a simple issue of fairness.

II. A FRAMEWORK FOR ENFORCEMENT ACTIONS

The Internal Revenue Service is now mounting a vigorous response to the tax gap and has identified major aspects of the gap as enforcement priorities through 2009.[3] As the IRS expands its enforcement initiatives going forward, it is important that the IRS develop the best possible framework for determining how to allocate its resources – in terms of enforcement, taxpayer education, taxpayer assistance, and protection of taxpayer rights.

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[1] Since 1973, compliance with the Federal income tax by individuals and corporations on legal-source income has been relatively constant, hovering between 81 and 85 percent. American Bar Association Commission on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance,* 41 Tax Law. 329, 334 (1988) [hereinafter the "ABA Report"].

[2] This reference to "taxpayers" refers to the number of returns filed, including joint returns.

[3] Internal Revenue Service, *Strategic Plan 2005 – 2009*, Publication 3744 (Rev. 06-2004), pp. 18-25.

A. Use National Research Program Data

The foundation for any resource allocation should be the National Research Program (NRP) data.[4] Although it does not provide a perfect snapshot of noncompliance, the NRP data should certainly constitute the starting point in determining the size of the tax gap and its key components.

B. Map Enforcement Initiatives to the Tax Gap

Different components of the tax gap will require different strategies and approaches. Thus, any recommendation for an enforcement initiative should be "mapped" to the tax gap. For example, if the IRS were to develop a comprehensive return preparer strategy, it might adopt one approach for preparers of individual returns with small businesses and self-employment income and another approach for preparers of high-income individual or corporate returns. Each of the tax gap components presents its own unique set of challenges.

C. Understand and Address Causes of Noncompliance

Once the key components of the tax gap have been identified and analyzed, we should consider (1) the causes of noncompliance and (2) ways to reduce the opportunity for noncompliance. By understanding what triggers or causes a taxpayer or segment of taxpayers to be noncompliant, the IRS can choose the appropriate method to foreclose noncompliance opportunities, be it expanding withholding of taxes at the source, increasing third-party payment reporting, or increasing information sharing between government agencies. Any proposed approach must be weighed against the taxpayer's privacy rights and expectations, the taxpayer's statutory and other due process rights, and the potential expense and other burden on compliant taxpayers.[5]

Traditionally, the IRS allocated resources by balancing revenue loss against the cost of collection actions. This approach, however, only takes into consideration direct revenue loss. Taken to the extreme, under this analysis, the IRS would only conduct audits on corporate and high-income individuals and on low-income taxpayers who receive the Earned Income Tax Credit (EITC). In fact, this

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[4] The National Research Program (NRP) is a comprehensive cross-functional effort by the IRS to measure reporting, filing and payment compliance for different types of taxes and different groups of taxpayers. NRP information will help the IRS identify areas of noncompliance on which to focus, thereby improving voluntary compliance. The IRS has been without such information for more than a decade. NRP currently reports payment compliance data for all types of tax across IRS Operating Divisions as well as filing compliance data for individual income taxpayers. NRP is also charged with measuring reporting compliance at a strategic level – it is currently conducting a study of individual income taxpayers and is in the planning stages of a pilot study of flow-through entities (i.e., partnership and S corporation returns).

[5] ABA Report, *supra* note 1, at 331.

description comes fairly close to summarizing the IRS examination program today.

If one adds *indirect* revenue loss into the equation, however, one might devise a very different enforcement strategy. We really don't understand the impact of our enforcement actions very well. What is the ripple effect of a few well and strategically placed audits? Do such audits result in less revenue loss than more numerous but poorly targeted audits? What is the impact of these two examination approaches on future compliance by the audited and other taxpayers? How effective are "soft" touches such as warning letters, self-audits, and even information campaigns?

Subject to the completion of the NRP, the best data we have today show that the largest portion (over 40 percent) of the tax gap arises from the underreporting of business income by individuals, which contributes to both the individual income tax gap and the employment tax gap ($81 billion and $51 billion, respectively, out of a $310 billion gross tax gap for 2001).[6] The IRS estimates that three-quarters of the employment tax gap may arise from self-employed individuals, including independent contractors.

Breakout of Employment Tax Gap[7]

Type of Tax	TY2001 Tax Gap ($B)	Percent Distribution
FICA tax	14	22
Self-Employment (SECA) tax	51	77
Unemployment (FUTA) tax	1	1
TOTAL	66	100

Clearly, we cannot ignore a compliance problem of this magnitude. Individual business income underreporting has two components – underreporting of actual business receipts and over-reporting of business expenses. Although all types of individual business income are underreported – farms, non-farm proprietorships, rents, royalties, and partnerships – farm and non-farm sole proprietorships are the largest source of underreported income. Approximately one-third of these income sources do not show up on tax returns – either for income or self-employment tax purposes.[8]

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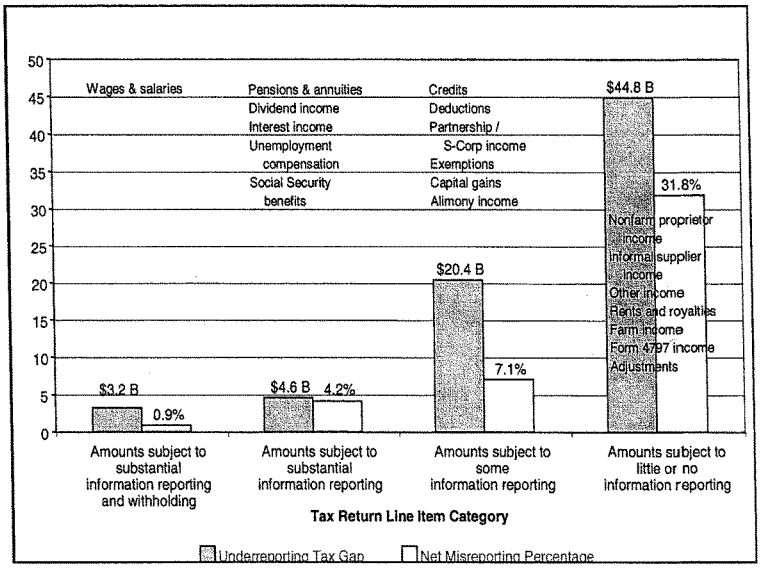
[6] IRS National Headquarters, Office of Research, *Tax Gap Map for Tax Year 2001.*

[7] *Id.*

[8] IRS National Headquarters, Office of Research, July 2004. The underreporting of income is often referred to as the Net Misreporting Percentage (NMP). The NMP shows the percentage of income that is not reported after netting underreporting of income and overreporting of offsets to income, such as deductions and exemptions. The NMP for self-employed taxpayers is estimated at 32 percent.

This relatively high rate of underreporting of income among sole proprietors is largely due to the general absence of information reporting by third parties on their earnings. Prior research studies show that reporting compliance depends directly on the "visibility" of the relevant transactions – i.e., the degree to which a type of income is subject to information reporting determines the degree to which it is "visible" to the IRS. This relationship is clearly demonstrated in the following chart:

Underreporting of Income By "Visibility" Categories
Individual Income Tax, Tax Year 1992[9]



Admittedly, increasing tax compliance by sole proprietors, particularly informal suppliers,[10] presents considerable challenges. This income is often in the form of

[9] Tax Year 1992 is the last year for which line-item compliance measures have been published. *See* Internal Revenue Service, *Individual Income Tax Gap Estimates for FY 85, 88 and 92,* Publication 1415 (Rev. 04-1996).

[10] Informal Suppliers are the least compliant proprietors. This category includes a broad range of sole proprietors who operate in an informal business style—typically with poor or nonexistent books and records, often on a cash basis, and often anonymously with no fixed place of business. Examples include street vendors, roadside stand operators, door-to-door salesmen, and moonlighters.

cash payments or without a paper trail. Under a traditional cost-benefit analysis, one might not even try to increase compliance. It simply costs too much to recoup a small per-taxpayer revenue loss; arguably, for the same expenditure of resources, one could get a better return on investment by auditing one high income individual. Because noncompliance by self-employed persons constitutes the largest single component of the tax gap, however, we cannot just walk away from this compliance problem. We need to develop a more creative approach.

D. Reduce Opportunities for Noncompliance

The two most effective steps Congress and the IRS can take to reduce the opportunities for noncompliance in this sector are (1) enforce existing, and expand, third-party information reporting requirements and (2) expand withholding at the source.

1. 1099 Reporting Compliance

Based on the 1988 Tax Compliance Measurement Program and other studies (all conducted more than a decade ago), various researchers have found that information reporting is strongly associated with much lower rates of misreporting by individual taxpayers. For example, wage income is almost entirely subject to both information reporting and withholding, with the result that less than one percent of wage income is estimated to be underreported on individual income tax returns.[11] In contrast, over 30 percent of sole proprietor income is thought to be underreported, and over 80 percent of informal supplier income is believed to be underreported.[12] These extremely high misreporting percentages appear to arise because these types of business income are subject to little, if any, third-party information reporting. Other types of compensation that are subject to information reporting but not to withholding (e.g., pensions and annuities) exhibit a misreporting percentage on the order of four to five percent – not quite as good as wage income, but still quite low.[13]

Based on these earlier data, we would expect that independent contractor earnings and other forms of personal compensation that are not currently subject to third-party information reporting are probably underreported to an extent somewhere between the rates associated with established sole proprietors and informal suppliers – perhaps on the order of 50 percent underreported.[14] However, if these types of compensation were to become subject to information reporting, we would expect them to be reported much like other forms of personal

[11] IRS National Headquarters, Office of Research, July 2004.
[12] *Id.*
[13] *Id.*
[14] IRS National Headquarters, Office of Research, July 2004. An independent contractor is subject to income reporting if income earned is greater than $600 per person per year.

compensation that are subject to such information reporting – on the order of about 5 percent underreported.[15] In other words, we would expect the introduction of information reporting to induce much greater taxpayer compliance.

Given the connection between income reporting and compliance, one might be tempted to require that *all* economic transactions be reported. Of course, that would impose significant, and in some cases unacceptable, burdens on taxpayers and the economy.

Fortunately, there are less burdensome alternatives involving information reporting. For starters, the IRS can do much more with the information it already has on hand. Although the IRS requires reports of non-employee compensation, these income reports are difficult to match to amounts reported on tax returns because they are lumped in with gross receipts on the tax form. If the IRS simply redesigned its Schedule C, Profit or Loss From Business (Sole Proprietorship), to include two separate lines for reporting income – one line for "receipts shown on 1099s" and one line for "other receipts" – the IRS would be able to conduct more accurate document matching. Further, because the IRS would be signaling that it is looking more closely at the source of gross receipts, taxpayers might feel pressured to report more non-1099'd income, thereby increasing compliance further.

Another approach to increasing reporting compliance is to ask a taxpayer on Schedule C or Schedule F, Profit or Loss From Farming, to affirmatively declare, under penalties of perjury, whether he or she paid more than $600 to any one individual or partnership during the calendar year. If the taxpayer answers this question in the affirmative, then the taxpayer must indicate on the schedule whether he or she filed the appropriate Forms 1099 reporting these payments.[16]

These two simple questions would confront the sole proprietor with his or her obligation to file income reports. Those taxpayers who were unaware of this requirement would be put on notice. For those taxpayers who weren't making reports because the recordkeeping is annoying and burdensome or who think the IRS is too busy to find them, the stakes and attendant risks would suddenly rise. For taxpayers who persist in assisting others in avoiding taxes by not making third party income reports after being explicitly queried on the tax schedule, well, the IRS would now have more ammunition to go after them. Either way, these two simple questions would "out" those taxpayers who are hiding independent contractor payments in cost of goods, or professional services, or miscellaneous expense categories.

With respect to informal suppliers, we could attempt to address this difficult problem by negotiating information sharing agreements with localities and states

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[15] *Id.*
[16] ABA Report, *supra* note 1, at 360.

that issue licenses. For example, localities that issue street vendor licenses could provide us with the names and addresses of vendors. With this information, the IRS could develop a local project for auditing a few of these vendors. The audit would specifically examine whether the vendor reported to the IRS payments made to those individuals staffing the vendor's carts. Having identified the vendor's subcontractors, the IRS would examine the subcontractor's returns to ensure that the subcontractors reported all income earned. This type of audit – what I call the "infection audit" – is highly effective in close-knit work communities. It does not take a large number of these audits to have a significant effect on compliance, since the presence of the IRS spreads quickly throughout the community by word of mouth. A regular cycle of these audits would put the message out on the street that the IRS is no longer a sleeping giant.

Many locally or state-issued licenses require a statement by the applicant estimating his or her annual gross receipts. For example, contractor's licenses are often issued in classes based on the dollar threshold of construction projects. If the IRS obtains this information from the states or localities, it can identify taxpayers who have never surfaced before or whose state or local license applications report gross receipts different from the amounts shown on their tax returns. In some cases, a simple inquiry from the IRS may prompt increased compliance.

Finally, Congress should consider expanding income reporting to corporations, perhaps linking it to a size criterion. As the American Bar Association has observed:

> Establishing reasonable and equitable criteria for reporting is a difficult task, but we believe that differentiating corporations from individuals and partnerships without considering size or complexity is arbitrary and inappropriate. Incorporated individuals and businesses should not have more opportunity for noncompliance than unincorporated ones of comparable size.[17]

The absence of a third-party reporting requirement for small corporations enables taxpayers to avoid the scrutiny of the IRS by the mere act of incorporation.

2. Non-wage Withholding

Internal Revenue Service data indicate that where withholding at the source is imposed, income reporting is nearly 100 percent.[18] In my 2003 Annual Report to Congress, I recommended withholding on non-wage payments, as both the Government Accountability Office (GAO; formerly the General Accounting Office)

[17] ABA Report, *supra* note 1, at 359.
[18] IRS National Headquarters, Office of Research, July 2004.

and the Treasury Inspector General for Tax Administration (TIGTA) have recommended previously.[19] Since issuing my report in January 2004, I and my staff have met with over thirty groups representing the interests of small business and have discussed our proposal and their concerns. While many of these groups continue to express concerns about our proposal, we believe this approach should be seriously studied.[20]

Certainly, no one wants to increase burdens on small business. As a matter of basic fairness, however, the size of the tax gap compels us to explore non-wage withholding. I believe that there are several ways to impose withholding at the source, or offsets on non-wage payments, while keeping the burden on the payor to a minimum. For example, the IRS could enter into voluntary withholding agreements under IRC § 3402(p)(3)(A) and (B) with various trades or industries. Congress could expand the Service's back-up withholding authority under IRC § 3406 to apply in specific taxpayer cases where there is a demonstrated history of noncompliance. The IRS could use its Federal Payment Levy authority under IRC § 6331(h) to offset Federal payments, including payments to Federal contractors. And Congress could authorize the IRS to require withholding, where practicable, when NRP data indicate significant underreporting in a specific trade or industry.

3. Noncompliance by Federal Contractors

Every federal agency head who enters into certain contracts is required by the Internal Revenue Code to file two information-reporting documents with the IRS.[21] Form 8596, Information Return for Federal Contracts, provides information about contract recipients, including the date of contract action and

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[19] *See* Hearing on *Compliance Problems of Independent Contractors*, GAO # 109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); *see also* GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108, July 1992, p. 4; General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 11, 1994, p. 37; GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Tax Administration: *Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, August 1996, p. 12; Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference # 2001-30-132, Aug. 2001, p. ii.

[20] In the 1940s, when wage withholding was implemented, similar concerns were expressed. One witness told the House Ways and Means Committee that wage withholding was "perhaps the most burdensome and impracticable plan that has ever been seriously proposed by any responsible public official." Hearings Before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong. (vol. I), 620 (1942) (statement of Laurence Arnold Tanzer). Yet wage withholding has been an extraordinary success story from the standpoint of Federal revenue, and it explains in large part why the U.S. has one of the highest tax compliance rates in the world.

[21] IRC § 6050M.

the total amount to be obligated under the contract. Form 1099-MISC, Miscellaneous Income, reports the amount paid each year to contractors. For purposes of Federal contract reporting, these forms are required to report contracts and amounts paid to corporations as well as individuals.[22]

Despite the fact that two documents are required to be filed with the IRS, the IRS does not have data on overall noncompliance by Federal contractors. Moreover, the IRS does not know whether Federal agencies are filing required Forms 8596 or whether agencies filing Forms 8596 on Federal contractors also file the required Form 1099-MISC reporting payments to those contractors.

The Taxpayer Relief Act of 1997 established the Federal Payment Levy Program, which authorizes the IRS to continuously levy up to 15 percent of certain federal payments.[23] The IRS sends a file of delinquent accounts subject to levy to the Financial Management Service (FMS), which manages the collection of delinquent Federal debt. Yet, according to a GAO report issued in February 2004, over 27,000 Department of Defense contractors owed $3 billion in unpaid taxes, and many contractors continue to receive contract payments without paying federal taxes owed.[24]

Form 8596 only reports the total contract amount obligated, the date of contract action, and the expected date of contract completion. Thus, the IRS can't match Form 8596 reported contract amounts with Form 1099 reports of amounts actually paid under the contract. With these pieces of information, however, an IRS matching program could determine tax return filing compliance and 1099 filing compliance. (As I discussed above, there is a strong correlation between income reporting compliance and overall compliance.) Further, the Form 8596 would alert the IRS to the fact that there is a future income stream available as a

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[22] No information return is required for any contract of $25,000 or less; any contract with a contractor who is acting in his or her capacity as an employee of a federal executive agency; any contract between a federal executive agency and another federal government unit; any contract with a foreign government; any contract with a state or local government unit; any contract with a person who is not required to have a TIN; any contract whose terms provide that all amounts will be paid on or before the 120th day following the date of the contract action; any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a federal executive agency or an agent of such an agency (e.g., a contract under which the contractor will collect amounts owed to a federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract); or any contract for which the IRS determines that information described in Treas. Reg. § 1.6050M-1 will not facilitate the collection of federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract. IRC § 6050A; Treas. Reg. § 1.6050M-1(c)(1).

[23] Taxpayer Relief Act, Pub. L. No. 105-34, § 1024(a)(1)-(2) (1997) (amending IRC § 6331).

[24] General Accounting Office, GAO Report to Congressional Requesters, *DOD Pays Billions of Dollars to Contractors That Abuse the Federal Tax System*, GAO-04-95, February 2004. DOD dispersed $86 billion to federal contractors in FY 2002 that was matched. DOD is not matching payment information from its 15 vendor payment systems, which dispersed another $97 billion to contractors in FY 2002.

levy source. These processes can be automated so they are not, after start-up, heavily resource intensive. Yet these processes would enable the IRS to "touch" the taxpayer and remind the taxpayer that the Service is, in fact, paying attention to tax compliance. This signaling would have a positive effect on taxpayer compliance.

E. Reinvigorate Local Compliance Activity

Prior to the recent IRS reorganization into four operating divisions, geographically based District offices provided local information during the development of the Annual Compliance Plans. These plans consisted of several components and outlined activities and goals for the various compliance functions such as collection, examination, and criminal investigation. Some portion of the Annual Compliance Plan was dedicated to locally generated segment-based compliance initiatives. The locally based portion was primarily formulated and overseen by local Compliance Planning Councils.

Compliance Planning Councils' membership included both compliance division chiefs and the local research offices, as well as noncompliance related division chiefs where appropriate. The council served as a cross-divisional forum for discussion of local, area, or regional compliance issues and determined which initiatives to study, test, and implement at the local level based on factors such as local compliance expertise and resources. This process allowed District Directors to "opt out" of nationally mandated market-segment-based work when it could be demonstrated that the local compliance levels were within tolerance or were of negligible significance. In this instance, resources could be redirected to the locally defined compliance work identified by the council.[25]

These initiatives are sorely needed at this time and are a way to address the largest portion of the tax gap, individual business income (self-employed) underreporting. Local initiatives could be developed in partnership with state and local tax authorities to address a demonstrated area of local noncompliance, such as the initiatives relating to informal suppliers like street vendors discussed above.[26] Through research, the partnership could determine what approaches will be most successful – including soft letters, office audits, or field audits. Local initiatives can be very helpful in learning about how information is disseminated through groups within a community. Designed properly, a local initiative can accomplish a great deal with very few resources.

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[25] Compliance Planning Councils also sought alternative treatments for compliance issues when appropriate. They looked for ways to solve a compliance issue prior to the examination, appeals, and collection processes. Alternative treatments saved human capital resources that could be used in more effective ways.

[26] In practice, state sales and use tax agents and representatives of the state unemployment tax commissions almost always beat the IRS to the door of noncompliant taxpayers.

F. Monitor Tax Return Preparers

1. The Role of Tax Return Preparers in Noncompliance

For Tax Year 2002, the latest year for which data are available, over 55 percent of individual income tax returns were prepared by a commercial tax return preparer or other tax professional.[27] Tax return preparers perform a vital function in assisting taxpayers in meeting their tax obligations. In fact, for many taxpayers, tax return preparers are the gatekeepers to the tax system. Thus, the quality of return preparation can make a taxpayer's interaction with the tax system a positive and uneventful one, or an adversarial and negative one. Tax preparers can contribute to noncompliance either through incompetence or by fostering a sense that noncompliance is acceptable.

The IRS is aggressively investigating practitioners who facilitate improper transactions by corporate taxpayers and wealthy individuals. It is doing virtually nothing, however, about unskilled and unscrupulous preparers who serve middle and lower income taxpayers. The Government Accountability Office has found that the IRS rarely levies penalties against preparers, and even when it does, it collects only 12 percent of those penalties.[28] This inaction not only enables noncompliance but also injures those preparers who are competent and ethical and who must compete with unregulated, incompetent, or unscrupulous preparers.

For two years now, I have advocated for regulation of unenrolled return preparers. Senate Bill 882, the Tax Administration Good Government Act, directs the IRS to do just that – by requiring unenrolled return preparers to register with the IRS and demonstrate their competency.[29] My office has met with virtually every major association representing return preparers, and we are currently conducting focus groups with return preparers at the Tax Forums this summer to discuss the details of this proposal. We have also talked with organizations and businesses that administer licensing programs for states and localities.

What we have learned to date is that competent preparers will accept a regulatory scheme so long as it is not overly burdensome, because certification distinguishes them from fly-by-night, unskilled preparers. We have heard many good suggestions, including requiring registration once every five years instead of annually, and providing a continuing education alternative to the annual update exam (following the initial entrance exam). We have learned that licensing programs administered by contractors can be self-funding without imposing

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[27] Internal Revenue Service, *Statistics Of Income Bulletin Winter 2003-2004.* Calculated from Selected Historical and Other Data (Tables 1 and 23).
[28] General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge,* GAO-04-70, October 2003.
[29] S. 882, § 141.

significant costs on licensees, thereby allowing valuable resources to be applied to enforcing compliance with the regulatory requirements.

We have also heard concerns about the proposed public information campaign required by S. 882. We are committed to ensuring that all types of licensed preparers – attorneys, Certified Public Accountants, enrolled agents, and those certified under S. 882 – will be identified and promoted by the campaign. In fact, the point of this consumer campaign is to warn taxpayers away from unqualified preparers and to educate taxpayers about the different types of preparers, including the limitations on or extent to which they can practice before the IRS. We look forward to working with the IRS and preparers to design a program that enables the majority of taxpayers to feel confident that their preparers are competent to prepare their taxes and that the IRS will punish preparers where they perform negligently or recklessly.[30]

2. Preparer Penalties Should Be Strengthened and Enforced

In addition to regulation of unenrolled preparers, the IRS needs to enforce the preparer penalties that are on the books today, and Congress should strengthen and enhance those penalties. At $50 per violation, preparers view many of the penalties as simply a risk of doing business, and a modest one at that. Other penalties, including the penalty for failure to sign a return, do not fully address the preparer abuses we see today. For example, preparers who are not authorized to practice before the IRS under Circular 230 prepare offers in compromise, Collection Due Process Hearing requests, and financial statements, which constitute IRS practice. None of these documents requires a preparer signature, and there are no preparer penalties for failure to sign.

Approximately 65 percent of taxpayers who claimed the Earned Income Tax Credit in 1999 used paid return preparers.[31] Almost half of the EITC returns filed in 1999, including those filed by paid preparers, involved an EITC overclaim.[32] The Associated Press recently reported that thousands of returns filed by Somalis located in Minnesota, claiming inflated refunds, were prepared by "corrupt tax preparers."[33] One social worker in the community noted that the Somalis are the victims in this case. He stated that "most Somalis have little

[30] We note that regulation of unenrolled return preparers is not merely directed at preparers of Earned Income Tax Credit returns or purveyors of Refund Anticipation Loans. Many small businesses are unable to afford the services of CPAs or even enrolled agents. An uninformed preparer can wreak havoc on a small business' finances. *See* National Taxpayer Advocate, *2002 Annual Report to Congress,* Publication 2104, (Rev. 12-2002), Example at 217.

[31] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

[32] Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (February 28, 2002), p. 11.

[33] Associated Press, *Tax-preparer scheme implicates 3,500 Somalis with suspect tax returns,* Duluth News Tribune, May 23, 2004, available at http://www.DuluthNewsTribune.com.

understanding about tax credits and deductions, which are unheard of in Somalia."[34] To counter just this type of egregious and predatory activity, Congress should hold preparers jointly and severally liable for any resulting EITC overpayment when they prepare EITC returns in reckless disregard of IRS rules and regulations.[35]

III. THE IMPORTANCE OF RESEARCH TO ACHIEVING AN EFFECTIVE COMPLIANCE STRATEGY

A. Compliance Strategies Should Be Based on Current Data

The IRS is currently making its resource allocation decisions relating to enforcement and compliance activities on the basis of Tax Compliance Measurement Program (TCMP) data that is sixteen years old. Obviously, we cannot get the National Research Program (NRP) results soon enough. We also must continue to conduct the kind of core research represented by the NRP on an ongoing basis.

B. Compliance Strategies Should Address the Causes of Noncompliance

It is not enough, however, to rely on NRP data alone in designing tax compliance strategies. While NRP data will tell us *where* we should focus our energies, it will not tell us *how* we should increase compliance in those areas, or *what* type of approach we should take. To increase compliance, the IRS needs a better understanding of why certain taxpayers are not complying with the law and what steps might cause or help them to comply. For many taxpayers, it's simply a question of what they can get away with, but that's not the case for everyone.[36]

In general, the IRS is faced with three types of taxpayers:

1. Taxpayers who are actively complying with the tax laws;
2. Taxpayers who are trying to comply with the tax laws or who would comply if they knew what the laws required of them; and
3. Taxpayers who do not want to comply with the tax laws and are not trying to do so.

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[34] *Id.*

[35] For a complete discussion of the National Taxpayer Advocate's proposals regarding the EITC preparer penalties and the EITC due diligence requirement under IRC section 6695(g), *see* National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), p. 272.

[36] It has been noted that most criminal laws are proscriptive, i.e., in order to comply, a person must refrain from doing an act, such as killing or using drugs. Tax laws, on the other hand, are prescriptive. In order to comply, a person must take certain affirmative actions, such as keep records, file, and pay. This level of complexity leads to a high degree of inadvertent noncompliance as well as the deliberate sort. ABA Report, *supra* note 1, at 351-352.

The IRS' goal must be to adopt policies and procedures that will move all taxpayers into Group 1 (compliant). Its challenge is to adopt a strategy that acknowledges there are differences between Group 2 (trying to be compliant) and Group 3 (noncompliant) taxpayers.

The membership in these three groups of taxpayers is fluid. That is, persons who are attempting to comply can easily be transformed into compliant or noncompliant taxpayers, depending in large part on their experience with the IRS. Taxpayers who are compliant can fall out of compliance as a result of a catastrophic event such as a divorce or illness. And noncompliant taxpayers can, in fact, "see the light," if only out of fear of the consequences of their noncompliance.

An effective compliance strategy would not be identical for the two noncompliant groups. For those taxpayers who are trying to be compliant, it is important to help them – and not to push them into noncompliance through enforcement tactics that frighten them from coming into the IRS to clear up past problems so they can make a fresh start. By contrast, for those persons who consciously choose to evade tax, a more heavy-handed approach would seem appropriate.

In order to design such a strategy, the IRS must conduct research into the motivation of noncompliant taxpayers. The IRS needs to understand why taxpayers don't comply with the law before it can significantly increase compliance. There is general agreement that traditional incentive-based models fail to fully explain the dynamics of tax compliance.[37] Clearly, there are also other factors involved. In fact, a recent survey commissioned by the IRS Oversight Board found that the strongest factor influencing tax reporting is personal integrity (88 percent), with 73 percent of respondents saying it has a great deal of influence on their behavior.[38] Taxpayers reported that other factors have much less of an influence, including third party reporting of income (64 percent), fear of an audit (59 percent), and believing that their neighbors are reporting and paying honestly (38 percent).[39]

Professor Leslie Book of Villanova University School of Law recently adapted sociological research in other areas to develop a typology of tax noncompliance. Professor Book identified at least eight types of noncompliance:

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[37] Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145, 1178 (2003).

[38] IRS Oversight Board, *2003 Compliance Study Report,* prepared by RoperASW, September 2003, p. 10 [hereinafter the "Roper Study"].

[39] *Id. at* 10. Despite the strong belief in their personal integrity, an increasing percentage of people cite fear of an audit as the factor that keeps them honest (+ 8 points from last year for those who say fear of audit has a great deal of influence). There has also been a slight increase in citing third-party reporting as the reason for compliance (+ 4 points).

- *Procedural noncompliance*: Administrative complexity is a hurdle to compliance.
- *Lazy Noncompliance*: Taxpayers are unwilling or unable to satisfy the requirements for compliance.
- *Unknowing Noncompliance*: Taxpayers experience confusion about the rules for compliance.
- *Asocial Noncompliance*: Taxpayers engage in classic tax cheating.
- *Brokered Noncompliance*: Taxpayers' reliance on advice of tax professional results in noncompliance.
- *Symbolic Noncompliance*: Taxpayers do not comply because they perceive inequities in the operation of the tax laws or tax administration.
- *Social Noncompliance*: Social or economic circumstances create an environment that does not discourage cheating.
- *Habitual Noncompliance*: Taxpayers develop a history of noncompliance and become emboldened by "getting away" with noncompliance in past years.[40]

This variety of underlying causes for noncompliance should convince anyone that NRP data, which identify the type of noncompliance (individual, employment, corporate), must be supplemented with research into the causes of noncompliance.

C. Tax Schemes "Tipping Point" Study

The Taxpayer Advocate Service is sponsoring research, conducted by the IRS Office of Program Evaluation and Risk Analysis (OPERA), that exemplifies the focus on understanding taxpayer compliance behavior and will allow the IRS to develop more effective compliance strategies. The goal of the study is to identify methods that will enable the Service to evaluate emerging abusive tax schemes, such as abusive corporate tax shelters and the slavery reparations scheme, and to prevent their dissemination. The research study is divided into two phases.

The objective of Phase I, which was completed on August 1, 2003, was to identify the approaches the IRS has developed that enable early identification of abusive tax avoidance schemes and mitigate their impact. The end product of Phase I was a comprehensive inventory of IRS activities in these areas. (See Appendix A.)

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[40] *See* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003). Professor Book draws largely from the social science perspective offered by Professors Robert Kidder and Craig McEwen. *See* Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 Taxpayer Compliance 47 (1989).

Phase I results show that the IRS units have identified a wide variety of shelters and schemes. They have also recently formed bodies to coordinate their efforts. Collectively, the IRS's efforts to combat abusive schemes demonstrate a significant commitment of resources. The range of mitigation strategies it employs includes public information and alerts, new disclosure requirements for promoters and participants, other outreach and communication to affected areas, examination and investigation, and litigation. This range illustrates the value of a coordinated and balanced approach combining outreach and enforcement to attain compliance.

A major challenge confronting the IRS is to build upon the work that has been done to become more proactive in our detection, evaluation, and mitigation strategies. This will allow us to better target and leverage our finite resources to prevent the growth of emerging schemes and minimize their impact.

Building upon the taxonomy of schemes developed in Phase I, the second phase of the study, which began in April 2004, will track the course of "infection" of certain schemes among the taxpayer public. The schemes chosen for analysis are the "home based business" and "claim of right" schemes.[41] The study will attempt to identify who were the key "agents" of the scheme, what paths provided the most fruitful dissemination, and what particular aspect of the scheme appealed to the population so that they were persuaded to participate.[42]

Statistical modeling techniques are being applied to IRS data sources to look for patterns within schemes. The goal is to identify any common characteristics among schemes, promoters, and participants that might assist with early identification of emerging tax schemes and mitigation of their impact on taxpayers and the IRS. The team is also evaluating the application of behavioral modeling techniques to supplement findings from the statistical modeling study currently being conducted.

D. Inherent Limitations of IRS Research

While I've spoken about the importance of using research data well, and I believe the IRS research staff is second to none, it's important that people understand the inherent limitations on the accuracy of the data. In short, we don't know what

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[41] "Claim of Right" schemes consist of frivolous or fraudulent requests for refunds citing IRC § 1341, in which a taxpayer attempts to take a deduction equal to the entire amount of his wages. The taxpayer typically submits a Form 1040 or Form 1040X reporting wage income and other income items and attaches a Schedule A claiming a miscellaneous itemized deduction on the ground that the wages are deductible because they are compensation for personal labor which is not taxable, or because there was an equal exchange of labor and/or services for the amount claimed.

[42] This aspect of the study relies heavily on the concept that an idea can act as an epidemic, as discussed in Malcolm Gladwell's book, *The Tipping Point: How Little Things Can Make A Big Difference* (2000).

we don't know. And that's true both for estimated underpayments of tax and estimated overpayments of tax.

On the underpayment side, the IRS cannot determine with accuracy how many persons were required to file tax returns but didn't, or how much illegal source income went unreported. While the IRS can make estimates of under-reporting generally, the estimates are only estimates. For example, the IRS might audit an electrician who performs jobs for both businesses and homeowners and was paid by some homeowners in cash. If the electrician did not report some or all of the cash transactions, it is difficult for the IRS to determine how much income went under-reported, yet its estimates of unreported income rest on audits of taxpayers just like this one.

On the overpayment side, the IRS knows that millions of taxpayers fail to claim all the credits, such as the EITC, and other deductions for which they are eligible, but it does not attempt to project how much of a Federal revenue windfall results from taxpayer failure to claim those benefits. In addition, it is significant that the IRS has a high no-response rate for of much of its correspondence, including correspondence examination notices.[43] Thus, IRS adjustments may simply reflect default adjustments and not state the correct amount of tax due. In FY 2002, for example, the Taxpayer Advocate Service closed more than 30,000 cases involving the IRS's EITC Revenue Protection Strategy examinations, and in more than half of the cases, the IRS ultimately agreed to a change in the result determined at the examination level.

Therefore, while IRS's compliance strategy should be based on the best research we have, no one should blindly cite the research conclusions as if they present a perfect snapshot of reality. They can't and they don't.

IV. THE MORAL DIMENSIONS OF TAX COMPLIANCE

The IRS Oversight Board's 2003 Compliance Study Report found that 81 percent of individual taxpayers believe that no form of cheating on taxes is acceptable, down from 87 percent in 1999.[44] The report also found that although 95 percent of taxpayers at least "mostly agree" that paying taxes is a civic duty, since 1999 the proportion of taxpayers who "completely agree" that it is every American's civic duty to pay their fair share of taxes has steadily declined, from 81 percent in 1999, to 72 percent in 2002, to 68 percent in 2003.[45]

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[43] Data provided by the EITC Program Office to TAS for FY 2003 indicate nearly a 40 percent no response/undeliverable rate for EITC correspondence. The no response/undeliverable rate including Statutory Notice of Deficiency is 53 percent.
[44] Roper Study, *supra* note 38, at 6.
[45] *Id.* at 9.

To me, however, the most interesting finding of the Oversight Board's study pertains to taxpayers' expressed preference for whom the IRS should enforce the laws against. Not surprisingly, taxpayers want the IRS to go after corporations (83 percent say it is very important) and high-income individuals (79 percent).[46] Yet only 70 percent and 63 percent of taxpayers say it is very important to enforce the tax laws against small businesses and low-income taxpayers.[47] There is clearly a "not in my backyard" mentality at play here, which creates a dissociation of tax compliance from personal integrity and civic duty.

I believe that the Congress, the Administration, and the IRS must make the case that paying taxes is a civic duty. We can disagree and advocate about how the tax laws are structured and about the rate and incidence of taxation. But once these decisions are made, taxpayers must make their best efforts to comply.

We need to shift taxpayers' focus from using someone else's noncompliance as an excuse to not comply. We must appeal to that strong element of personal integrity that the Oversight Board's study suggests is the strongest factor influencing compliant behavior. We must make taxpayers see that noncompliance has its victims and that its victims are us. We facilitate noncompliance by our silence, in a thousand little ways – by our failure to object when someone at a neighborhood barbecue gloats and jokes about not reporting certain income or deducting personal expenses on a business return or by agreeing to pay a child-care provider in cash at a lower rate of pay than when the payments are reported to the IRS.

We need to make it clear that it is not okay to cheat on your taxes. In 1988, the American Bar Association Commission on Tax Compliance noted that it is not easy to modify prevailing norms and attitudes toward tax compliance. It recommended, however, that Congress authorize a broad-based public information campaign, modeled after the campaigns against smoking and drunk driving. Such a campaign would have three basic messages:

1. Tax cheating has direct and indirect victims.
2. Tax cheating is a widespread social problem and does not affect just a few people.
3. Everyone should attempt to influence the behavior of others: just say NO to tax cheating.[48]

I believe this proposal should be resurrected and considered. Such a campaign could be designed to build upon the findings of the Oversight Board Study and appeal to the personal integrity of all U.S. taxpayers. The campaign, coupled with media coverage about IRS efforts to identify, deter, and punish taxpayers

[46] *Id.* at 16.
[47] *Id.* at 16. With respect to low income evaders, the percentage increased by 7 points from 2002.
[48] ABA Report, *supra* note 1, at 383.

who cheat, could go far in making taxpayers not feel like chumps if they comply with the tax laws.

V. BALANCING TAX ENFORCEMENT AGAINST TAXPAYER RIGHTS

The tax system historically has struggled to achieve the right balance between enforcing the tax laws and respecting taxpayer rights. Indeed, perceptions about IRS shortcomings have often led to fitful shifts between emphasis on enforcement and emphasis on taxpayer rights. As the IRS is now stepping up enforcement activities, it is the role of the National Taxpayer Advocate to help ensure that the aggressive enforcement of the tax laws is balanced by the aggressive protection of taxpayer rights. Moreover, it is the role of TAS to serve as the safety valve for any excesses or oversights that might occur during the implementation of enforcement initiatives.

In my most recent report to Congress, delivered on June 30, I focused on the protection of taxpayer rights as a mandatory component of tax administration. I noted that enforcement of taxpayer rights assures taxpayers that the IRS' enforcement of the tax laws will be balanced and fair. It is easy to give lip service to the term "taxpayer rights" but much more difficult to incorporate this concept into action. My report identified three measures to bolster the protection of taxpayer rights:

A. Taxpayer Rights Impact Statement

The IRS often implements new procedures, guidelines, or requirements that further its enforcement or administrative goals but may place a significant burden on the time, rights, or privacy of taxpayers. In 1998, Congress strengthened the Office of the Taxpayer Advocate and created the Taxpayer Advocate Service (TAS) to act as a safety valve when institutional tendencies within the IRS do not adequately take account of taxpayer rights. Beginning immediately, the Office of the Taxpayer Advocate will prepare a Taxpayer Rights Impact Statement (TRIS) on major initiatives to help the IRS incorporate an awareness of taxpayer rights into its program planning and implementation. If the IRS function responsible for developing an initiative asks for our input during the planning phase, our taxpayer rights perspective can be incorporated into the initiative's design. I think this is preferable. However, if the IRS does not request a TRIS prior to program implementation, TAS will analyze programs on its own accord, if and when appropriate.

B. Improved IRS Employee Training

Over the next few years, the IRS plans to hire thousands of new employees as part of its initiatives to strengthen its enforcement of the tax laws. For these

employees to pursue tax noncompliance aggressively yet fully respect taxpayer rights, they require training in the foundational, technical, and behavioral aspects of tax administration, including training in the importance of world-class customer service and respect for taxpayer rights. During FY 2005, the Office of the Taxpayer Advocate will study key aspects of the IRS training program for new employees and make recommendations consistent with its objectives.

C. Increased Awareness of the Taxpayer Advocate Service

Other functions of IRS generally are and should remain the first point of contact for taxpayers needing assistance with their problems, but taxpayers must be better informed that TAS is available as a backstop when regular IRS procedures fail. A recent study commissioned by TAS indicates that approximately 1.5 million taxpayers at any given time meet the statutory "significant hardship" test and thereby qualify for TAS assistance. Thus, as part of IRS employee training, employees should be educated about existing guidelines for referring cases to TAS. In addition, the study found that approximately 43 percent of taxpayers who qualify for TAS assistance at any given time report that they feel intimidated by the IRS. They therefore are unlikely to call the IRS to obtain assistance and are in danger of becoming habitually non compliant. The Office of the Taxpayer Advocate has developed an outreach strategy to inform this taxpayer population about TAS and its ability to assist these taxpayers in resolving their tax problems.

VI. Conclusion

The Commissioner has made it clear that the IRS is back in the business of tax law enforcement, and that is a good thing. But it is essential that the IRS strive to maintain a balance between enforcing the laws and protecting taxpayer rights. A balanced approach protects taxpayer rights as aggressively as the law is enforced. A balanced approach acknowledges that not all taxpayers who make errors are intentionally noncompliant, and recognizes that different noncompliant behaviors require different responses. It strives to support and appreciate taxpayers who are complying with tax laws, to provide assistance, education, and opportunities (including gentle persuasion) to taxpayers who are attempting to comply, and to take firm, direct, and immediate action against taxpayers who do not want to comply. A balanced approach does not ignore areas of noncompliance simply because they are difficult to deal with. It includes creative approaches to intractable problems. And it does it on a solid foundation of research, so that valuable and limited resources are used wisely and effectively.

APPENDIX A: ABUSIVE SCHEMES "TIPPING POINT" STUDY

[For electronic copies, the Abusive Schemes "Tipping Point" Study will be transmitted as a separate file.]

Appendix A: Abusive Schemes "Tipping Point" Study

August 1, 2003

MEMORANDUM FOR NINA E. OLSON
NATIONAL TAXPAYER ADVOCATE

FROM: Mark J. Gillen
Director, Office of Program Evaluation and Risk Analysis

SUBJECT: Summary of OPERA's Analysis of IRS' Posture for Identifying and Mitigating Abusive Tax Avoidance Transactions and Schemes – Phase I

The attached briefing documents represent the Office of Program Evaluation and Risk Analysis' observations from our review of the Service's efforts for identifying and mitigating abusive tax avoidance transactions and schemes.

Our objective was to determine what approaches, processes, and procedures the Service has developed and/or implemented that would enable (1) early identification of abusive tax avoidance schemes and (2) mitigation of the impact of these schemes before they proliferate.

The attachments summarize the information compiled from reviewing the four operating divisions and other functions with responsibilities and activities relating to abusive tax avoidance transactions and schemes. This includes the offices and programs specifically developed to combat abusive schemes or scams. OPERA did not, however, validate any of the approaches, processes, and/or procedures noted by the divisions or functions.

Attachment A lists those individuals and organizations that we interviewed during our review. The additional attachments (Attachments B through G) provide a snapshot of the strategic initiatives and internal structures to detect and mitigate abusive schemes and scams as well as those schemes and scams already identified by the Service.

If you have any questions or need additional information, please contact me at (202) 927-5647, or have someone from your staff contact Timothy Morrison, Senior Manager at (202) 927-5641.

Attachments

OPERA Study of IRS' Posture for Identifying and Mitigating Abusive Tax Avoidance Transactions & Schemes

Phase I Observations and Proposed Plans for Phase II

Briefing for the National Taxpayer Advocate

August 1, 2003

Since our initial briefing with you on May 21, 2003, and the briefing we gave to the Abusive Tax Evasion, Avoidance Schemes & Devices (ATEASD) Executive Steering Committee (ESC) on June 26, 2003, we have updated our compilation (updates are highlighted with gray shading) of the Service's efforts to identify and mitigate abusive tax avoidance transactions and schemes. In addition, we have annotated and updated this briefing (highlighted with gray shading) document that we originally gave to the ATEASD ESC and incorporated our modified proposed plans for the second phase of this project.

Background

- With the apparent increased appetite for tax avoidance schemes, like abusive tax shelters, and scams, such as slavery reparations, the National Taxpayer Advocate's Office requested analytical assistance from OPERA to identify what IRS is doing to detect emerging schemes or scams and to minimize the implications of those detected.
- NTA and OPERA have collaborated on a compilation of IRS detection and mitigation initiatives to identify the Service's current posture, capability, and direction relative to abusive schemes and scams.
- The collaboration started with those known to have explicit responsibilities for abusive taxpayer activities, like: OPERA's recent review of the communications/outreach activities related to slavery reparations; those in Criminal Investigation involved with fraud detection; those in Research who have studied IRS' previous Tax Protestor Program; and those in LMSB who have pursued abusive tax shelters.
- Between those contacted with known related responsibilities, Intranet research, and OPERA's work with the CFO's Office reviewing the FY2005 strategic planning submissions; we have learned that there are numerous units involved in the detection and mitigation of abusive schemes and scams and that their activities are being increasingly coordinated as well as made known to the public.
- We also learned about the ATEASD and other coordinating bodies that have been established to further and leverage the efforts of the many throughout the Service involved with the detection and mitigation of abusive shelters, schemes, and scams. We have received meaningful insights about these individual and collective efforts from the ATEASD membership and extensions of it in the respective organizations.

Study Objectives

- Identify what approaches, processes, and procedures the Service has developed and/or implemented that would:
  - Enable early identification of abusive tax avoidance schemes, and
  - Enable the Service to mitigate the impact of these schemes before they proliferate.

Methodology & Scope

- Conducted interviews with officials from various operating divisions and operating units who are known to play an active role in identifying, assessing and/or mitigating abusive tax avoidance transactions and schemes.
- Researched IRS Intranet and reviewed various documents related to abusive tax schemes and scams.
- Contacted others whose related activities were brought to our attention in the interviews or research to identify their role and relationship to IRS' abusive scheme and scam detection and mitigation efforts.

Information Compiled

- Based on those interviewed, we learned that numerous IRS units have identified abusive taxpayer behaviors as serious concerns and have strategic initiatives and internal structures to detect and mitigate abusive schemes and scams. *(Attachments A, B, C-I, and C-II, CIII respectively).*
- We have also compiled information about the schemes and scams identified along with the unit identification and mitigation efforts, as well as illustrations of the unit structures and related activities. *(Attachments D-I, D-II, E & F, respectively)*
- IRS has also initiated efforts to coordinate and leverage these unit activities, including: establishing the ATEASD ESC and other coordinating bodies; and warning the public about the "Dirty Dozen" for 2003 of common scams, as well as others that have since been identified, including the advance child tax credit scam recently brought to the public's attention. *(Attachment G)*

Observations

- IRS has **extensive efforts underway to combat abusive taxpayer behavior**. While the abusive tax shelter area is further along with regard to its coordinated detection and mitigation capabilities, the comparable efforts relating to abusive schemes and scams are being aggressively developed in literally every major unit, through their strategic plan

initiatives along with other activities, and coordinated through bodies like the ATEASD.

- While we noted that **W&I is the only major unit without a strategic initiative related to abusive taxpayer behavior**—beyond an OP to support the efforts of the other units--a structure or official responsible for schemes or scams, or full ATEASD membership; it has comparable strategic efforts to learn about its segment's "taxpayer of the future", W-4 initiative, EITC program activities, as well as the inclusion of individual taxpayers in the detection capabilities managed by CI and SBSE.
- The compilation of the collective efforts across the Service to identify and mitigate abusive shelters, schemes, and scams shows a considerable commitment to combat these behaviors. Most noteworthy may be the **range of the mitigation strategies, which employ the full arsenal of tools available to the tax administrator** from public information and alerts, new disclosure requirements for promoters and participants, other outreach and communication to affected areas, examination and investigation, and litigation. We were struck by the range of treatments applied to combating the abusive behaviors detected as well as the response from taxpayers to each of the techniques employed. This range illustrates and epitomizes the value of a combination of service and enforcement in IRS efforts to attain voluntary compliance.
- IRS units have identified numerous abusive taxpayer behaviors through a wide variety of shelters, schemes, and scams; and have **recently formed bodies to coordinate its collective efforts to combat the proliferation of these behaviors**. While the Service's efforts to detect and combat abusive taxpayer behaviors are expansive, the generation and proliferation of these activities by promoters, scam artists, and others is imposing—especially through mass mediums like the Internet.
- The coordinating bodies are at a relatively formidable stage, with **their natural evolution to proceed from coordinating our activities relative to the known abusive behaviors to learn from our experience to attempt the earliest possible identification** of abusive behaviors to preclude their proliferation.
- Among the many challenges facing those combating abusive behaviors is **clustering or categorizing the shelters, schemes, or scams identified in meaningful ways**, especially since their identification emanates from a variety of sources and are initially assessed within the various unit structures.
- The other natural evolution of this extensive body of work is to analyze and assess our individual and collective capability, based on what has been identified and mitigated, to **determine how to get into a more proactive posture through early detection, proliferation assessment, and tailored mitigation strategies.** This capability would build upon the work that has been done and evolved to where we are today. It would build upon this work to achieve earlier identification and even predictive analytical capabilities. This would allow us to better target and leverage

our finite resources to preclude proliferation that casts us into a reactive mode and at a distinct disadvantage to minimize the compliance implications.

Where Do We Go From Here?

- Possibly, draw upon those who collaborated with us to compile this portrayal to **learn more about the various means for clustering or categorizing** the identified abusive taxpayer behaviors.

  Note: While we are continuing to coordinate with SB/SE/SPDER on the knowledge management initiative, we do not know the extent to which these efforts will align.

- During our June 26, 2003, presentation of our preliminary results of the first phase of the project to the Abusive Tax Evasion, Avoidance Schemes and Devices (ATEASD) Executive Steering Committee (ESC), ESC officials suggested that OPERA consider using schemes like the Misuse of the Disabled Access Credit and Home-Based Business, which have a broad base and have widely proliferated. Since the ATEASD meeting, we have talked with those in SB/SE involved with these schemes and others. We will be meeting as early as next week with the ATEASD Co-Chairs to discuss our interests and plans for the schemes we ultimately select.
- We plan to look at the schemes selected for the following reasons:
  (1) To gain an appreciation for them from initial identification by the IRS, what parts of the Service were involved, what they did, when they did it, and to what effect. By doing this, we would gain an understanding of the IRS' coordination and mitigation efforts by seeing how the processes and structures described in our Phase I compilation were applied, which would include the Service's outreach, communication, and compliance activities.
  (2) This would also involve determining how the scheme(s) proliferated; that is, the type of promoter, the method(s) employed by the promoter to disseminate the scheme, the characteristics of the scheme, and the characteristics of those who participated in the scheme.
  (3) Then we will try to determine if any key traits can be identified, both of the scheme and those participating in it, that would assist the IRS in more quickly identifying and mitigating similar schemes in the future. This will include identifying whether other analytical tools could be employed to enhance the IRS' early detection capabilities and mitigation strategies for future schemes by trying to apply such tools, through a proof-of-concept, to the data already captured through the project or otherwise readily available.

Attachment A

Interviews Conducted
Large and Mid-Size Business (LMSB)
LMSB Office of Tax Shelter & Analysis (OTSA) Manager
Director Office of Pre-Filing & Technical Services (PTFS) & Co-Chair Abusive Tax Evasion, Avoidance Schemes and Devices (ATEASD)
Small Business/Self Employed (SB/SE)
Director SB/SE Reporting Enforcement
Program Manager Abusive Tax Schemes
SBSE Laguna Nigel Lead Development Center
Deputy Director SBSE Compliance Policy &Co- Chair ATEASD
Territory Manager (TEC) Houston, TX
Issue Specialist, Compliance Policy, Reporting Enforcement Abusive Tax Promotions
Director Centralized Workload Section & Delivery
Program Analyst- SBSE Reporting Compliance, Ogden Frivolous
Criminal Investigation (CI)
CI Financial Crimes
CI Refund Crimes
CI Philadelphia Lead Development Center
Tax Exempt and Government Entities (TE/GE)
Group Manager EO & EO Abusive Scheme Coordinator
Senior Technical Advisor to TEGE Commissioner
Tax Law Specialist, EP
Tax Law Specialist EO
Wage & Investment (W&I)
Chief Strategy & Selection, Reporting Compliance
NHQ Communications & Liaison (C&L)
National Director Office of Communications
Media Relations Branch Chief
Appeals
Office of Appeals, Director Technical Services
Office of Appeals, Technical Services, Tax Policy/Procedures
Chief Counsel
Special Counsel of the Chief Counsel
Senior Counsel to the Chief Counsel

Attachment B

Abusive Tax Schemes Strategic Initiatives

As result of OPERA's analysis of the FY05 Strategic Assessment submissions, we learned that TEGE, LMSB and SBSE identified abusive tax schemes as one of their key initiatives. The table below shows the specific TIP for each Operating Division (OD) that addresses the abusive tax scheme issue.

Operating Division	TIP #	Initiatives to address Abusive Tax Schemes
TEGE	TIP #3	Abusive tax schemes involving various types of tax-exempt and government entities are beginning to surface and appear to be growing.
LMSB	TIP #5	Combat abusive tax avoidance transactions (ATAT) by encouraging voluntary disclosure and registration, providing early analysis and published guidance, initiating alternative resolution methods and maintaining a strong enforcement regime that includes promoter audits, summonses and targeted litigation.
SBSE	TIP #1	Compliance of SB/SE taxpayers continues to decline and tax avoidance continues to rise.
W&I	No TIP but did have an operating priority that commits to support the other OD's efforts to combat abusive taxpayer behavior.[1]	Although W&I did not include a TIP specific to abusive taxpayer behavior in its strategic assessment, it does have some related strategic efforts underway, such as its "Taxpayer of the Future" analysis, W-4 initiative, EITC program activities as well as the inclusion of individual taxpayers in the detection capabilities managed by CI and SB/SE.

[1] **Operating Priority**- Select W&I Compliance work to support high-priority Service commitments, such as high-income taxpayers, NRP priorities, abusive schemes, and offshore credit card abuses, associated with **TIP #3**– Improving W&I Enforcement Programs May Reduce the Risks of Non-Compliance in W&I's FY05 Strategic Assessment.

Attachment C-I

Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
LMSB	Office of Tax Shelter & Analysis (OTSA)	In February 2000, the Service announced the creation of the Office of Tax Shelter Analysis (OTSA) as part of the Pre-Filing and Technical Guidance (PFTG) function in the LMSB division. It is the focal point for IRS tax shelter activities and is responsible for implementing the Service's tax shelter initiatives. It also serves as a receptacle for information that comes to the attention of the Service relating to potentially improper tax shelter activity by corporate and non-corporate taxpayers. At the same time the IRS created OTSA, it also announced three separate groups of temporary and proposed regulations as part of a coordinated effort to combat shelters. The three regulations were: 6011, Disclosure Rules: Requires taxpayers to disclose on their returns certain transactions that have characteristics common to tax shelters. 6111, Registration Rules: Tax shelter organizers are required to register confidential corporate tax shelters with the IRS. 6112, Investor Lists: Requires the seller or organizer of a potentially abusive tax avoidance transaction to maintain a list identifying each investor who was sold an interest in a transaction. OTSA is responsible for reviewing disclosure statements and maintains a disclosure database as a resource to help agents in the field and provide management reports. OTSA also reviews registrations filed with the Service and maintains a registration database to facilitate the compliance process. In addition, OTSA processes investor lists obtained and disseminates information to the field for compliance action. Working closely with the Office of Chief Counsel and Treasury's Office of Tax Policy, OTSA evaluates the tax treatment of new and emerging forms of tax structured transactions to identify improper transactions, while at the same time protecting legitimate business transactions. To facilitate the receipt of information, OTSA also maintains a Tax Shelter Hotline service with a toll free number to be used by persons wishing to submit information to the Service relating to particular tax shelter transactions.
	Tax Shelter Committee	On September 6, 2001, LMSB established a Tax Shelter Committee to provide leadership and executive oversight in implementing its tax shelter program. The committee is comprised of the Commissioner and Deputy Commissioner of LMSB, the Director of Pre-Filing and Technical Guidance, LMSB Division Counsel, the five Industry Directors, the Director, International, and the Directors of Field Specialists and Research & Program Planning. Representatives from Chief Counsel, Appeals and Treasury may also be invited on an *ad hoc* basis, depending on the subject matter discussed.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
	IRC Section 6700 Committee	On December 10, 2001 LMSB established an IRC 6700 Committee to serve as a Subcommittee of the Tax Shelter Committee. The purpose of the Committee is to ensure consistency and uniformity in the identification of promoters selected for examination. It is authorized to approve all LMSB tax shelter promoter activities, including promoter contacts, examinations and penalties. Generally, examiners may not contact a promoter with respect to any tax shelter promotion unless approval is first obtained from the 6700 Committee. Examiners may, however, conduct an income tax examination of the promoter or investor without seeking approval of the Committee. Membership of the committee includes: Director, Financial Services Industry (Committee Chairperson), Senior Industry Advisor, Financial Services Industry, Director, Field Operations, Financial Services Industry, LMSB Area One Counsel, LMSB Senior Legal Counsel- Corporate Tax Shelters, and Manager, OTSA. A representative from Criminal Investigation is consulted as appropriate.
SB/SE	SB/SE Lead Development Center-Laguna Niguel	The LDC was established in April 2002 to provide a centralized, expedited process for identifying and approving promoter investigations. The center receives and develops leads on abusive tax schemes and promoters from external and internal sources, and researches abusive tax promotions for purposes of detection and case building. The center also systematically conducts Internet research to identify leads and detect sites, promoters, and promotional materials that market Abusive Tax Schemes over the Web. Effective April 1, 2002, Delegation Order SB/SE 4.60 provided the authority to the LDC Program Manager to approve SB/SE promoter investigations under IRC Sections 6700, 6701 and 7408. The office was moved to Laguna Niguel, CA in August 2002.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
	Compliance Policy Reporting Enforcement, Abusive Tax Avoidance Transactions (ATAT) Program	Reporting Enforcement's ATAT Program develops and implements Division-wide policies and strategies to combat Abusive Schemes and Shelters. The ATAT Program consists of two HQ Program Managers (one covering Domestic Schemes and Shelters and the other covering Offshore Transactions), supported by two Field Executive Champions. The two ATAT Program Managers provide program coordination and ensure ATAT processes and policies are consistent across the Division. The specific programs within this section are: Abusive Tax Schemes, Abusive Trusts, Offshore (non-credit card), and Complex Tax Shelters Reporting Enforcement recently redesigned its ATAT Program infrastructure to include 7 additional Policy Technical Advisors, 2 Senior Program Analysts, and a new GS-15 Project Manager to support the ATAT Promoter Strategy and Issue Management. Case Building and Classification efforts have been restructured. Both are now centralized in two Campuses with classification now being conducted by Subject Matter Experts and Technical Advisors.
	Issue Management Teams	Issue Management Teams (IMTs) have been established to develop strategic approaches to working and resolving ATAT issues/promotions. Designed as high-powered, small teams that are integrated with Counsel, other Operating Divisions (ODs), TEC, SB/SE Executives, Compliance Policy, SB/SE Territory Managers, and Group Managers, the IMTs play a key role in identifying emerging issues, developing and implementing alternative resolution strategies, coordinating with Counsel and other ODs, developing guidance, monitoring field participant/promoter inventories, and coordinating with campus activities. The hiring of 6 field GS-14 Technical Advisor-Case Coordinators to support the IMTs has been authorized.
	SB/SE Executive Steering Committee	This Executive Steering Committee is a cross-functional group composed of the Director, Reporting Enforcement and other Compliance Policy, TEC, and Compliance Field Executives, including the Director, Compliance Area 11 (Denver), and the Director, Compliance Area 13 (Oakland). The Committee provides coordinated executive oversight of SB/SE's ATAT Strategy and Issue Management Teams utilizing data contained in Integrated Process Reports, Risk Assessment Matrix, and research conducted by Policy Technical Advisors. Committee responsibilities include working with the Issue Management Teams in developing a strategic approach to working ATAT issues/promotions and emerging issues, developing and implementing alternative resolution strategies, inventory monitoring and brokering, and providing coordinated guidance to the field.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
SBSE	Ogden Frivolous Return Program	Servicewide consolidation of the receipt and processing of all frivolous documents at the Ogden Compliance Center (OCC) began August 14, 2000. The remaining nine service centers will refer frivolous documents to OCC. The IRS, through administration of IRC Section 6702, will address noncompliance based on unfounded legal or constitutional arguments. The Frivolous Return Program (FRP) was consolidated at the OCC on January 1, 2002. All receipts of frivolous filings with the exception of open controlled cases and Congressional cases should be routed to OCC per IRM instructions. The FRP identifies those individuals filing frivolous returns, documents, and/or correspondence and attempts to educate them as to their obligations to file and pay taxes. A frivolous return or response is defined as noncompliance with filing and/or paying tax based on unfounded legal or constitutional arguments per IRM Section 4.19.16.3. This program targets individual behaviors by responding to specific actions. This includes working frivolous filings by identifying them in initial submission processing to conducting audits and assessing tax and penalties and on to identifying promoters of the schemes and referring the promoters through Area Counsel to the Department of Justice for civil prosecutions. The FRP resides under SB/SE Compliance/Compliance Policy/Campus and Filing Compliance/ Service Center Compliance that is the policy area that structures the FRP. The FRP is a national program with a coordinator in every campus and the group that processes the work located at the Ogden Compliance Services. Service Center Compliance sets policy for other organizations on frivolous anti-tax schemes. The FRP also has an internal database and an employee process to discover new schemes as well as a couple of systemic extracts to identify existing frivolous filings. In addition, the FRP has a RIS to identify new types of frivolous filings and a request for an outside contractor to data mine new filings. All 10 campuses have been trained in how to identify frivolous returns during pipeline processing. They have streamlined the civil injunctions process and preparer penalties assessed at the campus rather than the field; created an IDRS extract to identify specific filings that meet pre-determined criteria; and created SERP Alerts to prevent processing of amended returns meeting FRP return criteria.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
	Offshore Credit Card Project (OCCP) Oversight Board	This Oversight Board is chaired by the Deputy Director, Compliance Policy (SB/SE), and includes members from SB/SE Compliance Policy, SB/SE Counsel, LMSB, CI, Appeals, and the Department of Justice. The Board has been established to ensure effective communication and coordination with all Operating Divisions. The Board initially focused on the offshore credit card project. It was later expanded to address issues from OTSA and the International Office within LMSB. Discussions include addressing promoters outside of the country. There is a seven country-meeting schedule to discuss issues. The DOJ is interested in tracking whatever inventory exists on abusive schemes. The OCCP is an initiative aimed at bringing back into compliance with U.S. tax laws participants who used "offshore" payment cards or other offshore financial arrangement to mask or shelter their income. Judicial summonses have been issued to credit card companies and merchants. Data obtained is being analyzed to identify U.S. persons from the offshore card transactions. The OCCP is lead by a Reporting Enforcement Project Manager. Ongoing efforts include building a pipeline to deliver cases to the field, development of a Collection Strategy, the Offshore Voluntary Compliance Initiative (OVCI), implementation of a Communication Plan, including taxpayer education on abusive scheme awareness, and field Counsel support to examiners.
	Compliance Area 15 – Establishment of Special Enforcement Program (SEP)	Five Special Enforcement Program (SEP) groups have been created in Compliance Area 15 (International) to focus on the Offshore Abusive Tax Avoidance Transactions and the John Doe Summons cases. These groups and a Collection group will report to the same Area 15 Territory Manager.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
SBSE	Taxpayer Education & Communication (Centers for Excellence on Abusive Schemes) Toolkits)	The TEC Abusive Schemes Center of Excellence (COE) Team is the creators of the toolkits. The toolkits that have been developed to address abusive schemes are a collaborative effort among TEC, Compliance, CAS, LMSB, CI, Chief Counsel, and Communications and Liaison. Also, the primary content of the toolkit is an accumulation of many of the initial products and tools developed through the collaborate efforts in addressing abusive schemes. The comprehensive strategy outlines that the COE's tiered structure is designed to provide communication linkages between the COE, TEC Headquarters, and all TEC Areas and Territories in order to accomplish the following goals: Provide consistent guidance throughout TEC to address abusive scheme issues. Eliminate duplicative efforts in the creation of counter-marketing messages. Develop and deploy a consistent, nationwide abusive scheme counter-marketing strategy. Develop and deliver consistent messages to internal and external national and local stakeholders about abusive schemes. Identify locations and types of promotions to ensure this information is shared with other functions, such as Compliance and CI.
TE/GE	Internal Abusive Scheme Committee	The TE/GE Abusive Tax Scheme Committee has been in existence since January 2003. This group consists of representatives from each of the different areas within TE/GE – Employee Plans, Exempt Organizations and Government Entities. They are in the process of moving from education to actually discussing and addressing specific issues.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
CI	CI Lead Development Center-Philadelphia	As of the Summer of 2002 the CI Philadelphia Lead Development Center was designated to specifically work on researching and identifying abusive tax schemes and their promoters. This change of focus was dramatic and required extensive planning and implementation of new procedures and partnerships with other areas of the Service. For instance, the Philadelphia LDC installed several key databases for data mining and researching patterns of abusive schemes and their promoters. The Philadelphia LDC formed partnerships with Operating Divisions in the Philadelphia Campus that assist their LDC in the identification of abusive returns. These partnerships have been instrumental in the identification of abusive schemes. The CI Philadelphia LDC researches their databases by performing queries on known abusive patterns to identify potential cases. These cases are thoroughly developed and research packages are prepared and sent to the CI Field Office for further investigation. Also, they are partnering with the Examination and Collection Operating Divisions to send parallel investigations to their respective Field Offices. Both civil and criminal investigations are being worked in conjunction with each other. This is ground breaking territory. The Philadelphia LDC has invited Examination and Collection Revenue Officers and Revenue Agents to work in the LDC to form a "research lab" and partner with the analysts to research and identify abusive schemes, promoters and investors. The Philadelphia LDC has been identified in the CI Bulletin as the lead center for developing abusive schemes nationwide. This LDC was advertised as a "resource" for questions and specialized research involving offshore trusts and other flow-through entities. As a result, this LDC has received and is handling numerous field office requests for advice and research on established investigations. Some of the program areas and cooperative projects being worked with SB/SE includes the following: Offshore Voluntary Compliance Initiative (OVCI) Parallel Civil and Criminal Investigations (6700 Program) Offshore Credit Card Program (OCCP) – Merchant Summons Abusive Scheme Identification and Case Development. The Philadelphia LDC is working with HQ Financial Crimes on a recommendation to consolidate all CI abusive scheme investigations relating to foreign/domestic trusts in the Philadelphia LDC for coordination, control and development. A database is being developed to centralize information relating to abusive schemes to facilitate coordination nationwide.

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Internal Structures Established by Units to Identify and Combat Abusive Schemes and Shelters

Operating Division	Organization/ Group	Description
	Return Preparer Program (RPP)	The Return Preparer Program was implemented in 1996, and established procedures to protect revenue by identifying, investigating, and prosecuting abusive return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or negligent return preparers. Return Preparer Fraud generally involves the preparation and filing of false income tax returns (in either paper or electronic form) by preparers who claim inflated personal or business expenses, false deductions, unallowable credits or excessive exemptions on returns prepared for their clients.
	Questionable Refund Program (QRP)	The Questionable Refund Program, administered by CI, is a nationwide multifunctional program established in January of 1977. The QRP was designed to identify fraudulent returns, to stop the payment of fraudulent refunds and to refer identified fraudulent refund schemes to CI field offices. While the primary focus is on individual tax returns, business tax returns are also reviewed under the QRP. In addition, QRP has been responsible for the identification of substantial abuse in other programs, which has resulted in the savings of hundreds of millions of dollars from fraudulent schemes in abusive tax shelters and fraudulent claims for the Earned Income Tax Credit (EITC).
W&I	N/A	W&I does not have comparable structures for identifying and mitigating abusive tax schemes but supports many of those established by other units through its operating priority (OP) which specifically deals with W&I Compliance work to support high-priority Service commitments such as high income taxpayers, NRP priorities, abusive schemes and offshore credit card abuses. In addition, W&I work with others through its support of CI's Questionable Refund Program (QRP) and the Questionable W-4 Program.

Attachment C-II

Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
Cross-divisional	Abusive Tax Evasion, Avoidance Schemes & Devices (ATEASD) Executive Steering Committee (ESC)[2]	The ATEASD ESC serves as a forum to develop a unified cross-divisional IRS strategy for dealing with abusive schemes and devices, both internally and externally. The ESC will ensure thorough coordination of enforcement activities and resource issues on promoters. The work of the ESC may involve all IRS divisions and functions as well as outside stakeholders including other federal and state agencies. The ESC will not supplant line authority and accountability, which resides within the Business Units. The ESC members include: Large & Mid Size Business (LMSB) Division Small Business/Self Employed (SBSE) Division LMSB Counsel SBSE Counsel Tax Exempt & Government Entities (TEGE) Division TEGE Counsel Chief Counsel, Special Counsel on Tax Shelters Criminal Investigation (CI) Division CI Criminal Tax Counsel (Adhoc) Appeals (Adhoc) Wage & Investment Division (Adhoc) Other ad hoc members may be identified as needed to facilitate data gathering and analysis, address legal issues and consider decisions on use of enforcement tools. The ESC is co-chaired by the Director, Pre-Filing and Technical Guidance (LMSB) and the Deputy Director, Compliance Policy (SBSE).

[2] An Executive Oversight Committee has recently been formed that is comprised of Senior Management Officials from each of the ODs, Chief Counsel and Appeals. The purpose of this group is to deal with broad overall policy decisions relating to abusive tax avoidance transactions and schemes. The status of this committee is pending.

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
NHQ Communications & Liaison (C&L)	Communications Division & Media Relations	The Communications Division, led by National and Field Media Relations, plays an important role in countering tax scams that have surfaced. In recent years, their activity has increased significantly. They have issued dozens of news releases and added exposure on IRS.gov for tax scams and schemes. Their basic goal is to relay information to the public, by way of the news media, when they become aware of scams or potential scams affecting taxpayers. These consumer alerts are designed to heighten awareness and prevent taxpayers from being scammed. They use a variety of methods to deliver the agency's messages to the media and the public, including: Writing and distributing news releases and Tax Tips. Targeting e-mails for group distribution to the media, practitioners and others via Digital Dispatch, IRS Newswire and Tax Tips (Combined circulation: approximately 120,000). Posting material on IRS.gov on the front page and in The Newsroom section. Disseminating information for use by other parts of the agency, including C&L's Internal Communications National Public Liaison, Legislative Affairs and Government Liaison and Disclosure. Other parts of the agency using these include CI, TEC and SPEC. Media Relations learns about scams through several avenues: Internal Sources – Media Relations can be alerted to scams through internal channels, such as the Operating Divisions, CI and TIGTA. These contacts generally come through the imbedded communicators in these organizations. External Sources – Another frequent source of scams, particularly emerging scams, is through external sources. These can be from the news media, who contact Field or National Media Relations with questions. They also can hear from external groups that have contact with the agency through organizations such as Governmental Liaison (example state attorneys general office) and Legislative Affairs (congressional offices). The agency also gets outside information from groups such as the Better Business Bureau.

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
Chief Counsel	Senior Counsel Executive for Dealing with Potentially Abusive Tax Avoidance Transactions	Beyond the normal Counsel activities for advice, guidance and litigation of cases or issues raised for its consideration, in December 2002, a new Senior Counsel position, reporting directly to the Chief Counsel, was created within the immediate Office of Chief Counsel to focus on potentially abusive tax avoidance transactions and other marketed tax products. The new Senior Counsel works with IRS personnel on early identification and interdiction of potentially abusive tax avoidance transactions through analyzing information obtained from various sources, including from disclosure initiatives, tax shelter registrations, taxpayer and promoter examinations and other sources (both public and private). In addition, the Senior Counsel supervises a staff of attorneys and leads multifunctional Task Forces composed of both Chief Counsel and IRS personnel formed to analyze particular transactions and structures and to make determinations as to whether listing notices or other forms of published guidance should be issued on the transaction or structure, and to expedite the publications of such guidance. In addition, the Senior Counsel acts as the Chief Counsel's principal representative on these matters in dealings with the Operating Divisions of the IRS and with the Department of the Treasury. Finally, the Senior Counsel will interact with the private sector to continually stress the attention, focus and priority the Office of Chief Counsel places on potentially abusive tax avoidance transactions, and to foster a dialogue with the private sector on matters such as the disclosure and registration processes and settlement initiatives.
Appeals	Technical Services	In addition to their traditional role in supporting IRS by resolving tax controversies, without litigation, Appeals is working with the ODs to combat abusive tax avoidance transactions and schemes. The Office of Technical Services within Appeals is comprised of two Tax Policy & Procedure units as well as a Technical Guidance unit. These units are responsible for participating in working groups with the ODs to do independent assessments and develop settlement guidelines. Appeals has noted in its FY 2003 - 2004 Strategy and Program Plan that abusive tax shelters are expanding into additional areas and increasing in complexity. Tax shelter promoters are soliciting more industry and high-income individuals. Appeals will partner with LMSB and SBSE to make productive use of Appeals Alternative Dispute Resolution (ADR) Strategies for tax shelters across IRS business units. They have outlined their intent to accomplish this strategy through the following actions: Coordinate with the operating divisions and Counsel with respect to identification and development of abusive promotions and schemes. Continuously evaluate the success of the process applied and make adjustments, as warranted. Include abusive tax shelters in the Appeals Coordinated Issue (ACI) program. Select an ACI Specialist to coordinate issue resolution and articulate case resolution practices. A Specialist was selected. Timely develop Appeals settlement

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
		guidelines for each abusive tax position with an identifiable, well-defined fact pattern. (Note that some issues may be broad and encompass numerous fact patterns, and thus could be considered multiple shelters. In this case, the issue would be addressed in a different manner than a specific position with an identifiable fact pattern). Expand Delegation Order (DO) 247 to delegate settlement authority to LMSB and SB/SE following review and approval by the Appeals ACI coordinator. This was accomplished by DO 4-25. Tailor the resolutions process to individual shelters, utilizing the following Appeals tools, as appropriate: DO 247 Fast Track Settlement Early Referral Traditional Appeals process including Post-Appeals mediation and arbitration programs. Conduct joint outreach strategies for internal and external stakeholders. Milestones for tax shelters are dependent upon the development and communication of the strategies by the Operating Divisions.
Cross-divisional	Abusive Tax Evasion, Avoidance Schemes & Devices (ATEASD) Executive Steering Committee (ESC)[3]	The ATEASD ESC serves as a forum to develop a unified cross-divisional IRS strategy for dealing with abusive schemes and devices, both internally and externally. The ESC will ensure thorough coordination of enforcement activities and resource issues on promoters. The work of the ESC may involve all IRS divisions and functions as well as outside stakeholders including other federal and state agencies. The ESC will not supplant line authority and accountability, which resides within the Business Units. The ESC members include: Large & Mid Size Business (LMSB) Division Small Business/Self Employed (SBSE) Division LMSB Counsel SBSE Counsel Tax Exempt & Government Entities (TEGE) Division TEGE Counsel Chief Counsel, Special Counsel on Tax Shelters Criminal Investigation (CI) Division CI Criminal Tax Counsel (Adhoc)

[3] An Executive Oversight Committee has recently been formed that is comprised of Senior Management Officials from each of the ODs, Chief Counsel and Appeals. The purpose of this group is to deal with broad overall policy decisions relating to abusive tax avoidance transactions and schemes. The status of this committee is pending.

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
		Appeals (Adhoc) Wage & Investment Division (Adhoc) Other ad hoc members may be identified as needed to facilitate data gathering and analysis, address legal issues and consider decisions on use of enforcement tools. The ESC is co-chaired by the Director, Pre-Filing and Technical Guidance (LMSB) and the Deputy Director, Compliance Policy (SBSE).
NHQ Communications & Liaison (C&L)	Communications Division & Media Relations	The Communications Division, led by National and Field Media Relations, plays an important role in countering tax scams that have surfaced. In recent years, their activity has increased significantly. They have issued dozens of news releases and added exposure on IRS.gov for tax scams and schemes. Their basic goal is to relay information to the public, by way of the news media, when they become aware of scams or potential scams affecting taxpayers. These consumer alerts are designed to heighten awareness and prevent taxpayers from being scammed. They use a variety of methods to deliver the agency's messages to the media and the public, including: Writing and distributing news releases and Tax Tips. Targeting e-mails for group distribution to the media, practitioners and others via Digital Dispatch, IRS Newswire and Tax Tips (Combined circulation: approximately 120,000). Posting material on IRS.gov on the front page and in The Newsroom section. Disseminating information for use by other parts of the agency, including C&L's Internal Communications National Public Liaison, Legislative Affairs and Government Liaison and Disclosure. Other parts of the agency using these include CI, TEC and SPEC. Media Relations learns about scams through several avenues: Internal Sources – Media Relations can be alerted to scams through internal channels, such as the Operating Divisions, CI and TIGTA. These contacts generally come through the imbedded communicators in these organizations. External Sources – Another frequent source of scams, particularly emerging scams, is through external sources. These can be from the news media, who contact Field or National Media Relations with questions. They also can hear from external groups that have contact with the agency through organizations such as Governmental Liaison (example state attorneys general office) and Legislative Affairs (congressional offices). The agency also gets outside information from groups such as the Better Business Bureau.

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
Chief Counsel	Senior Counsel Executive for Dealing with Potentially Abusive Tax Avoidance Transactions	Beyond the normal Counsel activities for advice, guidance and litigation of cases or issues raised for its consideration, in December 2002, a new Senior Counsel position, reporting directly to the Chief Counsel, was created within the immediate Office of Chief Counsel to focus on potentially abusive tax avoidance transactions and other marketed tax products. The new Senior Counsel works with IRS personnel on early identification and interdiction of potentially abusive tax avoidance transactions through analyzing information obtained from various sources, including from disclosure initiatives, tax shelter registrations, taxpayer and promoter examinations and other sources (both public and private). In addition, the Senior Counsel supervises a staff of attorneys and leads multifunctional Task Forces composed of both Chief Counsel and IRS personnel formed to analyze particular transactions and structures and to make determinations as to whether listing notices or other forms of published guidance should be issued on the transaction or structure, and to expedite the publications of such guidance. In addition, the Senior Counsel acts as the Chief Counsel's principal representative on these matters in dealings with the Operating Divisions of the IRS and with the Department of the Treasury. Finally, the Senior Counsel will interact with the private sector to continually stress the attention, focus and priority the Office of Chief Counsel places on potentially abusive tax avoidance transactions, and to foster a dialogue with the private sector on matters such as the disclosure and registration processes and settlement initiatives.
Appeals	Technical Services	In addition to their traditional role in supporting IRS by resolving tax controversies, without litigation, Appeals is working with the ODs to combat abusive tax avoidance transactions and schemes. The Office of Technical Services within Appeals is comprised of two Tax Policy & Procedure units as well as a Technical Guidance unit. These units are responsible for participating in working groups with the ODs to do independent assessments and develop settlement guidelines. Appeals has noted in its FY 2003 - 2004 Strategy and Program Plan that abusive tax shelters are expanding into additional areas and increasing in complexity. Tax shelter promoters are soliciting more industry and high-income individuals. Appeals will partner with LMSB and SBSE to make productive use of Appeals Alternative Dispute Resolution (ADR) Strategies for tax shelters across IRS business units. They have outlined their intent to accomplish this strategy through the following actions: Coordinate with the operating divisions and Counsel with respect to identification and development of abusive promotions and schemes. Continuously evaluate the success of the process applied and make adjustments, as warranted. Include abusive tax shelters in the Appeals Coordinated Issue (ACI) program. Select an ACI Specialist to coordinate issue resolution and articulate case resolution practices. A Specialist was selected. Timely develop Appeals settlement

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Cross Cutting Structures Established to Identify and Combat Abusive Schemes and Shelters

Operating Unit	Organization/ Group	Description
		guidelines for each abusive tax position with an identifiable, well-defined fact pattern. (Note that some issues may be broad and encompass numerous fact patterns, and thus could be considered multiple shelters. In this case, the issue would be addressed in a different manner than a specific position with an identifiable fact pattern). Expand Delegation Order (DO) 247 to delegate settlement authority to LMSB and SB/SE following review and approval by the Appeals ACI coordinator. This was accomplished by DO 4-25. Tailor the resolutions process to individual shelters, utilizing the following Appeals tools, as appropriate: DO 247 Fast Track Settlement Early Referral Traditional Appeals process including Post-Appeals mediation and arbitration programs. Conduct joint outreach strategies for internal and external stakeholders. Milestones for tax shelters are dependent upon the development and communication of the strategies by the Operating Divisions.

Attachment C-III

Research Projects in Support of IRS Efforts to Identify and Combat Abusive Schemes & Shelters

[For illustrative purposes only- not intended to be all inclusive account of Research Initiatives]

Research Unit	Description
NHQ Office of Research-Intelligent Business Group (IBS)	The mission of the Intelligent Business Solutions (IBS) Group is to explore new, intelligent software technologies and apply these technologies to the solution of IRS business problems. Research's IBS group has been involved in providing support to combat abusive tax shelters since 1992 when they participated in a collaborative effort between Los Alamos, the AI Group and CI with the Electronic Fraud Detection System (EFDS) effort for CI. Many of IBS's recent projects were initiated to use advanced technologies (i.e, neural networks, fuzzy logic, data mining, & behavior modeling) to help curtail the proliferation of abusive tax schemes and shelters. Some of NHQ Research's current efforts that are being developed in conjunction with the ODs include: Abusive Corporate Tax Shelter (ACTS) Model I & II – This project was initiated as a proof-of concept to determine if neural networks is an appropriate tool for the IRS to employ. The purpose of this project was to 1) develop a probability model to detect the likelihood of non-compliance by corporations in the CIC, and 2) scope the size of the abusive tax shelters in terms of compliance/loss of revenue. (NHQ Research, LMSB Research, and HNC Contractor) Schedule K-1 Link Analysis – provides link charts showing entities that are connected and use Schedule K-1 to report taxable income or losses (S Corps, Trusts, & Partnerships). Link analysis and visualization techniques will assist IRS in uncovering tiered structures both domestic and offshore, (flow-through entities) that are often used to camouflage taxable income with questionable schemes and abusive tax shelters. Graph mining is being used to look for structures of financial transactions using flow-through entities to avoid tax. (NHQ Research & SB/SE, LMSB, CI, and MITRE) Financial Products – pilot to test application of internet software for the purpose of developing an automated system to analyze unstructured financial data for the purpose of identifying questionable financial products that are used by business entities to reduce tax liability. (NHQ Research & LMSB Research) Off-Shore Credit Cards – application designed to uncover and develop leads for identifying taxpayers that are using an off-shore issued credit card account to camouflage income and/or evade taxes. (NHQ Research, SB/SE Compliance Policy, Reporting Enforcement, and a Contractor)
SB/SE Research	SB/SE Research in its current configuration was created upon the stand-up of SB/SE. Each of the major Operating Divisions, including SB/SE, acquired an embedded Research operation by virtue of receiving and incorporating a percentage of the former District Offices of Research and Analysis (DORAs). The allocation of DORAs to the new Operating Divisions was determined by various analyses and decisions made during the Modernization process. Some of the projects involving abusive schemes that SB/SE Research is engaged in include: Off-Shore Credit Cards – project researches offshore credit card holder information to identify abusive schemes. This information is also used to determine the best cases for Examination selection. (Contractor Supported) Internet Promoters – SB/SE Research has been profiling Internet promoters of abusive schemes, including their methodology. The purpose of this effort is to determine the feasibility of designing and implementing an efficient Internet search process for proactively identifying promoters or abusive schemes, and characterize the process that promoters may use to establish web sites and how taxpayers may find such web sites. Research has offered suggestions including having the IRS counter-market sites displayed at the top of Internet search results for certain keyword phrases such as "stop paying taxes". Project results are also used in lead development and Examination case selection.

Attachment C-III

Research Projects in Support of IRS Efforts to Identify and Combat Abusive Schemes & Shelters

[For illustrative purposes only- not intended to be all inclusive account of Research Initiatives]

Research Unit	Description
	K-1s and Link Analysis-a joint project with NHQ Office of Research requested by SBSE Compliance. (See NHQ –Intelligent Business Group Schedule K-1 Link Analysis.) K-1s and Tiering of Flow Through Income from Partnerships, S-Corps, and Trusts-An analysis of tiering structures including such items as income flows and business relationships between the K-1 payers and payees to identify possible areas of compliance risk due to tiering. What is the relationship between tiering and abusive tax schemes/tax shelters? Do different patterns of tiering, income flows and loss flows exist when a tax shelter entity or abusive scheme is involved in the tiering structure? K-1 Profile Reports for Form Types 1041, 1120-S and 1065- Conduct research to build our knowledge base. This includes analysis of income and losses to foreign recipients, those with missing or invalid TINs or other potentially abusive situations. OVCI Profile-Profile Per Return and Amended Return Characteristics of Taxpayers that Self-Identify and/or File Amended Returns Under the Offshore Voluntary Compliance Initiative. Obtain information from examination and collection outcomes so that risk based scoring models can be developed. Profile the Universe of SB/SE Taxpayers With International Features-Describe the population of international filers and identify the needs of SB/SE international taxpayers with relation to the four TEC priorities of e-submission, abusive schemes, voluntary agreements, and burden reduction. Study Abusive Trust Audits After Examination to Determine Taxpayer Behavior Patterns. Profile Foreign Trusts that File a F1041NR to Identify Promoters and Participants of Offshore Abusive Schemes. Implement Strategies to Combat Abusive Tax Schemes by Identifying Schemes, Alerting the Public, Taking Enforcement Action Against Promoters and Participants, and Utilizing Research to Assess the Magnitude of the Problem. Assist in Quantifying the Measurement of TEC's Effectiveness in Counter-Marketing the Promotion of Abusive Tax Schemes. Identify Schedule C legitimate businesses Versus Part Time Dabblers, Hobbyists, and Abusive Scenarios. Profile of Taxpayers Claiming the Disabled Access Credit -- This profile was completed as an example of initial research steps that would be useful when prioritizing abusive schemes for outreach and identifying markets for the outreach. The purpose was to characterize the taxpayer population claiming the disabled access credit, understand the background of the ADA and the disabled access credit, and offer recommendations and opinions on how to measure the extent of abuse and TEC impact on this abuse. The profile includes quantification and description of the market segment that could potentially abuse the credit, a literature survey on other research and oversight, and an overview of IRS processing related to this abusive scheme. Also included were conclusions and recommendations on next steps for TEC as they consider outreach for other abusive schemes.
LMSB Research	LMSB's embedded Research function came to be in the same fashion as SB/SE's. The LMSB Operating Division stood up a bit sooner than the others. Research is currently working on projects such as: Compliance Lab – This project looks at complex interrelationships between returns which are created solely to avoid tax. Abusive Tax Avoidance Transactions Predictive Model – predicts the likelihood a corporation is engaging in abusive tax avoidance transactions.

Attachment C-III

Research Projects in Support of IRS Efforts to Identify and Combat Abusive Schemes & Shelters

[For illustrative purposes only- not intended to be all inclusive account of Research Initiatives]

Research Unit	Description
W&I Research	A major focus of the Wage and Investment Research function has been in support of the Division's efforts to fully engage and combat abusive tax avoidance transactions and schemes. Some of the projects W&I Research is involved in include: Business Rules for Filing Analysis Module (FAM) – A joint venture between W&I and SB/SE Research to develop a set of methodologies for particular tax issues to allow prototyping for identifying non-compliance. Early results from the customer are exceptionally positive and this project will result in these methodologies functioning as the "engine" for the FAM Module in the Remote Exam Reporting Compliance CONOPS. Questionable W-4 Program – This project profiled taxpayers who has shown evidenced of under withholding of their Federal Income Tax liabilities and did not pay their balances due upon filing of their returns or receipt of notices. The project included highlighting of multiple-year offenders and amount of income tax under withheld. This research now permits the ability to "hone in" on those taxpayers who clearly demonstrated the improper use of the W-4 system. Alimony Paid: Risk Determination and Application of Risk-Based Compliance Techniques – A project that is designed to test and analyze potentially non-compliant filers who claim payment or do not claim receipt of alimony. The research looks not only at a single year of non-compliance but the year-to-year use by certain taxpayers of alimony claimed payments as a means of incorrectly reducing tax liabilities by varying degrees. EITC Claims Study – A project that assesses the population of filers (and practitioners) who amend tax returns (1040X) EITC Implementation Team - Upcoming work with the IRS EITC Implementation Team, which is responsible for implementing the three increments of Treasury Task Force recommendations stemming from the 1999 EITC compliance study. The first piece of this study is a test of procedures for certifying qualifying children. Standard Mileage Rate Project – This project has identified the schemes taxpayers are using to avoid proper reporting of Schedule C expenses. Federal Case Registry (FCR) Evaluation Study – A project that analyzed the FCR data as applied to examinations of putative and 3rd party claimants of EIC. The study identified those taxpayers who attempted to claim EIC by using various dependents they were not entitled to claim under EIC rules. Child Tax Credit (CTC) Analysis – Research that identified the over-claim schemes in CTC filers' arena. The results are to be provided in July to those responsible for processing incoming returns in preparation for CY04 filing season. The application of the "flags" will enable the Service to identify false claimants of CTC. CI QRP Project - Research is working as part of the CI QRP project to identify those return preparers who may be incorrectly or illegally claiming dependents for their clients. This is the sixth consecutive year W&I Research has assisted CI with this project.
TE/GE Research	TEGE Research is a small operation, which came about with the standup of the operating division. Discussion with the Director of Research indicates that there are currently no projects concerning tax avoidance schemes ongoing.

Attachment C-III

Research Projects in Support of IRS Efforts to Identify and Combat Abusive Schemes & Shelters

[For illustrative purposes only- not intended to be all inclusive account of Research Initiatives]

Research Unit	Description
CI Research	Criminal Investigation Research – The function spends the vast majority of its time working within and alongside the larger Criminal Investigation programs. One Research project they did conduct is the: The Pilot Connection Society (TPCS) Compliance Report – Criminal Investigation analyzed the results of a comprehensive compliance effort to counter the activities of TPCS, a frivolous non-filer organization. TPCS promoted the use of abusive trusts, "untax" packages, and other sophisticated means to enable members to evade their income taxes by concealing assets and withdrawing from traditional banking systems. The subsequent compliance of over 10,000 members of TPCS was also analyzed years later.

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
Issue Identification Activities	Office of Tax Shelter & Analysis (OTSA) Hotline Disclosure Initiative Resolution Initiatives for taxpayers engaged in selected tax shelters New Policy on Tax Accrual Workpapers Mandatory penalty consideration in tax shelter listed transaction cases Mandatory Information Document Requests (IDRs) Summonses to promoters 3 Regs: (Disclosure Statements Registration Rules, & Investor Lists) Promoter Investigations Field Audits Registration Filings Confidential Informants Referrals from the Field Investor Lists Other Operating Divisions (ODs) SB/SE's Lead Development Center (LDC) CI's LDC Corporate Tax Shelter	SB/SE Lead Development Center (LDC) Hotline Systematic Internet Research SB/SE LDC working with research and counsel to develop more aggressive techniques for finding promoters and schemes marketed over the web Promoter Investigations Secured revision to Services Voluntary Disclosure Practice (News Release IR 2002-135) Offshore Voluntary Compliance Initiative (OVCI) Last Chance Compliance Initiative (LCCI) Taxable Amended Returns Project Field Audits SB/SE redesigned its Abusive Tax Avoidance Transaction (ATAT) Program Infrastructure to support identification of emerging issues ATAT Promoter Strategy Issue Management Team (IMT) Strategy Centralized case building and centralized classification by subject matter experts (SMEs) and Technical Advisors (TAs) in 2 Campuses, to improve case quality and facilitate identification of inventory FTA - Information Sharing Agreements with State Tax Agencies	Determination Letter Program Exam Process Other OD Exams Tax Professionals (attorneys, accountants) Newspapers, Trade Publications ATEASD ESC Toll-Free Number Internal Training RICS/Guidestar Internal TE/GE Abusive Schemes Committee	Normal Investigative Process Produces Leads Informants Practitioners Employers External Stakeholders Questionable Refund Program (QRP) Return Preparer Program (RPP) Service Center Leads SB/SE LDC CI LDC Newspaper Research Compliance Strategy Enforcement Strategy	Questionable W-4 Program CI QRP EITC Program

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
	Check Sheet Internal Training for examiners ATEASD ESC	Foreign Country tax information exchange agreements TEC/SPEC (internal/external communication) building coalitions with practitioner and other external groups to help identify emerging schemes Partnering with FinCen to obtain access to Bank Secrecy Act (BSA) data to conduct Trend Analysis / Data Mining Offshore Compliance Working Group (cross-divisional) exploring improved use of existing data, and new sources of data to identify offshore compliance risks and emerging issues OTSA Questionable W-4 Program CI-sharing of promoter lists CI's LDC Coordination with other ODs Newspaper Articles Cases from the field LMSB promoter investigations Ogden Frivolous Return Unit Internal Research SB/SE Executive Steering Committee OCCP Oversight Board ATEASD ESC Emerging Issue subgroup of ATEASD ESC DOJ Credit Card Summons			

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
		Investor Lists Referrals from Field Internal Training			
Tax Schemes/Shelter Transactions	Listed transactions" are those identified by the IRS as abusive tax avoidance transactions. Summary of Listed Transactions 404,401 Accelerator Multi-employer welfare Lease Strip Foreign Tax Credits Transactions substantially similar to those at issue in ASA Investerings Partnership and ACM Partnership Charitable Remainder Trusts Lease in Lease Out (LILO) BOSS 301 Reg re Liab Assumed, BOSS Fast Pay Using Conduit to artificially allocate income Debt Straddle Son of BOSS Stock Compensation Guam Trust	Domestic Abusive Trusts/Foreign Issues Abusive Preparers Charitable Trusts ADA Credit Anti-Tax Corporate Soles Offshore Compliance Projects **"10 or More Employer VEBA Plans"** IRC 861 Stop Filing Scheme (Employer Abatement Project) Basis Shifting (IRC 302/318; Notice 2001-45) CARDS (Custom Adjustable Rate Debt Strategy) Cash or Deferred Arrangements (CODA) (401k Accelerator Plans) **Charitable Contribution Schemes** Corporate Owned Life Insurance (COLI) Constitutional Arguments Contingent Liabilities (IRC 351; Notice 2001-17) Domestic Abusive Trusts/Foreign Issues Eliminator I Notice 2002-50) Eliminator II (Notice 2002-65) Equity Swaps (Notice 2002-35) Executive Compensation	Listed Transactions: Certain Trust Arrangements Seeking to Qualify for Exception for collectively bargained welfare benefit funds Abuses associated with S Corp ESOPs Certain reinsurance arrangements (PORC) 401K Accelerators Intermediary Transactions LILO Transactions Certain trusts purported to be multiple employer welfare funds	Frivolous tax arguments Foreign & domestic abusive trust tax evasion schemes Refund fraud schemes Return preparer schemes	Questionable W-4 abuses EITC abuses Other Credits Schemes Questionable refund schemes High income taxpayers related schemes Offshore credit card abuses

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
	Intermediary Transactions Contingent Liability Basis Shifting Sec 302 NRPM- Redemptions taxable as Dividends CARDS Notional Principal Contract/Contingent Swaps Notional Principal Contract 401k Accelerator 401k Accelerator, not reportable Modified Rev. Rul. 2002- 45 for taxpayers electing to change method of Accounting Eliminator I-Tiered Partnership Straddle Eliminator II-S Corp & P/ship Straddles -Privately Owned Re- Insurance Corporations (PORC) Abuses assoc. with S Corp Employee Stock Ownership Plans (ESOPs) Offshore Deferred Arrangements Collectively Bargained Welfare Benefit Funds	Family Limited Partnerships Frivolous Filer Home-Based Businesses Lease In - Lease Out (LILO) Lease Stripping (Notice 95-53) Miscellaneous Credits (EITC, Housing, etc.) Offshore Credit Card Promotions (OCCP) Offshore Employee Leasing **Producer Owned Reinsurance Company (PORC)** Private Foundations Questionable W-4 Program Slavery **Reparations** S-Corp – ESOP Ownership Son of BOSS (Notice 2000-44) Split-Dollar Life Insurance (Notice 2002-59) Stock Options – non qualified Stock Options – sales to family partnerships Synfuel Credit (IRC 29) Supporting Organizations – TE/GE Trust Owned Life Insurance (See Split-Dollar Life Insurance) Taxable Amended Returns Zero Tax			

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
Mitigation Efforts	Requiring Promoters to register shelter transactions Practitioner Coordination (i.e. ABA, AICPA, TEI) Published Guidance Outreach & Education (tax forums) Promoter & Investor Audits Coordination with ODs, Chief Counsel, Appeals, DOJ ATEASD ESC Internal RA Training Procedures & Handbooks Internal Memos, News Releases, Checksheets Issue Champions IRS Website Settlement Initiatives Issue Management Tools Pre-filing Agreements (PFA) Industry Issue Resolution (IIR) Fast Track Dispute Resolution Limited Issue Focused Examinations (LIFE) Other Alternative Dispute Resolution Tools	Internal & External Abusive Schemes Toolkits Developing Service-wide ATAT Toolkit that includes methodology for identifying, coordinating, and handling emerging issues, frivolous tax schemes, and complex technical issues Taxpayer & Stakeholder Outreach Practitioner Coordination IRS Website Tax Forums Consumer Awareness sites Issue Management Teams Issue Champions CI/SB/SE Parallel Investigations ATEASD ESC SB/SE Executive Steering Committee Offshore Compliance Oversight Board Offshore Compliance Working Group Media Outreach Civil (Injunctions) & Criminal Actions DOJ Press Releases IRS News Releases, and Public Notices Court Injunction Orders posted on enjoined promoter web site Treasury Statements Congressional Statements Promoter/ Promoter Penalty	Coordination with LMSB, SB/SE, CI Published Guidance Website (Soft Guidance) TE/GE Internal Abusive Schemes Committee ATEASD ESC Outreach/Education Internal Training Determination Letters Collaboration with DOL RICS/Guidestar data analysis	Investigations/Convictions Tax Fraud Alert (counter marketing) Intercept Searches with metatags or key word tags Fraud Detection Centers Parallel Investigations Outreach/Media/Publicity Activities Tax Scheme Promoter Strategy (Non-filer Enforcement Program, Foreign & Domestic Abusive Trust Program, Fraud Program, Employment Tax Program, Return Preparer Program, & Questionable Refund Program) Enforcement Strategy Computer Crime Development Center DOJ Press Releases Coordination with other ODs IRS & CI Internet	Coordination with SB/SE & CI Outreach/Education Website IRS News Releases

Attachment D-I

Snapshot of Unit Identification & Mitigation Activities to Combat Abusive Tax Schemes

	LMSB	SB/SE	TE/GE	CI	W&I
		Investigations Participant Examinations Coordination with other ODs, Chief Counsel, Appeals, DOJ and other Government and State Agencies Return Preparer Program Taxable Amended Return Project Designed Risk Assessment Matrix and Prioritization Process Developed Inventory Brokering Model Developed Integrated Process Reports Cross Divisional Leadership and Coordination Initiated Guidance Projects to Support Field Developed Promoter Strategy Developed Issue Management Strategy Designated Field Case Coordinator positions Created Teams on emerging issues with LMSB/TEGE Questionable W-4 Program Bundling Offshore Collection Cases to DOJ to effectuate simultaneous Court filings and publicity		sites Practitioner Target CI Public Information Officers Coordination with other Government Agencies (FBI, FTC, SEC, DOJ, USAO)	

ATTACHMENT D-II

Description of Select Programs Offered by SB/SE and LMSB

SB/SE Programs

Frivolous Return Program (FRP) (Ogden Campus)

The FRP identifies those individuals filing frivolous returns, documents, and/or correspondence and attempts to educate them as to their obligations to file and pay taxes. FRP has been essential in countering abusive tax scheme activity surrounding Reparation claims, Foreign Tax Credit Claims, Zero Tax cases, Constitutional Arguments, etc. This centralized processing unit provides early and accurate identification of frivolous filings and appropriate tax assessments, denial of erroneous refund claims, and consistent treatment. This includes working frivolous filings from identifying them in initial Submission Processing to conducting audits and assessing tax and penalties as well as identifying promoters of the schemes. Since its inception in January 2000, the unit has received 293,838 cases and closed 179,671 cases. Revenue protected was $3,200,000,000 with $142,000,000 in additional tax assessments and 9,617 in frivolous return penalties assessed.

Questionable W-4 Program

SB/SE designated an executive to work closely with other SB/SE employees and W&I to develop a strategy for stemming the flow of Questionable W-4s. New tools to identify egregious W-4s are under development. The Questionable W-4 database was mated against the Frivolous Filer Database. This match was used to identify common characteristics and will be used in future decision-making processes. SB/SE is making employer contacts to ensure that their responsibilities are being met and to survey for potential promoters using the W-4 process to advise participants on strategies for "opting out" of their filing requirements.

Offshore Credit Card Program (OCCP)

The OCCP is an initiative aimed at bringing back into compliance with U.S. tax laws participants who used "offshore" payment cards or other offshore financial arrangement to mask or shelter their income. Judicial summonses have been issued to several major credit card companies and merchants. Data obtained is analyzed to identify U.S. persons from the offshore card transactions. Identified U.S. cardholders are forwarded to a central processing site in Philadelphia where relevant data is collected from internal and external sources to build case files with information useful for the classification and examination process. An outside vendor has been secured to automate the identification and case building process being used in the Philadelphia Campus. Sorted and prioritized cardholder data will be run against this automated process.

In January 2003, SB/SE announced the Offshore Voluntary Compliance Initiative (OVCI) aimed at encouraging the voluntary disclosure of unreported income hidden by taxpayers in offshore accounts and accessed through credit cards or other financial

arrangements. Under the initiative, eligible taxpayers have to pay back taxes, interest, and certain accuracy and delinquency penalties, but will not face civil fraud and information return penalties. To obtain the benefits of the initiative, taxpayers must disclose information about who promoted or solicited their participation in the offshore financial arrangement. OVCI reflects an attempt to bring taxpayers back into compliance quickly while simultaneously gathering more information about the promoters of these offshore schemes.

The Taxable Amended Return Project is aimed at identifying high-income individuals who have attempted to avoid detection, penalties, and the disclosure of OVCI promoter information by filing amended or delinquent returns that do not identify offshore activities. An initial test review of a sample of delinquent and amended returns indicated that criteria established by the project did assist in identifying taxpayers attempting to avoid detection in offshore schemes. The project is still being tested.

Last Chance Compliance Initiative (LCCI)

Similar to OVCI, LCCI reflects a "last" attempt to bring taxpayers with unreported income from offshore transactions back into compliance quickly while simultaneously gathering more information about the promoters of these offshore schemes. The first waive of LCCI letters will go out June 16, 2003 to individuals identified in connection with OCCP but who failed to come in under OCVI.

ATAT Strategy

Reporting Enforcement recently redesigned its ATAT Program infrastructure to add an additional ATAT Program Manager to cover Abusive Offshore Transactions. Seven new Compliance Policy Technical Advisors, two Senior Compliance Policy Program Analysts, and a new GS-15 Project Manager will also be hired to support the ATAT Promoter, Emerging Issue, and Issue Management Strategies. Issue Management Teams (IMTs) that include Executive Champions, have been formed to identify emerging issues and to develop and implement alternative resolution strategies in ATAT promotions. The hiring of six fields GS-14 Case Coordinators to support the IMTs has also been authorized. Further, ATAT Case Building and Classification efforts have been significantly restructured. Both are now centralized in two Campuses (Philadelphia – offshore ATAT cases; Ogden – Domestic ATAT cases) with classification now being conducted by Subject Matter Experts (SMEs) and Technical Advisors (TAs).

Partnering with other Divisions to Identify Emerging Issues

SB/SE is working with FinCen to obtain access to Bank Secrecy Act (BSA) data to conduct Trend Analysis / Data Mining. SB/SE participates in the cross-divisional Offshore Compliance Working Group exploring improved use of existing data, and new

sources of data to identify offshore compliance risks and emerging issues. SB/SE also participates on the "emerging issues" sub-group of the ATEASD ESC.

LMSB Programs

3 Treasury Regulations under Sections 6011, 6111 and 6112 of the Internal Revenue Code

At the same time the Service announced the creation of OTSA, it issued three separate groups of temporary and proposed regulations as part of a coordinated attack on shelters. Disclosure Statements (section 6011)- Every corporate taxpayer that is required to file a return for a taxable year and that has participated directly or indirectly in a "reportable transaction" must attach to its return a disclosure statement. A separate disclosure statement is required for each "reportable transaction." A reportable transaction is either a listed transaction (or a substantially similar transaction), or a transaction which meets two out of five prescribed characteristics, and that meets the projected tax effect test. Note: Effective June 14, 2002, this regulation was modified to extend the same reporting requirements to individuals, trusts, partnerships, and S Corporations.

One of the items that must be included in the disclosure statement is: the names and addresses of any parties who promoted, solicited, or recommended the taxpayer's participation in the transaction and who had a financial interest, including the receipt of fees, in the taxpayer's decision to participate.

Tax Shelter Registrations (section 6111) & Maintenance of Investor Lists (section 6112)- IRC 6111 & 6112 require tax shelter organizers or sellers to register all tax shelters with the Secretary and to maintain lists of investors and information about the transactions.

Registration: An organizer or seller of a tax shelter must register the shelter no later than the day on which the first offering for sale of interests in a tax shelter occurs by filing Form 8264 with the Ogden Compliances Service Center. Information required on the registration includes identification and description of the tax shelter and the tax benefits represented to the investors.
Investor Lists: any person who organizes a potentially abusive tax shelter or sells an interest in such a shelter has to maintain a list identifying each person who invested in the shelter. Any person who is required to maintain a list shall make the list available to the Secretary for inspection upon request, and shall retain any information required to be included on such list for seven years.

OTSA Hotline

OTSA maintains a Tax Shelter Hotline, which allows interested persons to submit information to the Service relating to particular tax shelter transactions and activities. Persons wishing to submit information to OTSA may do so via mail, telephone, fax or email. All information received is entered into a log and a file is established. OTSA reviews the information and makes appropriate referrals for compliance or other action.

Corporate Tax Shelter Check Sheet- OTSA disseminated a tax shelter check sheet to assist LMSB agents in identifying corporate tax shelters.

Information Document Request (IDR)- A mandatory IDR is required to be issued in all LMSB corporate examinations started after April 23, 2002, or in process on April 24, 2002. The purpose of the IDR is to assist agents in identifying and developing tax shelter issues.

Issue Champions
Issue champions are approved by the Commissioner, LMSB, upon recommendation of the LMSB Tax Shelter Committee. They are appointed when a particular abusive tax avoidance transaction becomes significant enough to warrant executive oversight and direction. For several transactions that impact more than one OD, multiple issue champions are appointed to ensure compliance and resolution matters are properly evaluated and coordinated.

ATTACHMENT E

Large and Mid-Size Business (LMSB) Example on Disclosure Initiative

[For illustrative purposes only – not intended to be a comprehensive account of LMSB OTSA initiatives and/or activities].

Background Why IRS Offered This Disclosure Initiative
IRS believed that many taxpayers entered into questionable transactions based on representations of financial advisors who marketed these transactions to them. These taxpayers became aware that those transactions may be challenged upon an IRS audit and result in additional tax and penalties. IRS recognized that taxpayers might have been reluctant to voluntarily come forward and disclose the transactions due to the potential substantial penalties that might follow. As a result, the IRS offered a disclosure initiative to give taxpayers a limited time to come forward and disclose transactions without fear of incurring a penalty.

Disclosure Initiative-Announcement 2002-2: The disclosure initiative, that began December 21, 2001 and concluded April 23, 2002, provided taxpayers with a 120-day opportunity period to voluntarily disclose their participation in questionable tax shelters and other items that may have resulted in an underpayment of tax. The initiative was designed to provide IRS with information that would help them more readily identify tax shelter promoters, find other taxpayers who have not disclosed their participation in a tax shelter and identify emerging abusive transactions.

Taxpayers making disclosures were required, among other things, to describe the material facts of the item, provide the names and addresses of the promoters who solicited their participation, provide copies of materials and documents requested, and sign a penalty perjury statement regarding the accuracy of the information provided.

IRS aggressively examines the activities of promoters, who by law are required to maintain lists of all investors who bought tax shelters from them. Once IRS receives the investor lists from the promoters, they are able to identify other taxpayers who may have participated in tax shelters but failed to disclose them.

OTSA received 1,664 disclosures from 1,206 taxpayers who disclosed their questionable transactions. Taxpayers have disclosed transactions in which they claimed deductions or losses amounting to billions of dollars. These disclosures have been assigned to field agents to audit and resolve the disclosed transactions.

Mitigation Efforts
For those who voluntarily disclosed a transaction in accordance with the announcement, IRS promised to waive certain accuracy-related penalties that might apply to tax shelters and other questionable items that resulted in an underpayment of tax.

Disclosure under this initiative did not affect whether the IRS would impose, as appropriate any other civil penalty applicable under Code, or investigate any associated criminal conduct or recommend prosecution for any violation of any criminal statute.

ATTACHMENT E

Large and Mid-Size Business (LMSB) Example on Disclosure Initiative

Published Guidance
Published Guidance such as notices, revenue rulings, and announcements provide the general public with IRS's position on certain transactions. The intended purpose of published guidance is to serve as an early warning system to inform and deter taxpayers from participating in abusive transactions.

It has been noted that although abusive tax avoidance transactions are not easy to define, once they are disclosed and discovered they can be easily recognized. For this reason, the best tool IRS has in dealing with abusive transactions is early identification. Identifying questionable transactions early enables IRS to gather information and issue published guidance, in some cases even before transactions show up on tax returns.

[*Note: Source of data is from OTSA documents, IRS News Releases, and discussions with OTSA officials*]

ATTACHMENT F

Small Business and Self-Employed (SB/SE) Example on Lead Development Center Activity on Schemes and Promoters

[For illustrative purposes only – not intended to be a comprehensive account of SB/SE initiatives and/or activities].

The Office of Reporting Enforcement within SB/SE Compliance Policy has the responsibility of providing Division-wide policy guidance for Fraud, Anti-Money Laundering, and Abusive Tax Avoidance Transaction (ATAT) compliance processes. Also, the office has the Lead Development Center (LDC) that identifies and builds promoter cases.
Issue Identification

Lead Development Center

The LDC was established in April 2002 to centralize the receipt, identification, development of leads on Abusive Tax Schemes and Promoters, as well as authorize and refer 6700/ 7408 investigations to the Planning and Special Programs (PSP) offices to the field groups for examination. The Center receives internal and external leads, and researches abusive tax promotions for purposes of detection and case building. Also, the LDC systematically conducts Internet research to identify leads and detect sites, promoters, and promotional materials that market Abusive Tax Schemes over the Web. Currently, the LDC is working with research and Counsel to develop more aggressive techniques for finding promoters and schemes marketed over the internet.

The SB/SE Delegation Order 4.60 provides the authority to the LDC Program Manager to approve promoter investigations under IRC sections 6700, 6701 and 7408. As of July 1, 2003, there are 489 promoter investigations in the field and 526 promoter leads in the LDC to be evaluated and developed.

Mitigation Activities

Internal and External Toolkits

The ATAT *Internal Toolkits* (Anti-tax Law Evasion, Home-Based Business Schemes, Employee Leasing, Abusive Trusts, Disabled Credit Schemes, Offshore Schemes, Offshore Voluntary Compliance Initiative) were developed to provide SB/SE employees with the official language and products that they are expected to use in abusive scheme outreach efforts. Also, this is an effort to ensure consistent messages are delivered nationwide. The *External Toolkits* (Anti-Tax Law Evasion, Home-Based Businesses, Abusive Trusts, Disabled Credit, and Offshore Schemes) are prepared as an effort to reach the maximum audience by partnering with external stakeholders. These toolkits will aid stakeholders in assisting the IRS with counter-marketing against abusive tax schemes. It has been publicize that TEC has a major priority to counter-market against abusive tax schemes by educating potential investors to avoid the schemes.

ATTACHMENT F

Small Business and Self-Employed (SB/SE) Example on Lead Development Center Activity on Schemes and Promoters

It is noted in the abusive schemes internal toolkits comprehensive strategy, that most of the schemes encountered, will fall within, or have components of the following general topics:

Abusive Offshore Tax Avoidance Schemes
Abusive Home-Based Business Schemes
Abusive Trust Schemes
Anti-Tax Law Evasion Schemes

However, the Service is working on developing additional toolkits that would address specific schemes. One of the more specific toolkits developed address the subject regarding Misuse of the Disabled Access credit. As of March 2003, TEC noted that 78% of the schemes match up to the five toolkits

Reporting Enforcement is also working with other ODs to develop a Service-wide ATAT Toolkit that includes a methodology for identifying, coordinating, and handling emerging issues, frivolous tax schemes, and complex technical issues.

Parallel Investigations

A parallel proceeding between SB/SE and Criminal Investigation involves simultaneously investigating or litigating of separate civil and criminal aspects of a case involving a common set of facts. Due to the fact that the Service is facing numerous abusive schemes, it has been recommended that the Service perform parallel investigations. The Service's civil and criminal functions would consider all the potential benefits and risks involved in conducting parallel proceedings and make the best possible decision to enforce the tax laws, promote voluntary compliance and protect the revenue.

In the past, the Service has traditionally completed the criminal investigation before seeking civil remedies. This practice allowed the promoter(s) to continue marketing the abusive scheme while being investigated criminally.

The parallel approach does not mean the IRS should conduct civil and criminal investigations jointly. However, it allows simultaneously civil and criminal investigations to be conducted separately and distinctly.

An example of some of the civil remedies includes the following:

Section 6700, penalties against promoters of abusive schemes.
Section 6701, penalties against preparers.

ATTACHMENT F

Small Business and Self-Employed (SB/SE) Example on Lead Development Center Activity on Schemes and Promoters

Section 7408, authorizes an injunction in a U.S. District Court if a person violates 6700 or 6701.

Some of the criminal violations are:

Internal Revenue Code (IRC) 7201, Tax evasion.
IRC 7206(1), Filing false returns.
IRC 7206(2), Aiding and assisting in the preparation of false tax returns.

The SB/SE operating division with the IRS has developed procedures, which documents the process for starting a parallel investigation with the CI.

[Source: SB/SE web-site and discussions with SB/SE officials]

ATTACHMENT G

Coordination Activities

[Efforts identified below may not include all coordination activities across IRS units on schemes and scams]

ATEASD ESC[4]- forum to develop a unified, cross-divisional IRS strategy for dealing with abusive tax schemes and shelters. The primary focus is on coordination of enforcement activities and resource issues. The ESC's efforts are also coordinated with outside stakeholders, including federal and state agencies.
Issue Champions- Issue Champions are appointed by the LMSB Commissioner upon the recommendation of the Tax Shelter Committee when a particular tax shelter issue is significant enough to warrant executive oversight and direction. In some instances, when an issue impacts another IRS Division, that division may appoint a co-issue champion to serve with the LMSB champion to ensure compliance and resolution matters are properly evaluated and coordinated. For example, for the Son of BOSS tax shelter issue, executives from both LMSB and SB/SE have been appointed to serve as joint issue champions.
Issue Management Teams- Similarly, SB/SE established Issue Management teams that include Executive Champions to provide a strategic approach to issue management.
Parallel Investigations- CI & SB/SE pursue civil and criminal investigations in parallel. A six-way conference is held between CI & SB/SE to ensure IRS makes business decisions about investigations that are in the best interest of IRS's efforts to stop the promotion of abusive schemes. LMSB is considering incorporating parallel investigation methods in its promoter investigations.
Coordinated Outreach/Communication Efforts- to educate and warn taxpayers through a consistent message about abusive schemes and the consequences of participating in them. One of the most prominent public warnings has been the "Dirty Dozen" of Tax Scams for 2003, which has appeared in every major media outlet and picked-up by many other local outlets as well. In addition, LMSB issues notices of "Listed Transactions", alerting the public to transactions it identifies as abusive and warning taxpayers not to invest in these transactions.

News releases developed by C&L are utilized by the various ODs to raise awareness to each of their respective customers about the IRS' position on abusive schemes.

SB/SE's internal and external toolkits are developed through a collaborative effort with TEC, Compliance CAS, LMSB, CI, Office Chief Counsel and the Office of Communications and Liaison (C&L). The internal toolkits are used by SB/SE employees in their abusive scheme outreach efforts and the external toolkits are used to aid stakeholders in assisting the IRS with counter marketing against abusive tax schemes.

[4] An Executive Oversight Committee has recently been formed that is comprised of Senior Management Officials from each of the ODs, Chief Counsel and Appeals. The purpose of this group is to deal with broad overall policy decisions relating to abusive tax avoidance transactions and schemes. The status of this committee is pending.

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV

Mr. Chairman, thank you very much for calling this hearing to discuss how we can eliminate the outrageous disparity between taxes that are rightfully owed and what is currently collected.

Last April, hundreds of thousands of West Virginians sat down to calculate their income taxes. They worked their way through all the forms to determine their "fair share" according to our tax laws. Many folks in West Virginia struggle to make ends meet, and paying their fair share of taxes can be difficult. But they pay their taxes because they know it is the right thing to do.

Well, Mr. Chairman, I think that those honest West Virginians would be appalled by the evidence we are going to discuss today. They have a right to expect that their government will protect them by fairly enforcing the tax laws. We all understand that when some people are allowed to get away with not paying their taxes, it imposes a greater burden on every honest taxpayer. And I am embarrassed to tell my constituents about the inept and unfair enforcement provided by the IRS today.

This year more than $300 billion in taxes, three-quarters of our projected budget deficit, will go uncollected. Fancy accountants and lawyers will make millions of dollars promoting tax shelters. Indeed from the period 1996 to 2000, a time of unprecedented profits and growth in corporate America, more than 60 percent of U.S. corporations did not pay any federal income taxes.

Three years ago Enron collapsed revealing unscrupulous tax avoidance schemes. Last year most of the Democrats on this committee cosponsored Senator Baucus' bill to close those loopholes, but no law has yet been enacted. It would be shameful for Congress to enact another piece of tax legislation before taking steps to close the indefensible loopholes that corporations use to avoid paying their share of taxes.

Closing loopholes is one step that Congress must take without delay. But we also must ensure that the enforcement of our current laws is fair and reasonable. Nobody wants the Internal Revenue Service to act like loan sharks, harassing people or threatening them. But honest taxpayers need to know that they are not fools. They need to believe that their neighbors are also paying their fair share of tax. Yet the state of the IRS enforcement capabilities is discouraging.

Over the last five years the level of enforcement personnel at the IRS has decreased by 25%. The likelihood of a corporation being audited has decreased by 67%. And 80% of individuals who are known to use abusive tax shelters are not pursued. The IRS knows of millions of cases of delinquent taxes that it does nothing to collect. In fact, the Defense Department is aware that more than 27,000 of its contractors owe billions of dollars in unpaid taxes, but the government continues to do business with these companies.

While all of these taxes go uncollected, the IRS has devoted enormous resources to make it more difficult for low income workers to claim a modest Earned Income Tax Credit. This pattern of inadequate and selective enforcement is inexcusable.

It is time for us to stop just wringing our hands and expressing outrage. It is the responsibility of this committee to oversee this nation's tax collection system. And I want to work with my colleagues here to ensure that the system is fair and efficient. I look forward to hearing from today's panelists, especially Commissioner Everson, what specific recommendations they have for closing the tax gap. And I hope that all of the panelists will be candid about the reforms necessary and the resources required.

I want to be able to say to the hundreds of thousands of honest taxpayers in West Virginia that we have done everything possible to see that they are treated fairly.

IRS OVERSIGHT BOARD

Statement of Raymond T. Wagner, Jr.

Member, Internal Revenue Service Oversight Board
Testimony Before the Senate Finance Committee

July 21, 2004

Hearing on Bridging the Tax Gap

Introduction

Mr. Chairman, Senator Baucus, and members of the Committee, thank you for the opportunity to testify before the Senate Finance Committee. I am Raymond T. Wagner, Jr. I recently marked my first anniversary as a Member of the IRS Oversight Board.

It's been an exciting year and I have learned a lot about the needs of taxpayers and the IRS. I'm pleased to be able to testify to you today on the subject of the tax gap.

Characteristics of the Tax Gap

Mr. Chairman, the National Taxpayer Advocate reported in her 2003 Report to Congress that the IRS has estimated the gross tax gap for 2001 as approximately $311 billion. This amount is the difference between what taxpayers pay voluntarily and what they are supposed to pay. The IRS also collects approximately $55 billion as a result of late payments and additional enforcement activities, so the net tax gap for 2001 was estimated at about $255 billion.

These numbers sound precise, but they are in fact estimates. The exact size of the tax gap is uncertain. The Commissioner made this point in testimony earlier this year before both the House and Senate Appropriations Committees. Current estimates are based on a model developed under the now-defunct Taxpayer Compliance Measurement Program (TCMP),last used in 1988. The program's model was extended to 2001 based on current demographics, but assumes that taxpayer behavior remains the same.

However, the tax administration system and our economy have markedly changed since 1988, and the nature of these changes provides more opportunities for increased non-compliance. For example:

- The tax code itself has grown increasingly complex during this period.
- In the past several years, we have seen a proliferation of abusive tax shelters coupled with an erosion of ethical standards among tax professionals, including the large-scale selling of abusive schemes by formerly respected members of the accounting and legal professions.

- Surveys conducted by the IRS Oversight Board indicated an erosion of taxpayer attitudes regarding the acceptability of cheating. In 2003, 17 percent of Americans believed it was acceptable to cheat at least a little on their taxes, compared to 11 percent in 1999.
- Economic growth produced large growth in the numbers of high-income taxpayers, increased capital transactions that are more difficult to audit, increased the number of taxpayers claiming tax credits, and spurred the formation of S-Corporations and partnerships, all of which provide more opportunities for non-compliance. The table below illustrates how certain elements of taxpayer reporting have increased between the years of 1990 and 2001.

Changes in Taxpayer Reporting From 1990 to 2001

Taxpayer Attributes (in thousands)	1990 (note 1)	2001 (note 2)	Percent growth
All individual returns	113,717	130,255	15%
Individuals reporting AGI > $100,000	3,165	11,035	249%
Individuals reporting AGI > $1,000,000	61	192	215%
Individuals reporting net capital gain	9,217	12,631	37%
Individuals reporting net capital loss	5,070	10,840	114%
Individuals reporting partnership income	3,210	4,357	36%
Individuals claiming tax credits	12,484	49,793	299%
Number of corporations	3,716	5,035	35%
Number of S-corps	1,575	2,986	90%
Number of partnerships	1,553	2,132	37%

Source: IRS SOI Bulletins
Note 1: The year 1990 was chosen because it is the closest year to 1988 (the last year for TCMP) for which statistics of income information is available.
Note 2: 2001 is the year for which the tax gap is estimated at $311 billion.

The National Research Program (NRP) is a IRS-wide research effort to determine compliance with the tax laws. This information will be used to help the IRS develop compliance measures and estimates of the tax gap, select returns for examination, and identify areas where instructions and pre-filing taxpayer services can be improved. Through the NRP, the IRS will update its research on the tax gap for individual taxpayers. As a consequence of the trends I just described, it would not be surprising if the NRP results show significant growth in the tax gap.

Consequences of the Tax Gap

Mr. Chairman, the tax gap is not just a statistic thrown about by academicians and tax experts. It is far more insidious. We must get behind the tax gap number and examine its corrosive effects upon our entire tax administration system and the fiscal health of the nation. The tax gap's consequences are all too real and we feel them in our everyday lives.

- First, at the most basic level, the tax gap is an injustice. It means that honest taxpayers are bearing the financial burden of those who do not pay what they owe. The men and

women who play by the rules – regardless of income bracket – pay more in taxes to make up for those who game the system and cheat. In a very tangible way, we are subsidizing this army of tax scofflaws.

- Second, our nation finds itself, in a time of fiscal constraint with many worthy but competing federal programs, from homeland security to education, chasing after the same scarce budget dollars. We need the extra tax revenues that closing the tax gap would provide.

- Third, and perhaps most troubling, the tax gap undermines confidence in the fairness of our tax administration system and contributes to non-compliance. Honest taxpayers hear and read about growing tax cheating that goes unpunished. Promoters of abusive tax avoidance schemes openly flout the law and dare others to follow their lead. Discouraged by a lack of enforcement, some taxpayers go so far as to wonder if they too should not cheat. Why should they pay if no one else is? As previously noted, the Board's own research points to an erosion of taxpayer attitudes towards cheating.

Recommendations to Reduce the Tax Gap

The tax gap was not created overnight, nor can it be reduced overnight or dealt with in a single year. It can be however, by following a thoughtful, multi-year, strategic plan with persistence, discipline, and skill. Successful execution of the plan involves all participants in the tax administration system—the IRS, the Administration, Congress, taxpayers, and tax professionals. This must be a unified effort.

The plan's strategies are simple in concept but challenging to execute. Some are already underway, but more must be done to bring the desired results. Each strategy reinforces the others, and together form an integrated whole. They are:

1. Increase the effectiveness of the IRS
2. Provide additional resources
3. Measure results
4. Simplify the tax administration system

1. Increase the effectiveness of the IRS

The IRS Oversight Board recently approved the *IRS Strategic Plan 2005-2009*. Its major theme is **Service plus Enforcement Equals Compliance**, which Commissioner Everson will describe in his testimony. The plan's underlying goal is to bring *all* taxpayers into voluntary compliance. Education and service will help taxpayers who make honest mistakes to understand and comply with their tax obligations. At the same time, effective enforcement efforts will be aimed at those who willfully flout the tax laws.

The Board fully endorses that approach, and believes that the plan describes the goals that the IRS must achieve in the next five years:

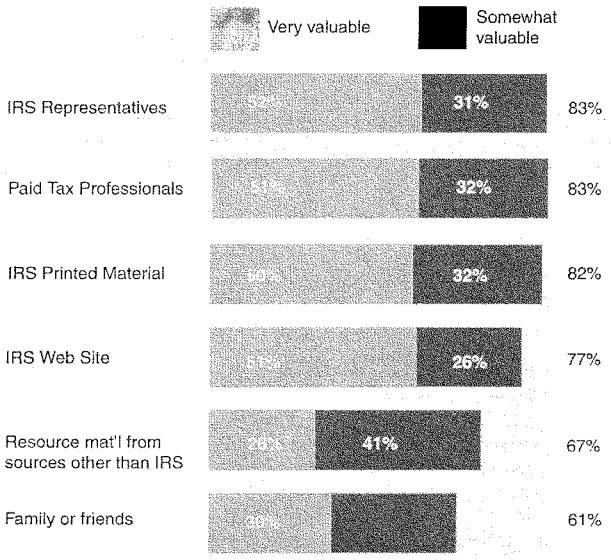
A. Improve Taxpayer Service
B. Enhance Enforcement of the Tax Law
C. Modernize the IRS Through its People, Processes, and Technology

A. *Improve Taxpayer Service*

Taxpayers value the services the IRS provides to help them navigate an incredibly complex tax code and meet their responsibilities under this law. The IRS has made considerable strides in improving customer service during the past five years and these improvements are reflected in taxpayer satisfaction surveys such as the American Customer Satisfaction Index (ASCI). Taxpayers are better able to get through on the agency's toll-free lines and receive correct answers to their tax law and account questions. IRS web site usage continues to surge and new features such as "Where's My Refund?" and "Where's My Advanced Child Tax Credit" have been added. Electronic filing of individual tax returns grew by 15 percent in 2003.

Taxpayers value these services. The 2003 IRS Oversight Board Taxpayer Attitude Survey found that "the most heavily relied upon source of tax information and advice are IRS representatives (83 percent see them as very/somewhat valuable), closely followed by IRS printed publications such as brochures (82 percent) and the IRS Web site (77 percent). The only non-IRS-provided information source that is as highly rated is a paid tax professional (83 percent.).

Taxpayers Value IRS Service



Source: IRS Oversight Board Taxpayer Attitude Survey 2003

The Board believes that improved service directly contributes to improved compliance. Mistakes and lack of information can contribute toward non-compliance. And it's no wonder; because the

tax code's complexity grows with each passing year. The IRS now estimates that it takes 28 hours and 30 minutes to complete an average tax return versus 7 hours and 7 minutes in 1988.

The IRS must do everything it can to help taxpayers navigate and understand their responsibilities under the code. A failure to meet this pressing need would invite further noncompliance.

The Board finds IRS customer service to be a work in progress still with ample room for improvement in key areas such as telephone tax law accuracy. In this regard, the Board believes that complacency is the worst enemy.

B. Enhance Enforcement

As the tax gap illustrates, enforcement remains a serious challenge for the IRS, and there is no broad turnaround in sight. However, the Board recognizes that some improvements have been made. For example, the IRS has been able to put the brakes on the rising collection backlog. The Treasury Inspector General for Tax Administration (TIGTA) also found that many collection compliance indicators showed improvement in FY2003. Collection re-engineering, which the Board strongly supports, is generating positive benefits, such as a 15 percent increase in the number of Taxpayer Delinquent Accounts closed and a substantial jump in the use of enforcement tools, such as liens, levies and seizures. Other innovative programs are refocusing resources in key areas:

- To pursue promoters of abusive shelters, domestic and offshore abusive tax avoidance transactions (ATAT), high-income taxpayers, and unreported income, the IRS is focusing resources away from traditional examination functions into key strategic areas.
- To improve its initially unsuccessful K-1 matching program, the IRS redesigned forms and related instructions, making them easier to understand, simplified the filing process, and worked closely with stakeholder groups to build understanding and support for the program.
- To crack down on abusive shelters, the IRS has increased its use of promoter audits. The IRS has over 100 such audits in progress, and established a Lead Detection Center to centralize and develop leads on abusive tax avoidance transactions.
- To shorten the cycle time on large corporate audits from five years to two years, the IRS is using a streamlined process to identify issues for audit by focusing on materiality and risk analysis.
- To strengthen its Office of Professional Responsibility, the IRS appointed an experienced director, and proposed tougher penalties on professional misconduct.

Enhancing enforcement is a major IRS goal for the next five years and it is already putting in place an aggressive plan to improve its enforcement efforts. Commissioner Everson has described the IRS' plan in more detail, but key elements of its plan involve deterring abusive tax schemes and behavior that erodes confidence in the tax administration system, ensuring that tax professionals follow the law and adhere to high standards of integrity, deterring criminal activity, and placing greater emphasis on the activities of tax exempt and government entities and their misuse by other taxpayers. This last area is a growing area of abuse and I commend the Finance Committee for its hearing on this subject in June.

C. *Modernize Itself through People, Processes, and Technology*

The Board believes that human capital is the IRS' greatest resource and strength, and one of its greatest challenges. The IRS possesses an extremely talented and dedicated workforce that produces very high-quality work in spite of technological and resource limitations. However, the IRS workforce cannot be taken for granted. It must be carefully selected, trained, and given the skills and tools it needs to meet the demands of tax administration in the 21st Century, including new and greater enforcement challenges. The IRS must develop an agency-wide human capital strategic plan that keys in on five areas:

1. **Replace lost critical talent** – The IRS has a "graying" workforce with 25 percent eligible to retire by 2006. Many of these individuals possess critical skills, such as maintaining legacy IT systems, and institutional knowledge of enforcement that could easily be lost.
2. **Build skills for complex work** – Tax administration will become more complex in the future as demonstrated by the challenges in combating abusive tax avoidance transactions that are increasingly more sophisticated and harder to detect. Enhanced IT skills will become more important in this new environment, such as the use of technology as the preferred means of doing business.
3. **Manage change** – Even though the IRS customer-focused organization is firmly in place, change will continue throughout the agency. The IRS is no longer a static organization; new technology and process redesign will bring further challenges and greater change, and with it, an increased demand for leaders and managers with change management skills and experience.
4. **Enhance performance** – Given budgetary constraints, the IRS must enhance its performance each year to meet greater work demand and improved customer service and enforcement goals. Management skills take on greater importance in such a high performance, goal-driven environment.
5. **Engage the entire workforce** – Workforce engagement remains a challenge. Surveys indicate that upper management levels of the IRS are engaged in its mission and strategic goals; but the same cannot be said for front-line managers and rank-and-file employees. This is particularly troubling for front-line enforcement personnel.

Getting the right people with the right skills into the right jobs is but one part of the equation when it comes to providing quality customer service and improved enforcement. To balance it, we must give them the technology to do their jobs effectively and efficiently.

The IRS is modernizing its processes and technology through the Business Systems Modernization (BSM) Program. This program has experienced serious schedule delays and cost overruns, and in December 2003, the Oversight Board released an independent analysis of this program in which the Board made nine specific recommendations for turning around the critical but troubled program.

However, the Board still believes that the overall Modernization plan is sound and well-designed. Moreover, it is critical to the future of tax administration and reducing the tax gap. The IRS Oversight Board firmly believes that the IRS Modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and

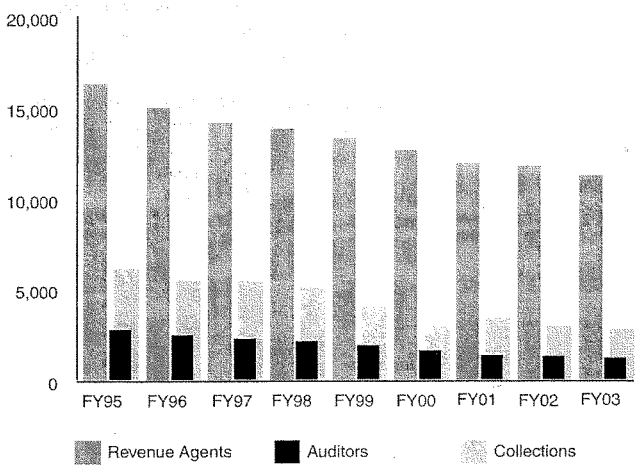
at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. We remain convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan.

2. Provide additional resources

One important strategy for closing the tax gap is combating egregious noncompliance. In the past two years, the IRS sharpened its compliance focus on promoters and participants of abusive tax shelters and tax evasion schemes. The Board supports this focus–but the job cannot be done unless adequate resources are available for the IRS to fight back.

Enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. The agency continues to be outmanned and outgunned. In FY2003, the IRS was able to pursue only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated $447 million uncollected. Meanwhile, TIGTA notes that the combined Collection and Examination function enforcement staffing declined from 25,000 at the beginning of FY1996 to 16,000 at the end of FY2003, a 36 percent decline. This staffing shortfall has produced startling consequences.

Number of Examination and Collection Staff Stagnant



Source: Treasury Inspector General Tax Administration (TIGTA) Analysis

According to former IRS Commissioner Charles O. Rossotti in his "Report to the IRS Oversight Board: Assessment of the IRS and the Tax system," released in September 2002, fewer resources means that:

- 60 percent of identified tax debts are not pursued
- 75 percent of taxpayers who do not file a tax return are not pursued
- 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued
- 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued
- 78 percent of partnerships and similar document matching are not pursued.

The table below illustrates the extent to which several categories of enforcement workload the IRS can and cannot accomplish and the resulting revenue loss per year.

Known IRS Workload Gap

	Known Workload in Contacts or Cases/Yr				Direct Revenue Loss Per Year	Direct Cost to Fill Gap	
	Required	Done	Gap	%Gap		FTEs	Dollars
Collection of Known Tax Debts							
► Field and Phone Accounts Receivable (TDA)	4,506,060	1,816,713	2,689,347	60%	$9,470	5,450	$296.4
Identification and Collection of Taxes from Non-Filers							
► Non-Filer Cases (TDI)	2,490,749	625,025	1,865,724	75%	$1,693	2,016	$101.5
Collection of Underreported Tax							
► Document Matching	13,300,000	2,926,980	10,373,020	78%	$6,960	4,740	$229.2
Identification and Collection of Underreported Tax							
► Cases of Abusive Devices to Hide Income	82,100	17,000	65,100	79%	$447	3,418	$272.1
► Individuals Over $100,000 Income	123,006	54,468	68,538	56%	$266	2,603	$207.2
► Individuals Under $100,000 Income	843,380	296,986	546,394	65%	$4,492	7,435	$430.1
► Small Corporations	39,659	29,721	9,938	25%	$54	640	$50.9
► Mid and Large Corporations	24,523	17,684	6,839	28%	$6,526	1,812	$180.0
Total	1,112,668	415,859	696,809	63%	$11,786	15,908	$1,140.3
Tax Exempt							
► Reporting Compliance	20,690	6,780	13,910	67%	NA	1,192	$101.6
Grand Total	NA	NA	NA	NA	$29,909	34,664	$2,180

Source: Commissioner Rossotti, Assessment of the IRS and the Tax System, End of Term Report to IRS Oversight Board, Sept. 2002

The IRS Oversight Board finds the IRS' inability to keep up with a growing workload to be a dangerous weakness in the tax administration system. Mr. Chairman, the Board acknowledges that the IRS's budget has increased in each year of President Bush's Administration, and that the Administration's request for FY2005 is significant against other non-defense, non-homeland security discretionary funding. That commitment is commendable, and the Board recognizes and thanks President Bush and Secretary Snow for their efforts, especially at a time when the nation must balance many important and competing priorities.

However, the Board believes that now is a critical time for our tax system to be strengthened, not merely maintained at current levels.

In its special report on the IRS FY2005 budget, the Board addressed this issue head-on by reinvesting in the IRS to produce tangible benefits and results for America's taxpayers and our nation. The Board calls for a pragmatic budget that reflects the complex world in which the IRS must operate and be funded.

The Board recommends IRS funding of $11.204 billion for FY2005, which is a 10 percent increase from FY2004, with a significant increase of 3,315 full-time equivalents (FTEs) to boost enforcement efforts. If enacted, the Board's budget would increase our nation's revenue by approximately $5 billion each year once the IRS has hired and trained additional enforcement personnel.

Under the Board's budget, the IRS would have the additional resources to:

- Close over an additional 1,000 cases involving high risk/high-income taxpayers and promoters who avoid paying income taxes by using offshore credit cards and abusive trusts and shelters.
- Boost audit rates by 42 percent from FY2004 to examine companies that use aggressive tax avoidance tactics, such as offshore transactions and flow-through entities.
- Contact an additional 200,000 taxpayers who fail to file or pay taxes due; a 40 percent boost from FY2004 and a 27 percent increase from the Administration's request. This alone will allow the IRS to collect $84 million more in revenue owed than the Administration's request would allow.
- Sustain the one-on-one assistance that millions of Americans rely on at tax time. The Board's budget will ensure that the IRS will be able to maintain its improved service to taxpayers by answering eight out of ten phone calls.

By comparison, the Board believes the Administration's FY2005 budget cannot achieve its stated goal to add almost 2,000 personnel to bolster the IRS' enforcement efforts, and will threaten hard-earned improvements in customer service. This year's request will lead to a $230 million shortfall in the IRS budget because it fails to budget adequately for an anticipated $130 million of congressionally-mandated civilian pay raises, rent increases, and at least $100 million of unfunded expenses.

In its FY2005 budget recommendation, the Board anticipates a 3.5 percent pay raise for civilian employees, which achieves parity with the Administration's call for a 3.5 percent military pay raise. The Administration, by contrast, calls for a 1.5 percent civilian pay raise. The Board believes that the 1.5 percent civilian pay increase fails to recognize recent history. FY2005 will likely be the fourth year in a row in which the Administration has called for IRS staff increases, while not covering pay raises or required expenses.

The Board was established to bring to bear its collective expertise and familiarity with private sector best practices on the IRS' problems. To the private-life Board members, investments in enforcement pay for themselves many times over, not only in revenue dollars but by the deterrence value of reinforcing the belief that all taxpayers are paying their fair share. A strong business case can be made for providing the IRS with several hundred million dollars so it can

collect billions in revenue. Closing the tax gap is imperative. At a time when federal revenue as a percentage of the economy has shrunk to 1950s levels and we face a $500 billion deficit, the Board believes that we must strengthen our tax collection system.

For that reason, the Board recommends that both Congress and the Administration reevaluate their methodology by including the revenue value to the country when estimating budget requests for the IRS. Indeed, considering the positive impact of additional resources provides a better framework for making informed decisions and will lead to a more effective IRS.

3. Measure results

Mr. Chairman, reducing the tax gap requires a firm grasp and understanding of current levels of voluntary compliance. As previously noted, the data we now have is old and unreliable. However, beginning in 2005, the NRP will provide for the first time in more that 15 years solid estimates of voluntary compliance for the various segments of the U.S. taxpayer population. But the NRP is more than numbers and raw statistics.

Reducing the current unacceptable levels of non-compliance requires that we better understand the factors that drives voluntary compliance and non-compliance. That too is an important part of NRP's mission – finding out what makes taxpayers meet their obligations of their own accord. In other words, we have to know what is working and what is not in both customer service and enforcement. Based on this data, management can then make informed decisions that can boost levels of compliance and help close the tax gap.

The IRS is no stranger to measures. Under former Commissioner Rossotti's leadership, the agency effectively deployed and used measures to help improve customer service in key areas such as service on its toll-free telephone lines. These so-called "end result" and "outcome" measures not only tracked progress but helped the IRS establish higher goals for improving its service to taxpayers.

However, the lack of reliable voluntary compliance data has hampered the IRS' ability to effectively use outcome measures for enforcement. The IRS has been forced into the position where it must use interim measures such as the audit rate to track compliance. This is a reasonable approach with the data available, but unsatisfactory in the long term. By their very limited nature, interim measures cannot gauge the impact of education and outreach, practitioner oversight and audit rates on voluntary compliance or how to best utilize resources to achieve the most favorable outcome. The NRP will turn around this situation.

The NRP data will provide the IRS with information on the individual voluntary compliance rate. And just as importantly, it will provide an accurate baseline from which the IRS can begin to set long-term goals for the tax system compliance activities discussed in this testimony. This is a positive step and the Board cannot stress enough the importance of this data and the establishment of a long-term compliance goals. However, this is only the beginning. The IRS must also understand the voluntary compliance rates for businesses, corporations and the tax-exempt entities and what drives voluntary compliance for these taxpayers.

Mr. Chairman, as I mentioned earlier in my testimony; measures are more than sheer numbers. Establishing long-term goals can be very powerful in energizing an organization. Take for

example, the long-term goal established for e-filing. Although the 80 percent target was directed specifically at the IRS, it required the shared commitment of the IRS, the practitioner community, software developers and other partners to work towards achieving it. And while the goal may not be reached by 2007, its impact is undeniable. It energized the participants in the tax system to work together in an effort to achieve success.

Long-term goals for compliance can similarly energize the IRS and participants in the tax system to work together to close the tax gap. Recently, Senator Baucus proposed that the IRS raise voluntary taxpayer compliance to 90 percent by 2010. While I agree that we should set the bar high, I caution against establishing a value for the goal without knowing where voluntary compliance is today. Here again, the NRP can provide some valuable assistance.

In addition, the voluntary compliance goal should be embraced by all in the tax system and should not rest solely on the IRS' shoulders. We are all in this together and to improve voluntary compliance takes the effort and commitment of taxpayers, the IRS, practitioners, the legal community, the Administration, Congress, the business community and tax advisors. We all have a stake in improving the well-being of the tax system. And we need the right measures and outcome goals to achieve that measure of success.

4. Simplify the tax administration system

The IRS Oversight Board is precluded by law from addressing tax policy issues, but it would be remiss not to address the cost of our nation's complex tax system; a cost ultimately borne by taxpayers and the IRS.

The costly, confusing, and debilitating complexity of the tax code directly feed the tax gap. The National Commission on Restructuring the IRS, of which the Chair was a member, said the following on complexity of the tax code:

> *The Commission found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. . . . The Commission found that significant noncompliance—both inadvertent and intentional—results from various obstacles within the current system, including the cost of compliance and the complexity of the tax law.*

A particularly troublesome complexity looming on the horizon is the Alternative Minimum Tax, as it threatens to ensnare more taxpayers in succeeding years. In her annual report, IRS National Taxpayer Advocate Nina Olson recommended repeal of the AMT, saying:

> *The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers....[T]he AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code.*

The Board fully concurs with her assessment, and urges the Administration and Congress to consider accepting this recommendation in future legislation.

However, while it cannot and will not recommend specific legislative remedies to address the cost and burden of tax complexity borne by all of us, the Board believes that most efforts to simplify the tax code simply tinker at the edges. For that reason, the Board believes that by solving the fundamental problems at the heart of a complex tax code requires fundamental reform. The Board strongly encourages that Congress and the Administration explore ways to simplify our tax code. The potential for the benefits could be enormous for our society and our economy.

Conclusion

Mr. Chairman, in conclusion, I want to thank the Committee for holding this valuable hearing and shedding some important light on the nation's tax gap. The tax gap is an affront to all honest taxpayers and saps our nation of precious resources when it needs them most. The tax gap is an enormous problem that has been mounting for years. However, the IRS Oversight Board believes that in time, it can be solved through the four-pronged approach I have outlined today. Given the right tools and resources, the IRS is up to the task at hand. But it cannot go it alone. The ultimate success in closing the tax gap rests in all of our hands and in our shared commitment and dedication to the integrity and viability of our tax administration system. Thank you and I would be happy to answer your questions