

STATEMENT OF
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UNITED STATES SENATE

CONCERNING
CLOSING THE TAX GAP

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I thank the Committee for inviting me to testify today about the progress the government is making in closing the tax gap.

While the tax gap remains a significant challenge, it is important to recognize the dramatic improvements in tax enforcement since 2001, the most recent year for which we have a reliable estimate of the tax gap. When I took office just under four years ago, "tax enforcement" had been out of style for several years. Sophisticated professionals competed to design complicated tax shelters, cloaking the transactions in layers of secrecy. Promoters of frivolous tax scams marketed their schemes openly, on the internet and at public seminars, touting the fact that the IRS had not challenged them as evidence of the supposed validity of the schemes. Offshore banks offered anonymous credit cards and layers of trusts to conceal income from the IRS. Honest tax professionals – lawyers and accountants who tried faithfully to obey the law – increasingly lost clients to less scrupulous people who crossed the line between legitimate tax planning and illegal tax evasion with little fear of consequences, and with profits handsome enough to neutralize what fears might remain.

What effect the revival of tax enforcement will have on the tax gap cannot be measured immediately. But we can already see its impact on the behavior of taxpayers and tax advisers. They now know that we in the Executive Branch, and you in the Legislative Branch, are paying attention. They no longer assume that their sophisticated schemes are beyond our ability to detect. They no longer relax in the comfort of believing that they

can advertise or engage in tax fraud schemes without consequence. They now must factor in the very real risk that they will be caught, and if caught, that they will face civil penalties and possible criminal prosecution.

Although it takes time for our enforcement actions to affect the tax gap, a poll the IRS Oversight Board took last July and released last week provides concrete evidence of our progress. For the first time since the poll began in 1999, the 2004 results showed a positive trend in public confidence in tax enforcement. The poll results are consistent with our success in demonstrating our commitment to detect, pursue and punish tax offenders.

My remarks this morning will focus on two topics:

First, steps we at the Department of Justice Tax Division have taken over the past four years to increase tax law enforcement and help close the tax gap; and

Second, challenges we face in the future.

President John F. Kennedy said,

The integrity of [the tax] system depends upon the continued willingness of the people honestly and accurately to discharge this annual price of citizenship. To the extent that some people are dishonest or careless in their dealings with the government, the majority is forced to carry a heavier tax burden.

That "heavier tax burden" is the tax gap – the difference between taxes owed and taxes paid.

The Tax Division plays a critical role in attacking the tax gap. Some determined tax evaders will change their behavior only if they know that the Tax Division will back up the IRS through criminal enforcement, civil judgments or court orders compelling compliance.

But that is only part of the Tax Division's contribution. The Tax Division is important to the administration of the tax system precisely because it is not the IRS. Rather, it is part of the Department of Justice.

The Department's name describes its mission. *Justice* requires that the laws be enforced uniformly and fairly. The Justice Department's devotion to the fair and uniform enforcement of the laws *Congress passes and the President signs* gives citizens the faith they deserve to have in the institutions of their government.

It is in this atmosphere of *dedication to enforcement of the laws* that the men and women of the Department of Justice Tax Division work every day. While the Division does collect many millions of dollars in taxes every year, the Division's mission is not to collect taxes. It is to do justice – through the fair and consistent enforcement of the tax laws. Knowing that all taxpayers will be treated fairly and consistently encourages honest taxpayers to pay what the law requires, secure in the knowledge that their neighbors and competitors are not gaining an unfair advantage by failing to do so. And knowing that the government really will enforce the laws deters people who might otherwise violate the law if they thought they could get away with it.

By promoting justice, therefore, the Tax Division also promotes the voluntary compliance that is essential to closing the tax gap and building a vibrant, efficient and healthy tax system.

We all know that the tax system would not work if, believing that the tax system was not fairly administered, people did not voluntarily comply with their tax obligations. An IRS three or four times its present size could not compel payment of a fraction of the trillions of tax dollars paid into the Treasury each year, if compulsion were the only means for getting payment.

For our system of voluntary compliance to succeed, it must be seen to be fairly enforced. At the same time, the tax collector must be given power to collect information about taxpayers' financial affairs, to investigate potential fraud, and to collect taxes that are due and owing. But Congress did not vest this vast power in the IRS alone. Congress gave the ultimate enforcement power—the power to approve and pursue criminal prosecutions, and the authority to litigate in the district courts, Court of Federal Claims, and courts of appeal—to the Department of Justice. The Department of Justice, through the Tax Division, independently determines the correctness of the Government's litigating positions and the merits of the cases it brings and defends. This independence provides an institutional

check on the power of the IRS and reassures the taxpaying public that the system is fair.

By bringing together all (but Tax Court) tax litigation under the auspices of the Attorney General, and coordinating nationwide the Government's advocacy using an experienced and expert cadre of tax litigators, the Tax Division ensures that the tax system is efficient and cogent and promotes voluntary compliance.

TOPIC 1: STEPS WE HAVE TAKEN

The Tax Division has concentrated its efforts and resources on solving specialized problems that have arisen in recent years. In particular, we have:

- Worked to combat corporate tax shelters
- Sought court injunctions to block tax scams
- Pursued individuals and businesses using offshore bank accounts to avoid taxes
- And focused on criminal enforcement to promote deterrence.

CORPORATE TAX SHELTERS

In the 1990s, some tax advisers marketed sophisticated tax shelters that they claimed would eliminate billions of dollars in tax liabilities. The people who bought into these tax shelters banked on two assumptions they probably considered pretty solid:

- One: They would never get caught. They assumed the government wasn't smart enough or staffed enough to discover or untangle their complex transactions.
- Two: Even if they were caught, they could rely on "opinion letters" from counsel to avoid penalties.

The last two years have seen each of these assumptions proven wrong. The Tax Division has brought numerous suits against the full array of people and businesses engaged in tax shelter design, promotion, and financing -

including but not limited to banks and investment houses, accounting and law firms. As a result, transactions have been discovered and taxpayers have been identified.

Some tax shelter promoters have tried vigorously to hide their clients' identities behind the shield of privilege. But Tax Division attorneys prevailed in their presentation of the government's view, and courts have ordered the promoters to hand their client lists and transaction documents over to the IRS. Judges have noted the "waste of judicial resources" in dealing with frivolous privilege claims and have chastised the lawyers and accountants involved. With promoters' files opened for IRS inspection, tax shelter purchasers know they cannot hide, and hundreds are now voluntarily seeking to come in from the cold and pay billions of dollars in taxes, interest and penalties.

The second mistaken assumption was that an opinion letter is a "get out of penalties free" card. Tax shelter buyers now know they cannot unreasonably rely on opinion letters to avoid penalties. In a significant decision last year, the Tax Division prevailed at trial in the case brought by Long-Term Capital Holdings, a hedge fund that infamously collapsed a few years ago. The trial court held that reliance on opinion of counsel will help taxpayers avoid penalties only if the reliance is reasonable. In upholding the multi-million dollar penalty the IRS had imposed, the trial court strongly criticized the conduct of the lawyers who had provided unreasonable opinions.

Moreover, as for the merits of alleged tax shelters, in the last four years, the Tax Division has closed down shelters estimated to be worth over \$11 billion industry-wide, by obtaining authoritative appellate decisions on the shelters' lack of merit. The shelter cases that the Division is currently handling implicate over \$20 billion in taxes, interest and penalties payable to the Federal Treasury.

The victories the Tax Division has won, both in identifying tax shelter buyers and in proving that their shelters lack merit, have given the IRS the leverage it needs to make settlement initiatives attractive. The IRS recently announced that 1165 of the more than 1800 taxpayers identified as having engaged in the abusive "Son-of-BOSS" tax shelter had participated in the

IRS's tough settlement initiative, and had paid nearly \$3.5 billion as a result. They would not have stepped up to pay these huge sums had the Tax Division not provided a credible threat of detection and punishment.

TAX SCAMS

Tax shelters for corporations and wealthy individuals are at the "high end" of the tax-avoidance spectrum. At the other end are scams and frivolous schemes peddled to many thousands of people. Up until 2001, the scamsters who sell these low-end tax fraud schemes often went for years without significant government attention. They often used the fact that they had been selling their scheme out in the open, without government intervention, as proof of its legitimacy.

Many were benefiting from the fact that criminal investigations take a long time, and the government was reluctant to take civil action while a criminal investigation was pending. But when a scheme is ongoing and continuing to cost the Federal Treasury, that reluctance to take civil action didn't make sense.

So in 2001, we instituted a program to bring civil injunctions to halt the sale of tax scams. Our initiative has used the "kingpin" theory of enforcement. By halting the scams at the promoter—or kingpin—level, the Tax Division has effectively used its resources to focus on these *few* "enablers" and prevented tax evasion by *hundreds of thousands* of taxpayers. This initiative has saved the Treasury billions and recovered some revenues that had already been lost.

This program has been enormously successful, after starting almost from scratch. In Fiscal Year 2000, for example, no promoter of tax fraud schemes faced a Justice Department injunction complaint. Since then, the Tax Division has filed suits against 129 promoters, 69 in Fiscal Year 2004 alone. In mid-March, the Division obtained its one hundredth injunction against a promoter under this initiative.

The Division's success in this area, where few efforts were being made before, stems from three basic principles we have advocated:

1. Existence of criminal conduct should not bar us from pursuing civil remedies.
2. We cannot permit the fraudsters to peddle their wares in public without taking public action against them.
3. We should use all available tools to pursue promoters.

Consistent with these principles, most of the targets of the Division's injunction work so far have been people who promoted their schemes publicly. We are denying them the ability to claim that "nothing is being done, so it must be OK," and we are strengthening the public perception that the law is being enforced.

Schemes we have enjoined to date include most of those you find on the IRS's "Dirty Dozen" list on its website. These cases involved nearly 400,000 taxpayers, and attempted to cheat the United States Treasury of nearly \$2 billion. To name a few:

1. Claims that people are not required to pay taxes for various frivolous reasons, such as the argument that Section 861 of the Internal Revenue Code exempts U.S. citizens from paying taxes on income received in the U.S.; or that one can expatriate oneself from the tax system without leaving the U.S.
2. Claims for non-existent tax credits, for example, that descendants of slaves can claim tax credits as reparations
3. Schemes setting up sham trusts to allow taxpayers to deduct personal expenses
4. "Warehouse banks" to commingle and conceal assets
5. Schemes advocating filing tax returns falsely reporting "zero" income
6. Urging employers to fail to withhold, report or pay payroll and income taxes

OFFSHORE CREDIT CARD INITIATIVE

To help the IRS identify people and businesses who had stashed money overseas in an attempt to hide it from the IRS, the Tax Division brought suits to serve and enforce John Doe summonses on issuers and processors of offshore debit and credit cards. The results of that effort were huge: millions of dollars in taxes were collected, hundreds of promoters and thousands of offshore account holders were identified, and more than a few criminal investigations are in progress.

CRIMINAL PROSECUTIONS

The prospect of civil enforcement alone will not convince everyone to comply with the tax laws. So the law provides criminal penalties as well. We therefore conduct criminal investigations and prosecutions where appropriate, punishing tax cheaters with prison sentences and convicted criminal status, not just civil penalties and interest. Criminal prosecutions deter tax fraud and reassure honest taxpayers that the law is being enforced fairly and uniformly. Through prosecutions, we send a clear message: Tax law is law, and the criminally culpable will be punished.

Once again, our efforts are paying off. In the last three years, the Tax Division has increased the number of prosecutions it has authorized by 60 percent. At the same time, we have cut the average time it takes to authorize prosecutions by nearly 50 percent.

Tax Division prosecutors review cases referred by the IRS for potential criminal prosecution and determine whether criminal prosecution in a particular case is appropriate and should be authorized. This is the first time in the investigation process that the evidence is reviewed by experienced and independent tax prosecutors. Some of our lawyers have prior service as IRS agents. Others have advanced law degrees in taxation or are certified public accountants. All are experienced in prosecuting criminal tax cases, and all decisions are approved by senior managers with decades of experience.

As a result, the Tax Division is equipped to perform a meaningful, independent review. Also, our lawyers review cases that arise all across the country and are in the best position to ensure that cases developed in one part of the country are treated in similar manner to those developed elsewhere. No other organization within the federal law enforcement community has such institutional expertise in criminal tax prosecutions. Such a centralized review is critical to reassure taxpayers that the law is being applied evenly and fairly, which, in turn, promotes greater respect for the law.

In addition to reviewing and authorizing tax prosecutions, Tax Division attorneys conduct a wide variety of grand jury investigations and prosecutions, either on our own or as co-counsel with Assistant United States Attorneys. In all cases, the ultimate decision whether to approve tax charges rests with the Tax Division, which brings its national perspective to bear in making that decision.

I want to focus on two areas in which Tax Division prosecutors have made significant strides: offshore enforcement and illegal tax protestors

Offshore Enforcement Efforts

Offshore tax schemes are often difficult to detect and prosecute. The countries employed in such schemes usually have strict bank secrecy laws. Compounding the problem, crucial information sought by Tax Division prosecutors—information necessary to prove U.S. tax violations—is often not covered by treaty provisions. Furthermore, even when IRS investigators and Tax Division prosecutors are able to obtain the information, many tax haven countries will refuse to extradite tax criminals. We have nevertheless overcome many of these obstacles by relying on our cadre of experienced prosecutors, some of whom have developed expertise in gathering evidence from foreign countries. For example, when we need to obtain banking records or other business documents from off-shore entities, our attorneys will make requests pursuant to treaties, where they are applicable. They will also issue subpoenas to offshore businesses doing businesses in the United States in their efforts to identify records needed in a prosecution. And they will aggressively pursue the tax cheats who use foreign bank secrecy laws to try to hide income and assets.

Illegal Tax Protest Activities

Under another initiative, our criminal prosecutors focus on illegal tax protest activities. Tax schemes in this category include claims that the individual is a “sovereign citizen” not subject to U.S. laws, the U.S. income tax is unconstitutional, the taking of sham “vows of poverty” by taxpayers, and the harassment of government employees and judges. Of course, every court to have ruled on such arguments has held that they are without merit. Still, the arguments continue to be offered. It is important that we ensure that the tax laws are enforced with respect to all citizens, both to protect the fisc, but also to reassure honest taxpayers—who comprise the vast majority of taxpayers nationwide—that they are not shouldering an unfair portion of the tax burden. Tax Division attorneys have and will continue to prosecute criminal tax conduct.”

TOPIC 2: CHALLENGES FOR THE FUTURE

The Tax Division can sometimes help lead the IRS into new areas of tax enforcement, such as our effort to expand the use of civil injunctions to stop tax scam promoters. But for the most part, the *input* of the Division’s workflow is driven by the IRS’s *output*. When the IRS’s enforcement efforts decline, so does the work of the Tax Division. When IRS increases its enforcement efforts, its need for a strong Tax Division to back up its efforts rises as well.

We are happy to observe that the IRS has increased its emphasis on enforcement in recent years. The effects of that increased emphasis are already being seen in the Tax Division. And clearly there is more to come. Tax Division activity is always a lagging indicator of the level of IRS enforcement activity. Because only when IRS administrative tools fail to resolve the matter must the Tax Division come to bat.

The IRS’s Son-of-Boss initiative is a good example of this. The IRS’s recent announcement concerning the number of taxpayers who participated in the Service’s “Son of Boss” settlement initiative was striking, not only because of the \$3.5 billion the Service has received through the initiative but also because of the *hundreds* of taxpayers, whom the IRS has already identified, who did not accept the deal and whose tax liabilities will now be

litigated in court. And the "Son of Boss" initiative is only one of several settlement initiatives that the IRS has in the works.

The Tax Division is proud of the role we have played in providing the enforcement "stick" that makes the IRS's "carrot" of settlement initiatives effective. It is essential that the Tax Division be able to continue providing this support that is so critical to the IRS's success in promoting voluntary compliance.

CONCLUSION

The men and women of the Tax Division have given us all plenty of reason to be proud and pleased - as citizens and taxpayers - of what they have achieved in promoting fair and uniform enforcement of the tax laws.

Our collection efforts bring in tens of millions of dollars each year to the Federal Treasury, typically nearly as much as our annual appropriation. Through the successful defense of refund claims, we additionally save the Treasury hundreds of millions of dollars each year. Over the last four years, through actual collections and direct refund savings, we have saved the Treasury nearly a billion dollars per year. These are the direct savings, and do not include the many billions of dollars saved through the establishment of precedent and the deterrent effect of our litigation and prosecutions.

By closing down sophisticated tax shelters, enjoining tax scams, and appropriately prosecuting criminal activity, we are promoting justice.

There is much left to do, and we in the Tax Division look forward to continuing to undertake these challenges. And I look forward to answering your questions.

Thank you once again.