
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



**The Offshore Credit Card Project Shows Promise,
but Improvements Are Needed to Ensure That
Compliance Objectives Are Achieved**

August 2003

Reference Number: 2003-30-160

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Phone Number / 202-622-6500

Email Address / TIGTACommunications@tigta.treas.gov

Web Site / <http://www.tigta.gov>



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 15, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report - The Offshore Credit Card Project Shows
Promise, but Improvements Are Needed to Ensure That
Compliance Objectives Are Achieved (Audit # 200230056)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) had implemented an effective project to combat abusive offshore credit card accounts. Our overall objective was to determine how effective the Offshore Credit Card Project (OCCP) is in identifying abusive schemes using offshore credit cards and the actions taken to ensure future taxpayer compliance.

In our opinion, the OCCP reflects an innovative approach to combat tax-evasion schemes involving offshore credit card accounts. This approach complements the IRS' compliance strategy of focusing its resources on the high-risk areas of noncompliance. The OCCP uses the records from John Doe summonses¹ and merchant summonses² to trace the identities of credit card holders that may be hiding taxable income in an offshore bank account.

While the OCCP shows promise, improvements are needed to ensure fairness to all taxpayers, effective use of resources, and the availability of information to manage the Project. First, the OCCP had not established formal guidelines for assessing the

¹ A John Doe summons is any summons that does not identify the person with respect to whose liability the summons is issued. A John Doe summons can be issued only after approval by a Federal court.

² Referred to as "second level" John Doe summonses.

accuracy-related penalty. Without such guidelines, the IRS cannot ensure that the tax law is applied consistently and fairly for all taxpayers.

The second improvement area concerns the effective use of resources. The IRS may be examining returns beyond the assessment statute date for OCCP taxpayers even though most cases may not meet the Internal Revenue Code (I.R.C.)³ criteria for extending the statute. The effect of this decision is that unless fraud or a substantial understatement of gross income is proven, or the taxpayer did not file a tax return or information document, no assessments of tax can be made.

Finally, the 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. For example, there is no management information system that captures specific data regarding completed examinations of U.S. Individual Income Tax Returns (Form 1040) based on OCCP issues, including penalty assessments or costs of the Project. The existing IRS systems do not provide complete or timely information to assist management in controlling the Project, measuring noncompliance, enhancing the classification process, targeting training areas, controlling referrals to other enforcement functions, and targeting taxpayer education.

We recommended that the IRS provide formal guidance and training, and review OCCP cases to ensure consistent application of the accuracy-related penalty. The IRS should also ensure that OCCP resources are not expended on cases that result in barred assessments. To ensure compliance with provisions of the I.R.C., the IRS should request that the Office of Chief Counsel formally review the memorandum that provided guidance on allowing the examination of tax returns after the assessment statute date to determine its compliance with provisions of the I.R.C.⁴ Finally, the IRS should develop a system to quantify the specific results of OCCP cases at key points in the examination process and to identify patterns and trends.

Management's Response: Management agreed with some of our recommendations and stated that they have already completed some corrective actions. Specifically, management issued a written alert to their field offices reminding revenue agents to always consider the accuracy-related penalty. Management includes the application of penalties as part of the case review process, and if management determines that the need to further address this issue exists, a training module for future OCCP training classes may be developed.

Also, management conducted and documented a national review of in-process OCCP cases and will include this type of case in the Examination Quality Measurement System. Further, management is working with the Small Business/Self-Employed (SB/SE) Division's Office of Research in identifying trends that will result in the

³ I.R.C. §§ 6501(c)(1) and 6501(e) (2001).

⁴ I.R.C. § 6110 (2001).

development of cases, and management is capturing and analyzing data to identify patterns and trends in closed OCCP cases.

However, management did not agree with our second recommendation for ensuring resources are not expended on OCCP cases that may result in barred assessments. Management stated that revenue agents are instructed to consider the various scenarios for assessment statute extensions on each examination, specifically the provisions of I.R.C. § 6501. The written guidance provided to the field requires review and concurrence through the Territory Manager level in order to continue an examination past the assessment statute date. Management also stated that the closed cases available during our review would not be indicative of future cases, and to apply the rate of cases not meeting the I.R.C. statute extension criteria to the open inventory may not be reliable and would not affect a significant number of OCCP cases.

Also, management did not agree with our recommendation that the Office of Chief Counsel formally review the "Office of Compliance Policy's Statute of Limitations Management Memorandum" to determine its compliance with provisions of I.R.C. § 6110. Management stated that such a review is unnecessary because the memorandum reflected a business decision and not a legal determination from the Office of Chief Counsel. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment: We agree that the corrective action of issuing a written alert to the SB/SE Division field offices is a good first step; however, we believe it is not as effective as incorporating the accuracy-related penalty into formal guidance documents as it appears in other abusive scheme program guidance. The significantly low rate of assessing the accuracy-related penalty on OCCP cases suggests that the penalty may not be considered in most cases. The portion of our recommendation concerning including the penalty assessment consideration in the review process has been sufficiently addressed. However, we believe that the OCCP training should immediately incorporate accuracy-related penalty assessments into the curriculum since management's response does not clearly indicate how the IRS will determine there is a need.

While we support the IRS' efforts to combat abusive offshore schemes beyond the statute when warranted, we are concerned that the IRS is at increased risk of the assessment being barred because the statute has expired. The OCCP open cases pertaining to Tax Years (TY) 1999 and prior accounted for over 36 percent of the open cases in field inventory at the time of our review. As we reported, less than 20 percent of the closed OCCP cases met the extended statute criteria of the I.R.C. We are concerned that management does not have the data to support their assertion that this issue will not affect a significant number of cases. Therefore, we believe that many of the open TY 1999 OCCP cases assigned to the field may not ultimately meet the I.R.C. criteria, resulting in inefficient use of resources. Further, the records from the March and August 2002 John Doe summonses have not yet been received. Depending upon time spent on taxpayer identification, case building, issuing formal document requests,

serving secondary summonses, and interviewing witnesses, the risk of barred assessments will continue to be an issue.

The purpose of our third recommendation was to have the Office of Chief Counsel make the determination as to whether this guidance is communicating a “business decision” or providing guidance on a significant tax issue that should be in compliance with the provisions of I.R.C. § 6110. Based on the importance of the OCCP in combating abusive offshore credit card accounts, we believe that examining tax returns after the assessment statute expiration date for a class of taxpayers is a significant tax issue and not merely a business decision. We still believe that the formal advice of the Chief Counsel is warranted to determine if the guidance on this tax issue is subject to provisions of I.R.C. § 6110.

We recognize that the IRS had taken some actions during and subsequent to the audit. However, the corrective action regarding the management information system is not sufficiently comprehensive to provide for the quantification of the project results and costing data. Without sufficient information, the IRS will have difficulty in determining its progress in combating abusive offshore credit card accounts. While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement concerning them to the Department of the Treasury for resolution.

The Treasury Inspector General for Tax Administration (TIGTA) has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, “Limited Official Use Information and Other Legends” of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Section within the TIGTA’s Office of Chief Counsel.

Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

**The Offshore Credit Card Project Shows Promise, but Improvements Are Needed
to Ensure That Compliance Objectives Are Achieved**

Table of Contents

Background Page 1

The Offshore Credit Card Project Is Taking an Innovative
Approach in Combating Abusive Schemes Using Offshore
Credit Card Accounts Page 2

Consistency Is Needed in Assessing Penalties..... Page 4

Recommendation 1:Page 6

Potential Statute Expiration May Have an Adverse Impact
on Resource Allocation Page 7

Recommendation 2:Page 10

Recommendation 3:Page 11

A Management Information System Is Needed to Capture
Results of Offshore Credit Card Project Cases to Assist in
Ensuring Compliance Objectives Are Achieved Page 11

Recommendation 4:.....Page 13

Recommendation 5:.....Page 14

Appendix I – Detailed Objective, Scope, and Methodology..... Page 15

Appendix II – Major Contributors to This Report Page 16

Appendix III – Report Distribution List Page 17

Appendix IV – Management’s Response to the Draft Report..... Page 18

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

Background

Congressional witnesses have estimated that 1 to 2 million taxpayers avoid \$40 to \$70 billion in taxes annually using offshore bank accounts.¹ The term “offshore” is generally used to mean a jurisdiction that offers financial secrecy laws and tax benefits in an effort to attract investments from outside its borders. To combat these abusive schemes, the Small Business/Self-Employed (SB/SE) Division initiated the Offshore Credit Card Project (OCCP) as a strategic priority for Fiscal Years (FY) 2003-2004. The SB/SE Division made a significant commitment of over 600 direct Compliance staff years² for this initiative.

In testimony before the Congress,³ the Internal Revenue Service (IRS) Commissioner described abusive schemes using offshore bank accounts as causing the largest revenue loss to the Department of the Treasury, being the hardest to detect, and undermining the fairness of the tax system. The IRS Commissioner has said that “diversion of income to offshore tax havens with strict bank secrecy laws represent [sic] a significant area of noncompliance with tax laws.”

Offshore credit cards are an easy and covert way for a taxpayer to access offshore funds. Generally, behind each offshore credit card are at least two foreign (offshore) bank accounts:

- An escrow account equal to 100 percent to 200 percent of the credit line extended.
- An account used to pay charges to the offshore credit card account.

There are valid and legal purposes for offshore bank accounts; however, some people are using them to evade

¹ Testimony before the U.S. Senate Finance Committee during the hearing on the nomination of Pamela F. Olson, Assistant Secretary for Tax Policy, August 1, 2002.

² A direct compliance staff year is 2,000 hours and costs approximately \$94,000. Therefore, the labor cost allocated for the initiative is over \$57 million (609 staff years x \$94,000).

³ Testimony of the Internal Revenue Service Commissioner before the U.S. Senate Finance Committee, April 11, 2002.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

taxes. Debit and credit cards have allowed offshore bankers to offer easy and instantaneous access to offshore accounts without any paper trail.

Promoters openly market offshore schemes to the general public at seminars and over the Internet for fees that sometimes exceed \$3,000. The promoters include banks, accountants, trustees, lawyers, software companies, and tax haven country government officials.

We performed this audit at the SB/SE Division Headquarters Office in New Carrollton, Maryland, and visited the SB/SE Division Compliance Office in Mays Landing, New Jersey, and the Philadelphia Compliance Site in Philadelphia, Pennsylvania, from October 2002 to April 2003. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Offshore Credit Card Project Is Taking an Innovative Approach in Combating Abusive Schemes Using Offshore Credit Card Accounts

In our opinion, the OCCP reflects an innovative approach to combat tax-evasion schemes that use offshore credit card accounts. This approach aligns itself with the IRS' compliance strategy of focusing its resources on high-risk areas of noncompliance.

The IRS approach is multifaceted and includes coordinating Compliance activities with media coverage and the Criminal Investigation function to heighten taxpayer awareness. In summary, the IRS obtains cardholder and merchant credit card records to identify the taxpayer, builds cases for assignment to the Compliance field function, generates media coverage, and refers promoters for criminal investigation.

Compliance activities

In October 2000 and March and August 2002, the IRS petitioned a Federal court for authority to serve John Doe

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

summonses⁴ on 2 major credit card companies for the records of foreign bank accounts in more than 30 countries. The cardholder records obtained from the credit card companies did not include cardholder identifiers such as name or Social Security Number.

In addition to the cardholder records from the John Doe summonses, while building OCCP cases the IRS issued merchant summonses⁵ for charge card transactions, which helped identify specific taxpayers. At the time we completed our audit, the OCCP had not yet obtained the records requested in the March and August 2002 John Doe summonses.

Once the taxpayers' identities are established, examination techniques are used to determine whether a compliance issue exists. In July 2001, the IRS obtained 1.7 million records that included over 235,200 credit card numbers from the October 2000 John Doe summons. The IRS Compliance function then initiated examinations in May 2002. At the time of our review, the OCCP had developed over 2,100 cases. More than 1,740 of these cases were assigned to the IRS Compliance field function; the remaining cases were awaiting classification.

The IRS resources devoted to combating abusive tax schemes and scams (including the OCCP) significantly increased from FYs 2002 to 2003. In FY 2003, the Field Examination Plan included 609 direct staff years for the OCCP. In addition, the Plan included 396 direct staff years for other types of abusive schemes that include offshore activity.

Media coverage

Related to the OCCP, the IRS publicized the Offshore Voluntary Compliance Initiative (OVCI).⁶ The OVCI

⁴ A John Doe summons is any summons that does not identify the person with respect to whose liability the summons is issued. A John Doe summons can be issued only after approval by a Federal court.

⁵ Referred to as "second level" John Doe summonses.

⁶ Revenue Procedure 2003-11 (January 14, 2003).

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

provides relief from certain penalties if taxpayers come forward and make a voluntary disclosure of their offshore activity. However, taxpayers will still have to pay taxes on unreported income, interest, and certain accuracy or delinquency penalties. Results of this initiative were still pending at the time we completed our audit.

Promoter investigation activities

To address the offshore credit card promoters, the OCCP refers information on promoters to the SB/SE Division Compliance Reporting function where promoter information on abusive schemes is collected and investigated. Promoters lure both unsuspecting and unsuspecting taxpayers with the promise of lucrative tax benefits. The identification of promoters is another key to combating offshore tax evasion because gaining access to a promoter's list of investors can save the IRS resources.

While the OCCP shows promise, the IRS needs to make improvements. The improvements are needed to ensure fairness to all taxpayers, effective use of resources, and the availability of information to manage the Project.

Consistency Is Needed in Assessing Penalties

One of the IRS' Strategic Goals is to ensure that the tax law is applied fairly and uniformly to all taxpayers. The Internal Revenue Code (I.R.C.)⁷ provides for certain penalties that the IRS uses to ensure the fairness of the tax system by penalizing the noncompliant taxpayer. The IRS policy on penalty administration requires "...a penalty system that is designed to ensure consistency and accuracy of results in light of the facts of the law."

Properly and judiciously used, penalties promote voluntary compliance. The I.R.C.⁸ provides that the accuracy-related penalty be computed on the tax underpayment attributable to negligence. If a tax underpayment is attributable to a taxpayer's participation in an abusive offshore scheme and there is negligence, the revenue agent must develop the

⁷ I.R.C. § 6662 (2001).

⁸ I.R.C. § 6662(a) (2001).

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

accuracy-related penalty issue. Figure 1 shows a hypothetical example of the penalties on underpayments attributable to negligence.

Figure 1. Hypothetical Example of the Accuracy-Related Penalty on Underpayment Attributed to Negligence

Tax Due After Examination	Tax Due to Negligence	Penalty Range on Negligence
\$50,000	\$40,000	\$8,000 - \$16,000

Source: Treasury Inspector General for Tax Administration analysis. Penalty range reflects the accuracy-related penalty applied at a rate of 20 percent on the underpayment due to negligence or misconduct, up to 40 percent if the portion of underpayment subject to misconduct meets the test for gross valuation misstatement.

Using the IRS’ Audit Information Management System (AIMS),⁹ we reviewed the results of the OCCP cases that were closed during FY 2002 and the first and second quarters of FY 2003.¹⁰ These closed cases resulted in additional tax after examination totaling over \$1.6 million.¹¹ At the time of our review, the accuracy-related penalty was not assessed in 62 percent of the closed cases.

The accuracy-related penalty is not being consistently assessed because the OCCP project office had not established formal guidelines for assessing it, specific to the Project. In contrast, the IRS has provided specific guidance pertaining to the accuracy-related penalty for other compliance initiatives. For example, the abusive trust and abusive tax shelter initiatives provided formal guidelines to the field instructing that the accuracy-related penalty be assessed in most of these types of cases. Also, the OVCI

⁹ A computer system designed to give the Examination function information about returns in inventory and closed.

¹⁰ At the time of our review, the OCCP closed case data existed for this time period only.

¹¹ Subsequent to the issuance of our draft report, we obtained additional information for the third quarter of FY 2003. Accordingly, the \$1.6 million in additional tax after examination increased to \$3.3 million.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

guidelines provide for the accuracy-related penalty to be assessed on those taxpayers that voluntarily come forward.

Also contributing to the cause is that OCCP training provided to revenue agents does not cover the application of the accuracy-related penalty. In fact, the sample cases shown in the OCCP training package do not show the penalty assessment when there is additional tax. The goal of fairness to all taxpayers requires that penalties be consistently applied. In addition, there is a risk that not penalizing these taxpayers could result in further noncompliance because they may simply move to another abusive arrangement.

Subsequent to our audit fieldwork, the OCCP project office issued guidelines to the field reminding the revenue agents of the IRS policy on penalties. In addition, the project office implemented an in-process review of cases including a review of penalty determinations.

Recommendation

To ensure fair and equitable taxpayer treatment, the Deputy Director, Compliance Policy, SB/SE Division, should:

1. Through formal guidance, training, and review ensure the OCCP consistently applies the accuracy-related penalty in accordance with IRS policy.

Management's Response: Management agreed in part with our recommendation. Management issued a written alert to their field offices reminding the revenue agents to always consider the application of the accuracy-related penalty as an alternative to the fraud penalty, or when otherwise applicable. Management stated it includes the application of penalties as part of the case review process and, if management determines that the need to further address this issue exists, a training module for future OCCP training classes may be developed.

Office of Audit Comment: We agree that the corrective action of issuing a written alert to the SB/SE Division field

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

offices is a good first step; however, we believe it is not as effective as incorporating the accuracy-related penalty into formal guidance documents as it appears in other abusive scheme program guidance. The significantly low rate of assessing the accuracy-related penalty on OCCP cases suggests that the penalty may not be considered in most cases.

The portion of our recommendation for including the penalty assessment consideration in the review process has been sufficiently addressed. However, we believe that the OCCP training should immediately incorporate accuracy-related penalty assessments into the curriculum, since management's response does not clearly indicate how the IRS will determine there is a need.

Potential Statute Expiration May Have an Adverse Impact on Resource Allocation

The IRS attempts to examine tax returns soon after they are filed. To prevent the IRS from having unlimited time spans to complete examinations, the I.R.C. provides for a statute of limitations¹² for assessing taxes, making refunds, or crediting tax. The I.R.C. provides for the timely assessment of tax, generally within 3 years¹³ after the return was filed.

The IRS cannot assess additional tax after the assessment statute of limitations date. Even if the tax adjustment was determined before the statute expiration date, if the tax is not assessed, the assessment is barred. However, the I.R.C.¹⁴ does provide for an extended statute when:

- The tax return is false/fraudulent.
- There is a sufficiently large omission of gross income (25 percent of reported income).
- The tax return or information document is not filed.

¹² I.R.C. § 6501(a) (2001).

¹³ Generally, additional tax must be assessed within 3 years of the date that a return or information document was due or the date that the return or information document was actually filed, whichever is later.

¹⁴ I.R.C. §§ 6501(c)(1) and 6501(e) (2001).

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

The building of OCCP cases is complex, and initiation of the examination of Tax Year (TY) 1999 cases occurred late in the examination cycle.¹⁵ As a result, these cases from TY 1999 may have reached the assessment statute expiration date of April 15, 2003, before the IRS made additional examination tax assessments. Therefore, the assessments may be barred, except for those tax returns that were false or fraudulent, had a sufficiently large omission of gross income, or were not filed.

In January 2003, the IRS provided guidance¹⁶ to the field not to close TY 1999 OCCP cases merely because the assessment statute was expiring. Specifically, since these cases are part of the OCCP, the field may allow the assessment statute to expire if the case has not been sufficiently developed to make an accurate assessment. If these cases include fraud or omit income in excess of 25 percent of the gross income stated on the tax return, or if an information document is not filed, the statute would be legally extended. However, at the time of our review,¹⁷ less than 20 percent of the closed OCCP cases met the extended statute criteria of the I.R.C.¹⁸ If this rate applies to the open TY 1999 OCCP cases assigned to revenue agents in the field,¹⁹ very few assessments may be possible. As a result, the revenue agent effort expended on cases worked beyond the statute expiration date may result in inefficient use of resources since the assessment may be barred.

Basis for extending the assessment statute date

Guidance to the field was provided in the form of a memorandum issued by the Deputy Director, Compliance Policy. We were advised that the Office of Chief Counsel

¹⁵ Examination and disposition of income tax returns should be completed within 26 months after the due date of the return or the date filed, whichever is later.

¹⁶ Office of Compliance Policy's Statute of Limitations Management Memorandum (January 24, 2003).

¹⁷ Includes closed cases from OCCP inception to March 31, 2003.

¹⁸ I.R.C. §§ 6501(c)(1) and 6501(e) (2001).

¹⁹ Open OCCP cases on the AIMS as of March 31, 2003.

TD P 15-71

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

(SB/SE Division) participated in the preparation of the memorandum. However, the memorandum was not issued as a formal Chief Counsel Advice (CCA) document and, therefore, was not subject to the provisions of I.R.C. § 6110.²⁰ This section provides for the public inspection of Office of Chief Counsel determinations, including rulings, determination letters, technical advice, and memoranda.

While CCA documents are not legal precedent, the Congress²¹ believes the public is entitled to know the rules applied in its dealings with the IRS. The Congress wanted all taxpayers to have access to the “considered view of the Office of Chief Counsel’s Headquarters Office on significant tax issues.”

We support the IRS’ effort to combat these abusive arrangements. Also, we recognize that the I.R.C. provides for the extension of the assessment statute date in certain situations. However, the IRS still needs to ensure that sufficient information is available on a case-by-case basis to make certain that the provisions of the I.R.C. are complied with, so that resources are used efficiently and individuals’ rights are protected.

Based on the importance of the OCCP in combating abusive offshore credit card accounts, we believe that examining tax returns after the statute expires for a class of taxpayers is a significant tax matter. Therefore, we believe the memorandum may be subject to provisions of I.R.C. § 6110. We did not develop the reason why the Office of Chief Counsel did not follow this legal review process.

This condition could continue because the records from the March and August 2002 John Doe summonses have not yet been received. The records should include transactions occurring in the years 2000, 2001, and 2002. Depending upon time spent on taxpayer identification, case building

²⁰ I.R.C. § 6110 (2001).

²¹ House of Representatives Conference Report to Accompany H.R. 2676, H.R. 105-599, (Page 298).

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

and examination, the risk of expiring statutes may again be an issue in April 2004.

Recommendations

To ensure efficient use of resources and compliance with applicable tax law, the Deputy Director, Compliance Policy, SB/SE Division, should:

2. Provide further guidance pertaining to OCCP cases to ensure that resources are not used on cases in which the assessment may be barred.

Management's Response: Management did not agree with this recommendation and stated that revenue agents are instructed to consider the various scenarios for assessment statute extensions on each examination, specifically the provisions of I.R.C. § 6501. The guidance provided to the field requires review and concurrence through the Territory Manager level in order to continue an examination past the assessment statute date. Management also stated that the closed cases available during our review would not be indicative of future cases, and to apply the rate of cases not meeting the I.R.C. statute extension criteria to the open inventory may not be reliable and would not affect a significant number of OCCP cases.

Office of Audit Comment: We support the IRS' efforts to combat abusive offshore credit card account schemes beyond the statute, when warranted. However, we are concerned that the IRS is at increased risk of the assessment being barred because the statute has expired. The OCCP open cases pertaining to TYs 1999 and prior accounted for over 36 percent of the open cases in field inventory at the time of our review. As we reported, less than 20 percent of the closed OCCP cases met the extended statute criteria of the I.R.C. We are concerned that management does not have the data to support their assertion that this issue will not affect a significant number of OCCP cases. Therefore, we believe that many of the open TY 1999 OCCP cases assigned to the

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

field may not ultimately meet the I.R.C. criteria, resulting in inefficient use of resources.

Further, the records from the March and August 2002 John Doe summonses have not yet been received. The records should include transactions occurring in the years 2000, 2001, and 2002. Depending upon time spent on taxpayer identification, case building, issuing formal document requests, serving secondary summonses, and interviewing witnesses, the risk of barred assessments will continue to be an issue.

3. Request that the Office of Chief Counsel formally review the Office of Compliance Policy's Statute of Limitations Management Memorandum to determine its compliance with provisions of I.R.C. § 6110.

Management's Response: Management did not agree with this recommendation and acknowledged that the Office of Compliance Policy's Statute of Limitations Management Memorandum was not issued as a formal CCA document. Management believes that this is acceptable because it reflected a business decision and not a legal determination by the Office of Chief Counsel.

Office of Audit Comment: The purpose of our recommendation was to have the Office of Chief Counsel make the determination as to whether this guidance is communicating a "business decision" or providing guidance on a significant tax issue that should be in compliance with the provisions of I.R.C. § 6110. Based on the importance of the OCCP in combating abusive offshore credit card accounts, we believe that examining tax returns after the assessment statute expiration date for a class of taxpayers is a significant tax issue and not merely a business decision. We still believe that the formal advice of the Chief Counsel is warranted to determine if the guidance on this tax issue is subject to provisions of I.R.C. § 6110.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

A Management Information System Is Needed to Capture Results of Offshore Credit Card Project Cases to Assist in Ensuring Compliance Objectives Are Achieved

Abusive schemes are varied and difficult to identify using the current IRS systems. Changes in tax laws, technology, filing patterns, and trends have created the need for the IRS to update and modify its approach to addressing abusive schemes using offshore credit card accounts. However, the IRS has not developed a management information system to give managers sufficient data with which to make decisions in combating abusive offshore credit card accounts.

The IRS maintains and controls its Examination inventory with the Examination Returns Control System and the AIMS. Special project codes are used to identify known issues for the returns selected for examination. However, these codes do not provide information to identify trends or patterns or help the managers in the decision-making process.

For example, there is no management information system that captures specific data regarding completed examinations of U.S. Individual Income Tax Returns (Form 1040) based on OCCP issues, including penalty assessments or costs of the Project. Also, the OCCP case-building process consists of procedures to identify taxpayers from a credit card transaction. The project office does not have a system in place to identify trends or patterns detected in the case-building process. The existing IRS systems do not provide complete or timely information to management to assist in:

- Controlling the Project.
- Measuring noncompliance.
- Enhancing the classification process.
- Targeting training areas.
- Controlling referrals to other enforcement functions.
- Targeting taxpayer education.²²

²² Targeting taxpayer education by industry, based on noncompliance.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

This condition developed because the concept for the OCCP originated from ongoing examinations and was implemented as a project without conducting a pilot to identify the necessary decision-support controls. Currently, OCCP management is in the process of establishing an internal control system.

The General Accounting Office's *Standards for Internal Control in the Federal Government* state, "Program managers need both operational and financial data to determine whether they are meeting their agencies' strategic and annual performance plans and meeting their goals for accountability for effective and efficient use of resources." The *Standards* further state, "Pertinent information should be identified, captured and distributed in a form and time frame that permits people to perform their duties efficiently."

Without pertinent information on case activities for abusive offshore credit card accounts, the IRS will have difficulty in determining its progress in combating abusive schemes that use offshore credit card accounts and preventing further noncompliance. In addition, while the IRS is increasing the resources devoted to working OCCP cases, management will not be able to effectively plan and allocate its resources to maximize examination results.

Recommendations

To provide management with information to help identify current and future abusive schemes and help allocate resources appropriately, the Deputy Director, Compliance Policy, SB/SE Division, should develop a system to:

4. Quantify the specific results of OCCP cases at key points in the examination process.

Management's Response: Management agreed in part with this recommendation. Subsequent to the completion of our fieldwork, management conducted and documented a national review of in-process OCCP cases and shared the results of the reviews with the Area Offices in a summary to

TD P 15-71

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

the Director, Field Operations, SB/SE Division. In addition, OCCP cases will be included in the Examination Quality Measurement System.

Office of Audit Comment: During our audit, we advised the OCCP project office of the need for a management information system. We recognize that management has taken some actions during and subsequent to the audit. However, these corrective actions are not sufficiently comprehensive to provide for the quantification of the project results and costing data. Without sufficient information, the IRS will have difficulty in determining its progress in combating abusive offshore credit card accounts.

5. Identify patterns/trends that will facilitate the OCCP in identifying and developing the most egregious cases.

Management's Response: Management agreed with this recommendation. OCCP management is working with the SB/SE Division's Office of Research in identifying trends that will result in the development of cases. In addition, as cases are closed, management is capturing and analyzing data to identify patterns and trends on a monthly basis.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine how effective the Offshore Credit Card Project (OCCP) is in combating abusive offshore credit card accounts and the actions taken to ensure future taxpayer compliance. To accomplish our objective, we:

- I. Determined whether the Small Business/Self-Employed (SB/SE) Division had established an effective management process (resources/goals/objectives/performance measures) to accomplish the mission of the Internal Revenue Service (IRS).
- II. Determined whether the SB/SE Division had developed a comprehensive operational plan for the OCCP. We determined whether the operational plan provided for:
 - A. Directing the effective allocation of resources and identifying costs while using advanced technology for data analysis.
 - B. Identifying trends, patterns, and issues associated with abusive schemes involving offshore credit card accounts. We also determined whether there was an improved process for case building and selecting the best cases to pursue among the many the Project identifies.
 - C. Providing quality and timely investigative support to field revenue agents. In addition, we determined whether the IRS had developed a model for the time it takes to complete an OCCP examination.
 - D. Identifying how the offshore organizations are promoted and the source of the funds that are transferred offshore.
 - E. Determining the appropriate treatment of those involved in abusive tax schemes involving offshore credit card accounts and developing strategies to prevent future noncompliance. We also analyzed closed OCCP case data from the IRS Master File¹ and the Audit Information Management System.²

¹ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

² A computer system designed to give the Examination function information about returns in inventory and closed.

**The Offshore Credit Card Project Shows Promise, but Improvements Are Needed
to Ensure That Compliance Objectives Are Achieved**

Appendix II

Major Contributors to This Report

Parker F. Pearson, Director
Philip Shropshire, Director
Edmond Watt, Audit Manager
Timothy F. Greiner, Senior Auditor
Michael Della Ripa, Auditor

**The Offshore Credit Card Project Shows Promise, but Improvements Are Needed
to Ensure That Compliance Objectives Are Achieved**

Appendix III

Report Distribution List

Commissioner N:C

Deputy Commissioner for Services and Enforcement N:SE

Acting Deputy Commissioner, Small Business/Self-Employed Division S

Acting Director, Compliance S:C

Deputy Director, Compliance Policy S:C:CP

Director, Reporting Enforcement S:C:CP:RE

Chief Counsel CC

Deputy Chief Financial Officer, Department of the Treasury

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

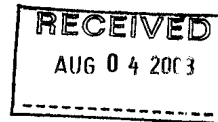
Appendix IV

Management's Response to the Draft Report

DUPLICATE



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



JUL 30 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Dale F. Hart 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved (Audit # 200230056)

I have reviewed your draft report regarding actions we have taken to implement the Offshore Credit Card Project (OCCP). We agree with some of your recommendations and have already completed some of the corrective actions; however, we disagree with others. We believe portions of this report require a "Limited Official Use (LOU)" designation under the Treasury Directive (TD) P-71-10, Security Manual. Public knowledge of our workload, timeframes, procedures, and resources may interfere with our examinations and investigations.

The IRS has implemented a multifaceted approach to address the significant challenges posed by offshore tax evasion and the use of offshore bank accounts. Your review was limited to one aspect of our strategy, OCCP which focuses on enforcement actions. However, due to recent events, we want to take this opportunity to ensure TIGTA has a clear understanding of the difference between the OCCP aspect of our strategy and the Offshore Voluntary Compliance Initiative (OVCI), a related but separate component, which was not addressed in your report.

The OVCI was launched on January 14, 2003, as an attempt to bring taxpayers voluntarily back into compliance while simultaneously gathering information about the promoters of offshore schemes. Taxpayers had until April 15, 2003, to request to participate and then, if accepted, they had 150 days to file correct returns.

We stand behind the numbers we have released publicly on preliminary OVCI results including the receipt of 1,299 applications identifying 487 promoters and the collection of over \$75 million. The dollars collected will continue to grow because the majority of taxpayers accepted into the program have until October 15, 2003, to amend their tax returns and pay back taxes. The cost of the OVCI program is approximately \$2 million to date.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

2

The OCCP was first implemented in 2000 to combat the use of offshore bank accounts in abusive tax schemes. One of our first initiatives in this area was to use the records from John Doe Summons¹ to trace the identities of credit card holders that may be hiding unreported taxable income in offshore bank accounts. We are committed to eliminating these and other abusive schemes, which cause some of the largest revenue losses in the Department of the Treasury.

We have improved the OCCP by issuing guidance, conducting reviews, and developing management information systems. Our reviews have helped us identify trends in the processes we have in place, analyze the quality of cases, and determine areas we need to make improvements. This project is still in a developmental stage, and we are continually making improvements to it.

Our comments on your recommendations follow:

RECOMMENDATION 1

Through formal guidance, training and review ensure the OCCP consistently applies the accuracy-related penalty in accordance with IRS policy.

CORRECTIVE ACTION

Specific guidance as to application of the accuracy-related penalty is provided in the Internal Revenue Manual (IRM) and applies to all cases in the Examination process. The OCCP cases have no unusual features that would require us to issue special guidance. We have, however, issued a written "alert" to our field offices reminding agents to always consider the application of the accuracy-related penalty as an alternative to the fraud penalty, or when otherwise applicable. Additionally, our Office of Penalty and Interest is reviewing all sections of the IRM relating to penalties, including the accuracy-related penalty, and will decide if updates are warranted.

The Small Business/Self Employed (SB/SE) Division is a participant in a cross-functional team, Consistency in Penalty Application for Abusive Schemes, which is looking at penalty consistency issues.

The application of penalties is also part of the case review process. If we determine a need exists to further address this issue with the field, we will consider developing and adding a training module for our future OCCP training classes.

IMPLEMENTATION DATE

Completed

¹ A John Doe summons is any summons that does not identify the person with respect to whose liability the summons is issued. A John Doe summons can be issued only after approval by a Federal court.

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

3

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

Provide further guidance pertaining to OCCP cases to ensure that resources are not used on cases in which the assessment may be barred.

CORRECTIVE ACTION

We do not agree with this recommendation. Our examiners are instructed to consider the various scenarios for assessment extensions on each examination. The Internal Revenue Code Section 6501 provides for an extended statute where there is evidence of a) a false return - a statute can be unlimited, b) no return filed - a statute is three years after filing a return or c) omission of 25% of gross income- a statute can be up to 6 years after filing a return. Projecting how many, if any, 1999 cases may ultimately result in barred assessments is difficult, if not impossible. All of the cases used during the review as a benchmark were part of the initial group of cases that were opened in 2002. These initial cases included certain taxpayer situations, such as foreign students, that were not indicative of what we will find in future cases. We quickly closed those cases that lacked audit potential. Cases with audit potential generally remain open due to the time that it takes to issue formal document requests, serve summonses, and interview witnesses. Hence, benchmarking against the first cases to close may result in unreliable figures.

We issued written guidance to our field offices requiring review and concurrence through the Territory Manager level on any recommendation to continue examining an OCCP return in which the normal statute may be expiring. We do not believe this will impact a significant number of returns and believe that continuing the examination is in the best interest of the Government.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 3

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

4

Request that the Office of Chief Counsel formally review the Office of Compliance Policy's Statute of Limitations Management Memorandum to determine its compliance with provisions of Internal Revenue Code § 6110.

CORRECTIVE ACTION

We do not agree with this recommendation. We acknowledge that the memorandum referenced in the report about the statute of limitations, issued on January 24, 2003, was not issued as a formal Chief Counsel Advice (CCA) document. We believe this internal memorandum was acceptable because it reflected a business decision made by the Deputy Director, Compliance Policy and was not a legal determination by the Office of Chief Counsel. The Office of Compliance Policy decided to permit agents to continue an audit beyond the normal 3-year statute in certain circumstances, based on sound business judgment. Specifically, the memorandum permits examiners to continue their audit if they believe there is a likelihood of fraud, a substantial omission of income, or a failure to file an information return. The decision on each case must be discussed, documented in writing, and approved by the territory manager.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

Quantify the specific results of OCCP cases at key points in the examination process.

CORRECTIVE ACTION

We conducted a national review of in-process cases, which included all Area Offices. We documented and shared the results of these reviews with the Area Offices in a summary report to the Director, Field Operations (SB/SE). The reviews included looking at key stages of the examination process to ensure appropriate application of examination techniques.

Additionally, we have a process in place to capture quality results through our Examination Quality Measurement System effort. We included the OCCP cases in this review process.

IMPLEMENTATION DATE

Completed

The Offshore Credit Card Project Shows Promise, but Improvements Are Needed to Ensure That Compliance Objectives Are Achieved

5

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 5

Identify patterns/trends that will facilitate the OCCP in identifying and developing the most egregious cases.

CORRECTIVE ACTION

We are working with our Office of Research (SB/SE) to help us identify trends that will result in the development of cases. One research office has analyzed the MasterCard data and provided its findings to us. Another office is studying the high percentage of non-filer cases the project has identified.

As case closures begin, we are capturing and analyzing data to identify patterns and trends on a monthly basis.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division at (202) 283-0200.