WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
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BEFORE
SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS'
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS HEARING ON
OFFSHORE ABUSES: THE ENABLERS, THE TOOLS AND OFFSHORE SECRECY
AUGUST 1, 2006

Good morning Chairman Coleman, ranking Member Levin and members of the subcommittee. It is good to be back before the subcommittee again.

Unfortunately, it seems that each time I appear before this subcommittee it is to discuss another example of individuals or corporations trying to avoid taxation either through outright refusal to pay their fair share of taxes or through schemes and shams designed to take advantage of the complexity inherent in the tax code. Today is no exception.

This subcommittee has a long and impressive history of investigating tax havens and offshore abuses that undermine the integrity of the Federal tax system and potentially divert billions of dollars from the United States Treasury. I am pleased to be here this morning to assist you in your latest efforts to examine offshore abuses.

The IRS has also been active in investigating offshore abuses. We are very concerned both with corporations who seek to inappropriately to shift profits to foreign low tax jurisdictions or get out of paying taxes altogether, as well as individuals who seek to avoid or evade U.S. taxes by moving assets to other countries. Our investigations include both routine tax examinations and, where necessary, criminal investigations of particularly abusive behavior.

However, we recognize this is an area where we still have a long way to go and I hope this morning that I do not understate the significant problems IRS encounters in handling these types of issues. They often involve other sovereign jurisdictions over which we have little or no control and with taxpayers that are often difficult to identify. As I will discuss later in my remarks, we have agreements with many jurisdictions, but there are limitations on our ability to use those agreements. And, victories are often short-lived. If we become effective in terms of enforcement in one jurisdiction, the promoters and the schemers simply move to another.

What I would like to do this morning is to offer a little background about these issues and explain why they are so difficult for us. I then want to explain how we are dealing with these challenges, as well as lessons learned. Finally, I will discuss what we think needs to be done moving forward.

Background

U.S. tax administration is complicated by the rapid pace at which our overall economy is becoming more global. A growing percentage of large and mid-size business tax filings are from multinational companies that have a variety of subsidiaries and partnerships operating within an enterprise structure where the ultimate parent is as likely to be foreign as domestic. In addition, a growing number of U.S. businesses acquire raw materials, inventory, financing, products, and services from foreign businesses.

These events are natural outcomes of an increasingly global economy and businesses have the right to optimize their global structures. Nonetheless, the complexities of globalization and cross-border activity continue to challenge U.S. tax administration. With multiple domestic and global tiered entities, it is often difficult to determine the full scope and resulting tax impact of a single transaction or series of transactions. Complexities of globalization and cross-border activity create opportunities for aggressive tax planning.

It is not just large corporations taking advantage of this globalization. Wealthy individuals are seeking ways to shelter income by moving it offshore or by participating in tax shelters organized by unscrupulous promoters who move in the shadows of the global economy.

This is complicated by the relative lack of transparency in the transactions that individuals can conduct offshore. Not only are the transactions themselves often intentionally designed, or carried out in a manner, to be abstruse, but the individual(s) engaging in the transaction, and their roles, are often intentionally difficult to identify.

Another challenge we face in this global environment is the increasing complexity of the Internal Revenue Code. As the Code continues to expand, becoming more complex and challenging to administer, large businesses and wealthy individuals are able to utilize every available resource to explore opportunities to reduce their tax liability by using the most intricate and complicated Code provisions, often in combination, to produce results not intended by Congress. Every new tax law, even those that are simple on their face, creates additional complexity while providing taxpayers with further tax planning opportunities. This adds to the challenge of administering the federal tax system. Many changes to the tax law make it more difficult for us to treat similarly situated taxpayers in a consistent manner.

Moving Assets/Entities Offshore

On June 13th, I testified before your colleagues on the Senate Finance Committee regarding compliance issues relative to large and mid-sized businesses. At that hearing, I talked about how taxpayers shift significant profits offshore by manipulating the price of related-party transactions so that the income of an economic group is earned in low-tax or no-tax jurisdictions, rather than the U.S., thus reducing the enterprise's worldwide income tax liability. Let me discuss a couple of ways in which this occurs.

The first two issues focus more on tax planning activities by multinational enterprises. The levels of aggressiveness vary from one taxpayer to another.

Transfer of Intangibles Offshore/Cost Sharing:

Tax issues associated with the transfer of intangibles outside the United States have been a high-risk compliance concern for us and we have seen a significant increase in recent years. Taxpayers, especially in the high technology and pharmaceutical industries, are shifting profits offshore through a variety of arrangements that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration. Cost sharing arrangements are often the method of choice for this activity. The buy-in amount in cost sharing arrangements is particularly troublesome. It is often understated, resulting in the improper shifting of income offshore.

As part of our response to these issues, we proposed a comprehensive set of cost sharing regulations in August 2005. These regulations seek to ensure such arrangements do not facilitate a disguised transfer of intangible assets outside the United States in a manner inconsistent with the arm's length standard. We intend to finalize them this year.

We have also established a cost sharing Issue Management Team (IMT) to improve Service-wide coordination in the identification, development, and resolution of cost sharing issues. The IMT issued a cost sharing audit checklist in 2005 that provides guidance to field examiners for developing potential cost sharing audit issues and ensuring consistency. The team has completed its efforts to identify and review cases with a cost sharing issue to determine the impact and compliance risk. The team is developing a coordinated issue paper that will provide the basis and support for examining issues and assist with potential Appeals Settlement Guidelines. We have issued guidance to field examiners for requesting transfer pricing documentation.

Transfer Pricing

Taxpayers are continuing to shift significant profits offshore. Taxpayers often manipulate the price of related-party transactions so that the income of an economic group is ostensibly earned in a low tax or a no tax jurisdiction, rather than in the U.S., thus lowering the enterprise's worldwide tax burden. We apply the arms length principle to determine the appropriate allocation of income between related parties based upon the application of acceptable transfer pricing methodologies (section 482 of the Code).

In response to the significant compliance risks of transfer pricing issues, we issued a Transfer Pricing Compliance Memorandum in January 2003 that provided instruction and guidance to all field examination personnel regarding potential transfer pricing issues. Additionally, our Large and Mid-Sized Business (LMSB) Commissioner issued a

Transfer Pricing Documentation Memorandum that requires all field examination personnel to request and review taxpayer transfer pricing studies. As a subset of the transfer pricing issue category, a section 936 Termination Strategy issue has been identified for additional compliance coordination. Associated with the sunsetting of section 936, taxpayers have created structured transactions to transfer U.S. intangibles that were used in Puerto Rico to other low tax jurisdictions. An IMT has been established to identify, coordinate, and propose resolution alternatives for this issue. Field examiners and technical advisors will provide technical support to teams with the development of this tax issue.

The Transfer of Intangibles and Transfer Pricing issues present significant compliance challenges in the multinational corporate/enterprise tax administration arena. IRS data indicates that aggregate examination adjustments are growing, as are the amount of adjustments made per taxpayer year under examination. These examinations are resource intensive, requiring a battle of experts over the valuation of assets migrating to low tax jurisdictions, or the appropriate “arms length” value to apply to related company transactions. The level of the non-compliance is likely to increase based upon results from the past 5 years of examinations. In the short term, In the short term, we are dedicating additional resources by utilizing outside experts to improve the IRS’ ability to prevail in valuation issues while in the longer term legislative fixes may be needed.

In addition to the items above, I shared two other compliance challenges in my June 13th testimony before the Finance Committee. The first was Abusive Foreign Tax Credit Transactions where taxpayers are creating complex transactions in an attempt to generate and claim foreign tax credits (FTCs) where the foreign-source income generating the credits is not taxed in the United States. The second was Abusive Hybrid Instrument Transactions where taxpayers can use hybrid instruments, hybrid entities, and similar structures to capitalize on differences between foreign and domestic tax laws because these structures are often treated differently for U.S. and foreign tax purposes. This kind of arbitrage can be the natural outgrowth of global economies and disparate tax systems. Concern exists, however, that in some cases, hybrid instruments or entities might be used to avoid U.S. tax rules.

Both of these compliance challenges are significant in terms of dollars per transaction and are not easily identified on the return nor readily disallowed upon examination. We have established IMTs to address these challenges and are evaluating options to reach the appropriate resolution based upon U.S. income tax laws.

I would now like to turn your focus to individuals and small businesses whose activities may be characterized, at best, as very aggressive tax planning and, at worst, as criminal tax evasion.

Abusive Tax Avoidance Transactions

One of the most difficult tasks the Service has encountered in addressing offshore compliance has been the identification of individual taxpayers who are involved in offshore arrangements. By their very nature, offshore abusive tax avoidance transaction (ATAT) arrangements are designed to conceal the identity of the taxpayers and to shield their ownership of assets and income from detection. Common characteristics of the use of controlled foreign entities (trusts, corporations, partnerships, joint ventures, etc.) in ATAT arrangements include:

- Nominee-owned foreign entities that are beneficially owned and ultimately controlled by a U.S. taxpayer
- Funds (derived and diverted from U.S. business activities) that are transferred offshore and often deposited into offshore bank accounts controlled by the U.S. taxpayer through the controlled foreign entities. Funds are typically repatriated with the use of offshore debit/credit cards.
- Taxpayers participating in ATAT arrangements seldom file required International Information Returns (Forms 3520, 3520-A, 5471, 8865, FBAR, etc.) indicating ownership of, transfers to and from, and income attributable to their controlled foreign entities.

As a result of the Service's experience and continuing compliance efforts, we have discovered that the most practical way in which to identify taxpayers who are involved in offshore ATAT arrangements that are shielded by a lack of transparency is by "following the money." The Service has identified four basic components to an offshore abusive arrangement in this regard:

- Devise an overall offshore plan (the Promoter/Promotion),
- Covertly transfer funds and assets offshore (Expatriation),
- Control the funds and assets transferred offshore (Control/Ownership), and
- Access the offshore funds (Repatriation).

The following are the primary categories of ATAT arrangements we see and are addressing:

- **Multiple Entity Arrangements:** The purpose is to divert business and personal income offshore and hide ownership of the assets. Many of these include tiered structures that start domestic then funnel funds and income offshore
- **Income Stripping:** Use of false invoicing to move income offshore from a legitimate domestic business entity. Generally consists of a controlled foreign entity billing for goods or services (i.e., insurance) at excessive rates or for non-existent goods or services (i.e., advertising, consulting, management fees).
- **Economic Citizenship:** Taxpayer purchases "economic" citizenship in a tax favorable offshore jurisdiction and seeks to avoid U.S. tax liability, either by renouncing U.S. citizenship or failing to properly report income.
- **IRA/401(k) Rollover Schemes:** Taxpayer transfers IRA/401K assets to a self-directed IRA/401(k) that invests in the taxpayer's 100% owned/controlled international business company (IBC). Taxpayer has full control over the funds through the IBC, although ownership is disguised. Funds may be repatriated without reporting the income or the pre-59½, 10 % penalty.

- **Offshore Employee Leasing (Notice 2003-22, 2003-18):** Avoids/evades income and employment taxes with respect to compensation received from a closely-held U.S. entity through use of offshore & domestic employee leasing companies. An offshore "non-qualified deferred compensation plan" (NQDC) is part of the contract, but the taxpayer gains immediate access to the funds from the NQDC through loans or the use of offshore debit/credit cards.

Financial Privacy Laws in Foreign Jurisdictions

Financial privacy laws in certain foreign jurisdictions are a significant hurdle in our efforts to battle offshore abusive tax shelters like those identified above. These jurisdictions deliberately attract foreign business with government policies such as enacting incentives that minimize or mitigate tax, "business friendly" regulatory/supervisory regimes such as exchange controls, disclosure requirements, and secrecy enforced by law.

It is their legal framework that makes them unique. In addition, these jurisdictions enable banks, trust companies, company incorporators, other financial intermediaries, and financial advisors resident in that jurisdiction to provide products and services to non-residents in their home countries.

These offshore secrecy jurisdictions are traditionally considered to have some or many of these characteristics:

- Little or no income tax
- Bank and/or commercial secrecy
- International banking facilities
- Modern communication and transportation facilities
- No currency controls
- Aggressive self-promotion
- Political and economic stability
- Asset protection laws
- Availability of competent professional services and ease of forming entities
- Lack of agreements with the United States requiring exchange of tax information

We are particularly concerned about offshore secrecy jurisdictions that:

- Offer the instant formation and management of foreign trusts, international business companies (IBCs) and other special purpose entities
- Lack transparency in that
    - They offer banking and financial secrecy by law and by custom (enforced by civil and criminal penalties including incarceration)
    - The beneficial owner of an entity, transaction or asset is unknown
- Does not exchange tax information with the U.S.

A few offshore secrecy jurisdictions have Tax Information Exchange Agreements (TIEAs) in place, as a means for the U.S. to receive information. However, we cannot take full advantage of a TIEA in situations where the US person's identity is unknown. In addition, even where the U.S. is able to secure information about a U.S. taxpayer, the TIEAs do not provide for assistance with the collection of U.S. taxes from foreign-based assets. This ensures that assets transferred by U.S. taxpayers to an entity in an offshore secrecy jurisdiction remain out of touch (with the possible exception of a court-ordered "writ of repatriation" in which a U.S. person is compelled to repatriate assets or face contempt of court charges).

Over the last few years, we have negotiated TIEAs with countries such as: Antigua/Barbuda, Aruba, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Isle of Man, Jersey and Guernsey. Most of these TIEAs cover the tax years beginning on January 1, 2006, for civil tax enforcement purposes and January 1, 2004 for criminal purposes. We hope these TIEAs will have a positive effect on tax compliance and transparency but the IRS does not have a meaningful track record for obtaining information under these TIEAs because of their limited coverage and recent effective dates.

IRS Actions and Lessons Learned

We have attempted to take a proactive approach to dealing with the challenges of effective tax administration in the environment described above. But, as I said earlier this is an area in which we have struggled. Our overall strategy depends on making compliance checks as often as possible, on a real-time or near-real-time basis, while being as current in our examinations as possible. We also need as much transparency, relative to taxpayer offshore activities and other indicators of risk, as possible.

In January, 2003, the Service announced a new initiative, called the Offshore Voluntary Compliance Initiative (OVCI). This initiative was aimed at bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with the law.

This initiative resulted in 1,321 applications representing 3,436 returns. We were able to identify 230 promoters who were previously unknown to the Service and we collected over $270 million at a cost of approximately $2 million. In reality, we did not have a good idea of the potential universe of individuals covered by this initiative. As a result, the incentive for taxpayers to come forward and take advantage of this initiative was diminished due to the fact that we did not have the ability to identify immediately and begin examinations for all non-participating individuals.

Contrast that with our Son of Boss initiative which we announced in May, 2004. In this instance, we had a known population of taxpayers. As a result, we had more than 1,200 taxpayers electing to participate. This is about two-thirds of the eligible taxpayers, and the total revenue collected in the form of tax, penalties, and interest has topped $3.7 billion. More importantly, all non-electing taxpayers involved in these transactions were identified and are the subject of current examinations.

These two initiatives demonstrate clearly the challenges we face when attempting to pursue initiatives where the identity of the universe of taxpayers is unknown.

We are looking at various methods to better address issues involving cross-border/multi-national enterprise activities. We have in general found cross-functional IMTs to be successful when we employ them to provide executive oversight and focus on areas of high risk, especially when focused upon technical issues requiring significant expertise. We have used IMTs to combat tax shelters, and have expanded their use to include other areas of high compliance risk. We have also used special teams of experienced personnel to assist with the examination of specific issues in the tax shelter arena, and plan to use similar teams to address other compliance issues. Additionally, we are working to enhance the use of internal web site information to better inform examiners of high risk areas and the steps they must take to ensure consistent application of the law.

The Offshore Credit Card Program (OCCP) is a compliance initiative designed to identify taxpayers who use offshore bank accounts to hide income and offshore credit cards issued by secrecy jurisdiction banks to repatriate the unreported income. In looking at these, we find significant incidences of Foreign Bank Account Reports (FBARs) that are not filed and significant incidences of potential fraud on unreported income. We issue "John Doe summonses" to primary and third party domestic credit card processors to identify cardholders. To date, we have trained over 1,200 revenue agents to examine offshore credit card activities and identify abusive offshore tax avoidance transactions.

We are also becoming more aggressive with our promoter investigations. By conducting such investigations, the Service is able to:

- Shut Down the Promotions: Use of IRC 6700 investigations and referrals to the Department of Justice (DOJ) for IRC 7408 injunctions.
- Obtain Client Lists: Lists are generally secured through the promoter investigation. Some lists have been from a treaty partner through the Joint International Tax Shelter Information Centre (JITSIC) as well as from the Offshore Credit Card Program. Once participants are identified compliance activity is initiated.
- Parallel Investigations: Civil and criminal cases are worked simultaneously to ensure promotion is halted expeditiously.

In January 2006, in a move that I believe sharpened and improved the strategic acuity of the Service's international collaboration, the IRS and the tax administrations of nine other countries agreed to the establishment of the so-called "Leeds Castle" Group. Under this new arrangement, the commissioners of the revenue bodies of China, India, and South Korea agreed to meet regularly with their counterparts from the US, the UK, Japan, Australia, Canada, France and Germany to consider and discuss issues of global and national tax administration in their respective countries. I particularly welcome the interest and enthusiasm of my counterparts in the economically burgeoning East Asian region in participating in this arrangement and regard it as critical in light of the vast increase in trade and interaction between their economies and our own, with correlated effects on tax administration.

Another body that I believe serves a very important strategic role for the Service in the realm of our international activities is the Joint International Tax Shelter Information Centre, or JITSIC. JITSIC, a joint effort of the Service and the tax bodies of the UK, Australia and Canada to identify and share information on a real-time basis about abusive tax avoidance transactions, has sharply improved our knowledge and understanding in a number of areas, including developments in the areas of foreign tax credit generation and so-called hybrid instruments that have been identified as among our most significant issues in corporate tax administration.

We are also pursuing a brokerage initiative which will have the dual purpose of assessing the withholding and information reporting compliance of the withholding agent and the U.S. beneficial owners of accounts established in the names of entities domiciled in secrecy jurisdictions. Two withholding agents are currently under examination, with more planned.

There are currently several Internal Revenue Code sections that provide for the application of penalties where U.S. taxpayers fail to file required information returns on foreign trusts (Forms 3520 and 3520A), foreign controlled corporations (Form 5471) and foreign controlled partnerships (Form 8865). Additionally, as a result of an agreement with the Financial Crimes Enforcement Network (FinCEN), IRS is now authorized to pursue and assess penalties under USC Title 31 for a taxpayer's failure to file Treasury Form 90-22.1 (Report of Foreign Bank and Financial Accounts or "FBAR"). To date, we have trained over 300 revenue agents with respect to foreign trusts and other offshore entities, and provided them with the tools to pursue both the information necessary to examine the offshore activities and the penalties for failure to provide such information.

In February 1995, Criminal Investigation (CI) established a formal International Strategy. One of the goals of the strategy involved placement of special agents as Attachés in foreign countries. These placements help facilitate development and utilization of information obtained from host foreign nations. The strategy has led to the placement of Attachés in eight United States Embassies around the world.

The use of undercover operations by our Criminal Investigation (CI) division is also critical to our success in investigating any offshore tax evasion scheme. The undercover agent helps us identify the primary perpetrators (promoters, accountants, and attorneys), their schemes and the movement of funds offshore and back onshore. This allows us to capture real time evidence of the crime.

Limited Success

We have experienced some limited success with our efforts. We have a number of offshore promoter investigations either completed or underway. We have permanently enjoined eight promoters of offshore schemes and we have an additional 7 injunctions pending. There are currently 124 offshore transaction promoter investigations in the field, including 32 parallel proceedings with our Criminal Investigation (CI) division. Additionally, we have almost 4,000 open participant investigations with over 1,500 of these involving the Offshore Credit Card Program. We also have identified another 2,568 cases that have been assigned to our examination groups.

We have brought recent civil injunctions against a number of individuals including:

- A Florida couple has been permanently barred from promoting a tax fraud scheme helping customers set up offshore trusts and corporations designed to conceal income and assets from the IRS.
- The DOJ filed to block an alleged sham trust scheme used to hide income and assets in Caribbean bank accounts by two individuals in Las Vegas.

Our CI division has also been active. In FY 2005, CI initiated 197 criminal investigations as opposed to 79 in FY 2003. The prosecution recommendations have increased from 80 in FY 2003 to 126 in FY 2005. The average incarceration rate has increased from 79.1 percent to 86.2 percent over the same period. Some recent examples of CI actions include:

- An indictment against 4 people in North Carolina on numerous charges, including running an offshore tax fraud scheme from the Bahamas, using offshore credit cards, obstruction of justice, money laundering, witness tampering, and perjury.
- An indictment against a key individual in an organization that sold audiotapes, CDs and tickets to offshore seminars on “wealth-building” strategies. The individual was deported from an offshore jurisdiction and is in United States custody. He was indicted in May 2004 for conspiring to defraud the IRS and has been in custody since January 10, 2006.
- A Denver man was sentenced in U.S. District Court to five and one-half years in prison, followed by three years of supervised release, in connection with his role in a particular organization. He was also ordered to pay more than $10,000 towards the costs of prosecution. He set up shell corporations for clients that were used to conceal nearly $9 million in taxable income. The clients transferred millions of dollars to secret bank accounts in the Turks and Caicos Islands and other foreign countries.
- A federal grand jury in Salt Lake City indicted six individuals for promoting a tax fraud scheme that cost the Federal Treasury over $20 million in taxes. The defendants’ scheme utilized, among other things, offshore companies, offshore bank accounts, the services of offshore nominees, and opinion letters which purported to give legal authority to the fraudulent transactions.

How Congress Can Help

Though it may sound repetitive, probably the single greatest thing that Congress can do in all of these areas is to simplify the tax code. The increasing complexity of the tax code combined with the complex and dynamic business models of many taxpayers provides for extremely complex tax implications. Some arrangements are perfectly within the boundaries of the law, but complexity creates opportunities for taxpayers and those who advise them to structure transactions and entities to minimize or avoid paying taxes in ways that were not intended by Congress. At the same time, the tension created by the desire of corporations on the one hand to maximize book-earnings, and on the other hand to minimize taxable earnings and increase cash flow, presents incentives which could drive non-compliant behavior.

I do not want to overstate the value of simplification in that many of the things I have described are simply a function of individuals or promoters taking advantage of different tax structures in different jurisdictions. To a certain extent, that behavior will continue regardless of how simple the code is. But, simplification does help everyone better understand their tax obligations and decreases the probability of them being deceived by the unscrupulous.

The second thing Congress can do is take appropriate steps to increase the transparency both of transactions and of taxpayers who participate in those transactions. Our long history of tax administration has taught us that the more visible the transaction, the more tax compliant it is likely to be.

The third thing that Congress can do to assist us in these areas is to fund fully the Administration's request for the IRS' annual budget. We are pleased that the Senate Appropriations bill for FY 2007, as reported by the Senate Appropriations Committee, approved full funding for the IRS. We urge your support for that bill when it reaches the Senate floor.

In reality, both you and I are limited by what we can do because we are dealing with individuals and businesses who are hiding their assets in foreign jurisdictions that use financial secrecy as a tool to attract commerce to their country. We are left to search for ways that will reduce the incentive for taxpayers to seek out such offshore financial arrangements. I suspect those incentives will need to contain both a carrot and a stick.

There are other tax policy areas which we continue to discuss internally and once we reach consensus within Administration, we will be happy to share them with you.

Conclusions

Mr. Chairman, let me repeat what I said earlier about you and this subcommittee. You have been at the forefront in investigating important areas of Federal tax non-compliance and you and your subcommittee are a respected watch-dog over everything that we do at the IRS.

The subject of the hearing this morning is no exception. Offshore tax shelters are robbing the American treasury of billions of dollars each year.

I have attempted to bring you up to date on many of the things we are doing in the offshore arena, and I hope this has been beneficial. I look forward to your continuing investigations into these areas and your assistance in halting abusive offshore tax shelters.

I appreciate the opportunity to be here this morning and I will be happy to respond to any questions.