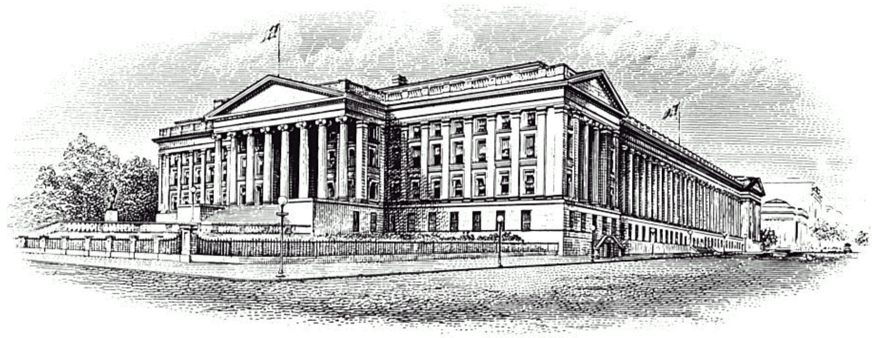

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE — Contact: Tara Bradshaw
March 21, 2002 — (202) 622-2014

Statement of
Mark A. Weinberger
Assistant Secretary of the Treasury for Tax Policy
Committee on Finance
United States Senate

Mr. Chairman, Mr. Grassley and other members of the Committee, thank you for inviting the Treasury Department to testify today on the important issue of abusive tax avoidance transactions. We appreciate the role that your Committee has taken in considering these matters. Through your statements and the release of your staff's draft legislative proposals, you have taken the lead in the public discussion about how best to address abusive tax avoidance transactions.

Abusive tax avoidance transactions are designed to take advantage of the incredible complexity of the tax law to obtain benefits that Congress never intended. Abusive tax avoidance transactions pose a threat to the integrity of our self-assessment tax system by eroding the public's respect for the tax law. They also waste public and private resources and harm the public fisc. As long as the tax law retains its current complexity, promoters will continue to develop these transactions and market them to corporate and individual taxpayers. As Secretary O'Neill has stated, we must simplify the Internal Revenue Code. Its complexity effectively aids and abets those who seek to improperly reduce their taxes. Nevertheless, until we simplify the Code, the Treasury Department and the IRS will continue to vigilantly pursue enforcement of our laws, within the contours of the current system, to address abusive tax avoidance transactions.

As you know, the Treasury Department has been evaluating the effect of the current disclosure regime, particularly the effect of the disclosure regulations issued in February 2000, before initiating a new course of action. We appreciate very much, Mr. Chairman, that the Committee has given us the time to complete our evaluation because what we have learned will result in more effective rules. Constant change is not helpful to tax administration; it makes it harder for taxpayers to comply with the law and harder for the IRS to administer the law. Accordingly, we should act deliberately to change the rules only after appropriate evaluation and analysis.

Treasury's testimony today will highlight the measures that we believe are necessary to address abusive tax avoidance transactions. Our proposals include administrative actions we already are beginning to undertake, as well as legislative proposals. Our administrative and legislative initiatives are similar in many respects to the proposals considered by your staff in the draft legislation they previously prepared.

The goal we all share is to ensure that each taxpayer pays its fair share of tax. We do not wish to interfere with legitimate business tax planning, but we must curb abusive tax practices that take advantage of complex tax laws to obtain unintended tax benefits. This goal can best be achieved through transparency and certainty. Transparency means that questionable transactions are disclosed for the IRS to review. Certainty means that taxpayers and promoters are subject to rules that clearly identify which transactions must be disclosed and registered and which transactions require list maintenance. Certainty also means that taxpayers and promoters cannot avoid detection. Finally, certainty means that rules will be enforced and penalties will be imposed in appropriate circumstances.

The measures we propose will provide transparency and certainty. These measures will create a web of rules that reinforce each other by requiring information reporting to the IRS about a questionable transaction both by the taxpayers participating in the transaction and by the promoters. These disclosure rules will allow the IRS to identify promoters from taxpayer disclosures, and other taxpayers from promoter disclosures. Taxpayers and promoters who fail to provide the required disclosure will be subject to significant penalties.

Treasury believes that if a taxpayer feels comfortable entering into a transaction, if a promoter feels comfortable selling a transaction, and an advisor feels comfortable recommending a transaction, they all should feel comfortable detailing the transaction for the IRS.

Before providing details about our new course of administrative actions and our legislative proposals, I think it would be helpful first to provide a context for our measures by describing the actions that Treasury and the IRS are currently taking to combat abusive tax avoidance transactions, and why we have concluded that more needs to be done. In the final analysis, however, we all must recognize that the complexity of the tax Code is the fundamental reason why taxpayers have the opportunity to engage in abusive transactions, and only by simplifying the entire system will such opportunities be eradicated.

Current Enforcement Status

Treasury and the IRS are working together closely to combat abusive tax practices. Some recent and important steps include a new voluntary disclosure initiative, new penalty guidelines, guidance that shuts down several abusive transactions, improved resource allocation and inter-agency coordination, enhanced tax information exchange agreements with offshore financial centers, and intensified enforcement efforts against the promoters of abusive tax avoidance transactions. Treasury and the IRS will continue pursuing steps that will enhance the Government's ability to curb abusive tax avoidance transactions.

Disclosure Initiative and New Penalty Guidelines

The IRS recently issued Announcement 2002-2, which provides an incentive for taxpayers to disclose questionable transactions. Under this program, which runs through April 23, 2002, the IRS will waive the accuracy-related penalty if a disclosed transaction results in an underpayment. The taxpayer, however, remains liable for the additional tax and interest. In order to obtain the benefits of the program, the taxpayer must disclose to the IRS all relevant information about the transaction, including the identity of any promoter. Almost 150 transactions already have been disclosed, and the IRS expects many additional disclosures in the coming weeks. The IRS will use the information received to identify promoters and taxpayers who have not disclosed transactions. For example, one recent IRS inquiry of a promoter resulted in a list of 17 investors. All 17 of the investors should have disclosed their participation to the IRS, but only 5 of the investors actually disclosed.

Along with this disclosure initiative, the IRS announced new penalty guidelines that will be used by the IRS' Large and Mid-Size Business Division. These guidelines make clear that penalties are an important tool to encourage voluntary compliance. The new guidelines require IRS agents to consider the appropriateness of penalties for certain transactions and require an agent's decision to assert or not assert penalties to be reviewed by a Director of Field Operations. The guidelines will ensure that penalties are impartially, fairly, and consistently considered in all tax avoidance cases.

Guidance Shutting Down Various Transactions

Treasury and the IRS are continually evaluating transactions that come to the Government's attention. When an abusive tax avoidance transaction is identified, Treasury and the IRS will issue guidance shutting down that transaction. For example, Treasury and the IRS recently published (i) a notice warning taxpayers that the IRS will challenge transactions using a loan assumption agreement to claim an inflated basis in assets acquired from another party (Notice 2002-21), (ii) a notice warning taxpayers that the IRS will challenge transactions improperly shifting basis from one party to another (Notice 2001-45), (iii) a notice announcing Treasury's intention to promulgate regulations that prevent the duplication of losses by a consolidated group (Notice 2002-18), and (iv) final regulations on hedging transactions that prevent employers from deferring tax on income from investments used to fund non-qualified deferred executive compensation (Treasury Regulation Section 1.1221-2). Treasury and the IRS are working to expedite the issuance of additional notices and guidance.

Improved Resource Allocation and Inter-Agency Coordination

Government resources must be used as efficiently and effectively as possible. Treasury has worked with the IRS to issue published guidance in controversial areas (such as research credit, accounting method and timing issues), that have consumed significant IRS examination resources. According to the IRS' Large and Mid-Size Business Division, these areas previously used as much as 40% of large case audit resources across industry groups. That placed an unacceptable burden on both taxpayer and IRS recourses. Treasury and the IRS believe that IRS resources are better used to address other important issues, including abusive tax avoidance transactions. Moreover, taxpayer resources are better allocated to growing their businesses.

The IRS also is working with the Department of Justice to ensure that the Government has a single, coordinated approach to cases in litigation.

Enhanced Tax Information Exchange with Offshore Financial Centers

It is more important than ever not to allow the financial institutions of any country to be used for an illicit purpose, including cheating on taxes. Treasury is working to ensure that the necessary tax information exchange relationships are in place so that no country serves as a safe haven for those who wish to hide income from the IRS. Secretary O'Neill made a commitment last summer to significantly expand our network of tax information exchange agreements, with a particular focus on achieving such agreements for the first time with significant offshore financial centers that have not been interested in cooperating with us on tax matters in the past. Importantly, these civil and criminal tax information exchange agreements will override bank secrecy laws.

Over the past few months the United States has signed important new tax information exchange agreements with the Cayman Islands, Antigua and Barbuda, and The Bahamas. These agreements, with jurisdictions that are major international financial centers located in our own neighborhood, will be an invaluable source of information to the IRS. These were the first agreements signed in nearly a decade.

However, Treasury is not stopping there. We are in ongoing discussions with many other jurisdictions, and we expect to be able to announce additional new agreements very soon. We remain committed to establishing a complete network of tax information exchange relationships as quickly as possible.

Treasury also is continuing to work within the OECD to keep international attention focused on the need for cooperation on information exchange on tax matters. We have been successful in refocusing the OECD project on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with tax laws. Treasury is very pleased that nineteen jurisdictions have committed to improving their transparency and information exchange practices since the refocusing of the OECD project last year. We look forward to continuing to work together with other countries to achieve real advances in this critically important area.

Intensified Enforcement Efforts Against Promoters of Abusive Tax Avoidance Transactions

Some promoters proliferate abusive tax avoidance transactions by developing them and marketing them to a large number of taxpayers. Because these promoters play a role in the existence of abusive tax avoidance transactions, the IRS is taking vigorous actions to curb their activities with respect to both corporations and individuals.

The IRS has contacted 30 promoters of corporate tax avoidance transactions and is working with the Department of Justice to ensure that these promoters provide us with information on questionable transactions, including the identity of the taxpayers who participated in them. The IRS and the Department of Justice are ready to go to court to ensure that promoters comply with the IRS' requests for information. Once the IRS obtains from promoters the identity of participating taxpayers, the IRS will initiate appropriate enforcement action against those taxpayers, including examinations and penalty consideration. The IRS also has opened 14 penalty audits with respect to promoters of corporate tax avoidance transactions.

In addition, the IRS is focusing on promoters of tax schemes that are directed primarily at individuals and small businesses. Although often less sophisticated than corporate tax avoidance transactions, these schemes are equally damaging to the fairness of our tax system. The IRS, working with the Department of Justice, already has obtained 6 injunctions against promoters of these schemes, and 12 other cases have been or soon will be filed. The IRS also is working to stop the use of offshore accounts that allows U.S. residents to hide assets in a tax haven country while using a credit card to spend that money in the United States. The IRS, again in coordination with the Department of Justice, has issued summonses to some of the major credit card networks and plans to issue summonses to certain vendors to identify the thousands of taxpayers who are participating in these schemes.

Treasury's Assessment of the Current Disclosure Regime

The current disclosure regime is a key component in combating abusive tax avoidance transactions. Under the current disclosure regulations, corporate taxpayers are required to disclose certain reportable transactions on their tax returns, and promoters are required to register confidential corporate tax shelters with the IRS and maintain lists of investors. Disclosure allows the IRS to identify potentially abusive transactions early in the process, to evaluate those transactions, to provide guidance on whether those transactions are proper, and, if necessary, to change the regulations or recommend legislative changes to shut down those transactions. Disclosure also helps the IRS identify taxpayers who participate in abusive transactions and promoters who market such transactions. Effective disclosure rules also are important to deter taxpayers from engaging in abusive tax avoidance transactions. A disclosure regime that increases the probability of IRS detection will change the taxpayer's risk/reward analysis and discourage taxpayers from playing the audit lottery.

For the year 2000 corporate returns, which were filed primarily in the fall 2001 filing season, only 272 transactions were disclosed by 99 corporate taxpayers. Treasury and the IRS are disappointed with the small number of disclosures. Treasury and the IRS also are disappointed with promoter compliance with the list maintenance rules. Some promoters are claiming they are not required to maintain investor lists or are refusing to provide the lists to the IRS in a timely manner.

After reviewing the operation of the current rules, Treasury and the IRS have concluded that significant changes to the rules are necessary. Treasury and the IRS have identified which rules are effective and which are ineffective. Based on this analysis, we are proposing changes that build on what has proven effective and alter what has proven ineffective.

The primary feature of an effective regime is certainty - certainty that transactions will be identified, certainty that the rules will be enforced, and certainty that applicable penalties will be imposed. Regardless of how artful or conceptually perfect the rules in the Code and the regulations are drafted, if they are not enforced – and especially if the tax community perceives that they are not being enforced – they will prove ineffective. The current rules do not provide the necessary certainty.

The current rules do not provide certainty in part because of their complexity. This complexity arises because the disclosure, registration, and list maintenance rules are different from one another and because they are each difficult to apply. For example, under the current rules, a transaction must be disclosed if it satisfies two of five filters, but does not qualify for any one of three exceptions. Some of the exceptions are highly subjective, including the exception if there is a "generally accepted understanding" that the tax benefits are allowable and the exception if there is "no reasonable basis" for the IRS to deny the tax benefits. Taxpayers and promoters are parsing these rules to avoid disclosure. They are interpreting the filters narrowly and reading the exceptions broadly.

In addition, the system must alter the risk/reward analysis for participating in questionable transactions by increasing the cost of not complying with the rules. The current rules do not provide incentives to disclose transactions because they do not impose meaningful penalties on taxpayers and promoters who fail to comply. For example, under the current rules, there are no clear penalties if a taxpayer fails to disclose a reportable transaction.

The existing rules were intended to create a web that would allow the IRS to identify and halt abusive tax avoidance transactions by tracing transactions through the system from promoters to taxpayers and vice versa. The possibility of the IRS finding out about a transaction from alternative sources would increase the "risk" of detection. However, the complexity and subjectivity of the current rules and the lack of meaningful penalties -- essentially, holes in the web -- do not afford certainty of disclosure, identification, or enforcement. Without this certainty, the current disclosure rules do not have the necessary deterrent effect.

Yesterday, Treasury announced an initiative to improve the disclosure and penalty regime through a combination of administrative actions already underway and new legislative proposals. These actions will increase certainty and make the disclosure regime more effective. A detailed description of the proposals is attached to this testimony. We have met with your staffs to provide an overview as well.

Administrative Changes

Many of the administrative actions will simplify and broaden the rules governing taxpayer disclosure and promoter registration and list keeping. For example, Treasury and the IRS intend to provide a single definition of a reportable transaction for purposes of the disclosure, registration, and list maintenance rules. The definition will provide clear, bright line tests that leave no room for interpretation or subjective inquiries. This single definition will allow the IRS to move quickly from a taxpayer's disclosure to a promoter's list of investors to other taxpayers who engaged in the reportable transaction. This will create a more perfect web that deters abusive tax avoidance transactions by increasing the certainty of IRS detection.

The IRS also is developing a new disclosure form that will be centrally filed with the Office of Tax Shelter Analysis. The form will request specific information needed to evaluate whether a transaction is an abusive tax avoidance transaction. The form will greatly help the IRS identify and evaluate transactions for which further action may be needed.

The new rules will deliberately cast a broader net than exists under the current disclosure and registration rules. For example, the initiative will extend the disclosure requirements to partnerships, S corporations, trusts, and certain individuals. In addition, the initiative will apply the disclosure, registration and list maintenance requirements to more transactions. Under the current rules, transactions that the IRS has identified as tax avoidance, or listed, transactions, must be disclosed, and we will keep that rule. We are replacing, however, the 2-of-5 filter test and eliminating the related exceptions in the current rules. In their place, we are creating clear categories designed to require disclosure of the types of transactions we are most concerned about. These include transactions that generate large tax losses, transactions that result in tax credits where the underlying assets are held a brief period of time, transactions that generate significant book-tax differences, and transactions marketed on a confidential basis. We recognize that these rules will require disclosure of many legitimate transactions, and we are eager to work with taxpayers to ensure that these rules are appropriately tailored. Simplicity and clarity, however, will remain our paramount goals.

Treasury and the IRS also will undertake administrative actions to increase penalties on taxpayers who fail to disclose reportable transactions. For example, Treasury and the IRS will amend the regulations to impose a strict liability accuracy-related penalty on taxpayers who do not disclose a listed transaction and who have an underpayment resulting from the transaction. In addition, the amended regulations will provide that taxpayers cannot rely on a favorable tax opinion as a defense to the imposition of the accuracy-related penalties if the taxpayer did not disclose a reportable transaction or a return position based on the invalidity of a regulation.

Because taxpayers rely on opinions for assurance that transactions are proper and will not be subject to penalties, Treasury and the IRS believe that tax opinions regarding tax avoidance transactions need to be regulated. We are currently taking steps administratively to mandate and enforce standards for opinions used to support tax avoidance transactions.

Legislative Proposals

Treasury's legislative proposals focus on enhanced penalties for taxpayers and promoters who fail to follow the disclosure, registration, and list maintenance rules. For example, Treasury is seeking a new and substantial penalty for taxpayers who fail to disclose reportable transactions. A corporate taxpayer, for instance, would be subject to a penalty of $200,000 for failure to disclose a listed transaction, regardless of whether the tax benefits of the transaction are ultimately sustained on the merits. Further, if the corporate taxpayer fails to disclose and loses on the merits, the taxpayer would be liable for a new strict liability penalty of 25% of its claimed tax savings. Treasury is also seeking legislation requiring public disclosure by corporate taxpayers of penalties for the failure to disclose listed transactions and accuracy-related penalties resulting from an undisclosed listed transaction.

For promoters, Treasury is recommending legislation that would enhance the existing penalties for failure to register a transaction. For example, a promoter who fails to register a listed transaction generally would be subject to a fine of $200,000 or 50% of its fees, whichever is greater.

Because Treasury wants to make sure that promoters identify taxpayers who have invested in reportable transactions, we are seeking an escalating penalty that would increase by $10,000 for each day that a promoter fails to turn over a list of investors requested by the IRS in writing. The IRS is facing too many delay tactics, and this needs to stop.

In addition to the preceding penalty proposals, Treasury believes that other legislative measures should be taken to curb abusive tax avoidance transactions. For example, legislative revisions to Code Section 6111 may be necessary for Treasury and the IRS to create a consistent definition of a reportable transaction for purposes of the disclosure, registration and list maintenance rules.

Treasury also proposes two substantive law changes. The first substantive proposal would amend Section 901(k) of the Code to deal with trading in foreign tax credits. Under the proposed rule, a minimum holding period for ownership of property would be required before taxpayers could claim tax credits associated with income from the property. The second substantive proposal would add a new provision to deal with a broad range of income stripping transactions. The new provision would address stripping transactions in a manner that would match the tax treatment with the economics of the transactions.

Conclusion

In conclusion, Treasury and the IRS are committed to combating abusive tax avoidance transactions. While the vast majority of taxpayers and their advisors attempt to comply with the letter and spirit of the law, the complexity of the current tax system provides too many opportunities for some taxpayers to participate in transactions that generate tax benefits never intended by Congress. The best way to eliminate these practices is to simplify the tax law and improve transparency so that questionable transactions are disclosed and subject to IRS review. Treasury has set forth a number of administrative and legislative proposals that provide clear and simple rules for disclosure, registration and list maintenance. We also propose new and increased penalties for failure to comply with these rules. Treasury and the IRS are moving forward to implement the administrative actions that can be undertaken without further action by Congress. In addition, we urge Congress to move forward with Treasury's legislative proposals. If enacted, these proposals would improve the effectiveness of the disclosure, registration and list maintenance rules, thereby changing the risk/reward analysis for taxpayers who otherwise might play the audit lottery to avoid paying their fair share of taxes.

Thank you again, Mr. Chairman, for the opportunity to speak today. The Treasury Department looks forward to working with the Finance Committee on the important task before us. I will gladly answer any questions the Committee may have.

-30-