

GAO

Testimony

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**INTERNAL REVENUE
SERVICE**

**Enhanced Efforts to
Combat Abusive Tax
Schemes—Challenges
Remain**

Statement by Michael Brostek, Director, Tax Issues



Mr. Chairman and members of the committee:

I appreciate the opportunity to testify on the Internal Revenue Service's (IRS) efforts to identify and deal with abusive tax schemes that primarily are used by individual taxpayers.¹ My statement today, based on work we have done at the committee's request, focuses on what is known about the extent of abusive tax schemes involving individual taxpayers, the status of IRS's efforts to combat such schemes, and challenges IRS faces in moving forward.

During hearings before this committee last April, several witnesses testified about the increased promotion and use of various types of abusive tax schemes and scams, including constitutional trusts, offshore trusts, and tax credits for slave descendants. Not all of these schemes were new, but in part due to the ease of marketing schemes cheaply through the Internet, schemes were flourishing. Use of such schemes can pose a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance if honest taxpayers believe that significant numbers of individuals are not paying their fair share of the tax burden. Thus, IRS's efforts to pursue abusive tax schemes are key to ensuring that such schemes do not undermine the federal tax system.

My statement today will make the following points:

- Estimating the extent of abusive tax schemes used by individual taxpayers is at best an inexact process because these schemes are often hidden. Nevertheless, IRS officials believe that the number and dollar consequence of schemes has grown in recent years. As of February 2002, IRS estimated that in tax year 2000 about 740,000 taxpayers had used abusive schemes. IRS caught about \$5 billion in improper tax avoidance or tax credit and refund claims, but estimated that another \$20 billion to \$40 billion had not been identified and addressed. Recent developments suggest that the number of individuals involved in one type of abusive tax scheme involving offshore accounts may be greater than what IRS estimated just 2 months ago, and thus, potential lost revenues may be higher.

¹Although overlap may exist between the types of abusive tax schemes used by individuals and other tax paying entities, like corporations, our work focused on those schemes generally used by individuals to inappropriately reduce the taxes they owe, or to generate refunds to which they are not properly entitled.

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- In part because no one individual or office could provide an agencywide perspective on IRS's strategy, goals, objectives, performance measures, or program results, it is difficult to provide a clear picture of all that is underway and being accomplished in IRS's efforts to address abusive tax schemes. Available information suggests, however, that IRS has created new offices, reemphasized and reorganized certain prior efforts, and planned to assign or already assigned at least 200 additional staff to its efforts. Limited data also suggest that IRS's enhanced focus has led to some increased success in convicting those promoting and taking advantage of abusive schemes, in publicizing these results, and in uncovering previously hidden major offshore compliance problems.
 - The sheer number of possible abusive tax schemes that likely will require face-to-face audits could outstrip IRS's available resources. Furthermore, identifying and handling these cases will require a better-coordinated effort on IRS's part. IRS has recognized these challenges and is beginning to work on solutions and options. To date, however, IRS has not developed a means to track the resources, in particular staffing, devoted to combating abusive schemes or developed goals and measures that Congress and IRS can use to assess its progress.

Background

According to IRS, during the mid to late 1990's, abusive tax schemes reemerged across the country. The use of abusive tax shelters, anti-taxation arguments, abusive tax schemes, and frivolous returns last peaked in the 1980's. IRS characterizes an abusive tax scheme as any plan or arrangement created and used to obtain tax benefits not allowable by law. Schemes run from simple to very complex, from clearly illegal to those carefully constructed to disguise the illegality of the scheme. Furthermore, users of schemes can range from those believing their position is correct to those who knowingly but willfully file incorrect tax returns. Schemes can be based on improper use of domestic and foreign trusts, inflated business expenses and deductions, falsely claimed tax credits and refunds, and various anti-tax arguments. Some schemes are created by tax professionals such as accountants, lawyers, and paid tax preparers, or by groups and individuals. Tax schemes are offered to taxpayers using various means, including conferences or seminars, publications, advertisements, and the Internet. Others are promoted by word-of-mouth.

Abusive tax schemes that are generally used by individuals fall into four major categories. For the first two of these, frivolous returns and frivolous

refunds, taxpayers submit a tax return that either states an argument that IRS can readily identify as frivolous, or a return with characteristics IRS has identified as reflecting a frivolous argument. For the other two types of schemes, abusive trusts and offshore compliance strategies, taxpayers' returns are less likely to reveal use of a clearly abusive tax scheme.

Frivolous Returns

These schemes generally use any number of anti-tax arguments to incorrectly claim that income is exempt from taxation or that IRS otherwise lacks authority needed to tax income. These arguments have been well litigated in the courts and consistently ruled to be without merit. Examples include the following:

- **Form 2555 Scheme:** In this scheme, individuals file an IRS Form 2555, Foreign Earned Income, and claim that their income was not earned within the United States. This is also known as the “not a citizen” argument in which taxpayers file returns stating they are citizens of the “Republic of [any state]” and not citizens of the United States, and thus, their income is not taxable.
- **Section 861:** Individuals using this scheme claim that under Internal Revenue Code section 861 income tax must only be paid on foreign income and, therefore, their income is not subject to tax or withholding. In these cases, taxpayers file a tax return and show a zero amount for wages. According to IRS, this argument has spread to some employers who are using it to avoid withholding and paying payroll-type taxes on their employees.

Frivolous Refunds

According to IRS, credit and refund abusive tax schemes are designed to substantially reduce taxes or create a refund for the taxpayer, generally by claiming eligibility for a credit that does not exist or to which the taxpayer is not properly entitled. One such scheme that has received much attention is the Slavery Reparation Refund scheme. According to IRS, promoters circulate or publish information claiming African Americans are eligible for slavery reparations. Taxpayers claiming this credit generally enter a significant amount on their tax return as a credit that results in a taxpayer realizing a refund if not detected by IRS.

Abusive Domestic Trusts

A trust is a legitimate form of ownership, which completely separates asset responsibility and control from the benefits of ownership. As such, trusts are commonly used in matters such as estate planning. An abusive

domestic trust scheme usually involves a taxpayer creating a trust that does not meet the Internal Revenue Code requirements that the assets and income of the trust not be subject to the control of the taxpayer. Once such an improper trust is established and the taxpayer has transferred business or personal assets to it, the scheme may involve further abuses, such as offsetting income of the trust by overstating its business expenses or including the taxpayer's personal expenses—like a home mortgage—as an expense of the trust. The taxpayer will often use multiple entities such as partnerships, limited liability companies, or secondary level trusts that can be tiered or layered to mask the taxpayer's continued ownership or control of the trust's income or assets.

Offshore Schemes

Abuses that involve foreign locations can take a wide array of forms and attempt to use a number of techniques to improperly avoid paying taxes. One common technique is simply to use foreign locations to add another level of complexity in obscuring the true ownership of assets or income and thus obfuscating whether taxes are owed and by whom. Use of foreign locations, for instance, can be combined with use of trusts to make unraveling the true ownership of assets and income more difficult for IRS. According to IRS, criminals long have used offshore schemes to disguise the true nature of their enterprise and the resulting income. Promoters of abusive tax schemes have, according to IRS, increasingly devised schemes that in some fashion involve transferring income or title to assets to foreign locations. Often foreign locations are selected because they are tax havens with little or no taxation on income in their jurisdiction, have privacy rules that help schemers hide what they are doing, or have other characteristics favorable to carrying out the schemes. According to IRS, once such transfers are established, income is often repatriated back to the U.S. owners through loans, credit cards, or debit cards. By using complex transactions and multiple entities, the individuals using these schemes attempt to hide their income and avoid potential tax liabilities.

Evidence of Rapid Tax Scheme Growth

According to IRS's fiscal year 2003-2004 Small Business and Self-Employed (SB/SE) Division Strategic Assessment Report,² abusive tax schemes represent a rapidly growing risk to the tax base. IRS estimates the

² The FY 2003-2004 SB/SE Strategic Assessment Report (Mar. 1, 2002) provides IRS assessment of critical trends, issues, and problems facing the Small Business and Self-Employed taxpayer customer segment.

potential revenue loss from these schemes to be in the tens of billions of dollars annually. According to an IRS official, to make accurate estimates in this area of noncompliance is difficult. For one reason, the nuances and types of schemes are constantly changing and evolving, particularly in the areas of abusive trusts and offshore compliance. Also, IRS's detection of schemes is challenging. Trust schemes, in particular, often involve multiple entities that are vertically layered or tiered in an attempt to disguise the true ownership of the income or assets of the trust. The difficulty in determining the significance of offshore compliance is also exacerbated because these types of schemes generally use tax haven countries to disguise the transactions and prevent IRS from routinely collecting tax-related information on transactions.

Despite the difficulties in accurately estimating the significance of abusive tax schemes, IRS provided us with estimates in four major scheme areas—Frivolous Returns, Frivolous Refunds, Abusive Domestic Trusts, and Offshore Schemes. According to IRS, its estimates were made in February of 2002 and were derived from information gathered during tax return processing and examination activities and from the work of IRS's Criminal Investigation, the law enforcement arm of IRS. According to an IRS official, these estimates were derived from tax year 2000 information, the last full year for which data were available. IRS's estimates are as follows:

- Frivolous returns: about 62,000 taxpayers with associated tax amounts approximating \$1.8 billion.
- Frivolous refunds: about 105,000 taxpayers with associated tax amounts approximating \$3.1 billion.
- Abusive domestic trusts: about 65,000 taxpayers with tax losses approximating \$2.9 billion.
- Offshore schemes: about 505,000 taxpayers with tax losses ranging from \$20 billion to \$40 billion.

IRS's estimates for the numbers of taxpayers and taxes in connection with frivolous returns and refunds, although not precise, likely have less uncertainty than its estimates of the numbers of taxpayers and taxes at risk in connection with abusive domestic trusts and offshore schemes. IRS's estimates for frivolous returns and refunds are based in large part on returns and refund claims that IRS has identified while processing tax returns and has addressed by pulling the associated returns and notifying the taxpayers that their returns contained errors that need to be corrected.

Thus, in these cases, IRS has a fairly direct basis for counting the number of taxpayers involved and the amount of tax involved. Furthermore, because IRS has pulled these returns from processing, in general, improper refund claims have not been paid out, and IRS is pursuing collection of the proper amount of tax when taxpayers have failed to pay the full amount owed.³

In contrast, although taxpayers using domestic trusts and offshore schemes may file tax returns, those returns alone seldom provide enough information for IRS to determine whether an abusive scheme was used. Therefore, IRS's estimates of the numbers of taxpayers and the taxes at risk for the domestic trust and offshore scheme categories generally rely on limited numbers of cases that have been examined or investigated, on intelligence obtained in the course of normal tax administration and Criminal Investigation activities, and on IRS officials' professional judgments.

Recognizing that offshore transactions are a significant factor in offshore schemes, IRS has been taking steps concerning the use of credit/debit cards issued by offshore banks to U.S. taxpayers. Although having an offshore credit card is not illegal, IRS believes that some U.S. taxpayers are using such cards to evade U.S. taxes. In October 2000, a federal judge authorized IRS to serve "John Doe" summonses on American Express and MasterCard to obtain limited information on U.S. taxpayers holding credit cards issued by banks in several tax haven countries.

On the basis of information received from MasterCard, IRS identified about 235,000 accounts issued through 28 banks located in 3 countries. IRS's ongoing analysis of these data leads it to estimate that between 60,000 and 130,000 U.S. customers are associated with these 235,000 accounts. In part because MasterCard is estimated to have about 30 percent of this market, IRS estimates that there could be 1 to 2 million U.S. citizens with credit/debit cards issued by offshore banks. However, this is a very preliminary estimate. IRS officials believe this estimate may be reduced because, among other things, a portion of these accounts may not be associated with abusive tax schemes. By comparison, only about 117,000 individual taxpayers indicated that they had offshore bank

³ IRS is not able to detect and stop every frivolous refund scheme. For example, IRS reported that in tax year 2000 about \$13 million in refunds was sent to taxpayers due to reparations filings. IRS has subsequently taken action to recover the funds.

accounts in tax year 1999. On March 25, 2002, IRS petitioned for permission to serve a summons on VISA International, seeking records on transactions using cards issued by banks in over 20 tax-haven countries.

The estimates of the number of individuals and dollar consequences associated with offshore credit/debit card schemes are very uncertain at this time. Nevertheless, IRS's February 2002 estimate of \$20 billion to \$40 billion in tax dollars at risk from offshore schemes may grow as IRS learns more about the extent of the problem.

Expanded IRS Efforts to Identify and Control Tax Schemes

No one individual or office could provide an agencywide perspective on IRS's strategy, goals, objectives, performance measures, or program results, for its efforts to address abusive tax schemes. Consequently, a clear and consistent picture of IRS's efforts was difficult to obtain. Available information indicates that IRS began increasing its efforts to combat abusive schemes over the past 2 or 3 years, continued to do so in 2001, and plans further future efforts. Limited data also suggest that these enhanced efforts have helped IRS convict more promoters and users of abusive schemes over the past 3 years, which IRS has publicized through enhanced communication strategies.

Organizationally, IRS identifies and deals with schemes in two primary ways—during its processing and examination of tax returns (compliance and enforcement) and through the work of Criminal Investigation (CI). However, most of IRS's programs to address abusive schemes are the responsibility of SB/SE and CI. IRS also works with various federal agencies in its efforts to identify and deal with abusive tax schemes.

Compliance and Enforcement Efforts

IRS has taken a number of steps to enhance its compliance and enforcement efforts—its audit and other civil enforcement activities—that focus on abusive tax schemes. In the past year, for example, IRS has increased staff years devoted to examining abusive tax scheme promoters, decided to assign about 50 more agents to promoter examinations and train them, and laid plans for assigning 200 or more additional staff to reviewing abusive tax schemes and offshore compliance schemes. Furthermore, IRS has created an organization that initially will focus on developing leads and cases related to abusive scheme promoters and that will monitor promoter web sites.

IRS identifies many abusive tax schemes during its normal tax return processing and examination activities. For example, when tax returns

initially are processed either manually or by computers, processes are in place to detect apparent frivolous returns or returns reflecting improper refunds. In these cases, the returns are pulled from processing to be forwarded elsewhere for follow-up action. Both the Wage and Investment (W&I) and SB/SE divisions in IRS process taxpayers' tax returns and both have responsibilities for identifying tax returns that may involve abusive tax schemes.

Three principal SB/SE efforts focusing on or related to abusive tax schemes are

- the Frivolous Return Program,
- the Office of Flow-Through Entities and Abusive Tax Schemes, and
- the National Fraud Program.

Frivolous Return Program

The Frivolous Return Program identifies the tax returns of individuals who assert unfounded legal or constitutional arguments and refuse to pay their taxes or to file a proper tax return. The program also identifies returns claiming frivolous refunds, such as those involving slavery reparations. Generally, IRS provides guidance to those who process tax returns to identify the characteristics of returns claiming such frivolous arguments or refunds. IRS also has programmed its computers to do so. The Treasury Inspector General for Tax Administration helped IRS develop software programs to identify slavery reparation schemes. Since both W&I and SB/SE staff process tax returns, both divisions are involved in identifying such returns.

Once identified, the returns are pulled out of the tax return processing stream and forwarded to the Frivolous Return Program unit where they are to be resolved with the taxpayer. The program was consolidated in January 2001, at the Ogden, Utah, Compliance Services Center. The compliance center staff enters information about each case into a database and assigns 1 of 31 different codes identifying the frivolous argument or refund being claimed by the taxpayer. Then, a notice requesting taxpayers to file a proper tax return is to be sent advising them that IRS has judged their tax return to include an argument that is without legal merit or a credit or tax refund to which they are not entitled.

IRS officials indicate that the number of staff assigned to the Frivolous Return Program unit in Ogden grew from 18 employees in September 2000 to 45 employees in September 2001. Some of this increase may not reflect

Office of Flow-Through Entities
and Abusive Tax Schemes

a net IRS-wide increase in full-time equivalents (FTE) for frivolous returns since the increase has, in part, been due to centralizing efforts in Ogden from other IRS locations. IRS officials expect to assign more employees to this program in fiscal year 2003.

The Office of Flow-Through Entities and Abusive Tax Schemes became operational in January 2000.⁴ The office was created to organize IRS's efforts in addressing abusive tax schemes, particularly trusts, and to identify their promoters and sellers. The unit's goals are (1) to catalogue and profile schemes and trends, (2) direct compliance resources to examine schemes and promoters or refer tax scheme promoters and participants for criminal prosecution, (3) increase employee knowledge and skills related to abusive tax scheme issues, and (4) enhance coordination within IRS on issues related to abusive tax schemes.

IRS expects to assign and train about 50 revenue agents this fiscal year to focus mainly on promoters of abusive tax schemes. The agents are to undergo training during the summer of 2002 and to begin examining cases by the fall of 2002. According to IRS, the number of abusive promoter leads increased from 25 in March 2001 to 155 in February 2002. In addition, the number of abusive promoter cases approved for further examinations has increased from 17 cases to 94 cases during the same period. The time spent on these cases is also increasing. IRS also reports that time spent on promoter examinations for fiscal year 2002 is expected to be 12.1 staff years, which is up from 4.4 and 1.2 staff years in fiscal 2001 and fiscal year 2000, respectively.

Furthermore, IRS plans additional expansion of its abusive tax scheme compliance efforts. For example, IRS expects to develop units that will include 8 to 10 agents in each of 15 locations. These units will address abusive tax schemes and flow-through entities. In addition, given the growing significance of the offshore credit/debit card schemes, IRS plans to create four special enforcement groups. Each group will be staffed by approximately 8 agents and will concentrate on these offshore schemes. This growth in staffing reflects IRS's increased priority for these schemes. IRS officials expect that the agents assigned to these units will be redirected largely from other compliance areas.

⁴ As part of a reorganization within SB/SE, the responsibilities of the Flow-Through Entities and Abusive Tax Schemes office were undergoing change in April 2002. We discuss these changes later in the testimony.

Schedule K-1 Transcription and Matching. In the spring of 2001, the transcription of Schedule K-1 information became a major responsibility of the Office of Flow-Through Entities and Abusive Tax Schemes.⁵ According to IRS, information provided on Schedule K-1s is important for determining whether recipients of flow-through income have properly reported that income on their tax returns. IRS can use transcribed data for information-matching to determine whether proper reporting of income occurred.

IRS believes that flow-through entities such as trusts and partnerships are increasingly being used in abusive tax schemes. IRS can also use these K-1 data in its return examination and tax collection activities to help identify abusive tax schemes.

Tax year 1995 marked the last year that Schedule K-1 information was transcribed by IRS. From 1990 through 1995, IRS transcribed approximately 5 percent to 12 percent of the Schedule K-1s received. After 1995, IRS did not transcribe Schedule K-1 information submitted with paper returns nor did it match the income information contained on the schedules with the information presented on individual beneficiaries' or partners' tax returns. IRS again started to transcribe tax year 2000 K-1 information during the spring of 2001 and completed the process in December 2001. IRS officials told us that the matching of the K-1 information against individual tax returns was to begin in March 2002.

IRS cites several reasons for reinstating its transcription and matching of Schedule K-1s. First, IRS has observed a significant increase in flow-through entities. The number of tax returns filed by Trusts, Partnerships, and S-Corporations has increased by 12 percent, 33 percent, and 35 percent, respectively, over the 6-year period from fiscal years 1995 through 2000. IRS also estimates an overall increase of nearly 2 million such returns by 2009. Second, based on a small study, in January 2002, IRS estimated that between 6 percent and 15 percent of total flow-through income would not be reported on tax year 2001 returns. Although data available to us at the time of this testimony were not clear, IRS estimates that income of about \$1 trillion was distributed to taxpayers from flow-through entities for tax year 2000. Third, IRS expects its Schedule K-1

⁵ The schedule K-1 is an information return that a flow-through entity sends to partners and beneficiaries with a copy to IRS. The schedule K-1 provides information on income distributed to partners and beneficiaries.

matching program not only to identify underreporting or nonreporting of income but also to improve taxpayer compliance. Transcription and matching of Schedule K-1 data are expected to increase accurate reporting of trust income on future tax returns just as matching of wage, interest, and other types of income has increased the accuracy of taxpayers' tax returns. As a result, the Schedule K-1 program places taxpayers who receive flow-through income on a more equal footing with taxpayers who are wage earners.

Lead Development Center. IRS has adopted a strategy of identifying promoters of tax schemes as a key to halting their promotion and identifying those who have taken advantage of the scheme and thus likely owe taxes. By early April 2002, SB/SE is to initiate a Lead Development Center. The center's primary functions are to develop case leads and assemble case information for distribution to compliance field offices for further investigation. Initially the center will focus on abusive tax scheme promoters, and over time, it will expand to perform similar functions for fraud and anti-money laundering cases. Also, the center will operate a computer laboratory that, among other things, is expected to monitor possible abusive promoter sites on the Internet. In addition, the center is to serve as a coordinating link among various IRS groups that deal with abusive tax scheme issues and with outside stakeholders such as the Department of Justice, the Federal Trade Commission (FTC), and others.

National Fraud Program

The National Fraud Program, which operates at IRS's campuses and field offices, coordinates efforts and provides oversight to IRS's compliance efforts to identify potential tax fraud. In addition, the program helps identify trends and disseminates the information within IRS and acts as a liaison on fraud cases involving bankruptcy and employment and excise taxes among other types of tax fraud. A National Fraud Program manager sets overall policy and program direction. Fraud managers are located in five area offices, and they oversee the activities of about 65 fraud referral specialists. These specialists assist other IRS revenue compliance staff in identifying cases with fraud potential, determining when indications of fraud are present, and developing potential cases. They also review fraud cases for technical accuracy and adequacy of supporting documentation to ensure appropriate and consistent application of fraud program guidelines and requirements. In cases where there is evidence of criminal activity, those cases are to be referred to criminal investigation within IRS.

Criminal Investigation

IRS's Criminal Investigation investigates and pursues promoters and sellers of abusive schemes and the individuals using such schemes. CI's

role is the enforcement of the tax laws for individuals who willfully fail to comply with their obligation to file and pay taxes and who ignore IRS's collection and compliance efforts. The most flagrant cases are recommended for criminal prosecution.

Criminal Investigation also administers the Questionable Refund Program that focuses on stopping the payment of various false tax refunds and, if warranted, on prosecuting the taxpayers involved. Furthermore, CI develops education and publicity activities warning taxpayers about abusive tax schemes and placed public information officers (PIO) in the field to specifically generate publicity regarding IRS's law enforcement efforts.

CI Enforcement Strategy

CI's enforcement strategy as it relates to fraudulent tax schemes is to focus primarily on the promoters of these schemes and on taxpayers who willfully use these schemes to evade taxes. For example, during a tax scheme investigation, CI generally attempts to gain access to a fraudulent promoter's list of clients to whom the promoter sold the scheme. In addition to pursuing the promoter, CI can then use the list of clients to determine who may have used the abusive scheme. CI determines which users of the abusive scheme merit investigation for possible prosecution and which users merit referral to IRS operating divisions for possible compliance and civil enforcement action.

Although CI has data on enforcement activity related to several types of tax scams (e.g., related to employment tax, refunds, return preparers, nonfilers, and domestic and foreign trusts), CI only separately tracked its promoter efforts for domestic and foreign trusts. (See table 1.) CI officials said that the number of full-time equivalent staff working on domestic and foreign trusts increased from 55 in fiscal year 1999 to 69 in fiscal year 2001.

Table 1: Summary of Domestic and Foreign Trust Cases from Fiscal Year 1999 through Fiscal Year 2001.

Cases	FY 1999	FY 2000	FY 2001
Indictments	35	53	32
(Promoters)	13	14	15
Convictions	24	31	45
(Promoters)	3	9	23
Active Investigations	131	126	165
(Promoters)	49	54	66
Prosecutions Recommended	57	44	30
(Promoters)	18	14	13

Note: Statistics in this table refer to individuals, such as indictments brought against 35 individuals in FY 1999.

Source: IRS Criminal Investigation.

Although no consistent pattern exists across all of the categories in table 1, CI has had increases in the number of convictions obtained over the 3-year period. Furthermore, looking only at promoter-related cases, indictments, convictions, and active investigations increased over the period while the number of prosecutions recommended declined. For purposes of deterring individuals from engaging in abusive trusts, the pattern of increasing convictions has provided IRS an opportunity to publicize more cases in which individuals have been found guilty. Further, the increases in indictments and convictions of promoters may help deter promoter activity in particular.

Because the investigative and legal processes can span several years, data like those in the table do not show whether the cases investigated lead to prosecutions, convictions, and indictments in that same year. Further, the data do not account for differences in the importance of cases, such as whether major fraudulent efforts are being successfully investigated and closed. IRS data do show that the average length of sentence for the abusive domestic and foreign trust program rose substantially from 35 months in 1999 to 64 months in 2001. To the extent that average length of sentence relates to the severity of the crime, IRS may be making headway in pursuing key abusive trust cases.

Questionable Refund Program

The Questionable Refund Program (QRP), administered by CI, was established in 1977. The QRP was designed to identify false returns, stop the payment of false refunds, and prosecute scheme perpetrators. Various false refund schemes are pursued under this program, including ones involving the earned income tax credit, the fuel tax credit, social security

refund schemes, and slavery reparations. Tax returns and return information are subject to manual processing or computerized information matching. IRS's compliance staff identifies those returns claiming a possible false refund generally during these various return examination processes and referred to Questionable Refund Detection Teams (QRDT). The QRDT staff within CI determines which returns should be pursued within CI or civilly. Schemes with criminal potential are referred to CI field offices for investigation while schemes lacking criminal potential are referred to the appropriate IRS compliance or collection group.

CI's Education and Publicity Efforts

CI's efforts to inform and educate the public about abusive tax schemes and to publicize the results of its enforcement activities related to such schemes take many forms and involve several types of media. CI has been particularly active in trying to disseminate information to the public to make them aware of IRS's activities and accomplishments in combating abusive tax schemes.⁶ In addition, CI has PIOs located across the country who work with local media to publicize IRS's efforts and results.

CI Education and Publicity Activities. CI's education and publicity activities focus on warning taxpayers about fraudulent tax schemes so that they will not be tempted to use such schemes. CI hopes that increasing media coverage of successful tax scheme prosecutions will deter the public from participating in tax schemes because the perceived risk of detection, prosecution, and resulting penalties and sanctions will be too high. In addition, CI officials believe that publicizing the prosecutions of promoters and users of tax schemes helps assure the public that people are paying their fair share of taxes.

CI posted its web page (www.ustreas.gov/irs/ci) on the Internet in September 1997. According to CI officials, over the past 2 years the Internet site has evolved into an important tool for educating and alerting the public about tax schemes and about CI's efforts to detect and deal with those who promote and use tax schemes. The Internet site provides

- fraud alerts warning the public of schemes where promoters are targeting unsuspecting taxpayers;

⁶ Other divisions within IRS also work to publicize IRS's activities related to abusive tax schemes. For example, SB/SE devotes part of its Internet site to fraud alerts and press releases.

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- information on topics including tax filing responsibilities, nonfilers, and abusive tax return preparers;
 - summaries of cases and successful prosecutions of promoters and users of fraudulent schemes; and
 - press releases and other IRS publications to generate a wide public distribution.

Tax practitioners are also targets of CI's publicity strategy. According to CI officials, some tax practitioners are using IRS's materials directly from the Internet site to inform those clients who may believe that a given tax scheme is legal. For example, clients may ask the tax practitioner to set up a fraudulent trust to reduce their taxes, and the tax practitioner can simply print the brochure about "Too Good to be True? – Trusts" from CI's Internet site to discourage the taxpayers from using such a trust.

In conjunction with using the Internet site as an informational tool to educate and warn the public of frivolous schemes, CI has taken steps to increase IRS's visibility and presence on the Internet. According to CI, it has recently intensified its efforts to improve the ranking of IRS's web page through the use of "metatags" or keyword tags. By doing so, IRS seeks to have Internet users who enter various terms in available Internet search engines find IRS's web page listed near the top of displayed search results. For example, CI is planning to add tags such as "pay no tax," and "form 1040" so that entering these terms will result in CI's Internet site being listed in the displayed search results.

CI is pursuing other possible strategies to ensure that CI's site rises to the top of Internet search responses. For example, CI staff has occasionally visited known promoter Internet sites to gather information on keywords used by those sites. IRS plans to incorporate those keyword tags into its Internet site. As a result, IRS expects to increase the odds that the CI Internet site would be included alongside Internet sites that promote questionable tax avoidance strategies. In addition, CI is working to create a web content manager position with responsibilities that include designing a strategy to maximize the potential of CI's Internet site. The manager would be responsible for helping to integrate CI data into the pages in IRS's Internet site that provide information to specific types of taxpayers.

CI Public Information Officers. In October 2000, CI established PIOs in each of IRS's 35 field offices. The PIOs serve as points of contact for all

internal and external CI communications initiatives, including the issuing of press releases and the coordination of important law enforcement media events. Although IRS has other media relations specialists located in its field offices, their duties tend to focus on publicizing tax filing season information, including the benefits of electronic filing. CI PIOs generate publicity regarding IRS's law enforcement activities including the detection and prosecution of abusive tax schemes.

Primary functions of the PIOs include

- establishing contacts with editors, reporters, and news directors to educate them on tax issues and provide information about IRS and CI to enable them to write in-depth articles.
- encouraging media to include more stories on the detection and prosecution of abusive tax schemes.
- getting articles included in trade and professional journals and magazines that are read frequently by professionals such as doctors, lawyers, and accountants to make them aware of abusive tax schemes.
- developing a local media strategy. Part of CI's local strategy involves generating a "hook" to get the stories focused more on communities. In addition, CI has employed a strategy of "bundling" news stories. For example, CI has been working cases on fraud involved in the restaurant industry. Once several such cases have been put together, CI will bundle these stories together into a single news story for possible publication in magazines and journals read by people in the restaurant industry.
- giving speeches and participating in a wide variety of presentations, panel discussions, and conferences with professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the American Medical Association, to create public awareness of CI's activities and to provide information about fraudulent tax schemes.

IRS Coordination Efforts

IRS works with various federal agencies in its efforts to identify and deal with fraudulent tax schemes. These include the Federal Trade Commission (FTC), the Securities and Exchange Commission (SEC), the Financial Crimes Enforcement Network (FinCen), the Department of Justice (DOJ), the Federal Bureau of Investigation (FBI), and the United States Attorneys Offices (USAO).

In some cases, IRS's coordination is on an informal basis, as it is with the FTC and the SEC, and involves the sharing of certain information and detection techniques. In other cases, the relationship is more formal, as in the case with DOJ or USAOs, which prosecute fraud and other tax-related cases with the assistance of IRS staff.

IRS officials participate in various federal agency working groups, including a multiagency task force to share information, skills, and procedures for combating fraud on the Internet; an IRS and DOJ working group created to examine the use of civil injunctions against abusive promoters currently under criminal investigation; and a money-laundering-experts working group. According to the officials we interviewed, these working groups are invaluable for developing networking relationships between agencies which facilitate information-sharing among staff.

IRS staff also attends quarterly meetings with staff from the FTC, SEC, and DOJ to develop joint initiatives to combat Internet fraud. These meetings have spawned other activities for IRS staff, including FTC-sponsored training seminars and periodic visits to FTC's Internet laboratory to keep current with FTC efforts to combat Internet fraud.

IRS Faces Substantial Challenges; Lacks Means to Assess Progress

IRS has tried to develop a better understanding of the potential breadth of the problem of abusive tax schemes involving individual taxpayers and the steps needed to coordinate and manage numerous efforts to combat abusive tax schemes. In some cases, these steps have been recently implemented, and in other cases, IRS is working to implement them. These expanded efforts have not been accompanied, however, by performance goals or measures that Congress and IRS can use to assess IRS's progress.

The increased scope of the abusive tax scheme problem, and perhaps especially the offshore compliance schemes, could strain IRS's audit resources. IRS is now beginning to gather data that will better enable it to estimate the magnitude and nature of the offshore credit and debit card schemes. Improved data will help IRS identify how many and what types of resources it may need to address the schemes. However, the evasive nature of these schemes may necessitate face-to-face audits in a significant portion of cases to determine whether taxes are owed and the amount owed. Even if the number of individuals involved in these schemes is a fraction of the reported estimate of 1 to 2 million, IRS's staff may be challenged to audit them and maintain its current audit coverage as well. IRS's face-to-face audits have been declining, decreasing from nearly 400,000 in fiscal year 1999 to nearly 200,000 in fiscal year 2001.

Accordingly, IRS has begun considering whether other techniques than audits could be used to resolve these cases. For example, IRS is considering options such as disclosure initiatives, settlement initiatives, and self-correction programs. These techniques will need to be tested and refined to determine which, if any, are effective.

The increased scope of abusive tax schemes has also led IRS to

- develop an improved process for selecting the best cases to pursue among the many that it identifies,
- develop a new policy to govern simultaneous criminal and civil enforcement investigations of taxpayers,
- consider how to ensure that increased volumes of scheme-related tax assessments are followed up by IRS's collection function when taxpayers are unable to pay in full, and
- use its internal research group and a contractor to develop better models for identifying indicators that taxpayers may be participating in abusive tax schemes.

In addition, a significant organizational change has just been implemented in SB/SE that is intended to increase program oversight and coordinate programs and units dealing with abusive schemes and related tax fraud activities. To that end, in the past few weeks SB/SE has divided its Office of Flow-Through Entities and Abusive Tax Schemes. Now, its efforts to ensure accurate reporting of income connected to flow-through entities will fall under a director for reporting compliance. IRS separated the flow-through entity effort from other abusive tax scheme efforts because it judged that the flow-through effort is more related to its traditional information-matching and examination programs than to its abusive scheme efforts. The flow-through effort will, however, also provide useful information for IRS to use elsewhere in investigations of abusive schemes.

The rest of SB/SE's major programs and efforts that are more directly focused on abusive tax schemes—the National Fraud program, the Abusive Tax Schemes program, the Lead Development Center, and the Anti-Money Laundering program—have been placed under a single executive for reporting enforcement. Monitoring the Internet and other media outlets where abusive tax schemes often are advertised will also be part of this centralized effort.

To date, however, IRS has not provided information on its staff year investments in combating abusive tax schemes and has not established performance goals and measures that IRS and Congress can use to gauge whether these efforts are achieving desired results. We testified recently that the IRS commissioner identified four major areas of systematic noncompliance. These areas not only focus heavily on abusive tax schemes involving individuals, but also include corporate tax shelter activity. The fiscal year 2003 budget request includes increased resources for compliance efforts, but, excluding the Earned Income Credit program, it is unclear from IRS's congressional budget justification how many resources IRS intends to devote to major areas of noncompliance or what performance measures will be available to Congress and IRS to assess progress.

Conclusions

IRS has long-standing programs and related efforts aimed at detecting and dealing with abusive tax schemes, particularly those related to frivolous tax returns and fraudulent tax refund claims. Recently, IRS has begun to take a more assertive and coordinated approach to detecting and dealing with an ever-changing array of schemes, including those involving the use of domestic and offshore trusts. In the past year, IRS has added more resources to these efforts, created new programs, and improved others, and it is reorganizing its operations. Furthermore, based on the limited data available, IRS appears to be realizing some increased success in convicting those involved in schemes, publicizing these results, and uncovering previously hidden major offshore compliance problems.

Nevertheless, it is difficult to get a clear picture of all that is underway in IRS—how much is new as opposed to reemphasized or reorganized, and how the pieces combine to form a planned, coordinated effort with specific, defined outcomes. One of the difficulties we encountered in gathering information was that no central office, group, or executive could provide us with an agencywide focus or perspective on IRS's strategy, goals, objectives, performance measures, or program results. Responsibility for the efforts was spread across various functions and groups within IRS. To some extent this lack of clarity is not surprising given the fairly rapid and ongoing change in IRS's efforts, the expanding scope of the problem, and the difficulty in determining the difference between what is legitimate, aggressive tax planning and an abusive tax scheme.

IRS has recognized that its multiple, enhanced efforts need to be better integrated. In an attempt to bring this integration to fruition, SB/SE is

reorganizing to place key efforts to combat abusive schemes under one executive. A centralized focal point should enhance IRS's ability to manage its efforts to reduce the prevalence or magnitude of abusive tax schemes.

To date, IRS has not provided information on its staff year investment in combating abusive schemes and has not established goals and measures for its efforts that it and Congress can use to assess its progress. We recently suggested that another committee consider asking IRS to provide more specifics on the level of resources it plans to devote to areas identified by the commissioner, such as abusive tax schemes, and on performance goals and measures for those efforts. This committee might want to consider requesting similar information from IRS.

Mr. Chairman, that concludes my statement. I would be pleased to respond to questions that you or other members of the committee may have at this time.