

TAXPAYER BEWARE: SCHEMES, SCAMS, AND CONS

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED SEVENTH CONGRESS
FIRST SESSION
ON
IRS OVERSIGHT

APRIL 5, 2001



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IRS OVERSIGHT “TAXPAYER BEWARE: SCHEMES, SCAMS AND CONS”

THURSDAY, APRIL 5, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:25 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Murkowski and Baucus.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thank you all very much for your patience while the Senate casts the two votes of this task. Normally, it would be my practice to start the hearing and to have the hearing go on with Senator Baucus and myself alternating as chairs to keep the hearing going.

We are here today to talk about a growing problem, hundreds of thousands of Americans who are participating in or considering participating in tax scams. Tax scams are as old as our tax code. The Internet is giving them a thriving new life. The number of participants in these tax scams is growing like a weed.

The Internet, of course, is greatly helping that growth. The Internet gives these tax con artists the unprecedented ability to reach out to millions of households very cheaply and very easily. We will hear testimony today that tax scams are not limited by income or geography.

Through the Internet, the con artists are making their pitch to Americans of every income level and targeting individuals throughout our country. For example, my own State of Iowa reports that it has seen record levels of scams and abuse in related areas of securities fraud.

This hearing will give the American people a better understanding of the snake oil that these hucksters are selling. We will hear about the old style scams, such as pure trusts, constitutional trusts, compensation for slave descendants, even setting up your own church. All of these are being put into new bottles and sold.

Let me be very clear that the focus of this hearing is solely on those tax schemes that are wholly outside the tax laws. This hearing is not about the gray areas of the tax law that have been referred to as corporate tax shelters. This is certainly a very important topic. And that important topic is one that the committee will be reviewing and addressing later this year.

As important in educating the American people to be aware of these tax con artists is, of course, reviewing the IRS' response to Internet-based tax fraud. Some of the bad apples claim that they must be right because the IRS has not caught them.

I am worried, of course, about claims that the Internal Revenue Service is a dog that does not have a bark or perhaps is not barking enough about this Internet tax fraud. So I think the agency must be active in this arena, catching these hucksters early before they have time to sell their wares because an ounce of prevention is worth a pound of cure, to be true here.

Of great concern are those promoters who are encouraging employers not to withhold income and payroll taxes for their employees. These employees are put in a terrible position, having to choose between the tax man and their jobs. That is not right and it should be a top enforcement priority of our Internal Revenue Service.

The agency should have active enforcement in this area. I think the agency can perform its critical enforcement duties while still giving the taxpayers protection that the constitutional laws allow. This is the same, if you stop to think of it, that police departments across the country are able to successfully perform their duties while balancing the needs to protect citizen's rights.

The IRS, tax experts, and we in Congress, all have a duty to ensure that taxpayers do not listen to the sirens' song of the tax con artist, and even better, that taxpayers do not even hear the song in the first place.*

Now, to Senator Baucus.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR
FROM MONTANA**

Senator BAUCUS. Thank you very much, Mr. Chairman. Obviously, this hearing is very important. We have a problem. Eleven days from now on April 16th, most Americans will have filed their Federal tax returns. All told, they will pay about \$1.1 trillion in income taxes at the very time we are debating the \$2 trillion budget.

We could have a larger tax cut, prescription drug benefits, pay down the debt more quickly, and pay for other priorities simply by cracking down on these six-figure tax cheats. They are costing the government and the American people approximately \$200 million a year.

In return, honest, hardworking taxpayers have a right to expect many things in exchange for their compliance. One of the most basic is fairness. We all understand that people do not like to pay taxes. Nobody does. But they especially do not like paying someone else's taxes. And that is exactly what happens if our tax system allows folks to cheat on their taxes and get away with it.

Unfortunately, there is evidence that cheating is becoming increasingly common. I was struck awhile ago this month when I was walking through an airport on my way back home to Montana. I

*For more information on this subject, *see also*, Joint Committee on Taxation staff report, "Overview of Present Law Relating to the Innocent Spouse, Offers-In-Compromise, Installment Agreement, and Taxpayer Advocate Provisions of the Internal Revenue Code," April 5, 2001, JCX-22-01.

saw a copy of a Forbes magazine headline, "How to Cheat on Your Taxes." I can tell you, that caught my eye. [Laughter.]

I mean, as a ranking member of the Finance Committee, I thought, hey, I had better learn about that. I better get that article and read it and see what is going on. And so I did.

Now, there are articles and there are articles. And you have to take everything you read with a grain of salt. But I was stunned by this article. I have a hunch that it is at least on the mark in terms of being on the right track. It may not be totally accurate, but it is clearly on the right track.

The article tells about more and bigger tax shelters than before, Caribbean tax havens, use of sham trusts, websites that promote outright tax fraud and the steady growth in the garden variety under reporting.

It is a problem, a big problem. If it persists, the average taxpayer who is playing by the rules and paying his or her share, will feel like a chump. Support for our system based on a largely voluntary system of reporting will deteriorate if not collapse.

Today's hearing gives us a chance to get a better understanding of this problem and the most significant forms of tax evasion. Why are they growing so rapidly? Most importantly, what can we do about it? How do we stop it?

Nobody loves the IRS but we have to give it the tools to do the job. Otherwise, the vast majority of honest taxpayers who are grumbling, but paying their fair share, are paying higher taxes while someone is getting a free ride.

One last point, we certainly have to have balanced here. You all recall that a few years ago, we were very concerned about an over zealous, sometimes abusive IRS. Hearings were held right here on that point.

Now, the pendulum has swung I think a bit too far in other direction. We are concerned that at least in some cases the IRS should be doing more than it now is. Of course, we should react, but we should not over react. We should figure out how to crack down on tax cheats and illegal shelters without posing unnecessary burdens on the average, hardworking, honest taxpayer.

I hope this hearing helps us to get this problem resolved. Thank you, Mr. Chairman.

The CHAIRMAN. I call on Senator Murkowski.

**OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S.
SENATOR FROM ALASKA**

Senator MURKOWSKI. Thank you very much, Mr. Chairman. I look forward to our expert witnesses. I think this is long overdue. And as a consequence, the realization that here we have in America an industry on the Internet whose sole goal is to rip off the American taxpayer.

I do not mean the people who pay their money to these scam artists on the phony ways to avoid paying taxes. But the people being ripped off to a large degree are honest Americans who will be struggling this weekend and probably next weekend to fill out their tax forms and pay their taxes.

Now, as a former banker, my observation is a little naive out there. But nevertheless, the realization is in the figures. By one es-

itimate, sham trusts and other schemes are costing the Treasury as much as \$300 billion a year. That is an astounding figure, Mr. Chairman.

And you know at this very moment on the Senate floor, what we are engaged in as a historic debate on whether we can return \$1.6 trillion of the surplus to honest, taxpaying Americans over the next 10 years.

If we could just rip out these tax scams, we could afford to return not \$1.6 trillion, but \$4.6 trillion back to honest American taxpayers over the 10 years. Just think about it, \$300 billion a year is what this is costing.

Now, what I do not understand is if there are hundreds of websites advertising and promoting these phony schemes to avoid paying taxes, why hasn't the IRS, why hasn't the FBI, why hasn't the Department of Justice established a specific strike force to shut down and prosecute the operators of these sites?

Now, here is a website that I picked up the other day, it claims that it can teach you how to legally eliminate the Form 1040 income tax and keep 100 percent of the money you earn. Think about that. People are buying this evidently. Now, if this claim is true, then every American certainly would have figured it out.

But we know it is not true. Yet, the site continues to operate openly and blatantly. Why? Mr. Chairman, if a website advertised legal heroin, legal cocaine, is there any doubt that the FBI and the DEA would have thoroughly investigated and prosecuted the operators?

The basic question that I want answered is why hasn't law enforcement been more aggressive in prosecuting these scams? And what type of resources do we really need to aggressively crack down on these frauds?

I do not know who said it, Barnum and Bailey, you can fool some of the people some of the time, but not all of the people all of the time.

Senator BAUCUS. I think President Lincoln.

Senator MURKOWSKI. Well, in the second round, it was Barnum. That is close enough.

This has turned into a circus obviously. Thank you, Mr. Chairman.

The CHAIRMAN. We thank you, Senator Murkowski.

Our first panel here is going to discuss these Internet connections. And they are going to do it from the standpoint of some of them as participants, some of them as combatants.

We have Aaron Bazar, computer engineer, North Potomac, MD, involved with the Institute of Global Prosperity, in a tax scam, lost \$8,000, now operates a website that alerts consumers to the Global Prosperity scam.

JJ MacNab, Ms. MacNab is an insurance analyst and certified financial planner, a fervent tax scam watchdog who monitors the Internet for newly formed trust scams.

Then, Robert Sommers, an attorney in San Francisco, specializing in tax law, operating website www.taxprophet.com, and writes a biweekly tax column in the San Francisco Examiner.

Then, Jay Adkisson of Irvine, CA, an asset protection attorney and investment advisor, also started quatloos.com.

Mr. Adkisson.

The CHAIRMAN. A website devoted to warning consumers about various tax and financial fraud.

Finally, our panel has Joseph G. Hodges, Jr., attorney and sole practitioner from Denver, speaking on his behalf today, a member of the American Bar Association, Real Property Probate Trust Section, the American College of Trust and Estate Counsel. Like other witnesses, Mr. Hodges seeks to educate consumers of trust scam artists.

We will go in the order in which I introduced you.

Mr. Bazar.

And then, we will have questions after everybody has testified. Also, let me state an administrative matter. If you have longer statements than your 5-minute presentation, those statements will be included in the record without your asking permission. If you have supplemental material that is not too great of an extent, it will be included as well. Otherwise, if it is larger, it will be received for our files.

And the red light, it does not mean that you have to stop right at the red light, but try to at that point summarize very quickly to make your last couple of points.

Mr. Bazar.

STATEMENT OF AARON BAZAR, COMPUTER ENGINEER AND WEBSITE OPERATOR, NORTH POTOMAC, MD

Mr. BAZAR. Thank you, Mr. Chairman. Good morning, Senators. Thank you for inviting me to speak today. It is an honor to be here. Last year, I lost approximately \$8,000 in 4 month's time in a pyramid scam propagated over the Internet.

It all started when I received an unsolicited, bulk e-mail message for a business opportunity. The e-mail said that I could make thousands of dollars and learn how to legally eliminate taxes. Four months later and not a penny richer, I discovered that this business had cease and desist orders in many States.

I was already disenchanted with the group because I felt that what they were teaching was not quite right. In addition, nobody I knew was actually making the money, except the person who initially brought us into the pyramid.

So I asked for a refund. When that did not work, I tried to get the authorities involved to put a stop to this fraud. Finally, after that did not work, I started my own website to warn the public.

The site has received tens of thousands of visitors over the past year. And I am positive that the site has helped many people from getting scammed, a job that the IRS, FBI, and FTC, as well as the State attorneys general are all failing miserably at.

Our government's lack of enforcement is precisely the reason why pyramid attacks and evasion scams are flourishing on the Internet today.

When I first joined the Institute of Global Prosperity, I had never even heard of the freedom movement. And I knew very little about tax protesters. I was just in it for the money.

It seemed like such a good idea at the time. I mean, who would not want to work from home, make thousands of dollars a week,

and learn how to legally stop paying taxes just like the wealthy elite of our country.

One reason these groups are so successful is that they pry on those who already distrust the government. These people are all too willing to believe the misinformation on the Internet and in the teachings of these groups. However, if they are like me and have no anti-government inclinations, then the con men do their best to reeducate you.

They drill ideas into new recruits like the government spies on us, we are tracked by our Social Security numbers. They will say things like the 16th amendment was never ratified. So taxes are illegal.

They will explain to you how paying taxes is voluntary because the IRS tells us so, right in the tax code. So you can just choose not to pay. Or that the Federal Reserve is run by the ultra wealthy and they illegally create money.

The majority of citizens in the country know that the tax system is completely unfair and benefits the wealthy. When somebody tells you that you can just leave the system by using special, get out of tax free forms in lieu of a 1040, it sounds too good to be true.

When you are then shown in your 1040 instructions exactly where it says that filing taxes is voluntary, you start to wonder. And then, finally, when you see many other people who have stopped paying taxes completely using these documents, you are sold.

Senators, I have never heard of the IRS stopping any of the thousands of people who are using these methods to evade paying taxes. And believe me, I have looked. If Americans are really obligated to pay Federal income taxes, why does the IRS allow these people to continue selling these products? And why are they not prosecuting those who are using them?

The IRS encourages the tax protester movement by their lack of enforcement. I have a better chance of being audited because I sent in a 1040 and pay my taxes honestly. Those who do not follow the 1040 seem to be getting away with it.

Let me get back to the Internet. Most scams on the web today employ the use of unsolicited bulk e-mail, otherwise known as "spam" to recruit people and their products. In my opinion, spam is truly the root of all evil on the Internet.

No legitimate company uses spam to advertise, only pyramid schemes, pornography sites, stock market scams, and other illegitimate businesses use spam. Spam cost consumers billions of dollars a year based on recent studies.

I know that there are already bills in Congress that are addressing the spam issue. And I hope it becomes illegal to send out these unsolicited, commercial e-mail. It will save the country billions of dollars paid by consumers and it will help prevent these pyramid and ponzi schemes from spreading as fast as they are.

If you have any doubts about how far reaching the problem is, I suggest that you check your private e-mail accounts. The chances are good that you will have e-mail with lines like "make \$2,000 to \$5,000 per week from home or eliminate credit card debt or legally reduce your taxes."

These are e-mails sent out by IGP and other groups like them. If you have not received e-mails like these, then you soon enough will. It is only a matter of time. My website has many samples of the spam that IGP sends out. And if you are interested, it is www.global-prosperity.com.

If somebody wants to steal from people, the Internet is the place to do it. The chances of getting caught, in my opinion, are virtually nil. IGP has been stealing from people for 5 years now without any repercussions. They ignore cease and desist orders because they know they can get away with it.

After I was scammed, I dutifully reported Jeff Seigal, the IGP agent, who ripped me off. I reported him as well as other IGP leadership to my State attorney general, the State attorney general of New Mexico, the FBI, the FTC, and anybody else who might listen.

I also contacted the Massachusetts attorney general's office because IGP's drop box was located there. And I also contacted the attorney generals in Washington State and Oregon. Nothing happened.

When I spoke to the various attorneys general's offices, they told me things like they had no money, it was the other States' problem, or it is the FBI's jurisdiction because IGP crosses State lines or it was a securities issue.

At least, the Maryland attorney general's office was honest with me. The officer there said that nothing was going to be done.

The CHAIRMAN. I imagine it is a tough spot.

Mr. BAZAR. Yes. I will finish up. I am about done, Mr. Chairman.

The CHAIRMAN. Please, go ahead.

Mr. BAZAR. I guess my point is that the Internet is a great place to be a criminal because you will not get caught. If you are a tax protester, there has never been a better forum to get your message out and make money too.

I think I can stop there.

The CHAIRMAN. Thank you, Mr. Bazar.

[The prepared statement of Mr. Bazar appears in the appendix.]

The CHAIRMAN. Ms. MacNab.

STATEMENT OF JJ MacNAB, INSURANCE ANALYST, CERTIFIED FINANCIAL PLANNER, AND WEBSITE OPERATOR, BETHESDA, MD

Ms. MACNAB. Good morning, Mr. Chairman and members of the committee. Roughly, 2½ years ago, I received a telephone call from a charity, a client of mine. They had just seen a presentation about something called a pure trust and wanted to know whether this remarkable sounding strategy might be beneficial for their donors.

The promoters guaranteed that anyone who placed their business and personal assets in this plan would never pay taxes again. From the charity's point of view, this meant that their donors would have much more after-tax income to donate to charity.

I started to research the pure trust. And I turned to the Internet for information. I found literally hundreds of websites promoting this concept. And after considerable digging, I finally located the notice from the IRS that they had issued in 1997, warning taxpayers that this particular planning tool was a sham that offered no tax benefits whatsoever.

Over the past 2½ years, I have continued to keep a close eye on this industry. And from what I have seen, there are two main types of tax cheaters out there. There are those that cheat in small ways. I will refer to them as “detail cheaters.” And then, there are those that cheat by trying to reduce their income and estate and capital gains taxes to as close to zero as they possibly can. I will refer them as “big picture cheaters.”

Detail cheaters might include someone who over inflates their home office deduction or who exaggerates the value of an automobile given to charity.

The second group, the big picture cheaters, generally fall into three distinct categories. There are tax protesters—they have been around for years—sham trusts, and offshore ventures. And the Internet has proven to be very fertile ground for the big picture cheaters.

Prior to the Internet, only the very wealthy were offered complicated schemes to reduce taxes, and then, they were usually charged exorbitant fees in the process.

Now, anyone with a modem and a computer can play the games that were once limited to the wealthy. The problem is these mass market people do not have the sophisticated advisors to tell them which schemes work and which schemes do not.

The growth rate for the online tax evasion industry is phenomenal. And unfortunately, right now, there are no dampening effects on this growth. To the average consumer, the IRS is practically invisible. And when you hear stories about friends and neighbors and e-mail correspondents who have gotten away with tax evasion for years and in some cases decades, the risk of audit begins to feel negligible.

In the past couple of weeks, there has been a lot of talk about the IRS using matching software to compare income from various sources with tax returns. To me, it would appear that such mathematical research is hunting for detail cheaters only.

As long as the big picture cheaters are effectively paying zero in taxes, all this time and money spent on small tax discrepancies is relatively fruitless. Right now, the online tax evasion industry is still relatively small. Most taxpayers out there are honest and ethical. And they use common sense to determine whether the advice they are receiving is good or whether it is a scam.

But the online tax fraud is growing so quickly, it is almost impossible to keep track of it. Now is the time to put a stop to it while it is still comparatively small. But stopping this industry in their tracks does not appear to be a goal right now of the IRS.

The promoters are not hard to find. As an exercise, I put aside 2 hours of uninterrupted time to see what kinds of things I could find by browsing on the Internet. To summarize, in 2 hours, I looked at 28 websites promoting questionable tax products and information.

I found multilevel marketing schemes offering everything from anti-snoring devices to constitutional products side by side. They guaranteed to remove all your assets and income from any future taxes.

I found a church selling church charters for \$300 so that you can “free your church, yourself, your business from undue tax burden.”

I found numerous forms of offshore trusts, offshore international business companies, and offshore private banks.

And perhaps, the most disturbing item was the website from a group whose founders were investigated by the criminal investigation division and who were arrested this last February. This would actually be Mr. Bazar's ex-group. And despite the arrests, more than a month ago, the websites and therefore their businesses are still up and running.

And this brings me to my main point. While the IRS' stated mission may be to better serve their customer, the taxpayer, it would seem to me that the customer would be best served if the IRS stopped these promoters as quickly as possible. Their undercover investigations often take more than 2 years to complete. During this time, the promoters are bringing in potentially thousands of new marks.

And as I said earlier, the promoters are not difficult to find. They are not hiding what they are doing. Almost every website I found in my 2-hour search included the name, address, and phone number for the promoter. All but one was located in the United States.

And they do not just exist on the Internet. They are in in-flight magazines, on radio talk shows. They take out full-page ads in USA Today and the Washington Times. There is actually an example on a chart on the side here. This ran I believe three times in major publications.

They are practically begging the IRS to review their products. And unfortunately, the IRS' silence is being interpreted as permission to continue.

Thank you very much.

The CHAIRMAN. Thank you, Ms. MacNab.

[The prepared statement of Ms. MacNab appears in the appendix.]

The CHAIRMAN. Now, Mr. Sommers.

STATEMENT OF ROBERT SOMMERS, ATTORNEY, WEBSITE OPERATOR, AND COLUMNIST, SAN FRANCISCO EXAMINER, SAN FRANCISCO, CA

Mr. SOMMERS. My name is Robert Sommers. I am a tax attorney from San Francisco. Good morning, Mr. Chairman and members of the committee. I have a website called the tax prophet. And as part of my website, I run the tax and trust scam bulletin board. I do this for one reason. It is to warn consumers about tax fraud, especially trust scams.

To illustrate the problem, I have a little experiment for everyone in this room. The next time you are on a cross-country flight or an international flight, check out the ads for offshore banking services in the in-flight magazine.

When you do that, you will come to one conclusion. There is a global industry with just one mission: separating Uncle Sam from his tax dollars. Take that industry now and migrate it to the web. And what you have is a global industry with an instant reach of every U.S. taxpayer who has access to a computer.

Mr. Chairman, I am of the old style here with the tax scams. My focus is on the tax scam artists and something called a pure trust

which is neither. My focus is on how they work and how to stop them.

The pure trust, in my opinion, is the foundation for all tax scams regardless of their complexity. The pure trust has been unchanged essentially for over four decades. The people who promote them, these trust scam artists, are the masters of form over substance.

Think of the pure trust as a magical black box. Taxable income pours up at the top. You pour it in. And magically, tax-free income flows from the bottom.

There is really two essential elements to the pure trust. One is a persuasive sales pitch which has remained unchanged since 1958. And the other is reams of worthless paper and documents calculated to trick the buyer into thinking they are doing something real.

There are two purposes for the pure trust. The first one is to hide the true ownership in income from all creditors, but especially the IRS. And then, the second purpose is, if discovered, these pure trusts have the ability to obstruct and stonewall.

And their promoters promote this to say, look, we can stonewall the IRS and the courts. Essentially, what they are doing is throwing sand into the bureaucratic machinery of not only the IRS, but also the courts, especially the tax court.

I would like to demonstrate how the pure trust works while we set that up. Let me just tell you the impact of the Internet. It has four consequences. What the Internet has really done is created what I call high-tech snake oil.

Let me go through what the four consequences are of the Internet. And then, I will get to the chart. By having the Internet, what we have is the snake oil salesman now has a worldwide reach, number one. They have expanded their marketplace throughout the globe. And this is becoming a problem not only in the United States, but other taxpaying societies, Australia, Canada, parts of Europe.

By having so many websites out on the Internet saying the same thing, it reinforces the legitimacy of the argument. The trust scam promoter can now look someone straight in the eye and say, look, there are 60, 80, 200 websites out there saying the same thing. This is right.

The Internet has allowed the use of e-mail. Spamming is a critical part of this. In other words, they can send out their get-rich-quick schemes to drive traffic to their website.

The Internet also allows these people to study tax fraud. What they have is they have an Internet community there where they can look and see what other people are doing and so they can fine tune their scams to always stay one step ahead of the IRS.

Just a quick example. The IRS for years was known not to audit trusts. That is how the pure trust operator knew that the IRS audited 1 out of 10,000 trusts or so. But then, IRS came out saying that they were going to crack down on trusts.

So what the pure trust people said was, well, if they are going to track down on trust, we will start calling these foreign trusts in which no tax returns are filed and no income is reported. The goal there, of course, is to fly beneath the IRS radar and to always stay one step ahead.

Let me just demonstrate just a typical three trusts, pure trusts scam. I have three trusts:

Trust One is a business trust; Trust Two is what I call a siphon trust; and Trust Three is the residence trust.

Let us assume that a business has \$1,000 of income and \$200 of expenses. So it would have \$800 of taxable income. Well, the trust promoter forms a business trust. And now, the money flows into Trust One.

What happens though is that out of \$800, they will pay \$50, that is really step three, flowing into this residence trust, but \$750 will go to what is called the siphon trust. The siphon trust will contain lots of phony deductions, inflated inventory. They may be charging outrageous rates for leases and things.

So out of the \$750 that goes into that trust, only \$150 leaves that trust. What happens now is I have \$200 in my residence trust.

Well, this is the fun one. What happens is that the person setting up the trust is told, well, the trust needs a headquarters. Well, why do we not make it your residence?

So they start depreciating the residence. Oh, you need a caretaker allowance. So what we will do is pay your medical bills, your food bills, your travel bills, your kid's education, all of that. So at the end, by the time we are finished, maybe \$50 will flow out to the taxpayer's Form 1040.

In this example, \$800 of income has disappeared down to \$50. That is your pure trust scam in a nutshell. The idea of flowing money around was to eliminate self-employment taxes up at the top there because they will want to avoid those too.

Let me just summarize very quickly. IRS needs to be committed against combating tax fraud. I have three concrete suggestions, all of which I think can be instituted without much cost. They need to have a strike force to search down these websites and shut them down. They also need to do that with spam. They need to crack down on spam.

Two, they need to fight propaganda with information. They need to develop their own separate website to educate the public regarding these scams and to have what we call a one-stop web portal for tax fraud information.

In other words, everyone in the country needs to go to just one site and they will find all the information necessary whether it is reporters, whether it is taxpayers, whether it is professionals.

And then, finally, they need a PR blitz. They need to get down and dirty with these people and do advertisements, do public service announcements, put articles in industry magazines, maybe even show up at trade shows and have a trade show booth. They need to do interviews and talk show appearances.

In conclusion, as our last Presidential election showed, the Presidential candidates go where the voters are. They were on Oprah. They were on Larry King. They know where the voters are. In essence, the IRS has to go where the taxpayers are as well.

Thank you.

The CHAIRMAN. Thank you, Mr. Sommers.

[The prepared statement of Mr. Sommers appears in the appendix.]

The CHAIRMAN. Now, Mr. Adkisson.

**STATEMENT OF JAY ADKISSON, ADKISSON FINANCIAL, LLC,
IRVINE, CA**

Mr. ADKISSON. Thank you, Mr. Chairman and members of the committee. Our Nation is plagued by a growing industry of fraud. This is an industry with a significant and increasingly sophisticated infrastructure that has as its purpose to cheat many thousands of Americans annually out of many billions of dollars.

This results in not only a total loss of the victim's savings, thus creating an additional burden on the social safety net, but also in disruption of the family unit and eventual disenfranchisement.

Tax frauds are the rising star of the scam industry and increasingly pervasive. The sale of materials purporting to magically free U.S. citizens of taxation is seemingly at an all time high.

Recent high-profile prosecutions by the Internal Revenue Service have done little to stem the ever growing tide of tax protesting or the proliferation of abusive trust schemes.

A large, talented, and increasingly sophisticated workforce of multilevel marketers and telemarketers is increasingly making the transition from quasi-legitimate products to the much more lucrative tax fraud business which they capably market on a mass basis.

Tax frauds, like so many other frauds often take advantage of offshore tax savings as a safe and unregulated base of operations to conceal their identities from prosecutors and to hide their ill-gotten gains.

The scam industry is inventing new and more sophisticated scams daily, many of which prey on the paranoid belief systems of Americans who are already disenfranchised, thus creating a negative cycle which feeds upon itself.

Financial frauds are also pervasive and include prime bank scams, advance fee fraud, and business opportunities scams. These scams cause not only direct economic harm and divert scarce law enforcement resources, but also stifle legitimate investments and risk-taking.

Efforts of private groups, such as mine, to warn the public about scams are very valuable. Yet, such sites as ours are outnumbered on a scale of 1,000 to 1 or better by the websites of scam artists who often attack our few private websites and attempt to get them shut down by denial of service attacks known as "joe jobs," a form of cyber terrorism.

These attacks are made not only by the scam artists directly, but also by the myriad of businesses that richly profit by providing technical support and like services to scam artists. The latter services are the backbone of the industry of scams and provide an invaluable infrastructure of support services, including cheap and anonymous web posting, conference calling, spamming services, and the like.

These services are richly compensated by the scam artists who often have no other overhead and though committing no crimes themselves are economically vested in the success of the scam artists committing their crimes.

The Internet has made the industry of scams more efficient by allowing scam artists to pitch their schemes to the masses while still concealing their identities from investigators. The Internet allows scam artists to engage in campaigns of disinformation and de-

ceit both to deter past victims from reporting their crimes to the authorities and prepare future victims for the next scam.

A full combat against the industry of scams can be joined. Enforcement difficulties and jurisdictional disputes, Federal versus State and Federal agency versus Federal agency must be resolved.

Another factor is an Internal Revenue code that is indecipherable to all but highly trained tax professionals, also a culture of non-compliance fold by 9- and 10-figure corporate tax shelters based on ridiculous but often technically correct interpretations of the code.

Policymakers must consider giving law enforcement greater authority and resources to deal with schemes at their inception, to grab the seed packet of the scam before it blossoms into a garden of defrauded victims. Likewise, those breeding grounds for scam artists, including the owners of Internet bulletin boards who profit by banner advertising, should be made responsible for their conduct to defraud victims.

The Internal Revenue code should be simplified at least as it relates to the direct taxation of individuals. And the culture of non-compliance must be eradicated.

That concludes my statement. Thank you.

The CHAIRMAN. Thank you, Mr. Adkisson.

[The prepared statement of Mr. Adkisson appears in the appendix.]

The CHAIRMAN. Now, Mr. Hodges.

STATEMENT OF JOSEPH G. HODGES, JR., ATTORNEY, MEMBER, AMERICAN BAR ASSOCIATION'S REAL PROPERTY, PROBATE & TRUST LAW SECTION; FELLOW AND REGENT, AMERICAN COLLEGE OF TRUST AND ESTATE COUNCIL, DENVER, CO

Mr. HODGES. Thank you, Mr. Chairman. I have to be sure that I disclaim any attempt here today to talk on behalf of either the American Bar Association's Real Property Section or the American College of Trust and Estate Counsel. My remarks are purely personal.

The CHAIRMAN. Thank you.

Mr. HODGES. I have been in private practice since 1968. And during that period of time, I have specialized primarily in estate planning and charitable gift planning.

And back in the early 1980's, I also became very involved in the use of the Internet by practicing attorneys, particularly attorneys in my area of the profession. And as a consequence of that, I have had hands-on involvement with several websites, including the one that the real property probate and trust law section has on the ABA's main site and the site that the American College has.

As a consequence of that, I have also had occasion to visit many of the sites that the other people here today have spoken about. And I have shared many war stories, if I can say it that way, with JJ MacNab over the last 3 or 4 years about many of these sites. And yet, today was the first time that I have ever met JJ in person. This has all been conducted by electronic mail.

What I think this all shows is that the impact the Internet has today on the proliferation of these tax schemes, scams, and rip-offs is phenomenal. And it is a totally unregulated industry, one that is very difficult to stop unless you have the right enforcement

mechanisms in place through the IRS and the various government investigative agencies to put the people who perpetuate these scams in jail.

It is not that the John Q. Public are the ones that are the victims here, except for the fact that they lose the money. They are the ones that pay the huge fees—\$10,000, \$15,000 for a package of paper that is virtually worthless. And if we do not beef up the enforcement in this regard, I am afraid that tax noncompliance will become the byword of the day.

Interestingly, at least in my profession, the American Bar Association's law practice management section did a study back in March of 2000 called "Lawyers Serving Society Through Technology." And this particular study was a commission that was set up by the president of the ABA.

I outline in my written submission some of the highlights of that report. And I thought I would just mention a couple of them here today, one of which is that there is a distinct possibility that a large segment of the legal profession, mostly solos in small firms, and I myself am a solo practitioner now, could be displaced by competitors providing legal solutions under the category of "legal information services," as opposed to the traditional "legal services" which is what lawyers do.

Perfect examples of this can be found on sites, such as the Nolo Press website where self-help is the byword of the day. People can find all kinds of books and materials there that allow them not only to enter these schemes and scams, but to virtually do every kind of basic legal service that they need without the assistance of proper professionals whether they be lawyers, accountants, financial planners, or whatever.

The report goes on to indicate that legal services seem to be commoditized today and that consumers now have a price choice that is moving away from the traditional hourly rate structure that lawyers are used to and is approaching what they like to call either an option or value-added, flat-fee approaches, such as prepaid legal plans or websites that offer lawyers direct contacts with the public in terms of being able to search out lawyers and what services they offer.

The report also notes that the ethical framework of legal services by the Internet is currently virtually not there. Now, there must be, I think, four or five commissions now in the ABA that have been set up in the last year to tackle that whole issue.

Perhaps, most importantly for lawyers, the report indicates that we are going to face increasing competition from other professionals, including accountants and MDPs which are multiple disciplinary practice firms, many of whom are not subject to the same ethical rules, while the unauthorized practice of law statutes in most States are virtually not enforced. And in some States like Arizona, they do not even exist anymore.

So anyone who wants to get into the business of providing financial products to people and particularly to our elderly citizens is free to do so. And yet, they have no formal training to function properly in that business.

I have also pointed out in my written statement a variety of the living trust scams and schemes that are out there not only in terms

of books, but in terms of presentations and seminars that are conducted, and how these have proliferated in trust kits and all kinds of things that are just virtually useless and people pay horrendous sums for.

Most importantly though, I think that my two organizations that I belong to have finally come around to the fact that they too need to play a role in educating the public. And they are moving in this direction with deliberate speed at this point in time.

The American Bar section that I am in will be meeting here in Washington in 3 weeks to approve the first phase of its public information part of its website. And the American College, although they have been a little slow in the development of that kind of material, does in fact have their practice committee working actively in this area.

And to their credit, they funded a major production for PBS called "Inside the Law." The particular show that they did, it was an hour-long production that was released in May of 2000 called "Death and Taxes, an Inside the Law" special.

And as of our meeting 3 weeks ago, I learned that the foundation has just funded a second video production with PBS in the same Inside the Law series. And this one will target the scams and things that the elderly people have been subjected to.

In addition, interestingly, the California Bar has a wonderful videotape that they did on scams that the elderly are subjected. And I wanted to make sure that the committee was aware of that. They use money that was obtained from a settlement of the prosecution of one of these scam artists to produce the video. So there is a way to spend the dollars wisely.

So at least from my perspective as a lawyer, I think the bar associations and our related organizations do have a proactive role to play. And we welcome that role and look forward to doing it.

[The prepared statement of Mr. Hodges appears in the appendix.]

The CHAIRMAN. We thank all of you for your testimony. We will take 5-minute turns now.

Other than what Mr. Sommers told us, he gave us three ideas that the IRS could do, a strike force to quickly shut down fraud websites, an information front to educate people, and a PR blitz which would be buying advertising against the tax scammers, what more could the IRS be doing to stop these tax frauds?

And I guess an extension of that, what should the IRS be doing to communicate to the public tax professionals and the press about these scams?

Now, I do not think Mr. Sommers needs to answer that. Maybe, all of you do not need to answer, but those of you that have ideas. Mr. Hodges touched on this a little bit with what the bar is doing, but I am thinking in terms of the IRS.

Yes, go ahead if you want to, Mr. Sommers.

Mr. SOMMERS. Well, yes, my presentation really dealt with the web-base, shutting down websites and web-based scams. But what about trust scams that are in operation now? What can they do now to attack these?

Well, every one of these scams has a weakness. They need a bank account. They need a taxpayer identification number.

IRS needs to get control of how they issue these taxpayer identification numbers. They need to make sure that these trustees who often de-tax themselves so that they do not have a Social Security number file with Social Security numbers.

They need to actually have a special unit to go over what trust tax identification numbers are being filed so that they can track those trusts and see if tax returns are being paid.

Also, the other escape these people use is they always open up bank accounts that pay no interest because they do not want 1099 forms from the bank going to the IRS. It seems to me that for trust bank accounts, 1099s should be issued regardless of whether there is interest being paid or not.

In short, the IRS really should follow kind of the "know your customer rules" that apply in the money laundering sense. They should know whether they are creating sham trusts or not or at least be able to track them through the taxpayer identification numbers because that is the entre. That is the ticket into the system. Once they are into the system, they disappear. But they need that access.

The CHAIRMAN. Anybody else?

Mr. Hodges.

Mr. HODGES. I just would suggest that a definite possibility that our section of the American Bar Association get together with the Internal Revenue Service with highly trained professionals and explore perhaps in 3 weeks when we are here for a 4 to 5-day meeting some of the ways that legally at least, we could do this and assist the IRS from our perspective.

I think that would be a very worthwhile meeting. And I would be more than happy to suggest that to our section leaders.

The CHAIRMAN. Maybe, Mr. Rossotti could also respond to that in the next panel.

Ms. MacNab, I think that you wanted to respond.

Ms. MACNAB. In particular, they need to go where the promoters go. They need to beef up their own website.

When I called the criminal investigations division about 2 years ago and asked about pure trusts, I was told that there is a 0.25 million of these plans already in existence. This to me seems to be a crisis.

They do have a criminal investigation website. But when you run a search on pure trust in any of the Internet search engines, the IRS website does not pop up. It is not one of your options. I am sure the computer person here could tell you better.

There are ways to make sure that your website comes to the top of the list. The IRS should be using the same techniques, metatags in particular, to make sure that their website is seen.

If you go through 10 or 15 or 12 pages of different websites, all of which say pure trust works, before you get to the IRS website, how many taxpayers are going to have that kind of patience? So they need to make sure that their website gets seen by consumers.

They also produced a wonderful brochure last year on what is a sham trust, what is an abusive trust, what are the warning signs. It was a wonderful brochure. It had lots of information. I do not know of a single taxpayer that has seen it.

The CHAIRMAN. All right. Did you want to respond, Mr. Bazar?

Mr. BAZAR. One comment or suggestion is that the IRS in their website have an aim more towards people who do not have a law degree. I mean, simplify it a little bit.

The CHAIRMAN. All right. That is very good advice for any government agency. [Laughter.]

Mr. BAZAR. I mean, there are a few standard arguments that all the tax protesters, for example, filing your 1040 is voluntary. I mean, all you have to have is a website that says, you must file a 1040. I mean, very simple things like that, I think that would help greatly.

The CHAIRMAN. All right. This will probably have to be my last question on this first round. To any of you, what roadblocks does the IRS face in going after these tax scams, particularly those on the Internet?

Ms. MACNAB. I will take this one. I think the biggest roadblock is going to be how easy it is to move money around on the Internet, especially offshore. You can move hundreds of thousands of dollars using virtual money right now. And it is totally untraceable.

To give you an example, the con artists are smart. The IRS recently subpoenaed—I believe it was American Express and MasterCard records to find out who had money offshore and was trying to bring it back on by using a debit or a VISA card or a MasterCard.

The promoters have pivoted from that. Now, they issue numbered credit cards. Your name does not appear anywhere on it. It does not appear anywhere in your account statements. How does the IRS know whose card that is?

I think the biggest impediment is going to be getting offshore promoters. It is too easy these days to move money. I have an example in my written testimony about how you can go online and in a period of about 5 minutes, you can sign up for a numbered Swiss bank account with a minimum investment of \$200.

Another website which I actually have copies of the front page of the website in the testimony, offers, I think it is, upwards of 60 offshore tax shelters on their website. All you do is point, click, choose which ones you want to buy, put them in your shopping cart, and check out, just like you are buying books at barnesandnoble.com.

It is very easy. This particular website is located in Cypress. It is easy, but it should not be impossible for the IRS to track these people down.

The CHAIRMAN. Anybody else before we go to Senator Baucus?

[No response.]

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. And maybe, you want to work for the IRS. [Laughter.] I mean, you have passion. You want to stop this stuff.

Ms. MACNAB. We do want to stop this stuff.

Senator BAUCUS. And we all do. And I appreciate the intensity of your testimony and how much this bothers you as a good, red-blooded American citizen. I deeply appreciate it. And I know Americans watching will feel the same way.

Why has the IRS not done more, or other appropriate agencies? I mean, you said, it is a wonderful brochure. Nobody has seen it. You have made several telephone calls. Nothing seems to happen.

Why? What is your best guess? Is this because this is all so new, because it is all so newly complicated? Is it because we need all a whole new sort of paradigm of thinking, a whole new set of laws in this Internet age, that we are not there yet? I am curious. What is the problem?

Mr. HODGES. From the legal side, I think you have made a good point. This is a very difficult kind of business to control. The Internet is a free wheeling environment. And it is worldwide.

And we can pass all the laws in the world, in the United States saying you cannot have sites with this, that, or the other material. And that will not do it because people just move offshore and broadcast it back to the United States.

But you can put I think enough legal sanctions in the law for fraudulent and misrepresentation activities. And those are real. Those are consumer laws. They are in every State in the Nation.

The hard part though is when you have a case like this and you go to your State attorney general. And so you get the answer that was alluded to earlier, that is either, we do not have the resources or the time or whatever.

And unless the thing is so egregious that they cannot avoid it, no prosecutions ever occur and no investigation is ever made. And these things just grow and grow and grow.

And if you do shut them down in one State, then they pick up their stacks and move next door to the next State and start up all over again. They change their name usually so that the identity is not easy to see.

But I think the service is finally after many years of basic no action, began to enforce the most egregious cases. But as JJ alluded to earlier, it takes at least 2 years to complete those investigations before the prosecution starts.

And in one particular case that I am familiar with where the fellow had committed the scams in the United States. It was a pyramid scheme. It made millions of dollars. He took the money down to the Bahama Islands and then was finally through the courts held in contempt and put in jail. He went through 6 months of jail, got out. And he is probably down in the islands again, enjoying his money.

And the court basically told him that he had to tell his trustee to repatriate the money to the United States. And he did not even bother to even try. And he did not have to. If he was willing to sit in jail for 6 months, that was his punishment, if you will, for entering a foreign trust scam like this.

And they count on that frustration. They count on the inability of the IRS or any other treasury agency to chase that money down and get it back once it gets out of the country.

Senator BAUCUS. Mr. Sommers.

Mr. SOMMERS. Senator Baucus, it does require a new paradigm. Again, from my perspective, I come at this from the consumer fraud standpoint. It needs to be stopped now. People are being ripped off paying for these.

IRS, they may not know about it until a tax return is filed 12, 18 months after the scam has even happened and they audit. And so in some ways, it is telescoping this upfront. The Federal Trade Commission knows how to do this.

In my perspective, what these people are doing is no different than selling phony diet pills, phony stock investment, or anything else. It happens to deal with tax.

But it is a consumer fraud issue that they can make lots of money on and get out of town before the ramifications are felt because, again, the IRS looks at it from a revenue standpoint. They need tax returns to audit. They need things to see.

Senator BAUCUS. But with the addition of the Internet, it makes it almost infinitely more difficult from an enforcement point of view.

Mr. SOMMERS. Well, once they get in the system, I think it makes it very difficult. I think the problem is that maybe IRS has waited for these to filter through the system and then make a big bust somewhere, get the records, and prosecute lots of people.

Well, by that time, we think it is too late because these guys know how to fly under their radar. And they have to get them on the front end.

One observation I would like to make here though, I just cannot resist. We are talking about \$300 billion of taxes. And all of us seem to be sole practitioners that are on the combatting side. JJ and I are doing this pro bono. Our websites are all pro bono. We do not make a nickel off of it.

So we have a \$300 billion a year loss in taxes being fought by, we have maybe, five solo practitioners up here who do not make a dime, but we are the ones out on the front line trying to combat these. So it seems like we are a little over matched here.

Ms. MACNAB. We need help.

Senator BAUCUS. Yes. It is not fair probably to make this next comment because we have not yet heard from the next panel. But I am just going to tell you, listening to the five of you, I have the impression that this is virtually unchecked, these kinds of things, whether the pure trusts or the offshore trusts or what not. This is virtually unchecked. I mean, is that an exaggeration?

Mr. HODGES. No. I think that is an accurate assessment, but I think it is also shows the power of education here could be so significant. And it is the ability of the public to understand going in that these are truly scams.

And how do we get that information to them? I think we try every method we can through organizations, through the IRS websites, through the IRS criminal investigation website, and brainstorm all of the public information as we can do it.

We have in Colorado, our attorney general, Gail Norton who is now the Secretary of Energy, produced this little, back-to-back pamphlet, it is called "Consumer Alert: Living Trust Scams."

This was all we could get out of her department when we were trying to just go after the typical, living trust false statements. But this little pamphlet has done more in Colorado to combat this kind of thing than anything else that has ever been produced out of the State bar or the AG's office there. So it can be done. And it is not expensive.

Senator BAUCUS. Go ahead.

Mr. SOMMERS. I just wanted to point. There really is some excellent work being done in this area by the government. It is in pockets. I point to Sacramento where I appeared at a trial of one of these trust scam artists.

And Ben Wagner who is the U.S. attorney there did a great job, secured a huge conviction, just did it again with a lady named Dorothy Henderson who just got 11 years in prison. And he is dedicated. He understands how this works. And the agents up there understand how this works.

They have some excellent people that the IRS could be tapping for my suggested strike force who understand this, who want to go after it, and know how to go after it. Unfortunately, these are criminal trials though. So maybe, part of the Internet is being unchecked, but there is some excellent work being done out there.

Senator BAUCUS. Could you expand on your strike force idea? What would the strike be, do, etcetera?

Mr. SOMMERS. Sure. I am envisioning no more than maybe 10 people, but it is a cohesive unit that can make decisions now. They need to make decisions within hours and days, not months or years.

I envision having two computer programmers searching the Internet daily for new tax scams, for tax scams and things, for spam, for e-mail spam. I expect them to do that in the morning. And at mid-day, they have a meeting with somebody in that room who could make a decision.

If the decision is made that that site should be shut down, letters of cease and desist go out immediately. And there is attorneys as part of that strike force ready to go to court in one or two days if that site does not come down.

I also think that that site should then be listed as suspect sites on the IRS website I talked about so that the public could be alerted as well. I also think anything dealing with that site, any injunctions, anything else needs to be right on that website as well so that these people have a matter of hours after they have been exposed and they are out of business or at least the public knows about it.

And that is my idea in a nutshell. I think when you look at it, it will not cost anything. I mean, you have to understand, these people get into the system and they clog it up. They get the IRS agents, the examiners. They sit there and they frustrate them.

And then, they go to collections. And collections, they try to do offers and compromise it for \$1 and say, gee. They do not tell them that their assets are in one of these trusts. So you have the whole IRS machinery having to deal with these.

The CHAIRMAN. Before you answer that question, the FTC does something similar to that in the areas of their jurisdiction.

Ms. MACNAB. If I can give you an example, 2½ years ago, I turned over all the pure trusts materials on the website to a CID agent. The website is still up and running.

A few months ago, I ran across another fraud on the Internet. It was not tax fraud. It was a sale. And I turned over the materials to the Federal Trade Commission. I went onto their website. I filled out the online form. I sent in all the materials that I had collected.

I got a call within a week. Two weeks later, they had written testimony for me to sign. Within a month of that, I got a phone call saying, thank you very much. My testimony was most effective. They had shut down the promoter.

Senator BAUCUS. Mr. Sommers, in your strike force, you had rattled off a list of very seemingly effective actions that the government could take. Is that available under current law? Can the government do that under current law?

Mr. SOMMERS. I guess you would look at the FTC model. I do not understand how the Federal Trade Commission can fight consumer fraud the way they do. I understand they are so aggressive, they put up phony websites. And then, when people click on them, they say, can you not tell this is a fraud? [Laughter.]

And so I do not know if it needs to be moved to the FTC or not because, again, my perspective is that it is a consumer fraud issue. Whether or not the IRS wants to not collect the tax dollars, I mean, that is a concern obviously to you and to others. But my perspective is the poor person being swindled.

Senator BAUCUS. Have any sites been shut down very quickly?

Mr. SOMMERS. No.

The CHAIRMAN. It might be appropriate for me to ask at this point that there are concerns about 1st amendment rights and the fact that the Internet operates overseas, that this would handcuff the IRS. Do any of you have views on that?

Ms. MACNAB. My understanding is that the FTC has been successful with some overseas websites. Perhaps, the IRS can work with them or learn from them.

The CHAIRMAN. What about any other 1st amendment issues here that come?

Ms. MACNAB. I will leave that to the attorneys.

Mr. SOMMERS. Well, again, I would like to fight the 1st amendment with the 1st amendment and have a website of information that people can find. I see that there should be no problem whatsoever with that.

To the extent that they are advocating illegal activity, there should not be a 1st amendment right. And again, I look at what the FTC is doing. And what is the difference?

The CHAIRMAN. But you are not saying that there is a 1st amendment right to do a sham trust?

Mr. SOMMERS. Unfortunately, I think that is what I am saying, yes.

The CHAIRMAN. There is a 1st amendment right?

Mr. SOMMERS. No, there is not a 1st amendment right to do a sham trust, no.

What I am saying is that this is no different than selling, as I said, phony diet pills, phony stock, whatever. This is consumer fraud. There is no 1st amendment right to go out and commit consumer fraud in any form. This just happens to be consumer fraud dealing with taxes versus any other kind of scam, a pyramid scheme or anything else in my view.

Mr. HODGES. I will second that. I think there is—no, it is just an easy answer. There is no protection in the Constitution for not only fraud, but egregious misrepresentation when it comes to the consumer.

And what is interesting is when we built the website for the American College about 5 or 6 years ago, we put a little part of our public side of that site. There is a quite an extensive private side. And ever since that site went up, there is one piece of material, one page on that site called "Do I Need a Will?" It is an American Bar Association pamphlet. And it has been consistently week after week after week since that site opened the most hit page on the site.

What that tells me, because we do not really advertise the existence of the site, is that the public is smart enough to find good information and to decipher the good from the bad if you just give it to them to read. And that is what I would like to see the American Bar do with its website, tell the truth and help people find the right professional help.

Mr. BAZAR. Can I respond?

Senator BAUCUS. Yes, go ahead.

Mr. BAZAR. I just have one comment. The FBI and the Justice Department set up a website called the "IFCC." It is called the Internet Fraud Complaint Center. This is where consumers can go to make complaints about online fraud.

My experience though with them was I sent in my complaints, the information. And what they did was they just sent it back to the State attorneys general and actually my local police, of all people. And it seems that this, the IFCC was set up to deal with complaints on the Internet. However, they do not really—from my impression, they do not have any sort of meat behind. They are just sort of a clearinghouse.

Senator BAUCUS. Getting at the question I was going to ask, namely, how often have you tried to persuade the IRS or FTC or any other agency to do something about all this? Have you talked to them, contacted them personally? Have you called up Commissioner Rossotti and said, hey, Chuck, we have to do something about this?

I am just curious as to what efforts you have made in dealing with the IRS.

Mr. BAZAR. I have called a few.

Senator BAUCUS. You have called a few.

Mr. BAZAR. I called as I mentioned in the speech. But I have called attorneys general. I have called the IRS. I have written to the FTC, the FBI.

Senator BAUCUS. All right.

Mr. BAZAR. I mean, I have done it all. And maybe, they have an investigation going on so they do not want to come out and do something.

Senator BAUCUS. Yes.

Mr. BAZAR. But my impression is that nothing is being done.

Senator BAUCUS. Ms. MacNab.

Ms. MACNAB. I contacted the criminal investigations division. All they said was give us what you have and we will take care of it.

Senator BAUCUS. Do you have any idea whether anything was done?

Ms. MACNAB. The website is still running.

Mr. SOMMERS. My experience is a little more passive. When people send me e-mails saying somebody is cheating out there, what should I do, I just refer them to the CID website.

Unfortunately, for some reason, you cannot e-mail the CID, the criminal investigations division. They want you to call them on a toll-free number. And I do not understand what that is about. People want to sort of communicate through e-mail and send them information.

You commented on how passionate we are. You should see some of the e-mail that we have received from these folks. And then, you would know what we are up against.

Mr. ADKISSON. If I could address that, Senator?

Senator BAUCUS. Yes.

Mr. ADKISSON. It seems that enforcement effectiveness and what they are doing varies by region. In the California region that Mr. Sommers and I are at, for instance, they have asked us to come and speak to IRS agents. And they have gotten publicity on some of the things they have done. In that region, they seem to have done very well.

In other regions, it does not seem that there is much activity going on. The agents that I have spoken with, it seems that this is a problem that they feel that the Internal Revenue Service is not really asked for, that although this involves an issue of taxation, that it is really a consumer fraud issue.

And although they feel that they have some responsibility over it, it is really not within their learning curve or the learning curve of their agents as to how to deal with this. It really is a very unique problem.

The CHAIRMAN. We have concentrated on two or three people involved in this, the tax scammer, the IRS, but there is a taxpayer. None of you have touched very much on the taxpayer and the impact upon the person that has been caught in this web.

And maybe, it is not fair to say that everybody has been caught is innocent because there are probably some of them that went into it with an open eye that maybe this really was playing the tax lottery in the sense of getting by without paying your taxes.

Any comments on kind of the innocent person that gets hit by this, maybe that went into it really feeling that they say this is legal, so why should I not be doing it?

Ms. MACNAB. Most of the taxpayers out there truly believe that what they are doing works. They do not think they are cheating. They do not think they are evading. They think, hey, this is the way it is. This is the law. And I am doing the right thing.

It is heartbreaking when you talk to some of these clients. And, for example, in the Institute of Global Prosperity arrests, they had a big show on it on CBS. When they were made public, people started coming out of the woodwork.

They are afraid. They do not know how to deal with this. They have somehow cheated the system. And they are going to get caught and they do not know what to do. Do they hide and hope that the IRS does not catch them? What do they do?

I mean, I would love to see some kind of, if not amnesty program, but then direct education program. Let these people know, you screwed up. All right. Let us fix it. Let us bring you back into the

system. We are not going to bite your heads off. We are not going to put you in jail if what you did was unintentional. How about we get you back in the system and get your back taxes and interest due? And if you work with us on this, we will waive penalties.

Come up with something to be friendly about bringing these people back in. There are an awful lot of them.

Senator BAUCUS. So what you are saying is that most of the taxpayers then were gullible in the first place?

Ms. MACNAB. Yes. Many of the promoters are also gullible.

The CHAIRMAN. Some of these innocent, gullible taxpayers I presume have gone to jail for fraud, have they, or at least they have a big penalty?

Ms. MACNAB. The IRS seems to be going after the very, very big ones, the big fish. And I guess they are hoping that sends a message to the little ones.

I have no idea how many people have gone through the system and not gone to jail. I know there have been a significant number of arrests, I think 164 in the last couple of years.

The CHAIRMAN. My point was about the individual taxpayers. Is that what you are responding to?

Ms. MACNAB. Right. Right now, they are going after promoters.

The CHAIRMAN. Yes.

Ms. MACNAB. I do not know how many individual taxpayers have gone through the system yet. I do not think it is priority for the IRS right now. I can only say that from an outsider's point of view. But I think they are assuming that they are going to bring in these big guys. And then, they will go after the little ones.

Senator BAUCUS. Well, does that not make some sense, I mean, just off the top of my head?

Ms. MACNAB. Sure.

Senator BAUCUS. Because after all, there is no criminal intent I would guess.

Ms. MACNAB. Well, why not go after the big ones and shut them down quickly?

Senator BAUCUS. Right. It is the promoters we are after I would guess.

Ms. MACNAB. In the multilevel marketing schemes, it is difficult. You have the top promoters who probably have a pretty good idea of what they are doing. They recruit, say, a dozen people. They recruit a dozen people. They recruit a dozen people.

The people that are in that middle area that are now recruiting underlings truly believe what they are doing, it works. Maybe, the top level people knew that was a scam. The second, third, fourth, fifth, sixth, or hundredth levels do not necessarily know it.

The CHAIRMAN. These are not the people that say that income taxes are not unconstitutional.

Ms. MACNAB. Sure.

The CHAIRMAN. These are people—well, that is what you are talking about as opposed to people that are saying, you do not have pay all your taxes. This is how you can avoid some tax.

Ms. MACNAB. It is both.

The CHAIRMAN. Both.

Senator BAUCUS. And that is why I think this massive publicity to educate people would help a little bit.

Ms. MACNAB. Very much.

Senator BAUCUS. It would theoretically reduce some of the gullibility.

Mr. SOMMERS. You want to shine that light on the problem. We need a path for remedial treatment. And the IRS has to say, look, if you follow this path, you do these, you amend your returns for so many years, you do whatever you have to do to get back into the system.

Right now, there is no path. When people come to us, we say, well, maybe the best we can do is get you a theft deduction for the fee you paid the promoter if you file your taxes voluntarily.

The problem is compounded when there is money overseas and there is money laundering implications and other things that professionals try to help them get their money back into the system to pay taxes.

What we really need is a clear path to say, all right, we are going to shut these guys down, but everyone who wants to come forward and clean up their taxes, this is exactly how you do it and this is what we will expect of you so there is a clear direction.

The CHAIRMAN. Let me touch on one thing that we have not discussed yet. And maybe, I referred to it in my opening comments. And maybe, it is not as big of a problem that we think it is.

But we have a new situation where employers are saying that they are not going to withhold their employee's income and payroll taxes. And obviously, that is unacceptable. But the problem is we have employees choosing between their jobs and their tax man.

What is the panel's thoughts on this matter? Is it a problem? Is it growing? And what about the IRS's response?

Mr. HODGES. If I may say so, I would take as an example the notice 9724 that the IRS put out back in 1997 on sham trusts. For a long time, all these sites were out there. Our clients would come and say, what do you think about this pure trust scheme or whatever?

And we could talk until we were blue in the face. And these organizations tell them, do not believe what your tax lawyer tells you because they are going to try to talk you out of this. And they do not know what they are talking about.

This notice did more for my clients to convince them that the IRS knew about these things and the truth than anything else. Why not do a similar notice tomorrow in this area of the withholding? These kinds of things from the service are very effective.

The CHAIRMAN. Ms. MacNab.

Ms. MACNAB. Your question actually is very good. This is very fairly new industry. If you can nip it in the bud, you can stop this from blossoming like the pure trust schemes. These people, they are not hiding, as I showed earlier, the USA Today has a full-page ad.

They have concerns and they truly believe they have a right to address them. They have asked on numerous opportunities for the IRS to review their materials and tell them they were wrong. Let the IRS do that. If they are trying so hard to get attention, give it to them.

The CHAIRMAN. You have another?

Ms. MACNAB. And this was a full-page ad in which they show three IRS agents who have endorsed their program, three ex-IRS agents.

The CHAIRMAN. One last thing, you may get questions in writing from either of us, but also more importantly because of the bill on the floor, a lot of the members could not come. They are at other committee hearings.

So if you do, and some of you who have not dealt with the Congressional process of a written response, make sure that my staff or Senator Baucus' staff would help you through that process. We would like to have answers in a couple of weeks if we could. Thank you all very much.

Senator BAUCUS. If I might, Mr. Chairman, on this very important subject?

The CHAIRMAN. Yes.

Senator BAUCUS. Did anyone want to say something that has not been asked yet? Or did someone say something so outrageous that it deserves a response? [Laughter.] Here is your chance.

Mr. BAZAR. I just want to comment. You are talking about the average taxpayers getting arrested. And I think that is a big problem. While the IRS probably has limited resources to go out and try to get the promoters, it is still the, hey, my neighbor has not been paying taxes for three years, it must be okay. The IRS is not doing anything about it.

And these people who are starting into it, getting into it mainly over the past few years, they are many, many examples for them to see, for people to talk to that are not paying their taxes and are getting away with it.

And I think maybe there should be some, at least a few arrests. You can put them on the website. People can see, hey, you really cannot do this. I am not a lawyer. I do not know the details of the law. As far as I can tell, there are no examples of people getting arrested.

The CHAIRMAN. Well, maybe, there has been more than one Iowan, but I can only think of one Iowan that for the last 20 years has been bothering me about the income tax being unconstitutional. Now, I suppose there is a lot.

Senator BAUCUS. There are a lot in my State, Mr. Chairman. [Laughter.]

Mr. HODGES. I think also, Mr. Chairman, it would be very important in this whole process as the public becomes more aware if people are caught in these schemes as taxpayers, they need to be treated gently. And, yes, it is a slap on the hand, but let them file the returns and pay the taxes they should have paid, but do not throw them in jail. The people you need to go after are the promoters.

And I think if you have an amnesty program, as was suggested earlier, you might finally find these people coming out of the closet, if you will, and being willing to testify as to how they have been duped. But most of my clients that I know that get into these things are so embarrassed, they do not even want their neighbors to know that they were suckers.

The CHAIRMAN. Would that be a general amnesty program? Or would you direct it towards people that we assume are out there involved in these tax scams?

Mr. HODGES. I would take the narrower approach first and see how well it works. And maybe, you might want to broaden it. There is probably a lot of tax avoidance things that people do because their neighbors do it. And therefore, they think it is legal. And why not?

You look at these websites. They will convince you that this is perfectly legitimate and that the IRS has blessed it. And it is as false as false can be.

Senator BAUCUS. Just one question, Mr. Chairman. The laws, again, are our current laws adequate? Or do we need new laws?

Mr. HODGES. I would not say the current laws are adequate. It is the enforcement of those laws that is important. I do not think we need another whole proliferation of laws. And we have excellent agencies like the service and the FTC who have the powers to do this. They just need to find the resources to pay attention to it.

Senator BAUCUS. Mr. Sommers.

Mr. SOMMERS. Yes. I would agree with that. I think the IRS does have the right to go in and get injunctions. They have started to use that on some of these things. It is too bad it takes so long to build the evidence, maybe as they get used to going in and filing for injunctions.

Again, if we had that strike force concept, you really would want those people to be able to go to court with not a lot of red tape.

Ms. MACNAB. As a non-lawyer, if I can add, there are also certain details that can be done. For example, under current law, you have to disclose whether or not you have any interest, either beneficiary or ownership interest, in foreign trusts.

The promoters say, all right, we are not going to call them trusts anymore. We are going to call them special interest partnerships where they set up foundations offshore. Now, you do not have to disclose it because it is not a trust.

The IRS has to pay attention to such things and adjust as needed.

Senator BAUCUS. What about resources? I mean, we often hear the IRS does not have adequate resources to go after a lot of this.

And I will even step into another old territory. I talked to some accountants who were telling me that the quality of agents at the IRS is probably not what it could and should be. And it probably is because of pay. Whereas, the bright people are on the outside.

And this is hard thing to say, but you hear it. Maybe, there are others in the IRS are maybe not quite as swift as some others. And I know that is a gross, broad statement. But is there any truth to either of those claims that you sometimes hear?

Mr. ADKISSON. I would like to answer that. The IRS is trained. And their agents are trained to do a very specific thing which is to review tax returns, check deductions, things like that.

This is fraud. Although it is tax fraud, it is really fraud, fraud. And to take people that are trained to do more accounting and tax return sort of work and to send them out, chasing people that are hardened, usually have very long criminal records or hardened scam artists in my opinion, is asking the IRS to do something that

it is just tasked for. And I think that has been a very significant problem.

Senator BAUCUS. Thank you.

Mr. HODGES. I would just add as a supplement in terms of resources. Follow the example in California where they went after this group. They got a judgement against them. And they took the money from that settlement and have done very positive things with it.

Maybe, that is the way you can finance a lot of this investigation. It is a little bit after the fact, but it is better than nothing.

Mr. SOMMERS. I think the problem with resources I have is you cannot calculate the amount of money being wasted now through the audit system, the collection system, and all the IRS personnel when these guys get into the woodwork.

I mean, they are dedicated to just grinding that machinery to a halt. And that has to cost enormous sums of money. Every document needs to be subpoenaed. You need to go to court all the time. They are selling stonewalling the IRS. And they will get away with it because the IRS will give up.

And also, just the educational aspects of trying to train all these agents to find it. That is why if you treat it as a narrow specialty and attack it from Washington, it just seems to make a lot more sense to me. And I think you would save. It will not cost money. It will save money.

Senator BAUCUS. Thank you.

The CHAIRMAN. Thank you all very much. Senator Baucus and I appreciate this grassroots information we get from people that are specializing in it. And more importantly, thank you for your altruism of trying to help the innocent taxpayer. Thank you all very much.

And I will call the second panel now. First, we have Charles Rossotti, Commissioner of the Internal Revenue Service. Next, Hugh Stevenson, Associate Director for Planning and Information, Bureau of Consumer Protection, the Federal Trade Commission. And then, Michael Brostek, Director of Tax Administration and Justice Issues at the U.S. General Accounting Office.

And we will start with Hon. Charles Rossotti.

**STATEMENT OF HON. CHARLES ROSSOTTI, COMMISSIONER,
INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Mr. ROSSOTTI. Thank you, Mr. Chairman and Senator Baucus. I appreciate the opportunity to be here. And I especially am pleased that you decided to hold this hearing on this very important topic. I think of this as what I call organized tax evasion.

I think it is very essential for the majority of taxpayers who are honest and pay what they owe under the law, that they have confidence that their neighbors and competitors are playing by the same rules. And I think that is what this is all about.

As the earlier panel noted, today, in a wide range of guises, there are individuals and organized groups attempting to mislead or entice taxpayers into believing that there is a way out of paying taxes.

Some of these groups use the Internet to promote or advertise their schemes. And these range from complex and prepared pack-

ages of documentation involving trusts and offshore bank accounts to more simple, but false arguments claiming that businesses do not have to pay their employment and withholding taxes.

So far this year, the IRS has issued two nationwide alerts warning taxpayers not to fall victim to a number of these scams. And some of the things that were mentioned in these alerts include such items as tax credits or refunds related to reparations for slavery to illegal ways to “un-tax yourself.”

One of the schemes that I think that you just noted, Mr. Chairman, that has received a considerable amount of publicity recently is aimed at telling employers that they do not have to withhold Federal income tax or employment taxes from the wages paid to their employees. We have made some publicity efforts around this topic. Taxpayers can get more information about this particular bogus scheme by simply going onto our website at irs.gov.

In terms of practical impact (there were some numbers thrown out earlier about revenue loss) the most important of these various tax schemes are those that try to sell packages to upper income taxpayers which claim to permit income taxes to be reduced or eliminated.

Essentially, these packages use a flurry of paper work involving domestic and offshore trusts and foreign bank accounts in most cases to appear to move income into tax-free countries or legal vehicles, while still allowing the taxpayers to maintain effective control over their funds.

And we have a chart that we are going to put up here that shows you. I am not going to run through it. Another one of your witnesses showed something similar.

Again, it shows the kind of flurry of paper work involving various entities and offshore bank accounts in most cases that are used to give the appearance that this money is being put in such a way that will not be taxable. And yet, the taxpayers actually maintain control of it.

Most of the people that buy into these particular kinds of schemes are upper income taxpayers, professionals, and business persons with at least six-figure incomes.

The promoters run a wide gamut from bankers, to convicted con men that are just going into their latest con, to crooked return preparers, to Americans living overseas who make a living selling services in connection with these schemes.

The IRS first became aware of the emerging magnitude of this particular problem in 1996 by an individual named John Mathison who was an owner of a bank in the Grand Cayman Islands. He began cooperating with Federal authorities in providing extensive financial information on hundreds of individuals who appeared to be engaging in ongoing tax fraud.

In April 1997, as was noted by an earlier witness, the IRS issued an official notice publicly cautioning taxpayers to be wary of trust arrangements that were promising benefits that are not allowable under the tax laws.

Although we have no really accurate measure of the size of this problem, we do have enough information to know that it is a major problem. One respected expert on offshore tax havens and money laundering, Mr. Jack Blum, has made estimates that there are \$3

trillion of assets in tax haven banks and that the annual revenue loss to the Treasury is at least \$70 billion a year.

As another indicator, on October 27, 2000, as part of our enforcement efforts, we went to U.S. District Court in the Southern District of Maryland and got authorization for the IRS to examine banking records of tens of thousands of U.S. persons who had offshore accounts in the Caribbean, most of whom had not disclosed these accounts to us as required on their tax returns.

With our new organization and our strategic plan in place, we are now able to be much more effective in combating this threat with a coordinated strategy that involves a full range of tools ranging from public education—it is very important letting the taxpayers know and warning taxpayers—to both civil and criminal enforcement against both promoters and participants in these schemes.

In terms of public education, we have issued a number of press releases and alerts to the public and to practitioners who can use them in educating their clients. These include the “Too Good to be True” trust brochure.

We also constantly post educational material on our website which is now receiving over 2 billion hits per year. It is a very popular website. And we are now noting, as is displayed here on some of the charts that are up to your right, some of these schemes.

In terms of going where the taxpayers are, we recently opened up a specialized part of our website for small business and self-employed taxpayers. This provides one-stop information to them for assistance in complying with the particular obligations that they have.

But we are also using this since it is a draw for these kinds of taxpayers to include warnings and examples of what to be wary of. This is shown on the first page of the chart in front of you.

Another important new initiative to identify these particular kinds of schemes is our new K1 matching program. Beginning in 2002, we will begin processing matching K1s reporting over \$700 million of income and also importantly reported losses on trusts and pass-throughs. This will help us to find problem cases and, of course, to follow up on audits when necessary.

We have also developed in the last year some specialized training program for our agents on these trust-related topics and begun active investigations, especially focused on promoters. We are currently auditing 17 promoters and 161 different abusive schemes for not only investigation, but possible injunctive action.

Earlier this year, we received one permanent injunction against some promoters. Also, a \$1.25 million penalty was assessed in this case. Another two injunction requests are currently pending before district court.

On the criminal side, the IRS investigations unit has already obtained 117 convictions of individuals on illegal trusts and has another 135 open investigations involving about 65 promoters.

And most recently, on February 28, 2001, our criminal investigation unit conducted the largest and most extensive enforcement action in the history of the IRS, including three dozen search warrants, involving suspected promoters of fraudulent trust schemes.

I also want to note for the benefit of those taxpayers and potential promoters who might be listening to this that the penalties for engaging in these activities for promoters and investors can be very stiff. Civil fraud can include a penalty of up to 75 percent of the underpayment of tax that is attributed to the fraud in addition to the taxes owed.

And for those who really promote these schemes, the penalties can be quite lengthy. We recently had 1 prison sentence of 11 years imposed against an individual that was promoting these schemes.

So Mr. Chairman, in conclusion, I want to assure you that we are very much aware of this problem. We have identified it as a key item in our plan to combat basically all these forms of what I call organized tax evasion.

We are definitely focused on this from both the point of view of public education and enforcement. I will say that the whole idea of public education as a key tool for the IRS is not one in the past was given as much attention as we feel it needed to be.

If you have read any of the things that I have said and we put in our plan, this is a key area of expansion for us. In listening to the earlier witnesses, we got some ideas of some things that we can do more effectively on this front. We will certainly use these ideas to help us improve what we are doing.

I also want to note, as you noted in your opening, Mr. Chairman, that we are focused on both effectiveness and fairness. These are the twin watch words.

We do not want to fall into the trap where we get so focused on just action without making sure we respect the rights of taxpayers that are required by law. We are not going to forget about that part of it either.

We are basically aiming at using all the tools at our disposal to warn the public to try to prevent these problems and to use our enforcement tools effectively in a focused way for those that are actually promoting these kinds of schemes.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Rossotti.

[The prepared statement of Mr. Rossotti appears in the appendix.]

The CHAIRMAN. Now, to Mr. Stevenson.

**STATEMENT OF HUGH G. STEVENSON, ASSOCIATE DIRECTOR
FOR PLANNING AND INFORMATION, BUREAU OF CONSUMER
PROTECTION, FEDERAL TRADE COMMISSION, WASHINGTON,
DC**

Mr. STEVENSON. Thank you, Mr. Chairman. And we very much appreciate this opportunity to talk about the FTC's approach to consumer fraud on the Internet. The Commission has submitted written testimony. I would be glad to answer questions about that. And I also would just like to hit the highlights here.

As we have heard already, what the Internet provides hucksters is this instantaneous, global reach, and the ability to inflict large scale consumer damage very quickly.

To respond effectively as law enforcers and especially one of the smaller law enforcement agencies, what we need to do is to be able to move at a quick-step pace and to be able, as we have heard from

some of the earlier comments, to work across borders in what is a global marketplace.

To do this, at the FTC, we have developed a systematic approach that involves both teamwork and technology. And let me highlight four components of that. One is a system to handle consumer complaints. A second is a system or strategy to monitor the marketplace for the claims being made. A third is strategy for aggressive and cooperative enforcement. And finally, there is the strategy for consumer education.

On consumer complaints, what we did first was get organized about handling the information that consumers were giving us about consumer fraud. We set up a consumer response center. In the first couple of weeks, we handled a couple of hundred calls. We are now up to about 50,000 consumer contacts of various sorts every month.

We set up a toll-free line. We set up and developed a computer system to handle the evidence that consumers were giving us about the frauds they were experiencing. We set up a web page for filing complaints right online.

And then, what we have done is once we get the information that we have, we combine that with the complaints that other folks collect. And in this, we have a number of partners, the Postal Inspection Service, the Better Business Bureau, the National Consumers League, a project in Canada called Project Phone Busters, Social Security's IG's office.

We combine all of those complaints in a project we call Consumer Sentinel. And then, what we do is we work that data. Internally, we have staff doing preliminary investigative reports and trends analysis. We have attorneys and investigators ready to do what we call rapid response cases.

And we have a couple of examples. One example in our paper is a verity case, an example of what this permits us to do when we use this systematic approach. What happened there is got a spike of about 600 complaints that just came in all in a bunch. The data analysts spotted it. The attorneys and investigators started working the case, getting declarations. And we were in court within a week or two.

And not all of our examples are that dramatic. But I think what we have seen quieter ways is an improvement in the speed at which we can respond which is one of the key elements in dealing with the Internet pace of fraud.

That case involved, I should say, people that were visiting particular websites and unbeknownst to them got their modem connections switched and as a result found that they had a long distance charge for a call to Madagascar which is sort of an illustration of the international component of this too.

Externally what we have done with this consumer sentinel system is to share the information out to the other consumer cops on the beat, so to speak, to support the cases that they are bringing. And we have 300 organizations in the United States and Canada and now Australia that have signed up for this data-sharing project, including the IRS, CID folks, data available through a restricted access law enforcement website.

We had built on this technology to include identity theft complaint information. We have a project with the Department of Defense called Soldier Sentinel to collect information in that way as well.

Now, the second component of our systematic approach is to use the technology and teamwork to monitor the market claims. We have done surf days, I think someone referred to earlier. I think we have done 26 of these and now with domestic and foreign agencies.

What we are doing is we are looking for particular kinds of suspect claims in a systematic way. Then, we follow up with e-mail warnings. And then, we follow up after that with possible law enforcement action.

We set up an Internet lab so that we can see the consumer's eye view of the market and also so we can turn what we are seeing into evidence so we can use in court. We have done Internet training in the United States and abroad. We trained 800 people from various agencies. I know that IRS folks have participated in a number of those trainings.

On the enforcement front, the FTC has brought approximately 170 cases involving Internet fraud of some sort against more than 500 defendants and recovered and redressed more than \$50 million, and a lot of that involving pyramid schemes which are one of the things that has proliferated in the new medium.

We have also used the web for consumer education. We have set up I think what we call the teaser sites where the websites are mimicking some of the suspect claims that we are seeing out there on the web. And it leads the consumer into the consumer education that they need to get in that scenario.

Finally, I would mention that we are also working on the international front. What we have seen that an increasing number of cases we are bringing has some international component, money offshore, defendants offshore, some international participation in some way.

And what we have done to address that is efforts on the litigation front. And I know we have consulted with the IRS folks on some of their experiences in offshore asset issues.

We have also worked on cooperation. We have done bilateral cooperation agreements with our counterpart agencies in Canada, Australia, and the U.K. We are working on a multilateral coordination as well through various venues, including what we call the international marketing supervision network in attempt to address this part of the problem.

So that is our start on enforcement for the Internet age. I would be glad to answer any questions. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Stevenson appears in the appendix.]

The CHAIRMAN. Now, Mr. Brostek.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ADMINISTRATION AND JUSTICE ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. BROSTEK. Chairman Grassley and Senator Baucus, I am pleased to be here to join the committee as you address a number of issues related to the role of IRS in enforcing the tax laws. As requested, I will discuss two topics, the relationship between IRS' audits of taxpayers and other programs they use to ensure that tax returns are filed and they are filed accurately and how IRS is managing the increased workload in two of its programs, offers and compromise and innocent spouse claims.

IRS' audit rate has declined substantially in the past few years. And this has received a lot of public coverage which raises a question of whether those declines in the audit rate are in some sense encouraging more noncompliance. The fiscal year 2000 audit rate was about 0.5 percent. And that was more than 70 percent below the 1995 rate and 45 percent below the rate for 1999.

Audits, however, are not the only tool that IRS uses to enforce the law. And as the table on the easel shows—and it is table 1 on page 4 of the testimony, it would show up better there—IRS performed about 238,000 field audits, face-to-face audits last year and about 380,000 audits through the mail, for a total of around 618,000. However, there were in contrast over 8.3 million total contacts with taxpayers under the other major programs that IRS has to enforce the law.

Also, as the first line of the table shows, 100 percent of taxpayers' returns are actually screened by IRS in some sense to identify those that should be followed up on.

These statistics demonstrate IRS' presence in enforcing the code and ensuring that taxpayers file accurate returns—it is much broader than is reflected just in the audit rate. However, the other programs that are used cannot actually substitute for audits.

These programs are reliant on information reported to the IRS by the taxpayers themselves and by third parties, such as employers, banks, and other financial institutions. Consequently, audits remain the primary tool for IRS to use in ensuring the accuracy of returns filed by taxpayers whose income or other characteristics are not subject to computerized checking.

In part, because audits are such an important tool, the decline in the rate raises a legitimate concern about possible adverse effects on the compliance levels in our system. Unfortunately, neither IRS nor anyone else knows the effect of these declining rates on voluntary compliance because we have not had a measurement of voluntary compliance since 1988.

Such a measure is key not only to determining whether compliance is declining, but in determining where it may be declining, such as in the areas we are talking about today, as well as how IRS may be able to address those declines.

For example, in its earlier studies of voluntary compliance, IRS reports that information was useful in better targeting its audit and enforcement efforts, in identifying areas in which forms and instructions might be changed, and even cases where statutes might need to be changed or clarified.

Two programs that are using resources that are normally devoted to audits or collection activities are the innocent spouse and the offers in compromise programs. Both of these programs have experienced a very large increase in their workload since the passage of the IRS Restructuring and Reform Act in 1998.

A significant part of IRS' response to that increase has been to shift staff to these programs from its other auditing and tax collection functions. These shifts are cited by IRS as part of the reason for the decline in the audit rate and in such things as use of liens and levies.

In addition to shifting staff, however, IRS has taken a number of steps to deal with the workload that has arisen in these programs. Regarding innocent spouse claims, IRS is essentially processing many of those claims centrally and has implemented a new case processing system that standardizes the questions that are asked of taxpayers and the documentation that is maintained for the case.

In addition, for innocent spouse, the workload seems to have become fairly stabilized. And therefore, IRS may have an opportunity to begin working down the caseload in this area and to free-up staff that could be shifted back into auditing activities.

The offer in compromise program is far less along in gaining control over its workload. The offer workload has increased by 83 percent in the past 3 years. IRS is just beginning to take steps, such as centralizing case processing into two centers.

If IRS is successful in improving its handling of the cases in these two programs, it may be able to redirect some of its resources to the kinds of things that are being talked about today to better enforce the law. However, given how recently these changes have occurred in the programs, it is not clear at this time whether IRS will be successful in working down those case inventories.

That concludes my statement. I will be happy to answer questions.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Well, we thank all of you. Before I start with questions, we have a person who was appointed by President Clinton to the IRS oversight board in the audience. And I want to thank Mr. Steve Nichols for attending this hearing and for his good work on the IRS oversight.

Would you stand, Mr. Nichols, so you can be recognized? Thank you very much. I appreciate that.

Mr. Rossotti, we have heard some very strong testimony. The IRS, of course, is kind of caught in the middle in some respects. It enforces the law, but the IRS also has to protect honest citizens from tax scam artists.

And nowhere is that more true than where the employers are being told that they are not going to have to withhold taxes. We have heard today some of the things that the IRS is doing. And I should commend the IRS for those efforts and for the fine work of many dedicated IRS employees. And so rhetorically, I am going to ask, is that enough?

But then, let me go on to ask the real question. Does the IRS need to be out there sooner and faster? Should the IRS be actively

finding scam artists as quickly as possible before the scam artists in a sense find and fleece the honest taxpayer of thousands of dollars?

Mr. ROSSOTTI. Yes, Mr. Chairman. We need to be aggressive and faster on the draw in a lot of things that we do.

Specifically with the Internet and some of the scams that proliferate, I think some of your earlier witnesses came up with some good suggestions on how we could improve in this area. I think the first step is to be active ourselves on informing the public, warning the public, and using a channel, such as our website and other channels to do that.

On the employment tax schemes that you mentioned that have begun to get a lot of publicity, we have been active. This is a notice that we put out specifically on employment tax schemes. And there have been a number of TV programs this week, a TV program that I was on that was specifically on this subject.

So I think using public education vehicles more aggressively is one of the things that we can do better. And it is one of the major strategies that we have. Historically, these vehicles were not a high priority at the IRS.

In the last 2 years, we have added some more resources to public education. I think even though it takes a little more resources, warning the public is the most efficient thing we can do.

I think one good thing about the American taxpayer is that they have common sense. They are pretty smart most of the time. When they see something that is too good to be true, with a little help from us, they will figure it out. So that is step 1.

Then, the other side, of course, is using our enforcement powers to find the promoters. It is important to note that with respect to the Internet, there are some aspects about taxes that we have to remember, such as taxes are a political subject, as well as an item that could be thought of in the same context as a consumer issue.

In other words, there are many people around the Internet that have strong opinions about taxes. They are allowed to express those opinions. They are even allowed to say that they think the tax system is unconstitutional.

Congress recognized that point explicitly in the restructuring act with section 3707 which made it illegal for us to designate anyone as a tax protester. We do not even use that term anymore.

People are allowed to protest; Congress has recognized that. If all they do is advise people or claim their opinions, no matter how wrong they might be, they are allowed to do that.

Where our authority comes in and where we are focusing is when they go beyond just expressing an opinion and try to actually sell something to a taxpayer. There are sections of the code that give us the authority to get an injunction if somebody goes beyond putting something out and making an opinion and goes and tries for example, to assist someone in preparing a return or sells a product that is aimed at enticing people into an illegal kind of a scheme.

And that is what we call our promoters. We have a lot of our efforts on both the civil side and the criminal side directed towards finding those promoters. It really is more going after the promoters on the website because anyone can come up and shut down one

website and put up another website. That does not take anything much.

Again, we can actually go after promoters and either get an injunction against the promoters in some cases or put them in jail which is what we are actually doing in a number of these cases. I mentioned statistics, 117, I believe I said, that have gone to jail. Then, we have a more permanent effect we think.

So what we are trying to do is to be much more effective on the public education side. There are certainly things we can do to improve our website, although it already gets 2 billion hits. In fact, a few of your witnesses came up with some ideas that we were writing down. We are going to follow up on those suggestions.

Again, public education is only one half. The other half is really going after the promoters and using all the tools that are at our disposal to do what we can to shut them down.

The CHAIRMAN. Is it possible that the IRS could adopt some of the successful strategies that agencies, such as the SEC and the FDC have had in quickly shutting down Internet websites?

Mr. ROSSOTTI. We have recently begun to consult with these agencies to find out more about these. I think Mr. Stevenson had some comments here about how effective he has been with getting consumer complaints in.

We have an ability to register complaints. We have a hotline, but it is a telephone line right now. We could certainly enhance that to take that kind of information over the website.

The precise authority to actually shut down schemes may be somewhat different in the tax area than it is in other consumer areas. But I think there is some very worthwhile things that we can do, like consulting with our colleagues here and finding out more about their techniques.

The CHAIRMAN. Well, let me ask you, do you need more authority or you do not know yet?

Mr. ROSSOTTI. Well, I do not think we know yet. We do have authority to shut down schemes through the tax shelter regulations and the injunctive authority. And we have used it, as I mentioned. And we got about 17 more of those that we are looking at.

I am not sure if there is anything more that we would need to do to cover specifically websites. We need to work on that a little more before I can say.

The CHAIRMAN. Two suggestions and then I will go to Senator Baucus. Number one, I think it was Mr. Sommers or maybe it was not him, but one of the witnesses. And I think he referred to it this way, you spend a lot of time going through hour after hour stuff on the website to find the information. If it were possible, and I think the implication was that it is possible, for the IRS to make sure that their information pops up first. Is that something that can be done? Or is that something that is costly?

Mr. ROSSOTTI. That is one suggestion that I think we need to look into and see if we can do something with it.

The CHAIRMAN. All right.

Mr. ROSSOTTI. I think there is good potential there.

The CHAIRMAN. Yes. And then, what about the other offer from the two lawyers that were on the first panel that they and maybe some other people would sit down from a legal standpoint and work

with you as a practitioner or people that are in this area? And they referred to an opportunity to do that maybe in a couple of months when they were going to be in town for some professional meeting.

Mr. ROSSOTTI. And also, another good suggestion. We also work closely with the bar association on many things, as well as other practitioner groups. By the way, 55 percent of the taxpayers in this country do have their returns prepared by a preparer and even over 80 percent for those in the upper income brackets.

So that is one of the really important strengths of the tax system in this country. To the extent that we can work with these preparer groups more effectively on this particular issue, that is definitely a positive thing. And I did hear that suggestion. And we will take them up on that.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Earlier, you mention, Commissioner, about K1s and other important techniques to try to get a match and so forth. But is it not true, at least according to the earlier panel, that a lot of these people are not going to get caught with K1s? That is just pretty garden variety stuff, K1, compared with the sophistication of what a lot of these people are doing.

Mr. ROSSOTTI. There is no question. But if you end up with one of these trust schemes like this for at least many of the people, especially the upper income people, they do file a 1040. And what they do, through these various flurry of paper work, is come up with something that offsets the income or moves the income.

And they may file a K1 if they actually have a trust. That gives us a clue. It is not going to enable us to do anything directly, but it may help us and we think it will help us to identify some of the cases that we can then follow up on more specifically. It is just one technique. It is not a solution.

Senator BAUCUS. I understand.

Mr. ROSSOTTI. But it is a technique to potentially find—

Senator BAUCUS. I understand. How many people do you think are out there in the category of promoters or maybe sub-promoters who are essentially perpetrating these schemes and basically ripping off the American legitimate honest taxpayer? How many do you think there are, just a rough guess?

Mr. ROSSOTTI. I really do not know. I do not know how many promoters there are. I will say though that we think that—some of them are informal networks of promoters.

Senator BAUCUS. Well, you can give me a definition if you want. Just what is your sense of the magnitude of the problem?

Mr. ROSSOTTI. In terms of the number of promoters, I really do not think I can give you a reliable estimate.

Senator BAUCUS. I am not going to hold you to it, just a guess.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. Are you talking about 10?

Mr. ROSSOTTI. Oh, no.

Senator BAUCUS. Are we talking about 1,000?

Mr. ROSSOTTI. There are definitely hundreds if not thousands of serious promoters. There is a lot more than that that are fringe elements if I can call them that that are just—

Senator BAUCUS. Let us just take the 1,000.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. All right. What are you doing about those 1,000?

Mr. ROSSOTTI. Well, that is where we are putting most of our investigative resources on.

Senator BAUCUS. How many of those 1,000 have you actually arrested?

Mr. ROSSOTTI. Well, we had, 117 convictions over the last few years. And we have 135 investigations.

Senator BAUCUS. All right. Over how many years?

Mr. ROSSOTTI. This is over about the last 2½ years since we have been really—

Senator BAUCUS. Those 117 were for what?

Mr. ROSSOTTI. They were mostly promoters touting illegal trust schemes. We have 135 open investigations right now.

Senator BAUCUS. I do not mean to give you a hard time, but do you think nevertheless that it is still a significant problem or not?

Mr. ROSSOTTI. It is absolutely a significant problem. And I think that one of the issues that is problematic is that we do not have a good handle on how significant it is. Clearly, part of the problem is identifying the people. And then, the other is actually doing something about it.

Senator BAUCUS. Do you have a plan as to when you think you will have a handle on this and get it under control? I mean, is it a 1-year plan? Is it a 5-year plan? You must have some kind of a plan so there is a beginning and an ending to try to get a hold of this thing, do you not?

Mr. ROSSOTTI. Well, I think when you say a plan with an ending, that is where I would be—

Senator BAUCUS. With benchmarks.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. I mean, first, you want to get a plan to figure out how many characters are out there.

Mr. ROSSOTTI. Right.

Senator BAUCUS. And then, by what date you are going to begin to get so many brought to justice so that you get that number down and so that the fraud, the amount of dollars that the American taxpayer is defrauded is down to an acceptable level.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. But you have to have some plan, do you not?

Mr. ROSSOTTI. We definitely have a plan to attack this, but I think where I might have to be a little more cautious is saying that there is an end point. Many of these kinds of schemes, as I think one of your earlier witnesses stated, has been going on for years. I mean, they come up and go.

As long as there is a complex tax system, there is going to be different varieties of scams. I do not think we will ever get to an "end point." I think we will be perhaps more or less effective at shutting down some of these.

Senator BAUCUS. There are estimates between \$70 and \$300 billion a year. What is an acceptable level for you?

Mr. ROSSOTTI. Well, I do not think there is anything that is acceptable.

Senator BAUCUS. Well, I will be honest with you, Commissioner. In listening to you, it kind of sounds like, well, you know, there is a problem. We will deal with it. There is always going to be a problem. It sounds to me like there is always going to be \$70 to \$300 billion in listening to you.

Mr. ROSSOTTI. Well—

Senator BAUCUS. All right. How are we going to get a hold of this thing?

Mr. ROSSOTTI. All I can really do to respond to you is to say that we have identified this as one of the key priority areas for our whole enforcement program, this area of illegal trust and schemes.

We are putting resources into it to learn more about the magnitude of it and shut people down as fast as we can go and also warn the public about it. Those are the three things.

Senator BAUCUS. All right.

Mr. ROSSOTTI. As we learn more about it, I think we will be able to be more responsive to your question about how we can get this down. I just do not want to make unrealistic promises.

Senator BAUCUS. I understand. But I am a little concerned when I hear, for instance, like, well, gee, that is a good idea. That is a good suggestion the FTC gave. Or that is a good suggestion that the earlier panel made.

My thought is, well, why have you not thought of that beforehand? These are pretty basic suggestions that they had here today. It just sounds like, to be honest, we are a little behind here.

Mr. ROSSOTTI. Well, I will say that we started on this program in a serious way probably almost 3 years ago. We put the first notices out. We had these things up on our website. We have had convictions of these promoters. We have had just recently the largest law enforcement action in the history of the IRS.

So I do not think that we have been failing to be aggressive about it. But I would also have to acknowledge that we can learn more. We can do better.

Senator BAUCUS. But this hearing is being televised. There is probably millions of people watching. What can you tell them to ensure them that they cannot get away with this stuff?

Mr. ROSSOTTI. Well, I think that one point that I think is very important to get across is that these schemes are not a good bet for the average taxpayer.

And notwithstanding whatever problems we may have and the speed with which we may get certain cases which is always going to be somewhat limited, it still is not a good deal for the average taxpayer to take a chance on trying to get away with one of these things.

As the other witness said, there are many different vehicles that we find to identify problems. Sometimes, it may take a little while, but we often get around to them. And the penalties are very, very stiff. I mean, the down side for this for both taxpayers and especially promoters is pretty serious in terms of civil fines, as well as criminal penalties.

So I have often said, if you want to gamble, you are better off to go to the casinos and take your chances there than taking your chances in one of these schemes.

Senator BAUCUS. Is it for IRS to enforce the problem? Or is it more FTC? I mean, it sounds like, according to the earlier testimony, it is kind of mixed here. Maybe, things fell through the cracks. I do not know. And one witness thought that the IRS is not really geared very well towards enforcement against these kinds of problems or the agents are just trained to do certain things a little bit different.

Mr. ROSSOTTI. Well, I think I would disagree with that. I think we have different kinds of agents. They are trained to do different things. In terms of finding these promoters in these deliberate schemes, we do have a criminal investigation division which is trained precisely to find these kinds of folks and put them in jail. And that is what we have been doing.

We are focusing more of their attention on these kinds of schemes. So I think they are very effective as a matter of fact. They are really pretty well recognized throughout the Federal Government in finding people who propose financial frauds.

Where historically I think the attention of the IRS has been less significant is on the public education side. That has not been as heavy a priority as it should be.

And we have taken some significant steps to upgrade that, to improve that. The web is one of the positive vehicles for education. There have been over 2 billion hits.

Senator BAUCUS. Of the 2 billion, how many of those 2 billion were aimed at your fraud subsection?

Mr. ROSSOTTI. I do not have that number. We could try to get that for you.

Senator BAUCUS. And one of the earlier witnesses suggested that she searched the web a couple, three times a day. Do you do that?

Mr. ROSSOTTI. Well, I think the problem that we have is that just searching the web and finding schemes is a relatively small percentage of our problem. Our problem is much more. We have a lot of information from a lot of sources on where these schemes are.

I do not think that is our bottleneck. I think our bottleneck, if you want to call it that, is reacting and doing the investigative work to actually find enough evidence to deal with the schemes. So we could certainly do more.

And we have done a significant amount of monitoring every day. We do a significant amount of monitoring. We could do more of it. But I have to honestly say that I do not think that is where our bottleneck is. I do not think that identification is our limiting factor.

Senator BAUCUS. I am sorry. The bottleneck, you think is where?

Mr. ROSSOTTI. It is the investigative and follow-up. That is the time consuming part.

Senator BAUCUS. Do I have to turn it over here?

The CHAIRMAN. Go ahead.

Senator BAUCUS. Why is that a bottleneck? What could be done to widen the neck of the bottle?

Mr. ROSSOTTI. Well, the point is that just finding somebody who is making some claims over the Internet is not something that we can do anything about. People can put up things on the website. They can do that no matter how much we disagree with it.

We have to get to the point where we find that they are actually following through with tangible action, such as helping people prepare returns or actually selling information. Sometimes, they are doing that directly over the web. But oftentimes, they are just advertising on the web.

Senator BAUCUS. Let me just read—we have a copy of a site here. I will mention the name. But it is pretty stunning, the claims here. It is not just saying, hey, we will lower your taxes.

It says, “We offer complete eradication of probate, gift, estate tax, inheritance, transfer taxes, reduction to near zero rates of Federal income taxes and State income taxes regardless of the country of origin, complete escape from Social Security taxes, capital gain taxes, Medicaid taxes, escape VAT, escape the ravages of loss,” etcetera. “In our entire history, we have never had a member suffer losses tax wise, legal wise, otherwise, money wise, or otherwise as a consequence for using our techniques. Privacy policy, WE HAVE NEVER PROVIDED THE CLIENT MEMBER INFORMATION TO ANYONE AND WE NEVER WILL.”

Now, that is going to raise a red flag.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. Now, that is the kind of site, hey, we are going to go and track those guys down.

Mr. ROSSOTTI. Yes.

Senator BAUCUS. What do you do when you see a site like this?

Mr. ROSSOTTI. Well, I think again I have to go back to the basic point though. I mean, anyone is entitled under the law to make any kind of false claim, unless we can establish that they have actually sold something to somebody that caused them to file false tax returns.

There is a significant amount of fact gathering and investigation that is required before you can go to court which is what you would have to do and convince a judge to give you an injunction. We cannot simply go in and say, we think these people are misleading the public and therefore we are going to shut them down. There are many websites that mislead the public, but we do not go in and shut them down.

Senator BAUCUS. If you would see this in your search, what would you do when you see this site?

The CHAIRMAN. We would like to have, if the same question was asked to you about an issue, a website that was not a tax area. Now, there may be a law that—I hope there is not a law that applies to this information of taxes versus a non-tax area.

But how would you respond to that, the very same question that Mr. Rossotti got?

Mr. STEVENSON. What we have done in some of these surf days where we are looking possibly suspect claims in a particular areas—

Senator BAUCUS. How many—

Mr. STEVENSON. I think we have done 26. And we have done these in cooperation with various agencies depending on the topic and whether their jurisdiction covers it on various issues, credit repair, get rich quick, multilevel marketing and the like.

And what we have done in general terms is we have surfed with partners, looked at using sort of the certain terms that may come

up in those kinds of sites, identify the sites that seem to be problematic, and then depending on the subject again, send them a warning notice or even a message telling them about the relevant law and saying that you may need to determine whether this is in compliance with that law.

And what we have done after that is gone back and checked to see, well, what happens to those sites. And we find that a certain percentage of them then go down either because they the people who may just not have appreciated what they are getting into or the notice may have been enough.

And then, we go back after that with an eye to what cases might be brought out of those. And different subject matters do pose obviously different challenges here, but that is sort of our general approach that we use.

Senator BAUCUS. All right.

The CHAIRMAN. Let me follow up then with Mr. Rossotti. We have an example up here. This is Anderson Arc and the Institute of Global Prosperity. Let us give you the benefit of the doubt, those who walk up to the line and do not cross the line. But here, we have somebody that is—are they in jail? They have been raided I suppose, but they are still operating.

Well, let us put it this way, the website is still up. Are you saying you cannot do anything?

Mr. ROSSOTTI. No. We can go in. And we have on occasion gone in and requested the court to give us an injunction to shut down a promotion scheme which could include their website. But obviously, going into to court to get an injunction requires investigation. It requires evidence gathering.

There is also a question of whether the first thing you want to do is to go in. There is some definite tradeoffs between getting an injunction and prosecuting the people for actual criminal activities. So that issue needs to be considered.

I think what one of your earlier witnesses pointed out is that if you really want to go after somebody that is a serious promoter, there is a period of 1 to 2 years potentially of investigation and then bringing the case to the U.S. attorney and to court.

And during that period of time, they may continue to do certain things that we do not like. That is true of any criminal activity. So it is really not just as simple as us knowing that there is a website and then just making a decision that we want to shut it down. We do not have the authority to do that.

The CHAIRMAN. Well, I do not think that Mr. Stevenson said that in every instance they can do that.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. But making inquiries have had the impact, let us put this way, a chilling impact.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. And maybe, the IRS without violating laws or the Constitution, raising questions might have that same chilling impact.

Mr. ROSSOTTI. Perhaps.

The CHAIRMAN. I do not know if that makes me sound like I am suggesting a police state because do not interpret it that way.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. But the extent to which you are really asking, inquiries and somebody is afraid to answer those inquiries because they might be exposing themselves as somebody violating the law, it seems to me to be if you are just asking for information, and as my staff just said, that is what the FTC does.

Well, let us move on. I have a couple more questions that I want to ask orally.

The CHAIRMAN. And then, now for you orally, in the 1998 act, the IRS was required to prepare a report on noncompliance, particularly willful noncompliance of taxpayers.

As I understand the requirement for the report was included in the statute at your request. Where is the report? And when could we expect to see it?

Mr. ROSSOTTI. I have to honestly say that, first, it is true that I was one of the people that suggested putting that in. We worked on preparing that report. And it was supposed to be done jointly with the Treasury.

At the time that we were getting the draft finished, the election was occurring and there was a change in administration. And that put the report into limbo very honestly. The new administration obviously is just getting cranked up. So in all honesty, that is what happened.

The CHAIRMAN. All right.

Mr. ROSSOTTI. It got caught during that period. And I think it is a very important report. We have the limitations in terms of data because I think as your GAO witness noticed, we have very, very old data in terms of measuring compliance. So the effectiveness of what we can say in this report is limited by that.

But we do have to work with Treasury now, with the new Treasury Department in order to get that report done.

The CHAIRMAN. And has there at least been a step taken in that direction?

Mr. ROSSOTTI. There has been. We worked on some drafts. And we have—

The CHAIRMAN. I mean with the new administration.

Mr. ROSSOTTI. With the new administration, frankly, they have been focused on the tax bill.

The CHAIRMAN. All right.

Mr. ROSSOTTI. They do not even have their whole staff in place yet. So I think it would not be fair to them to really focus on this.

The CHAIRMAN. Yes.

Mr. ROSSOTTI. I think we have to wait until they get their staff in place a little bit more.

The CHAIRMAN. It might be possible that people that would be more of the professional staff would be involved in it.

Mr. ROSSOTTI. Right.

The CHAIRMAN. Maybe, you could make some inquiry with them.

Mr. ROSSOTTI. Sure.

The CHAIRMAN. And then, it could move at that level.

Mr. ROSSOTTI. Yes, sir. We will. I agree that that is something that we should do. And we will.

The CHAIRMAN. All right. Now, I want to refer to the Webster report and ask of Mr. Rossotti, it revealed that criminal investigation had been drifting away from its primary mission of investigating

tax code violations into a broader array of financial offenses that had not very obvious direct connection with tax compliance.

And I know some of these were probably meant to be well intentioned in the areas of narcotic trafficking and stuff like that. But the investigations did not bring in the revenue that was anticipated.

Further, tax-related statutes were used in only a very limited number of these narcotics cases that criminal investigation participated. So one question. What steps are you taking to ensure that your manpower resources are being utilized in a manner that does not detract from the primary goal of tax compliance?

Mr. ROSSOTTI. Well, that is true. That is the principal finding of the Webster commission. And we have really taken that very seriously. That has been a major priority for our whole criminal investigation operation.

And a part of that, as was recommended by Webster, was to reorganize the whole criminal investigation function and reestablish that their mission was primarily tax compliance. We have a new leadership team in criminal investigation that is completely dedicated to that. And we have developed a strategic plan that develops cooperation between criminal investigation and our civil functions.

And as a matter of fact, illegal trusts is one of their number one priorities. As was noted, we just did the biggest criminal investigation action in the history of that organization. And it was focused specifically on this area.

So we have moved that organization very aggressively in that direction. I will say that because of the length of time that it takes to actually get cases out, you will not see the statistics showing that immediately. It takes a bit of time because there is an inventory of cases. And they have to work their way through the system.

The other thing that we have done though is try to reestablish a better and more effective relationship between the civil side of the IRS and the criminal side. This had gotten very, very distant because of the points that you made.

It used to be that most of the cases that got into the criminal investigation chain came as referrals from the civil side of the IRS. That had been going down for decades. And it had gotten to the point where there was a very, very low level of referrals.

We have taken some steps, although again it takes time for this to play out, to provide better support, better training within our civil side so that when there are cases that are identified that have criminal potential that those are in fact referred. That really should be our best source. And it had gotten very, very weak over the years.

So those are the two principal things that we have done.

The CHAIRMAN. If I may, again, going back to one of the suggestions on the first panel, and I am assuming in past discussions of amnesty, if I recall, there is a philosophical objection within IRS to any amnesty. And I do not think the Federal Government has ever had one. Is that right?

Mr. ROSSOTTI. Not that I am aware of.

The CHAIRMAN. All right. Now, they were suggesting that in a very narrow area of this to hopefully invite these people out. Is that also philosophically opposed by the IRS?

And I do not just blame you for the philosophical objection.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. That is kind of maybe a culture disease that it has. And I am not convinced that amnesty is always the right thing, but some States have used it effectively.

Mr. ROSSOTTI. Yes. I think that we would be a long way to actually going to the route of an actual amnesty. I think, first of all, that would be a Treasury policy issue.

The CHAIRMAN. All right.

Mr. ROSSOTTI. I myself would have to say I would have a lot of reservations about amnesty. I think that one thing that is true is that if somebody comes in voluntarily that has engaged in a tax avoidance scheme and does it completely on their own, we can work with them oftentimes to avoid any criminal penalties.

But if we identify it, then we are very reluctant to give people in effect what could be viewed as a free pass for everybody else. So we have to be very careful here about the signals that we send to taxpayers about the consequences of trying it out.

The CHAIRMAN. Well, I assume you would put a time limit on it.

Mr. ROSSOTTI. Yes.

The CHAIRMAN. I mean, you would be in amnesty forever. You would say, in the next 6 months if you report, you will get the benefit of amnesty.

Let me follow up on my last question. And this is unrelated somewhat to what we are talking about. And this is just kind of to get an update on the innocent spouse and the offer and compromise and installment agreements.

These three programs serve a very important purpose of getting taxpayers back into the tax system, having the government recover some or all of the money that is owed, allowing these people to get on with their lives without the constant worry and strain of that the IRS will be calling.

And I do not think that we here in Washington appreciate that these people probably have enormous heartaches and anxiety over their unpaid taxes. The three programs were meant to give people a fresh start.

Unfortunately, we have heard that these programs have been bogged down with people having to wait very long periods of time to reach an agreement or get a resolution of their problem.

So where are we with these three programs? Is there a problem? Do you see the problem getting better or worse? And finally, is there anything that we in Congress need to do to help the service solve these problems?

Mr. ROSSOTTI. Thank you very much. They are. With respect to installment agreements, I think that those are probably the most successful and widely available.

The CHAIRMAN. Yes.

Mr. ROSSOTTI. I do not have numbers, but I can get them for you in terms of the increase in installment agreements. And we have made steps to make them easily available at least at the lower end of the debt scale so that people can really have a right to an installment agreement almost automatically for certain kinds of debt. I think that part is going the best and is working reasonably well.

With respect to the other two programs, they are complicated, as the GAO witness noted. We have gotten a tremendous upsurge in business in volume in these areas since the passage of the Restructuring Act.

I think there is a very big difference between where we are today, in my opinion, in the innocent spouse program versus the offer and compromise program. I think we have made very significant progress in the innocent spouse program.

I wrote a letter after the joint hearing last year to Chairman Archer and laid out, because he asked me to, where we were going to be on that. And I indicated that the important thing from the taxpayer's standpoint is getting an answer, what we call a determination.

And we said that we would get down to we thought about 40,000 in inventory by the end of this fiscal year, the number of cases that had not gotten an answer yet. There will always be a positive number in inventory because there is a certain amount of time that it takes to process the cases.

We said that we would try to get the inventory down. We have already gotten to that level. And I think we may get down even further by the end of this fiscal year.

We have taken some significant steps at both automation, centralization, training, and other things. And I will not say that we have that one completely under control. We still need to reduce the lag time some, but we are well on our path there.

I cannot say the same with respect to the offer and compromise program. That has been a very difficult program. And it has consumed a very large quantity of the resources of our collection staff. And we still have too large an inventory of claims of offer and compromise requests that are in the pipeline. And they are taking too long.

We have some very aggressive steps that we are taking on that score. Probably the most important of which we hope to have in place to a significant degree by the end of this fiscal year is to set up two centralized sites with specialized resources to process most of those offers on a much more expedited basis.

And more than that, we do have a team that is headed by I think a very outstanding individual on our team who is studying not only the processing of these claims, but really how we go about evaluating them. And I think we do not have the answers to that task force yet.

We want to look at how much time we are spending and how much of the taxpayer's time we are spending versus how much we really need to spend to evaluate these. And we may have some discussions with you and your staff as we get a few months down the road because we really need to take another look at that.

I cannot say that any of us are satisfied with how that particular part of our program is operating. So we need to do better there, both processing wise and in terms of thinking how we actually do them.

Essentially a quick summary of where we stand on both of them. The CHAIRMAN. All right. That is my last question.

But perhaps, since the General Accounting Office has been observing this to some extent, I ought to ask your comment so we would have that in the record.

Mr. BROSTEK. Well, a couple of things. I would concur with Mr. Rossotti's assessment on the innocent spouse and the offers in compromise program. Between the two of those, the innocent spouse program does seem to be much closer to being under control.

The incoming workload seems to have stabilized. It is not rising rampantly any longer. And they have taken a number of steps. They do seem to be starting to process those cases more rapidly. Their centralization in the innocent spouse program has been underway and seems to be working.

In contrast, for the offer in compromise program, the workload is still increasing very rapidly. And the steps to try to centralize this processing and get more specialization in the staff are just getting underway now. So there is less optimism in terms of having that program under control.

One thing I had mentioned in terms of the general topic here, the tools I was referring to on the chart do have some potential to help out with the kind of situations that we are talking about today in that they can help identify taxpayers whose tax returns change dramatically from year to year and who might be involved in these kind of tax scam situations.

And to the extent that the auditors then can investigate those situations, it may provide some deterrent effect. If their neighbor sees that they have actually been audited by the IRS and the approach that they have taken to eliminate their taxes is not working any longer, news of that would certainly spread among their neighbors. And it also provides potential opportunity for the referrals to the criminal division that Mr. Rossotti spoke about.

The CHAIRMAN. Thank you. I am going to close by saying that I think this hearing is very educational, both for us, more importantly the taxpayer, maybe from the standpoint of suggestions that have come to the IRS from the first panel and from the practice of the FTC, very educational maybe even for the IRS.

I think that we have heard many good ideas then and good commitments from your agency, Mr. Rossotti, or from you, Mr. Rossotti. And I thank you for that.

I think we shed light on a very new and very serious problem. Senator Baucus and I will work together to oversee the IRS' response to this problem of Internet tax fraud and to ensure that IRS is finding these hucksters quickly and stopping them even faster.

And obviously, we have a responsibility to listen to Mr. Rossotti from a couple of standpoints, resources and from the standpoint of the law.

You might have even other things to suggest. Mr. Rossotti, we thank you for your cooperation for this hearing, for your future cooperation.

And thanks to the entire panel for your participation.

Our hearing is adjourned.

[Whereupon, at 12:52 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF JAY D. ADKISSON

Mr. Chairman and members of the Committee, I thank you for the opportunity to appear to discuss the growing problem of fraudulent schemes that are directed towards taxpayers. I am Jay D. Adkisson, an asset protection attorney and an investment advisor. I am also the creator of Quatloos.com, a private Internet website that warns the public about various sophisticated tax frauds and financial frauds.

AN INDUSTRY OF FRAUD

Our country is faced with a growing industry of scams and frauds, an industry much like any other service industry, except that scam artists have little overhead and typically evade the payment of taxes—advantages that make the scam industry very efficient and profitable.

In the past, most fraudulent schemes were run by small groups of scam artists and were relatively isolated. Today's fraudulent schemes take advantage of the Internet to market their scams to a wide audience, and to recruit otherwise innocent people as referral agents and resellers of these schemes.

Fraudulent schemes exact a significant toll upon our economy, our families, and our society.

First, there is the economic impact upon the thousands of citizens who daily lose substantial moneys, and often their entire life savings, to scam artists. Not only is this an immediate loss of moneys otherwise available in the economy for legitimate investments, but also it creates a longer-term problem of increasing the rolls of those who will not be able to provide for themselves after retirement.

Second, there is social impact caused by fraudulent schemes that tends toward the destruction of the family unit, by causing extreme embarrassment and shame to the crime victim. The elderly, in particular, are often afraid to admit to their families that they have been defrauded for fear that it will demonstrate that they are incompetent, leading them to be placed in a nursing home.

Third, and worse, the victims of fraudulent schemes, especially as they relate to schemes involving the payment of taxes, often become disenfranchised and speak with increasing negativity about the U.S. government (which they view as the culprit for not stopping them from being scammed), thus creating a cycle of anti-government paranoia that the scam artists feed upon. Indeed, a large cottage industry of "Patriots for Profit" exists to sell bogus literature, kits for "renouncing" citizenship, etc., to those who have been disenfranchised.

Tax Frauds

In the last two years, the greatest increase in the perceived frequency of frauds has come on the tax front.

Pure Trusts. Despite attempts by a large number of websites to warn about them, and several high-profile prosecutions initiated by the IRS, so-called "Pure Trusts" are still a common form of tax scam. These are trusts that purport to be based on the Contract Clause of the U.S. Constitution; fittingly, they are sometimes referred to as "Con-Trusts," not because of any constitutional issues, but rather because they are marketed by con men.

"Pure Trusts" are sold via the web, to church groups, at mass seminars, but now primarily by multi-level marketing programs that reward their members based not only on how many Pure Trusts they are able to sell, but also how many other people they are able to recruit to sell Pure Trusts.

Tax-protesters. The frequency of scams involving so-called “tax protesters,” i.e., persons who do not believe that they are required to pay income taxes under a variety of bizarre theories, is continuing to increase. Many scams are based on long-discredited tax protester arguments, such as false claims that the Sixteenth Amendment was never properly ratified, or that the only U.S. citizens subject to tax are residents of federally administered territories such as the District of Columbia, Puerto Rico and Guam. More recent tax protester scams have been more innovative, such as those relating to withholding issues and tax credits.

Offshore Tax Evasion. Despite recent pressures from the OECD and G-8 countries, many small countries encourage U.S. taxpayers to use their offshore financial centers to hide money abroad. Incentives include bank secrecy legislation, which effectively blocks any information sharing with U.S. tax authorities. The use of foreign entities owned by bearer shares to act as foreign services corporations continues to represent a major area of abuse. Although the Internal Revenue Service has taken important steps to highlight the illegal nature of such conduct, including several recent actions against high-profile promoters of offshore tax scams, there still exists a perception that there is little risk of being caught for offshore tax evasion. This perception is not assisted by the continued viability of certain corporate tax shelters, which take advantage of the laws of the offshore tax havens and perceived inconsistencies in the Internal Revenue Code to avoid hundreds of millions (and sometimes billions) of tax dollars per transaction.

One by-product of offshore tax evasion is the creation of phony offshore banks, which purport to hide cash from U.S. tax authorities, but are actually mechanisms for scamming the depositor’s cash outright. Of approximately 30 banks licensed by the government of Grenada, for instance, most of these banks have turned out to be scams. Another by-product of offshore tax evasion is that the same laws that are designed to encourage U.S. citizens to commit tax evasion are also available to scam artists to hide the criminal proceeds of their schemes.

Financial Frauds

Despite the efforts of the SEC to educate the public about scams such as “prime bank” and “bank debenture” schemes, the frequency of financial frauds continues to increase. Many of these schemes have purported tax avoidance features.

Attempts to Educate vs. Cyber-Terrorism

In addition to the websites of various federal and state agencies, several private websites now attempt to educate the general public about various scams. Unfortunately, these private websites (including ours) have been the subject of denial-of-service attacks by those seeking to silence criticism of their fraudulent programs, a form of cyber-terrorism that underscores the importance to scam artists of the Internet.

ROOT CAUSES

Multi-Level Marketing: The Breeding Ground for Scam Artists

Once a scam artist creates a fraudulent scheme, he needs a mechanism by which to market the scheme quickly and efficiently to as many people as possible. For this purpose, multi-level marketing is ideal.

Essentially, the scam artist can recruit many people to promote the fraudulent scheme by offering them not only a commission to sell the product, but also a continuing commission (or “tail”) for recruiting additional victims to perpetuate the scheme as resellers. Because the scam artist has little or no overhead and typically evades the payment of taxes, he can pay out large commissions and other inducements to sell the product and to recruit others to sell the product. Thus, scam artists can offer higher commissions and payouts than other programs.

Multi-level marketing helps scam artists identify people and groups who are susceptible to scams. Scam artists will often recruit successful multi-level marketers with access to existing “downlines” of other recruiters who have access to certain groups, such as churches or political organization.

Otherwise innocent people find themselves victims of a collapsed multi-level marketing program. As a result, they are often looking for a new program to quickly replace lost income. This makes them prime targets for scam artists offering promises of generous and immediate commissions.

Support for Scam Artists

The industry of scams and frauds includes support businesses that—though technically committing no crimes themselves—richly and unjustly profit by providing support to scam artists.

Telecommunication Services. For example, various businesses cater to multi-level marketing (MLM) programs by offering cheap and easily accessible “800” numbers with access numbers used to track commissions from sales of the program, conference call services, and credit card clearing services, and with little or no background checks of those buying the services, or other screening as to the legitimacy of the opportunity being offered. These services are readily available to the fraud artist to market and to sell today’s fraudulent scheme on a mass basis.

Internet Bulletin Boards. Other willing accomplices include Internet bulletin board services that derive banner-advertising revenues based upon the number of “hits” a certain web page receives. Web pages that promote scams typically have high hit counts, and are thus more profitable to the owners of the bulletin board services. Hit counts are high since the scam artists use the boards as a “resource” to prove that the fraudulent scheme is legitimate. Hit counts increase as victims of the scheme come forward to criticize the program, then as the scam artists respond to defend the program. The increased traffic results in higher advertising revenue for the bulletin board service. The bulletin board services typically ignore complaints that their boards are being used to perpetrate fraudulent schemes.

Spamming. Various persons profit by selling “spamming” services (i.e., the mass sending of unsolicited commercial e-mail); not so much to the instigators of fraudulent schemes, but more often to the people they recruit, with the leaders getting a kick-back from the spammer. This results in literally billions of unsolicited e-mails being sent annually, which reduces available bandwidth and harms the reputation and reliability of the Internet generally. And, as unbelievable as most of the spam advertisements are, they are invariably successful in attracting a number of new victims for the fraudulent scheme.

Bogus “Educational” Websites & Shills

A new phenomena created by the Internet is the “educational” website set up by scam artists as a third-party “resource” to prove the validity of their fraudulent scheme. This bogus website is invariably set up to look like a legitimate website, and sometimes even like a governmental website, but it actually contains false and misleading information so as to bolster the credibility of the scam artist’s story.

Another phenomena is the use of “shills,” being persons who are hired by the scam artists to post on various bulletin boards, etc., information that supports the scam and discredits those who would warn about the scam. Even after the scam has ended, these shills remain on the Internet to promise victims that the program is still on going and will pay out soon, and to discourage victims from cooperating with law enforcement.

Enforcement Difficulties

It is apparent that law enforcement is having a difficult time keeping up with the growing number of Internet scams. This can be attributed to the sharply increasing number of such scams, and that law enforcement resources typically seem to be directed at after-the-fact punishment of promoters (and sometimes the victims, as in the case of tax frauds), rather than immediate investigation of certain ongoing schemes.

Federal vs. State. An obvious problem for persons wanting to report a fraud, including victims, is whether to contact their local authorities, who may be ignorant of sophisticated schemes, or contacting the federal authorities, who may perceive the matter to be of local importance only.

Federal vs. Federal. Another problem for persons desiring to report a fraud is determining which federal agency to report the fraud to. Programs such as the Internet Fraud Complaint Center¹ and Consumer Sentinel² are significant steps in the right direction, and should be encouraged and expanded.

Non-Traditional Crimes/Aiding and Abetting. Just as the legal and financial professions are creating new and unique planning structures and products, so are the scam artists creating new and unique scams.

Consider, for example, the “fake country” scam. Scam artists will create an entire “virtual country,” complete with executive, judicial, and legislative branches. These fake countries then sell passports and corporate and bank charters. Some have even gone so far as to sell “government bonds.”

The longest running example of the fake nation scam is the so-called “Dominion of Melchizedek” which for years has been run out of the central California area. The Dominion has from time to time claimed parts of the Antarctic and underwater reefs in the Pacific as its territory. Yet, the lack of any physical territory has not pre-

¹ <http://www.ifccfbi.gov/>

² <http://www.consumer.gov/sentinel/index.html>

vented the Dominion from creating bogus corporations, banks, and other structures that are then used by criminals to perpetrate various forms of financial fraud, including a bogus mining stock scheme. For whatever reason, the promoters of the Dominion of Melchizedek (who themselves have criminal records) have managed to avoid prosecution.

Foreign Criminals. Finally, as fraudulent schemes are busted in the U.S., the promoters simply move outside of the U.S. to perpetrate their schemes via the Internet. Typically, offshore jurisdictions are used for this purpose.

Code Complexity/Culture of Non-Compliance

The present complexity of the Internal Revenue Code is a significant factor that favors those who perpetrate tax scams. The typical victims of tax schemes are unable to comprehend the Code in a way that would alert them to the fallacies of various schemes. Instead, they must rely on a trained tax professional that, the victim is told by the scam artist, has a vested interest in seeing that the victim complies with the tax code so as to generate fees.

Likewise, the growth and increasing visibility of so-called "corporate tax shelters" has given credibility to scam artists. If a large accounting firm can create hundreds of millions of dollars of deductions for large corporations, seemingly out of thin air by strange interpretations of vague code provisions, then it seems more realistic that an individual seeking to avoid a much smaller amount of tax could similarly benefit from strange interpretations of vague code provisions.

AVAILABLE SOLUTIONS

Possible solutions available to policymakers to stop the growth of the scam industry may include the following:

- Implement federal and local enforcement action aimed at identifying and stopping fraudulent schemes at the outset before they grow into major criminal operations.
- Require registration of multi-level marketing schemes with the SEC, with state securities regulators, and/or the FTC, with criminal penalties for non-registration.
- Require registration of unsolicited e-mail marketing campaigns, with criminal penalties for non-registration.
- Criminalize conduct that is intended to aid and abet fraudulent schemes, or require better self-regulation of Internet bulletin boards, etc., to prevent promotion of known types of fraudulent conduct.
- Increase all law enforcement agencies' programs to educate the public about fraudulent schemes, and dramatically expand the sections of Agencies' websites that recite enforcement actions.
- Simplify and re-write in plain language the Internal Revenue Code, or at least those portions relating to simple wage-earner income taxation.
- Restrict the marketing and sale of tax products by non-tax professionals.

SUMMARY

The promotion of fraudulent schemes has grown into a cognizable service industry, with sophisticated support and distribution networks. No longer are schemes created by the lone con artist and perpetrated on a purely local level. Now, fraudulent schemes are born with the idea that they will be marketed to the masses via the Internet and multi-level marketing networks, with the criminal proceeds hidden in some distant offshore tax haven. In combating these schemes, law enforcement authorities are hampered by questions of jurisdiction, lack of resources, and criminal laws that have not kept pace with the new schemes perpetrated by scam artists.

Some steps policymakers should consider taking to slow and reverse the fraudulent scheme industry include granting federal agencies more authority and resources to restrict the marketing of these schemes, and punishing not only the perpetrators but also those who aid and abet these schemes by providing the technological resources to disseminate fraudulent schemes to the public.³

PREPARED STATEMENT OF AARON BAZAR

Good Morning, Senators. Thank you for inviting me to speak today. It is an honor to be here.

³The author wishes to thank Chris Riser, Esq., of Highlands, North Carolina, for his assistance in drafting this statement.

Last year I lost approximately \$8000 and four months of time in a pyramid scam propagated over the Internet. It all started when I received an unsolicited bulk email message for a business opportunity. The email said I could make thousands of dollars and learn how to legally eliminate taxes. Four months later, and not a penny richer, I discovered that this "business" had Cease and Desist orders in many states. I was already disenchanted with the group because I felt that what they were "teaching" was not quite right. In addition, nobody I knew was actually making any money except the person who initially brought us into the pyramid. So, I asked for a refund. When that did not work, I tried to get the authorities involved to put a stop to this fraud. Finally, after that did not work, I started my own website to warn the public. The site has received tens of thousands of visitors over the past year, and I am positive that the site has helped many people from getting scammed, a job that the IRS, FBI, and FTC, as well as the State Attorney Generals are all failing miserably at.

Our government's lack of enforcement is precisely the reason why pyramid and tax evasion scams are flourishing on the Internet today. When I first joined the Institute of Global Prosperity, I had never even heard of the Freedom movement and I knew very little about tax protesters. I was just in it for the money. It seemed like such a good idea at the time. I mean, who would not want to work from home, make thousands of dollars a week, and learn how to legally stop paying taxes just like the "wealthy elite" of our country? One reason these groups are so successful is that they prey on those who already distrust the government. These people are all too willing to believe the misinformation on the Internet and in the teachings of these groups. However, if they are like me and have no anti-government inclinations, then the commens do their best to reeducate you. They'll drill ideas into new recruits like: The government spies on us. We are tracked via our social security numbers. The 16th Amendment was never ratified so taxes are illegal. Paying taxes is voluntary because the IRS tells us so right in the tax code, so we can choose not to pay. Or, the Federal Reserve is run by the ultra-wealthy and they illegally create money. The majority of citizens in this country know the tax system is completely unfair and benefits the wealthy. When somebody tells you that you can just "leave the system" by using special get-out-of-tax free forms in lieu of a 1040, it sounds too good to be true. When you are then shown in your 1040 instructions exactly where it says filing taxes is voluntary, you start to wonder. And then, finally, when you see many other people who have stopped paying taxes completely using these documents, you are sold. Senators, I have never heard of the IRS stopping any of the thousands of people who are using these methods to evade paying taxes; and believe me, I have looked. If Americans are really obligated to pay federal income taxes, why does the IRS allow these people to continue selling these "products," and why are they not prosecuting those who use them? The IRS encourages the tax-protester movement by their lack of enforcement. I have a better chance of being audited because I send in a 1040 and pay my taxes honestly. Those who don't file a 1040 seem to be getting away with it.

But, let me get back to the Internet. Most scams on the web today employ the use of unsolicited bulk email, otherwise known as "spam" to recruit people and sell their "products." In my opinion, spam is truly the root of all evil on the Internet. NO legitimate company uses spam to advertise; ONLY pyramid schemes, pornography sites, stock market scams, and other illegitimate businesses use spam. Spam costs consumers billions of dollars a year based on recent studies. There are already bills in Congress that are addressing the spam issue, and I sure hope it becomes illegal to send out unsolicited commercial email. It will save the country billions paid by consumers, and it will help prevent these pyramid and ponzi schemes from spreading as fast as they are. If you have any doubts about how far-reaching the problem is then I suggest you check your private email accounts. The chances are good that you will have email with lines like "make \$2000-\$5000 dollars per week from home," or "eliminate credit card debt," and "legally reduce your taxes." These are emails sent out by IGP. If you have not received email like these, then you will soon enough. It's only a matter of time. My website has many samples of the spam IGP sends out, if you are interested—<http://www.global-prosperity.com>

If somebody wants to steal from people, the Internet is the place to do it. The chances of getting caught, in my opinion, are virtually nil. IGP has been stealing from people for 5 years now without any repercussions. They ignore Cease and Desist orders because they know they can get away with it. After I was scammed, I dutifully reported Jeff Segal, the IGP agent who ripped me off. I reported him, as well as other IGP leadership, to my state Attorney General, the state Attorney General in New Mexico, the FBI, the FTC and anybody else who might listen. I also contacted the Massachusetts Attorney General's office because IGP's drop-box was located there and I also contacted the Attorney General offices in Washington State

and Oregon. Nothing happened. When I spoke to the various Attorney General offices, they told me things like they had no money, it was the other state's problem, or it is was the FBI's jurisdiction because IGP crosses state lines, or it was a securities issue. At least the Maryland Attorney General's office was honest with me. The officer there said that nothing was going to be done. Around the same time I was in contact with the authorities, the FBI and the Justice Department set up the Internet Fraud Complaint Center, IFCC. I was pretty excited because I thought that this would be the place to go and something might get done. After all, IGP has cost the public over \$300 million dollars. But, again, no action was taken. I thought the whole reason the IFCC was started was because the various state and federal law-enforcement agencies were not equipped to handle Internet fraud. But, the IFCC just seems to take complaints and forward them to the same people that would not do anything about the problem in the first place—the Attorney Generals and local authorities. I guess my point is that the Internet is a great place to be a criminal because you won't get caught. If you are a tax-protester, there has never been a better forum to get your message out, and make money too.

Senators, the wheels of "E-justice" do not exist. There are scams everywhere on the Internet but nothing is being done to stop them. I was lucky. I am young and can afford to pay off the debt I have accrued. I have been able to bounce back from my loss of faith in humanity too. However, there are many people who get on the Internet everyday that are not so lucky. When they receive the spam email in their boxes, what will they do? There is something wrong with the system when the IRS does not enforce our tax laws, the states wash their hands of responsibility on grounds of jurisdiction, and the FBI, SEC, and FTC do not go after people that steal millions of dollars from the public. White-collar crime is big business on the Internet today and the problem is continuing to grow.

Thank you.

PREPARED STATEMENT OF MICHAEL BROSTEK

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I am pleased to join you today as you address a number of issues related to the role of the Internal Revenue Service (IRS) in enforcing the nation's tax laws. As you requested, I will discuss two topics: (1) the relationship between IRS audits of taxpayers and other programs IRS uses to ensure that taxpayers' returns are accurate, and (2) how IRS is managing the increased workload in two of its programs offers in compromise and innocent spouse claims. My testimony primarily is based on our past work and reviews we are doing of the offer in compromise and innocent spouse programs. I will summarize my main points before providing more detail on these topics.

IRS audited over 600,000 taxpayers in fiscal year 2000, either face-to-face or through the mail. However, audits do not fully reflect IRS' efforts to ensure that taxpayers accurately report their tax liabilities. IRS has several programs that use computerized screening procedures to review all tax returns to detect certain types of errors, such as underreporting of interest or other types of income. These programs result in millions of contacts with taxpayers to inform them of adjustments IRS made to their tax liabilities, seek explanations for errors IRS believes were made, or ask taxpayers to check whether they erred on their returns. The programs vary in their similarity to audits; some of the programs are most similar to audits that IRS conducts through the mail. However, audits have statutory limitations—IRS is generally limited to one examination of a taxpayer's books and records for each taxable year. This limitation does not apply to the other programs IRS uses to ensure that tax returns are accurate. Further, the programs IRS uses to detect errors on tax returns are completely reliant on information that taxpayers report on the tax returns and that IRS receives from third parties. Therefore, audits remain an important tax enforcement tool. This is especially true for taxpayers whose income and other tax characteristics are not subject to routine third-party reporting to IRS. IRS' computerized checks on the accuracy of tax returns could help to free up staff to audit these taxpayers.

Recently, much attention has been focused on declines in IRS' audit rates for individual taxpayers, which in fiscal year 2000 fell 40 percent below the lowest previously reported audit rate. These declines are of concern because taxpayers may take low audit rates as a signal that underreporting or underpaying of taxes is unlikely to be detected, which might lead to declines in voluntary compliance. However, noncompliance can also be unintentional, for instance if a taxpayer errs due to misunderstanding a tax rule. If declining audit rates do affect voluntary compliance, the effect might be offset in part by use of IRS' other programs to detect inac-

curate tax returns or by IRS' efforts to better inform taxpayers of their tax responsibilities and to answer their tax-related questions. However, the net effect of these factors on voluntary compliance is not known, principally because IRS has not measured voluntary compliance in reporting tax liabilities since 1988.

The offer in compromise program was established to provide a means for taxpayers to settle tax debts that cannot be paid in full while providing for payment of some portion of the taxes owed. Under the innocent spouse program, IRS can relieve a spouse of tax debts based on equity considerations, such as not knowing that their spouses failed to pay taxes due. In 1998, Congress encouraged greater use of both of these programs. Since that time, the workload in both programs has increased substantially, leading to rising inventories of cases and concerns about the time taken to process cases. IRS' ending inventory of unresolved workable offers has almost tripled from fiscal year 1997 to fiscal year 2000. IRS' innocent spouse program, which received about 3,000 new cases in the 4 months prior to the IRS Restructuring and Reform Act (Restructuring Act), now receives on average about 5,000 new cases each month. IRS has taken a number of steps in both programs, including reassigning staff from other duties, to handle the increased workload. In the past two years, the offer-in-compromise program has experienced a greater rise in its workload and is not as far along as the innocent spouse program in implementing processes that IRS believes will help gain better control over the workload. Given how recently changes have been made in both programs, it is not yet clear whether the steps IRS has taken and plans to take will enable it to significantly reduce case inventories.

Audits and Other Programs for Ensuring the Accuracy of Tax Returns

IRS uses several programs to ensure that tax returns include all of the information necessary for properly determining taxable income and the tax due on that income. Although audits are a key program for ensuring that tax returns are accurate, they represent a small portion of the activities IRS undertakes for this purpose. Briefly, the key programs include the following:

- **Audits:** Section 7602 of the Internal Revenue Code gives IRS the authority to examine a taxpayer's books and records as well as to take testimony to ensure the accuracy of tax returns. Section 7605(b) restricts IRS' exercise of this authority by allowing not more than one examination of a taxpayer's books of account for each taxable year, unless the taxpayer requests otherwise or unless authorized by the Treasury Secretary. Section 6501 generally requires that examinations of a taxpayer's books and records must occur within 3 years of the taxpayer's due date for filing the tax return unless the taxpayer agrees to an extension of this period. IRS conducts face-to-face audits from its field offices (referred to hereafter as field audits) and correspondence audits out of its 10 service centers. Correspondence audits are conducted through the mail. They cover less complex issues than field audits and generally address only one or two issues on the tax return.
- **Information returns:** Under various sections of the Code, third parties are required to file information returns with IRS and taxpayers to report tax-related information such as wages, interest, dividends, or other income paid to taxpayers. In its information returns program, IRS uses computers to compare that information to the information that taxpayers provide on their tax returns, checking whether (1) taxpayers included income on their tax returns that information returns indicated had been paid to them (underreporter program), and (2) taxpayers filed a tax return when information returns indicated that they had received income (nonfiler program).
- **Math errors:** When a tax return is received and before it is accepted, IRS uses computers to identify and correct clerical and mathematical errors and to check the accuracy of Social Security numbers shown on the return. These clerical and mathematical error checks rely solely on information provided by the taxpayer on the return, while the Social Security number checks compare Social Security numbers on the return to data on Social Security numbers provided to IRS by the Social Security Administration. Section 6213 of the Internal Revenue Code identifies the specific items on the return that can be checked under IRS' math error authority. Table 1 provides some information about the workload in fiscal year 2000 for each of these programs.

Table 1: Fiscal Year 2000 Workload for IRS' Key Programs to Ensure Compliance by 125 Million Taxpayers

Fiscal year 2000 activities	Key programs to ensure taxpayers have filed accurate returns				
	Audits		Information returns		Math error
	Field ^a	Correspondence	Underreporter	Nonfiler	
Percent of filed returns screened by computer	100%	100%	100%	N/A	100%
Number of taxpayers contacted	237,561	380,204	1,353,545	1,251,375	5,751,000
Percent of taxpayers with filed returns contacted	0.19%	0.30%	1.08%	N/A	4.50% ^b

^a For this figure, "field audit" refers to all face-to-face audits done by IRS.

^b The rate for audit and underreporter cases was calculated using the 125 million taxpayers who filed in 1999 because it was from these taxpayers that IRS selected returns to audit and identified taxpayers to receive underreporter contacts in 2000. We used 127.7 million tax returns filed in 2000 to calculate the coverage for math error because it was these returns that were reviewed for math errors.

Source: IRS data.

As table I shows, in fiscal year 2000, all individual tax returns were screened for accuracy by IRS computers. For example, all tax returns are analyzed and scored by IRS' computers to determine which returns are most likely to be subject to a change if audited. Although the various programs screen all returns, not all items on the returns are reviewed, with the elements screened depending on the type of program. Also, the number of taxpayers who were contacted under each program varied. The largest numbers of taxpayers contacted in fiscal year 2000 were contacted under the math error program—about 5.75 million taxpayers, or 4.6 percent of all taxpayers. IRS did about 617,000 audits, of which over 60 percent were correspondence audits, and sent about 1.4 million underreporter notices and 1.3 million nonfiler notices.

In addition to these programs, IRS also has certain special programs that focus on the accuracy of specific tax reporting issues. For instance, IRS checks to determine whether the dependent Social Security numbers on a return also appear on returns filed by other taxpayers—a duplicate Social Security number check. IRS also checks whether an individual who has self-employment income has paid self-employment tax. These and other checks can generate what IRS calls "soft notices." The soft notices ask taxpayers to review their return for certain types of errors, but do not assess or propose assessing additional tax or otherwise change the tax returns. For the duplicate Social Security number and self-employment checks, IRS essentially screens all tax returns through its computers for these potential problems. In calendar year 1998, IRS sent about 1.9 million soft notices to taxpayers in connection with duplicate Social Security number and self-employment checks according to the most recent data we have from IRS.

How Audits Compare to Other Programs for Checking Tax Returns and How Audits Have Evolved Over Time

IRS' field audits clearly differ from IRS' math error, information return, and soft notice efforts since these audits are done face-to-face rather than through the mail. However, over 60 percent of the audits—correspondence audits—are less obviously different from the other programs for checking tax returns' accuracy because these audits are done through the mail. Correspondence audits are most like, but not identical to, some of the contacts IRS has with taxpayers in the information returns program and are least like the contacts in the math error program.

Information returns program and correspondence audit contacts with taxpayers can appear to be similar because, among other things, they both

- occur through mail originated in an IRS service center;
- usually involve an error that IRS believes it has detected in the accuracy of some item on a tax return;
- result in IRS' contacting a taxpayer after his or her return has been processed and, in most cases, the taxes have been paid or refund made;

- ask taxpayers to respond by agreeing or disagreeing that the error exists, and by providing at least some explanation of their position if they disagree;
- use an IRS employee known as a tax examiner who is to review any responses and is to accept taxpayer responses that appear to reasonably support their positions; and
- can result in IRS' assessing an additional tax liability if taxpayers do not respond.

However, differences also exist along many of these dimensions.

- Unlike the information return program, correspondence audits trigger the section 7605(b) restriction that limits IRS to one inspection of a taxpayer's books of account for each taxable year, unless authorized by the taxpayer or the Secretary of the Treasury. Correspondence audit notices generally ask taxpayers to provide information from their books and from records such as birth certificates and school records. Information returns program notices do not specifically ask taxpayers to provide copies of information from their books and records. Rather, taxpayers are asked only to explain the discrepancy between their returns and what IRS had reported to it on information returns. According to IRS officials, most taxpayers do so in a letter without sending copies of books and records.
- The potential taxpayer errors covered by the information returns program deal with types of income reported on information returns—such as wages, interest, and dividends.¹ Correspondence audits can deal with income as well as deductions, exemptions, and credit items that can be audited through the mail. Over 80 percent of correspondence audits that closed during fiscal year 2000 dealt with earned income tax credits.
- The tax examiners in the information returns program are not trained to do audits. Therefore, if the taxpayer sends in books and records that need more review, these tax examiners are to send the case to the correspondence audit unit.

These differences, particularly the section 7605(b) limitation, are significant. However, if taxpayers have had little experience in dealing with IRS, they may not understand the differences between correspondence audits and information returns program contacts. From these taxpayers' perspective, IRS has sent them a letter in either case that questions the accuracy of an item on their tax return and requires that they respond if they believe IRS is incorrect. If taxpayers do not respond, IRS ultimately can assess the additional taxes on the basis of the evidence it has in its files.

Math error contacts are more limited in their similarity to correspondence audit contacts. For example, both types of contacts can change the tax liability that taxpayers reported on the filed tax return, and both contacts are handled through the mail. Otherwise, math error contacts differ from audit contacts. For example, the math error program screens returns for errors before being accepted by IRS as valid returns. If an error is found, taxpayers are sent a notice within a few weeks after submitting their return. The math error notices do not ask taxpayers for information about the return, as would correspondence audit notices. Rather, math error notices inform taxpayers that they have made an error, and that IRS has made changes that increase or decrease their tax liabilities. If taxpayers disagree with the change, they can follow procedures to request that IRS abate, that is, reduce or rescind, the change in their taxes.

Although audits have the distinguishing characteristic of requiring taxpayers to submit books and records for IRS review, what is counted as an audit can change over time. For instance, in 1994, IRS concluded that certain service center contacts were no different than other types of contacts counted as correspondence audits. Subsequently, IRS has counted these contacts as audits. This change shifted a couple hundred thousand contacts to the correspondence audit program during that time period.

A movement in the opposite direction occurred in 1996. In 1996, Congress amended the statutory definition of a mathematical or clerical error to include missing or invalid Social Security numbers in claims for dependency exemptions and the earned income credit.² This change resulted in about 700,000 cases moving out of the correspondence audit program and into the math error program during fiscal year 1997.

In a broader perspective, the evolution of technology and the law has enabled IRS to make greater use of computers to perform what had required reviews of books and records by IRS auditors. The information returns program is such a case. Before Congress enacted laws requiring various institutions to file "information returns" on

¹ IRS also receives information returns for the mortgage interest tax deduction and may contact taxpayers about discrepancies related to it.

² P.L. 104-188 and P.L. 104-193.

income paid, IRS had little choice but to ask for taxpayers' books and records to determine whether they had underreported their income. IRS could only do this for a small portion of all taxpayers. With passage of the various information reporting laws and expansion of their use beginning in the 1970s, IRS began to receive copies of materials that were part of books and records without having to ask taxpayers directly for the information. As IRS' computing capacity grew in the 1970s and 1980s, it was able to match virtually all of the information returns it received with individual tax returns. IRS' enhanced computer capacity allows it to substantially verify all the income reported on tax returns by many individual taxpayers. In 1996, we reported that 45 percent of the taxpayers claimed the standard deduction and that all the income they reported on their tax returns was subject to information reporting.³ Because IRS does not have to directly ask taxpayers for information from books and records, none of these specific income verifications count under the definition of audits.

However, computerized checks on the accuracy of tax returns are limited in that they depend on information provided by taxpayers and third parties. Because a significant portion of income received by some individuals is not subject to third party information reporting, and because other items affecting tax liability such as most itemized deductions, also are not subject to information reporting, audits remain an essential program for ensuring that taxpayers file accurate tax returns. To the extent that the computerized checks that are now available to IRS help free up audit staff, IRS may be able to redirect the staff to audit taxpayers whose income and deductions are not well-covered by the information matching programs.

Measuring Voluntary Reporting Compliance Is Key to Understanding the Effect of IRS' Audits and Other Actions to Promote Compliance

The falling audit rates since fiscal year 1995 have generated concerns about increases in noncompliance because taxpayers may feel they can underreport income or otherwise underpay taxes with little fear of being caught. In fiscal year 2000, IRS audited 0.49 percent of the income tax returns filed by individual taxpayers. This rate was about 45 percent lower than the audit rate in 1999, over 70 percent lower than the rate in 1995, and about 40 percent lower than the lowest previous audit rate of 0.8 percent, which occurred in 1990.

An increase in the use of other programs, such as the math error and the information returns program, may help offset any tendency towards lowered compliance. However, the number of contacts in these programs has also been falling since fiscal year 1995. For example, the number of information returns program contacts for unreported income has fallen about 50 percent since 1995.

Other factors may also help to encourage overall voluntary compliance levels. IRS initiatives to help taxpayers better understand the tax law and their tax responsibilities may offset unintentional noncompliance resulting from such things as misunderstanding tax requirements. If these programs are reducing unintentional noncompliance, the overall voluntary compliance rate could hold steady, or even increase, even if some taxpayers intentionally underpay their taxes due to the signal that falling audit rates may send.

Neither IRS nor external observers know the net effects that the decline in audit rates and changes in other IRS programs have on voluntary reporting compliance. One reason is that IRS does not have current, reliable information on the levels of voluntary reporting compliance. IRS last measured overall income tax compliance for tax year 1988. IRS and others are concerned that the compliance information is out of date because the tax laws have changed, and because IRS has completely reorganized itself and refocused its philosophy to become more taxpayer service-oriented.

Because each of the programs IRS uses is best suited to identifying and correcting a specific type of noncompliance, it is important for IRS to know specifically where taxpayers are not reporting accurately. For example, the information returns program is best suited to identifying taxpayers who underreport income such as wages, interest, and dividends. Similarly, the math error program can best identify taxpayers who use an incorrect Social Security number for dependents or make a calculation error. However, at this time, only an audit enables IRS to identify noncompliance in reporting items that affect business net profit or loss, personal income not covered on information returns, and most personal deductions.

Having more information about the specific types and level of errors made by taxpayers in reporting items on tax returns has potential benefits beyond better targeting IRS' enforcement efforts. With this information, IRS also can analyze ways to improve voluntary compliance through nonenforcement efforts—such as better

³Tax Administration: Alternative Filing Systems, (GAO/GGD-97-6, Oct. 16, 1996).

education, service, and forms—as well as to improve resource allocation and the training of all types of IRS staff.

IRS is currently developing plans to again measure voluntary compliance. A draft business plan has been developed, and IRS is in the process of contacting various stakeholders to obtain their input. The project, called the National Customer Research Study, will measure all three areas of compliance—obtaining information on the proportion of returns that were filed properly, that reported the tax liabilities accurately, and that fully paid these tax liabilities. Because a voluntary compliance measure is key to understanding the effects of IRS' efforts to properly administer the tax laws, we are currently reviewing IRS' National Customer Research Study.

IRS' Offer-in-Compromise Program

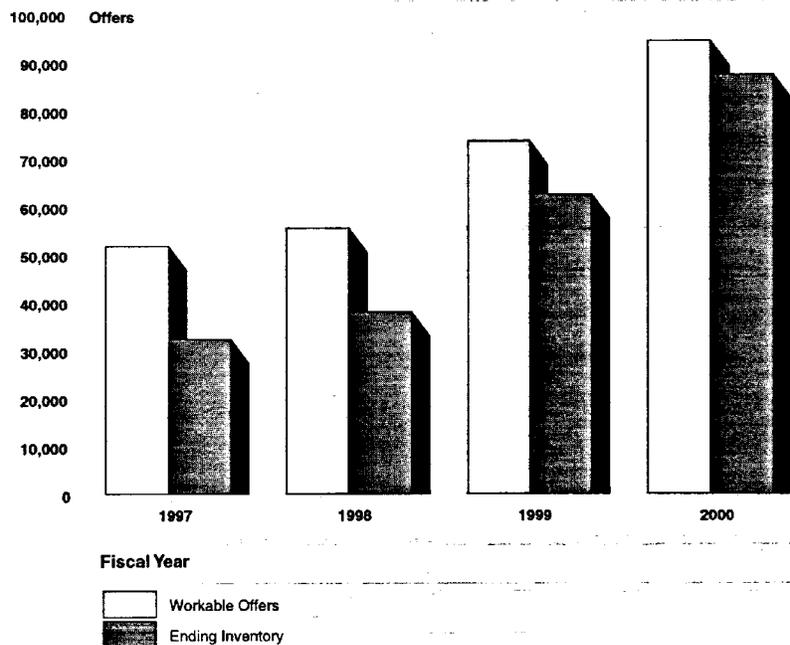
An offer-in-compromise is a contract between IRS and an individual or business taxpayer to settle a tax debt for less than the amount of the debt. Taxpayers can submit an offer for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code. Generally, offer agreements require the taxpayer to file returns and pay taxes for 5 years from the date IRS accepts the offer. Failure to do so permits IRS to begin immediate collection actions for the original amount of the liability. The offer-in-compromise program is currently administered by IRS' Small Business/Self-Employed (SB/SE) Division.

Offers were not widely used to resolve tax debts until 1992, when IRS adopted a new offer policy that placed more emphasis on the use of offers as a means to enhance overall compliance and to help manage the inventory of delinquent tax accounts. The goal of the new offer policy was to achieve collection of what was potentially collectible at the earliest possible time and at the least cost to government.

More recently, the Restructuring Act called for certain changes in the offer program directed at providing greater consideration to the taxpayer in resolving collection issues through compromise. Among other things, the Restructuring Act required that IRS (1) consider the facts and circumstances of each case when evaluating offers, (2) not reject offers from low-income taxpayers solely on the basis of the amount offered, and (3) independently review all proposed offer rejections before notifying taxpayers and allow taxpayers to appeal any such rejection. These changes were effective upon enactment of the act on July 22, 1998.

Trends in Offer Workload

IRS data show that its workload for the offer-in-compromise program has significantly increased in recent years. The number of workable offers—that is, offer applications that meet IRS' criteria to process them—has increased by 83 percent, from about 51,700 offers in fiscal year 1997 to about 94,500 offers in fiscal year 2000. Because IRS was unable to keep up with this increase in offers received, IRS' ending inventory of unresolved workable offers almost tripled, from about 32,300 in fiscal year 1997 to about 87,500 in fiscal year 2000. Figure 1 shows these trends in workable offers and ending inventory.

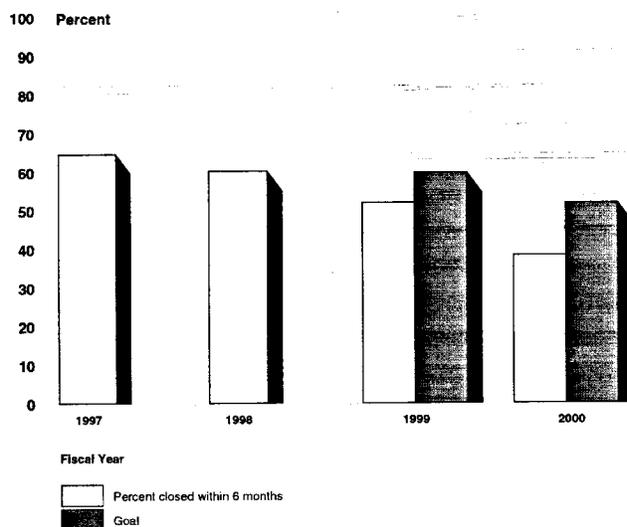
Figure 1: Trends in Workable Offers and Ending Inventory

Source: IRS data.

According to IRS, several factors contributed to the growth in the number of workable offers. First, the publicity resulting from the outreach and marketing efforts of IRS and tax practitioners brought the revised program to the attention of taxpayers and their practitioners. Second, prior to fiscal year 1999, IRS would not accept an offer-in-compromise application for processing if it was incomplete in providing such things as financial information or if the offer was missing the taxpayer's signature. In 1999, IRS began accepting all offer applications for processing except those from taxpayers in bankruptcy proceedings or taxpayers who had not filed all required federal tax returns. Instead of returning an incomplete offer, IRS now accepts the offer for processing and works with the taxpayer to obtain the information needed. Finally, IRS previously had installment agreements with many taxpayers that extended for up to 15 years and longer. In 1999, IRS decided to halt the practice of agreeing to such long-term installments and decided instead to work with the taxpayers on an offer-in-compromise with a deferred payment schedule. This shifted some of the workload from the installment agreement program into the offer-in-compromise workload.

IRS measures its timeliness in working offers-in-compromise by the percent of offers it completes within 6 months of the date the offer is accepted for investigation. As shown in the figure below, the percentage of offers IRS completed within 6 months has declined from 64 percent in fiscal year 1997 to 38 percent in fiscal year 2000. For fiscal year 1999, IRS established a goal to close 59.3 percent of offers within 6 months of the date the offer is accepted for investigation. It set a goal of closing 51.4 percent of offers within 6 months for fiscal year 2000. IRS did not meet either of these goals: it closed 51.4 percent of its workable offers within 6 months in fiscal year 1999 and 37.9 percent in fiscal year 2000. In addition, the percentage of cases in the ending inventory over 6 months old increased from 19 percent to 43 percent between fiscal years 1997 and 2000. Figure 2 shows the trend in offers closed within 6 months for fiscal years 1997 through 2000 and IRS' goals for fiscal years 1999 and 2000.

Figure 2: Percentage of Offers Closed Within 6 Months in Fiscal Years 1997-2000 and IRS' Goals for Fiscal Years 1999 and 2000



Source: IRS data.

According to IRS officials involved in the offer program, several program changes have contributed to IRS' inability to meet its 6-month goal for processing offers. These include:

- Relaxing the criteria for accepting offer applications for processing. The change in criteria for accepting applications, discussed previously, resulted in the time taken to obtain required information for a complete offer application being counted in IRS' processing time.
- Expanding the basis for accepting offers to include factors such as hardship and equity.⁴ IRS officials said that this was done because they believed, in considering and passing the Restructuring Act, Congress expressed its intent that IRS should be more flexible in working with taxpayers who want to settle tax debts. IRS officials said that they first consider the offer under their normal criteria for evaluating offers, and then the taxpayer must demonstrate that an exceptional circumstance exists that would make payment of the tax a hardship, unfair, or inequitable. Whenever these factors are considered, the process takes longer.
- Implementing the Restructuring Act requirement that IRS perform an independent administrative review of all proposed offer rejections. IRS has also included as part of this review all proposed decisions to return an offer because of a taxpayer's failure to provide information IRS requested. According to IRS officials, these reviews have increased processing time by almost a month for those offers that were reviewed.

The relationship between the number of workable offers and the capacity of staff to process them affected inventory levels. In an attempt to manage the growing numbers of workable offers and cases that have been in inventory more than 6 months, IRS shifted staff to the offer program from other field collection activities, such as tax delinquent account investigations. The total direct time charged to the offer program increased by 77 percent, from an equivalent of about 350 full-time

⁴Under IRS regulations prior to this change, IRS generally accepted offers based on doubt as to collectibility (taxpayers owe tax but cannot pay the entire debt) and doubt as to liability (taxpayers claim they do not owe all or part of the tax in question). Most offers were accepted based on doubt as to collectibility.

equivalent positions (FTE)⁵ in fiscal year 1997 to about 619 FTEs in fiscal year 2000. However, with the reassignment of more staff into the program, IRS officials said its most productive offer staff were taken off of casework in order to provide newly assigned staff on-the-job training and coaching, which decreased productivity. During the same period, the time directly charged to collection activities by all collection field staff decreased by 33 percent from an equivalent of 6,098 FTEs to 4,114 FTEs. Table 2 shows the trends in FTE utilization in the offer-in-compromise program for fiscal years 1997 through 2000.

Table 2: Direct Field Collection FTE Utilization for Fiscal Years 1997 to 2000

	FY 1997 FTEs	FY 1998 FTEs	FY 1999 FTEs	FY 2000 FTEs	Percent Change FYs 1997- 2000
Offer-in-compromise program	350	356	414	619	77 %
Total for all collection activities	6,098	5,487	4,532	4,114	(33 %)

Source: IRS data.

With the decline in staff assigned to all collection activities and an increase in collection staff working offers, the share of total direct collection FTEs devoted to the offer-in-compromise program has grown from about 6 percent of all collection activities to 15 percent between fiscal years 1997 and 2000.

Key Actions Taken by IRS to Address Offer Workload Concerns

In recent years, IRS has taken various actions to address its offer workload concerns. The key actions IRS has taken, designed in part to reduce inventory backlog and processing times, include

- assigning more staff to the offer program, as discussed previously;
- streamlining the offer process for certain cases; for example, IRS changed its investigation and processing procedures in 1999 by requiring less documentation for low risk offers and raised the maximum liability for streamlined offers from \$25,000 to \$50,000;
- creating an offer specialist position for revenue officers assigned to work offers;
- developing training programs for offer specialists, independent administrative reviewers, and walk-in and call-site employees so that they can better answer taxpayer questions about the offer program;
- developing an Internet-based self-help interactive offer application; this tool provides background information on the offer process, instructions, and electronic offer forms to assist taxpayers to prepare quality offers and thereby reduce up-front processing time—this effort was part of SB/SE's most recent strategic plan and was implemented at the end of fiscal year 2000;
- revising offer forms and instructions to make them more user-friendly;
- simplifying the deferred payment option by eliminating the collection of interest on the accepted amount; and
- contracting to study how to reengineer offer the process to reduce processing time.

Key Actions Planned by IRS to Address Offer Workload Concerns

SB/SE's fiscal year 2001 strategic plan sets forth two actions that IRS is to undertake to improve the efficiency of its offer-in-compromise program. They are to

- centralize the processing of new offers-in-compromise at two sites by August 2001 to improve offer quality, timeliness, and efficiency (The two sites are to assemble the initial case files used in processing all offers and fully process offers with liabilities under \$50,000 that meet certain criteria. Offers with liabilities over \$50,000 are to be sent to IRS field offices for evaluation and final processing. To carry out this action, SB/SE's plan states that 650 lower-graded

⁵An FTE generally consists of one or more employed individuals who collectively complete 2,080 work hours in a given year. Therefore, either one full-time employee or two half-time employees equal one FTE.

offer staff would be needed at the centralized locations. These staff reportedly would free up over 600 higher-graded revenue officer FTEs for other work by fiscal year 2004. IRS expects that centralization will enable its field staff to completely work its inventory backlog by fiscal year 2004 if the number of new offers received remains constant.); and

- consolidate onto one platform the key databases used by collection personnel to perform the administrative legal requirements for processing liens, bankruptcies, and offers-in-compromise. (This action is intended to allow more efficient access to information in these databases. The plan states that the database integration is to occur after fiscal year 2002.)

In addition, IRS is planning to revise the offer application package to better explain to taxpayers the requirements for submitting financial information with the offer application.

Summary and Observations

Through fiscal year 2000, the workable offers and the inventory of existing offer cases increased rapidly, and IRS' performance in meeting its goals for processing cases within 6 months deteriorated. In response, IRS reassigned staff who would have been performing other collection activities into handling offers. Faced with potential continuing high workloads, IRS has adopted a more long-term strategy of centralizing the processing of offers and hiring lower-graded staff to specialize in this function to free up collection staff for other activities. The centralization is planned to begin later this fiscal year. Among other things, it will require reassigning hundreds of employees and providing them facilities, equipment, and training. Although centralization and IRS' other initiatives may enable it to gain control over its growing inventory, success will require careful management of the centralization process and a leveling off in the growth of workable offers received by IRS. Consequently, it remains to be seen how much progress IRS will make and how quickly.

IRS' Innocent Spouse Program

Under tax law, married couples who file joint tax returns are treated as a single unit, which means that each spouse becomes individually responsible for paying the entire amount of the tax associated with that return. Accordingly, an "innocent spouse" can be held liable for tax deficiencies assessed after a joint return was filed, even if those liabilities were solely attributable to the actions of the other spouse.

However, if certain conditions are met, the innocent spouse may be able to obtain relief from the tax liability. The Restructuring Act revised the conditions for obtaining relief to make it easier for taxpayers to qualify for innocent spouse relief. The act liberalized the former conditions and added new conditions. Simply stated, the three basic provisions related to innocent spouse relief are as follows:⁶

- When the innocent spouse had no knowledge that there was an understatement of tax attributable to erroneous items of the other individual filing the joint return, and considering all facts and circumstances, it would be inequitable to hold the innocent spouse liable for the tax.
- When the innocent spouse otherwise qualifies, he or she may request to have the tax deficiency from a jointly filed return recalculated to include only items allocable to him or herself.
- When the tax shown on a joint return was not paid with the return, the innocent spouse may obtain "equitable relief" if he or she did not have knowledge that the funds intended to pay the tax were not used for that purpose. Equitable relief is also available for understatements of tax for which relief under the above two conditions was not available.

Each condition above has different eligibility requirements and provides different types of relief. Relief is generally available to taxpayers for liabilities arising after July 22, 1998, the date the act was enacted, and for liabilities that arose before that date but remained unpaid as of that date.

Currently, IRS' Wage and Investment (W&I) Division has overall responsibility for managing the innocent spouse program. W&I has an agreement with SB/SE whereby SB/SE field staff work innocent spouse cases requiring face-to-face contact with taxpayers. Prior to IRS' reorganization, the former Examination Division handled innocent spouse relief requests.

Workload Concerns Developed After the Restructuring Act's Changes

Limited data exist to determine the trend in innocent spouse workload. However, existing data suggest that workload increased substantially after the Restructuring

⁶IRC § 6015, and IRS § 66(c).

Act's changes. Prior to the Restructuring Act, IRS administered innocent spouse relief as part of its process of examining tax returns and did not keep statistics on the number of cases in which innocent spouse relief was requested or on the disposition of those requests. According to a statement by the IRS Commissioner, in the approximately 4 months before enactment of the Restructuring Act, IRS received about 3,000 innocent spouse cases. In the first 7 months after IRS established a system for more reliably tracking innocent spouse cases, it received over 43,000 innocent spouse cases.

Although innocent spouse submissions increased after the enactment of the Restructuring Act, data are not available to document the increase because IRS did not systematically track innocent cases until March 1999.⁷ Since cases have been tracked, it appears that the annualized innocent spouse workload has been relatively stable even though the submissions have not spread evenly over the fiscal year. The limited trend information currently available show that submissions tend to be lower in the early months of the fiscal year—October through January—then climb substantially during and after the tax filing season, before falling off again. Taking this pattern into account, the 43,255 cases received in the seven months after IRS instituted its case tracking system were within 12 percent of the volume received in the same 7 month period of fiscal year 2000—38,695. Further, the 16,422 cases received through March 6 of this fiscal year is slightly less than the 18,643 received during the comparable period the prior year.

When an innocent spouse case is received, IRS screens the case to determine whether it meets basic eligibility requirements before thoroughly investigating it. IRS data shows that the percentage of cases received that IRS determined met the eligibility requirements for consideration has declined substantially after fiscal year 1999. For the 7 months of fiscal year 1999 that IRS tracked the cases, about 90 percent of them were judged by IRS to be eligible for further review to determine if innocent spouse relief should be granted or denied. In fiscal year 2000, 54 percent of cases were judged to be eligible for further review. IRS data for fiscal year 2001—October 1, 2000 through March 6, 2001—shows that about 59 percent of cases received warranted further investigation to assess their merits for relief consideration.

On the whole, however, because IRS was unable to process this influx of new cases as rapidly as they were arriving, the inventory of cases being worked at the end of fiscal years 1999 and 2000 reached 33,232 and 39,552 cases, respectively. As of March 6, 2001, the inventory of cases in inventory remained similar in size to that at the end of the prior fiscal year. Table 3 shows basic workload statistics for the innocent spouse program since IRS began tracking the cases on March 6, 1999 through March 6, 2001.

⁷ IRS began limited tracking of innocent spouse cases on March 6, 1999 when it implemented the innocent spouse tracking system. If a taxpayer files a claim for innocent spouse relief covering more than one tax year or tax period, IRS evaluates the merits of the claims for each tax year individually to determine whether relief should be granted. Therefore, the claim for each tax year is counted as a case.

Table 3: Statistics on the Innocent Spouse Workload⁸

Dates received	Cases Received	Cases eligible for review	End-of-period inventory	Completed cases*
Between March 6, 1999, and September 30, 1999 ^b	43,255	38,992	33,232	NA
Between October 1, 1999, and September 30, 2000	60,987	32,762	39,552	32,202
Between October 1, 2000, and March 6, 2001	16,422	9,681	39,111	10,122

*We have included closed cases as well as cases for which IRS has reached its determination and sent a letter to the taxpayer, but for which the taxpayer's period to appeal the determination is still open.

^bFigures up to September 30, 1999, are approximate. Data on the number of cases completed up to September 30, 1999, are not available.

Source: IRS Innocent Spouse Tracking System data.

According to IRS, the increase in the number of innocent spouse cases received pursuant to the liberalized relief provisions led to its substantial inventory of open cases for several reasons:

- The Restructuring Act provisions were effective upon enactment of the law, giving IRS limited time to estimate likely increases in workload and determine appropriate staffing levels and make staffing assignments. The volume of cases received exceeded IRS' expectations, leading IRS to assign additional staff to the effort.
- The expanded innocent spouse relief provisions were especially complex. IRS had to develop guidance for the new and revised relief provisions and provide training for existing and newly assigned staff.

In response to the increased inventory of innocent spouse cases, in fiscal year 2000 IRS increased program staff more than anticipated: it had planned to devote 717 FTEs; it actually used 887 as shown in the following table.⁹

Table 4: FTEs for Processing IRS' Innocent Spouse Claims in Fiscal Year 2000

Fiscal year	Projected		Actual		Total	
	W&I	SB/SE	W&I	SB/SE	Projected	Actual
2000	115	602	119	768	717	887

Source: IRS.

For fiscal year 2001, IRS projected that W&I and SB/SE would use 169 and 409 FTEs, respectively. IRS attributes the decrease in projected FTE usage by SB/SE primarily to expected efficiencies in case processing pursuant to a plan to move workload back to the W&I's centralized case processing facility.

⁸IRS had about 7,000 cases in inventory that were closed before the tracking system was implemented that are not included in these numbers.

⁹IRS does not have good data on FTE usage for the program prior to fiscal year 2000.

Key Actions Taken by IRS to Address Innocent Spouse Workload Concerns

IRS has taken a number of actions to better manage its inventory of innocent spouse cases and help ensure that the claims are being processed in a timely, accurate, and consistent manner. Some of the actions were based on recommendations by the Treasury Inspector General for Tax Administration (TIGTA), and others were done on IRS' own initiative.

- In April 1998, as the Restructuring Act was being considered, IRS designated the Cincinnati Service Center as a central processing site for innocent spouse cases. The service center was to screen new cases. Those cases over a certain dollar threshold or that required face-to-face contact with taxpayers were to be sent to field offices to resolve, while the less complex and low dollar cases were to be handled by service center staff. IRS officials believed that this centralization would facilitate more rapid and consistent processing of cases because staff in the service center would specialize in the innocent spouse cases and follow consistent procedures and processes in resolving cases.
- In March 1999, IRS established an innocent spouse tracking system to more accurately assess the status of cases in inventory and resource needs.
- In May 1999, IRS added a national project manager, and in November 1999 three issue specialists were selected to help manage and oversee the nationwide operations of the program.
- In June 1999, IRS announced the establishment of a centralized innocent spouse review process for closed cases in order help ensure that case decisions were made as accurately and consistently as possible among the IRS offices involved in the program. Initially, 100 percent of the field office cases and a 10-percent sample from the Cincinnati Service Center were to be sent to the centralized review office. A sampling procedure is now being used to determine how many cases from the field should be forwarded to the centralized review office.¹⁰ IRS set a goal for fiscal year 2000 that the centralized review process would concur with the decisions made by the submitting offices in 85 percent of the cases reviewed. The concurrence rate achieved for fiscal year 2000 was 82.3 percent. The goal is 90 percent for fiscal year 2001.
- In April 2000, IRS made an internal web page available to examiners and other IRS staff as a central reference for information about the innocent spouse program.
- In January 2001, the first phase of an innocent spouse integrated case processing (ICP) system was implemented at the Cincinnati Service Center. The ICP uses algorithms that direct examiners through a series of questions leading to a decision about what, if any, relief is due to the taxpayer. The ICP also automatically prompts the examiner to create a documented case file. The ICP is intended to increase the accuracy and consistency of determinations since it is designed to help ensure that examiners consider all pertinent aspects of a taxpayer's case in accordance with the law. IRS is planning future enhancements to the ICP that would make it easier for examiners to access and update taxpayer data. IRS projects that the system will save about 50 FTEs in its first year and 60 in its second year of use.

Although IRS has undertaken many initiatives to better deal with the innocent spouse workload, it has experienced a number of problems in coping with the increasing workload and in implementing some of its initiatives. For example:

- The volume of cases received was considerably above IRS' expectations.
- To deal with the unanticipated increases in workload, IRS added temporary employees to the service center staff. However, according to a report by TIGTA on IRS' innocent spouse program, those employees spent a majority of their 90-day details being trained by permanent staff on how to work these complex cases.¹¹ This depressed the productivity of experienced staff without realizing much benefit from the additional temporary employees. When the service center could not keep up with the volume of cases, IRS distributed cases to the field offices that it had hoped to be able to process centrally.
- Between the July 22, 1998, passage of the Restructuring Act and December 7, 1998, IRS was developing interim regulations to implement the equitable relief provisions of the new law. Therefore, cases for which equitable relief could apply had to be held in the service center until the regulations were promulgated at which point their processing could be resumed and completed.

¹⁰The sampling methodology was set up by IRS' Atlanta District Office of Research and Analysis and is a projectible representative sample for each field office.

¹¹*Increased Attention Is Needed to Ensure Timely, Accurate Determinations on Innocent Spouse Claims for Relief*, May 2000.

- Although W&I is responsible for the innocent spouse program, when contacts with taxpayers are needed to resolve cases, the SB/SE division staff make those contacts. In our work, we found that several SB/SE field offices had completed only a small number of innocent spouse cases. The national innocent spouse program manager in W&I lacked authority to direct SB/SE managers to adjust staffing levels for innocent spouse cases to ensure more uniform processing of taxpayers' claims. In December of 2000 and January of 2001, a memorandum of understanding was signed by the Commissioners of W&I and SB/SE, respectively, on the use of field staff to work innocent spouse cases.

Key Actions Planned by IRS to Address Innocent Spouse Workload Concerns

IRS has identified operational priorities and improvement projects to help address workload case quality concerns.

The W&I division plans to

- develop an additional training course related to marital abuse and the equitable relief provision, improve the innocent spouse tracking system so that program performance data are more quickly available to program officials, and improve outreach to taxpayers and tax practitioners.

The SB/SE plans to

- begin moving innocent spouse cases back to the centralized case processing facility in Cincinnati to improve case processing, reduce cycle time, and reduce existing inventories. SB/SE would continue to work cases generated in the field offices,¹² but IRS estimates that new case starts in SB/SE field locations will decrease in fiscal year 2001.

Summary and Observations

Several factors suggest that IRS may be gaining better management control over the innocent spouse workload. Unlike the offer-in-compromise program, the workload for the innocent spouse program appears to have leveled off after increases following enactment of the Restructuring Act. With this leveling off and enhancements in its case processing capacity such as the new integrated case processing system, IRS plans this fiscal year to move many cases back into its centralized case processing facility, potentially freeing up hundreds of field staff to return to other examination-related duties. IRS also established a review process for innocent spouse cases to better ensure that the law is applied accurately and uniformly. IRS did not achieve its goal of an 85-percent concurrence rate between the determinations made in the review process and those that had been made in the field or the centralized processing facility, but did achieve an 82.3 percent concurrence rate. The automated integrated case processing system that has been implemented at the central case processing facility holds promise in helping IRS further improve accuracy and uniformity in applying the innocent spouse provisions because it standardizes the questioning process for determining eligibility and better ensures that all appropriate documentation is considered. Although these factors suggest growing managerial control over the innocent spouse inventories, considerable uncertainty remains. For example, we know little about why the portion of cases found eligible for detailed review has decreased or whether innocent spouse workloads will remain roughly stable.

We look forward to continuing to work with this Committee and Congress in considering the issues I have discussed today as well as other issues related to our tax system. This concludes my prepared statement. I will be happy to answer any questions you or other Members of the Committee may have.

PREPARED STATEMENT OF JOSEPH G. HODGES JR.

Mr. Chairman and members of the Committee, I want to thank you for inviting me here today to address this very important issue.

My name is Joseph G. Hodges Jr. I am a member of the Colorado Bar and a solo practitioner in Denver, Colorado. I also currently serve as a member of the Council from the Probate Division of the American Bar Association's Real Property, Probate and Trust Law Section, where I Co-Chair the Section's technology Committee, and as a Fellow and Regent of the American College of Trust and Estate Council [ACTEC]. However, the following comments are mine alone and are being submitted only in my individual capacity. They do not represent the position of the American

¹² IRS field staff are to investigate any potential innocent spouse issue that comes up during contacts with taxpayers. Some of these contacts end up as innocent spouse cases and would be handled by the SB/SE field staff.

Bar Association or the Section of Real Property, Probate and Trust Law, nor for that matter of the American College of Trust and Estate Counsel or its Board of Regents.

I am appearing before you today solely as a private practitioner whose law practice has, ever since its inception in 1968, emphasized estate planning and administration and charitable planned giving. As such, it, along with my many Bar Association and related Internet activities, have given me a unique and broad exposure to a variety of taxpayer schemes, scams and cons and people who have fallen victim to the same.

You have already heard a great deal from our previous speakers about the wide variety of schemes, scams and cons that are presently out there and being perpetrated upon the innocent and badly informed public, and especially our senior citizens. Thus, I will not belabor you with further examples, except to say that the recent advent of the Internet as a means for the affordable and mass delivery of such false and/or misleading material about the average citizen's two biggest fears and certainties in life, DEATH AND TAXES, has brought a whole new set of issues to bear on and further compound the problem.

The Impact of the Internet on the Delivery of Legal and Financial Services

Prior to the advent of the Internet as we know it today in the early 1980's, people who were in the business of providing financial and estate planning services had to rely heavily on marketing and using techniques that would convince people of their need for professional help and the quality of the services that were being offered. To a great extent, those contacts were made through personal and face-to-face visits that were precipitated by quality referrals often extended over a long period of time and resulted in a lasting personal and professional relationship with the client and the rest of the client's family members.

With the advent of the Internet and its world-wide scope, the model for the most effective and least expensive delivery of these sorts of traditional financial planning services has changed both dramatically and with lightening speed. As that has occurred, people no longer are seeking out referrals to qualified professionals. Rather, self-help has become the affordable method of choice for many Americans, witness the significant increase of things such as on-line stock brokerage services, software that will allow the consumer to handle many traditional legal matters without the need for professional advice or services.

As a consequence, the American Bar Association has finally begun to address in many ways the impact that this sort of technology is having on the traditional methods of practicing law. Some of those efforts are reported in the Report of the ABA Tech 2000 Task Force on the March, 2000 Law Practice Management Section's Conference entitled "Lawyers Serving Society Through Technology." The Executive Summary of this Report reflects a variety of concerns and calls for action, including:

(1) The effective use of technology appears to provide the most promising solution for connecting underutilized lawyers with people who have unmet legal needs.

(2) There is a distinct possibility that a large segment of the legal profession, mostly solos and small firms, could be displaced by competitors providing legal solutions under the category of "legal information services" (emphasis added), such as the Nolo Press Law Store [www.nolo.com] as opposed to traditional "legal services," witness the growing movement towards, and current serious concerns within the ABA about, Multiple Disciplinary Practice [MDP] within the big accounting firms and the Multiple Jurisdictional Practice [MJP] of law across state lines. A recent article that examines this subject in depth can be found in the January-February 2001 issue of the journal of the American Judicature Society (Vol. 84, No. 4), called Judicature. The article is by John Creacen, the Director of the Administrative Office of the Courts for the state of New Mexico and is entitled "Legal Information vs. legal advice: Developments during the last five years."

(3) The Internet is allowing some types of legal services to be "commoditized" such as the "self-help" preparation of simple Wills and Powers of Attorney, and even individual income tax returns, using software products that are produced by such reputable companies as Intuit and Kiplinger magazine.

(4) Things such as artificial intelligence and expert systems and document assembly have the potential to make revolutionary changes when they are deployed in combination with the Internet, such as Lexis-One [www.lexisone.com] or the Wealth Transfer Planning Wills and Trusts Preparation Web-based software that is now being made available to professionals and the public at www.lawontheweb.com.

(5) Consumer price choices are moving away from the traditional hourly rates approach to either auction or value-added flat-fee approaches, such as pre-paid legal plans, such as the AARP Legal Services network at www.LSN.aarp.org/info, or the new Elder Law Answers web site at www.ElderLawAnswers.com, or the new Elder Law Answers web site at www.rightpro.com.

(6) The ethical framework for delivering “legal services” on line is currently not in place.

(7) Lawyers will face increasing competition from other professionals, including accountants and MDPs, many of whom are not subject to the same ethical rules, while the unauthorized practice of law statutes [UPL] are becoming harder and harder to apply to combat these competitors, especially in an Internet context.

The essence of these recommendations and how Internet technology can be used in a positive way to revolutionize the delivery of legal services to the consuming public can be examined in more depth at the new ABA eLawyering web site at www.elawyering.org.

The Revocable Living Trust As The Be-All End-All Tool of Choice

Thanks in large part to the relative success of national organizations like The Lawyer’s Network [www.netplanning.com] (the “Loving Trust” network) and the American Academy of Estate Planning Attorneys [www.aeepa.com], and seminars like the “Tax Reduction and Total Asset Protection” conference that is put on nation-wide by National Training Conference and usually taught by “The Father of Asset Protection” himself, Jay W. Mitton, MBA, JD, of Provo, Utah, the existence of trust scams and trust mills has exploded in recent years.

Not a day goes by when one does not see an ad in the local papers for a Trusts seminar, often hosted by reputable brokerage houses and presented by card-carrying members of organizations like the Network or the Academy.

The sad part of this movement is that a lot of the publicity for these events borders on outright misrepresentation, and sometimes even fraud, such as by implying that the only way to save estate taxes is to have a revocable living trust, or that it is essential in all jurisdiction in the United States to avoid “PROBATE” at all costs.

As a result of seminars likes these, there has been a significant upturn in the amount of junk mail selling Living Trust Kits. In addition, many books on the subject are starting to show up in the stores, such as “Understanding Living Trusts” by Vickie and Jim Schumacher of Schumacher Publishing in Santa Monica, California, or “The Living Trust: A Cure For The Agony of Probate” or “You and Your Will: A Complete Do-It-Yourself Manual With Forms and Instructions” by Vijay Fadia that is published by Homestead Publishing Company of Torrence, California, or “Family Trusts” by Frank Croke with William Croke, Attorney-At-Law, that is published by Capital Management Press, or “60 Minute Estate Planner” by Sandy F. Kraemer Esq. that is published by Prentice Hall. As a consequence of this, the Attorneys General of many states, including my home state of Colorado, have finally begun to publish consumer booklets, like the one called “Consumer Alert!—Living Trust Scams” that Colorado’s former Attorney General, Gale A. Norton, published in cooperation with the AG’s Consumer Protection Unit.

Some Additional Solutions to the Problem

As a direct consequence of the significant increase in the amount of consumer fraud and misrepresentation in this arena, both the ABA RPPT Section and ACTEC currently have under serious consideration and development significant additions to the public education content on their Web sites, not only about all the many sorts of tax schemes, scams and cons that are so widely known to exist today, but more importantly about helping the public to seek out and find qualified and reputable professional help with their estate planning needs.

In the case of the ABA RPPT Section, their plan is to develop their public content much as the ABA Business Law Section has done already for the consuming public. The RPPT Section will be meeting in Washington, DC at the end of this month to give final approval to phase one of this new site.

In the case of ACTEC, although the public content part of its site had been slow in developing to date, the College’s Practice Committee currently has several proposals under active consideration. In addition, a year ago the College’s Foundation underwrote the cost of producing a one-hour program for PBS as a segment of the “Inside the Law” series called “Death and Taxes: An Inside the Law Special” that first aired nationwide in May of 2000, and the Foundation just recently approved the funding of a second such production focusing on Elder Law at its spring 2001 meeting last month. A similar public video educational effort was undertaken by the California Bar a year or so ago, this one focusing on elderly fraud issues, and it was funding out of the proceeds of the settlement of a case against one such perpetrator.

Conclusion

I hope the Committee can see from the foregoing and all the testimony today that the Bar Associations are becoming much more proactive in trying to combat the many tax scams and cons that are present today in the sincere hope that such pub-

lic educational efforts will bring about a quick and sudden but well-deserved “death” to most such schemes.

PREPARED STATEMENT OF JJ MACNAB

Good morning, Mr. Chairman and Members of the Committee. My name is JJ MacNab and I am an insurance analyst, financial planner, and writer located in Bethesda, Maryland.

This morning I will provide an overview of the tax evasion industry, their marketing practices, their surprising growth in recent years, and the role of the Internet in that growth. I will also address the current efforts by the Internal Revenue Service to curb these abuses and will comment on problems inherent in those efforts.

I. BACKGROUND

In the past ten years, tax evasion has grown from being a secret of the very wealthy to a mass marketed industry. An estimated \$300 billion in tax revenue is lost each year as a result of a variety of techniques ranging from sham trusts, offshore accounts, and abusive charitable schemes to the more sophisticated planning involving international business corporations and private offshore tax-exempt insurance companies.

As the promoters of these plans become more aggressive and their target market widens, this lost tax revenue will only increase. The IRS no longer acts as an effective deterrent to those who cheat, and where most taxpayers in the past begrudged their taxes, they paid them nonetheless, because it was the right and honorable thing to do. Today, many of those same people have decided that the system is corrupt and that only fools pay their taxes.

II. THE CAUSES BEHIND THE CHEATING

- **Tax protesters:** While many people assume that this is a small, fringe group of people, such a characterization would be incorrect. In the past few years, the tax protester movement has grown substantially and includes ex-IRS employees, attorneys, CPAs, and a wide variety of other professions. This growth is primarily due to the Internet, and the ease with which it allows people with common interests to share ideas, and to create inexpensive soapboxes upon which they can reach potentially thousands of readers at the same time.
- **Trickle Down Effect:** In 1989, Leona Helmsley made her infamous statement, “Only the little people pay taxes.” The little people listened and in the decade that followed her comment, have been taking increasingly aggressive steps to either reduce taxes or stop paying income taxes entirely. Abusive techniques which ten years ago would have only been promoted to a few hundred of the wealthiest Americans, are now mass marketed on the Internet, in in-flight magazines, on the radio, and in the back of respected newspapers and magazines.
- **Anger at Government Favoritism:** Our Tax Code is riddled with special interest tax credits and exceptions carved out for increasingly narrow groups. The size, complexity, and perceived government favoritism in the Code has eroded all respect for the tax system.
- **Greed:** Once paying taxes is no longer considered the honorable thing to do, it becomes easy for people to rationalize cheating.
- **No Fear of Reprisal:** The IRS is no longer effective at stopping or preventing tax cheaters. The odds of an audit have become so small that an increasing number of people have become “willing to risk the audit lottery.” And even if audited, most people believe that the Service has no teeth after the 1997 and 1998 hearings.
- **Scams:** Of those currently not paying taxes, perhaps the largest group has bought into a product or system that appears to be legitimate, but is actually a sophisticated confidence game. These consumers truly believe that what they have purchased is legal and ethical, and many of them are so enthused by their newfound knowledge and investment, that they, in turn, become marketers themselves.

III. IS THERE REALLY A PROBLEM?

Hundreds of thousands of middle to high income Americans are currently paying little or no income taxes at this time. The marketing has become increasingly pervasive and includes thousands of Internet websites, full page ads in USA Today and the Washington Times, mass emails, radio advertising, online bulletin boards, and word of mouth.

There are numerous tax evasion techniques being promoted, including the following:

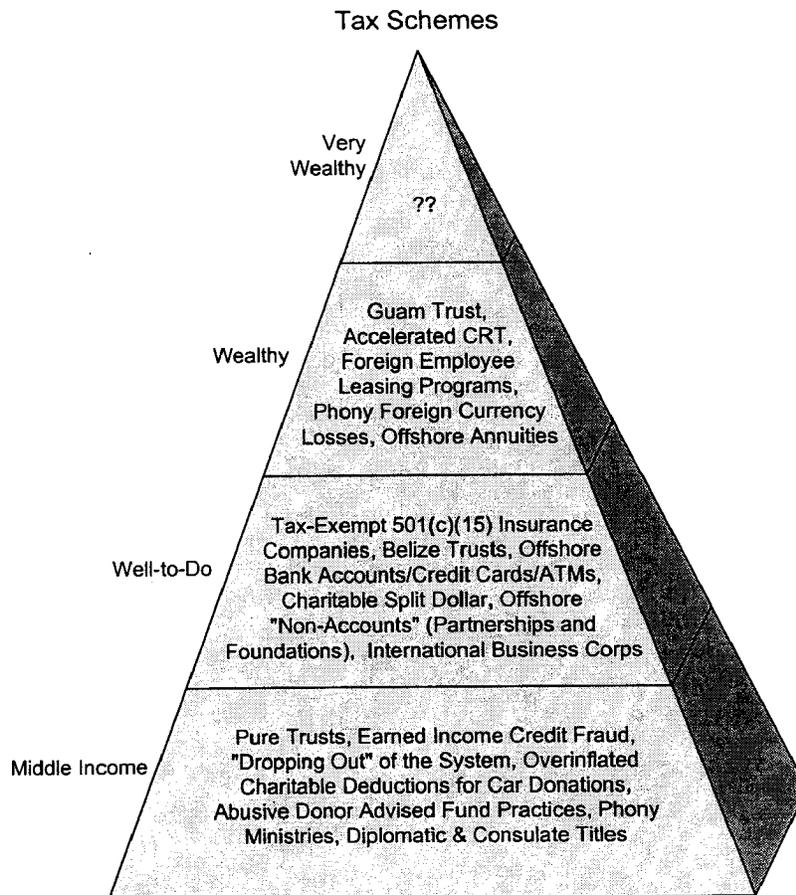
- “Tax-exempt” trusts and business structures;
- Offshore accounts, banks, businesses, trusts and foundations;
- “Dropping out” of the system by stopping all withholding and Social Security taxes, in some cases even filing for refunds of past years’ withholdings;
- Tax-exempt private insurance companies;
- Charity-like or religious entities established for personal use.

The target market for each technique varies; lower and middle-income consumers tend to buy into the simpler and less expensive techniques, higher income consumers lean more towards the complex and better researched.

The following chart is an example of the techniques being promoted to each income level. This is only a generalized example—there are many additional schemes not mentioned, and techniques listed often cross over into other income categories.

Some of the schemes are outright fraud; others thrive on ambiguity in the Tax Code. While the IRS has been unable to estimate the amount of taxes lost, the unofficial tally is approximately \$300 billion per year.

The top section of pyramid is largely unknown. Such high level techniques are usually kept secret through the use of non-disclosure agreements, where all the parties involved agree not to discuss the terms or details of the plan to any outsiders.



IV. EXAMPLE #1: PURE TRUSTS

Pure Trusts go by many names (Constitutional Trust, Complex Trust, Liberty Trust, Pure Business Trust, Equity Trust, USA Trust, or Common Law Trust, for example) and have been marketed aggressively on the Internet in recent years. When I spoke with the Criminal Investigations Division of the IRS in 1999, they estimated that approximately 250,000 of these trusts were in existence at that time. By now, the numbers of trusts in place is most likely significantly higher.

- **How It Works:** There are many varieties of pure trusts currently being marketed, both domestic and offshore, but in general, it works like this: you place all of your business or personal assets into a trust or series of trusts, and pay little or no income, estate, or capital taxes ever again. In the meantime, you maintain full control over your assets and all of your personal expenses become deductible.
- **Why it Sells:** The marketers who sell such products appeal to specific types of consumers. The following is a brief list of some of the sales pitches used by various marketers today:
 1. It's your "God given right" not to pay taxes;
 2. There is a government conspiracy to obscure the truth that you don't have to pay taxes;
 3. Taxes are "voluntary" therefore smart people will not volunteer to pay;
 4. Taxes are unconstitutional—the 16th Amendment was never ratified
 5. Taxes only have to be paid by US citizens (defined as someone born in or living in Washington DC or the US territories) and foreign companies doing business in the US;
 6. Rich people save money on their taxes with these plans, so should you;
 7. The IRS is weak. Even if you're caught, Senator Lott will protect you;
 8. Audit Lottery—odds are phenomenal that you won't be audited;
 9. These are elite tax planning services offered by sophisticated advisors;
 10. Planning for "attributational black holes"—you can't be caught by IRS computers;
 11. Everyone cheats; you're a "chump" if you don't too.
- **Who are the Promoters:** The Internet has made selling tax scams to the public remarkably easy. It costs almost nothing to set up and maintain a website, and sending mass emails to thousands of targeted readers is very inexpensive. The promoters include anyone with a modem and a web account and consist of individuals, small companies, franchises, multi-level marketers, affinity programs, and church groups.
- **The Size of the Industry:** As an exercise, I set aside two hours of uninterrupted time when I could browse the Internet to see how many tax scams I could find. I had done similar research in March of 2000 for a magazine reporter. Chart A shows a comparison of the number of websites that contained the phrase "pure trust" one year ago and today. The occurrence of "pure trust," for example, has grown from 867 web pages to 2,340, an increase of 170%. "Complex trust" occurrences have grown by almost 270% and "constitutional trust" has jumped by 536%. Despite the IRS' attempts to shut these particular programs down, they have increased dramatically in the past year.

	March 2000	March 2001
Common Law Trust	N/a	2,010
Complex Trust	490	1,810
Constitutional Trust	44	280
Contract Trust	N/a	972
Liberty Trust	N/a	354
Pure Business Trust	N/a	30
Pure Equity Trust	17	45
Pure Trust	867	2,340

Chart A: Pure Trust References on the Internet

In Appendix A of this report, I have prepared a summary of the actual websites I found during my two-hour search. Whereas early marketing materials and websites were generally characterized by patriotic themes and strong rhetoric, today's sites are quite often professional and many could pass for high-level law firms and financial services companies.

- **What's Being Done to Stop These Promoters:** While the IRS' Criminal Investigation Unit has been quite aggressive and successful at obtaining long prison sentences, their efforts are doing little to stop the marketing. Consumers have no idea that the IRS is winning or even fighting these cases, and considering that the bulk of the marketing materials state that the IRS is acting outside the scope of their authority, most of the consumers who have bought into these programs pay no attention to the IRS' warnings.
- **Undercover Investigations:** The IRS has recently done a remarkable job with substantial undercover investigations, obtaining large fines and long prison sentences, and they are generally getting the word out to the press through press releases and with their recent Abusive Trust brochure. From an outsider's viewpoint, however, their goal seems single-minded; they want to thoroughly punish those people who are breaking the law.

These undercover investigations, however, take too long to protect most consumers. The Anderson's Ark investigation, for example, took more than two years to complete, and during that time, possibly thousands of additional consumers were duped into participating in that scheme. To make matters worse, the Anderson's Ark website (www.andersonark.com) is still up and running even though the leaders have either been arrested or are currently fugitives from the law.

- **The CID Brochure:** The Criminal Investigation Division has produced a very good brochure and website outlining arrests, sentences, what to watch out for. Unfortunately, very few consumers have seen either. Until the IRS can get the word out to the same masses that are frequenting the tax fraud websites, their efforts won't go far.
- **The Marketing is Expanding Faster Than the IRS Can Act:** As one technique gets shut down, the marketers often adjust their sales pitch to incorporate the IRS' efforts:

1. **The Criminal Investigation Division is Illegal:** When the Criminal Investigation Division of the IRS releases arrest and conviction information, the promoters simply shrug. They instead point to their research, which "proves" that the Criminal Investigation Division is acting illegally, and cite examples of how the CID is losing their war. It is not uncommon to quote Senators Lott and Hatch on how the IRS oversteps its bounds and persecutes innocent citizens.

2. **Ours is Different:** When the IRS released their notice and brochure regarding Abusive Trusts, several promoters carefully "analyzed" this information and showed why their Pure Trusts products differed the "Bad Pure Trusts" described in the notice, or they simply renamed their program to something other than a trust.

3. **Following the Letter of the Law in Disclosing Foreign Trusts:** The IRS requires a taxpayer to disclose all ownership or beneficiary interests in offshore trusts. The marketers now recommend that their clients set up offshore partnerships or private interest foundations so that there is no “trust” in existence to be reported.

4. **Changing Gears:** The IRS has been clear about its position on Abusive Trusts. Many marketers have now pivoted to non-trust planning, such as techniques to avoid employer withholding of income and Social Security taxes. Since these marketers are only selling ideas and techniques rather than product, they usually state that their website materials are protected by the First Amendment.

- **Most Promoters are Simply Ignoring the IRS:** The number of websites selling pure trusts has blossomed in the past few months, despite the big investigations and arrests. In one week, I received three “spam” email messages, one to set up an offshore private bank, another to make \$5,000 per week from home helping others opt out of the income tax system, and a third which offers foreign accounts with numbered credit cards so that I can access my offshore money.

V. EXAMPLE 2: “DROPPING OUT” OF THE TAX SYSTEM

In February and March of this year, USA Today and the Washington Times each ran full page ads for a group who “proves” that taxes are unconstitutional, citing an ex Criminal Investigation Division Special Agent as their researcher. In January of this year, I received an email solicitation from an “Associate” of the Joy Foundation, offering me an opportunity to resell their information package showing employees how to “legally” stop taxes from being withheld from their paychecks.

Unlike the Pure Trust schemes, this is a relatively new scam on the Internet, but similar to the pure trust market, it is rapidly gaining momentum. A brief online search uncovered that the following companies have stopped withhold taxes, and have advised their employees that their income is not subject to any tax filing. Furthermore, several of these companies have applied for a refund for past years’ taxes:

No Time Delay Electronics Inc. (California)
 Moran Mortgage Company (Illinois)
 Sunshine Foot Clinic Inc. (Arkansas)
 DMI Mechanical (California)
 Home Investors Inc. (Missouri)
 Bosset Marketing Partners Inc. (Florida)
 Arrow Custom Plastics Inc. (Texas)
 Cencal Aviation Products (California)
 Batavia Enclosures Inc. (New York)
 Kristi Tool Company (Massachusetts)
 Certon Inc. (Texas)
 Ikon Roofing (California)
 N.T.D. Electronics (California)

This is a new industry, and if the IRS acts quickly, it can stop the schemes before they grow out of control. It does not appear, however, that the IRS considers such preventative measure a priority. On March 31, 2001, in an article entitled “Company Faces I.R.S. Suit for Not Withholding Taxes,” the New York Times reported the following:

Several senior I.R.S. officials have said in recent weeks that they expect that business owners who boasted about not withholding taxes would be indicted, but not for several years.

In contrast, the promoters of this program are making a concerted effort to increase their numbers. They have frequently referred to the IRS’ inactivity as “proof” that their strategies work and on the We The People website (www.givemeliberty.org) make the following prophesy:

We think the genie is out of the bottle now, and even if the IRS tries to stuff it back in, we’ve run off with the cork, and the genie will just escape again.

If the IRS does indeed wait years to indict, hundreds if not thousands more businesses will follow in the footsteps of the companies listed above. And these employers will advise their employees that their employment income is no longer subject to taxes. Waiting years to enforce the laws will only result in a large number of taxpayers falling into the trap of tax evasion, facing substantial future taxes, interest, and penalties which many will be unable to pay.

VI. EXAMPLE 3: PROLIFERATION OF FOREIGN ACCOUNTS

This is an extremely complex market, with literally thousands of variations that range from legitimate tool to scam and a thorough review is beyond the scope of this testimony. I have provided the following examples to give an idea of just how pervasive the marketing is, and how simple and inexpensive it is for consumers to move money offshore:

- **Swiss Bank Accounts:** You can now open a numbered Swiss Bank account online at *www.swissnetbank.com* with as little as \$200.
 - **Fill Your Online Shopping Cart with Tax Saving Devices:** A website called Global Money Consultants (*www.global-money.com*) allows you pick and choose your offshore entities with the click of a mouse. You simply add your items (Panamanian Foundations, Anonymous North European Debit Card, Niue Corporations, or a St. Vincent Offshore Bank, for example) into your virtual shopping cart and check out using your e-money account. Appendix B contains a printout of the front page of this website.
 - **International Business Corporations (IBCs):** To give an example of the growth experienced in the offshore market, in the late 1980s, the British Virgin Islands had roughly 10,000 of these phony corporations in place. In the year 2000, this number had swelled to approximately 350,000.
 - **Tax-Exempt Insurance Companies:** In the March 5, 2001 issue of Forbes Magazine, the article entitled "Are you a Chump?" outlined a tax evasion technique involving a 501(c)(15) insurance company used "to shield hundreds of millions of dollars or investment earnings from taxes" for a single wealthy taxpayer. This technique is now gaining popularity among the moderately wealthy and the IRS is currently granting tax-exempt status at a rate of ten per week.
- The Internet, savvy promoters, and smart encryptions programs have made it possible for average income taxpayers to move money offshore without being detected and without being traced by the IRS' computer systems. Unless the service goes to the source (the promoters), they have no way of knowing whose money is offshore.

VII. WHAT CAN BE DONE TO FIX THE PROBLEM?

- **Time is of the Essence:** As mentioned earlier, two to three-year undercover investigations may lead to substantial sentences and fines, but in the meantime, the promoters are selling their scams to thousands of innocent consumers. When senior IRS officials tell the New York Times that they do not intend to convict non-withholding employers until years from now, other employers (and their hapless employees) become involved in such programs in the meantime. If the IRS' mission is to serve the customer, many of those customers would be best served by being protected from charlatans. *The IRS must move quickly to shut down Internet marketers promoting tax fraud.*
- **Targeted Investigations:** There has been much talk in recent weeks about face-to-face audit counts and computer matching programs. While computers are useful in catching errors, they will do little to catch tax fraud promoters, who often are fully compliant in preparing their own tax returns. Furthermore, these promoters (as well as attorneys, CPAs, and financial planners) are quickly adapting to the IRS' matching system and are advising clients to take risk only in those areas where they can't be caught. The nickname for this technique is "attributional black hole planning." Furthermore, thanks to the Internet, to sophisticated encryption programs, and to a new digital form of money (e-money), transferring assets offshore without leaving a trace has become relatively simple. *The IRS cannot rely on computer programs to catch all or even most of the Internet-related tax cheats; they should also be using basic investigative techniques to locate the promoters online.*
- **Consumer Education:** When you perform an Internet search on basic tax fraud phrases such as "pure trust" or "international business corporation," the IRS' website does not appear in the results. The consumer fraud section of the IRS website should be expanded, with appropriate metatags inserted to ensure high placement in the various search engines. In addition, spokespersons for the IRS should be visiting the a wide range of talk shows and radio shows, and giving magazine interviews just as the fraud promoters do.
- **Working with Professionals:** All four professionals on this panel have dedicated significant time and energy over the past few years to learning about tax scams and informing consumers that these plans don't work. The IRS should consider working more closely with those in the private sector who have made an effort to track such scams.

VIII. SUMMARY

If left unchecked, this culture of tax evasion will blossom, and if it gains enough momentum, could render our current tax system useless. There has to be a concerted effort to better inform the public and in cases where promoters are selling tax fraud, such businesses and websites should be shut down as quickly as possible. While long-term investigations yield big sentences, in the meantime, thousands of additional consumers are falling into the promoters' traps.

APPENDIX A
Two Hour Research Project

Website	Business Name	Comments
www.yourtaxfreedom.com www.incometaxfreedom.com	The 4 Your Success Group (Minnesota)	"Many Americans have a very definite idea about how the Internal Revenue Service behaves. And in many respects, they are correct. Testimony before the Senate Committee in October of 1997 revealed, for the first time for many Americans, just how the IRS tries to intimidate and bully you."
http://landbusiness.safeshopper.com	Land Business Systems (Pennsylvania)	Also sells mineral supplements on eBay.com, battery recovery systems, "Liberty Pure Trusts," and "Constitutional Products."
www.taxgate.com	RBH and Associates (New Jersey)	"US Income Tax Law:" Very large Pure Trust and tax avoidance portal. Has more than 1,325 pages of data and articles. Not selling products, but charge \$165 for membership / consultation. Website states that it has 345,000 hits per month.
www.buildfreedom.com/economic/eco_6.html	Terra Libra Ventures (Arizona)	"Freedom" Portal. Offers books for sale, as well as free information such as "How to Stop Employers From Withholding Income Taxes."
www.heritage-institute.com	Heritage Institute for Estate Planning (California)	Offers Contractual Pure Trusts and Living Trusts. Explains that Pure Trusts are "safe" from Medicaid look-back rules. Displays the Better Business Bureau Reliability Seal.
www.solgroup.com www.puretrust.com www.no1040s.com www.cktrust.com	!SOLUTIONS! Group (Ohio)	Offers the Liberty Pure Trust. Also sells web-hosting and offshore investments. Counter shows almost 39,000 "hits."
www.yeimtel.com/~trusts	Without Prejudice (Tennessee)	Run by a "barrister at law" named Austin Gary Cooper. Offers the "Clark Kent Trust," (a Pure Trust) for \$578 and an expatriation / repatriation kit for \$388.
	Family of Eagles Ltd. / American Beauty Rose (Washington)	Pure Trusts sold by private appointment only.
www.webtrust.com	Localink Information Services (California)	Sells Living Trusts and Irrevocable Pure Business Trusts. Offers sample documents for \$9.95.
www.iossbs.org	Int'l Organization of Self Sufficient Benefit Societies (Nevada)	A "fraternal society". Also sells water purifiers, waste systems, pyramid greenhouses, offshore credit and ATM cards, offshore bank accounts and trusts.
www.i-f-c.com	Innovative Financial Consultants (Arizona)	Also offers Pure Trust Organizations, offshore banking, foreign bank formation, and Limited Liability Companies. Counter indicates almost 67,000 "hits."

Website	Business Name	Comments
www.f-f-a.com	Financial Fortress Associates (Texas)	Sells Pure Trust Organizations, Limited Liability Companies, conducts regular sales seminars, and claims 7,000 clients.
www.puretrusts.com www.givemeliberty.net http://webf0126.ntx.net	R&H Publishers (Oklahoma) BizNet Equity Management Trust (Florida)	Offers books, packages, and "do-it-yourself" manuals to set up Pure Trusts. Sells Pure Common Law Trusts through a "Do-It-Yourself Trust System." "Authorized dealer of EHMT". Currently hiring new dealers.
www.ehmt.com	Entrepreneur Holdings Management Trust (Florida)	No information. Just a one page site that says "International Strategies" with a phone number. Copyright information shows 1994-2001.
www.webyellowpages.com/pill	Prosper International League Ltd. (Florida)	Claim 20,000 customers and seven years' experience setting up Pure Trusts. Multi-level marketing program. Also offers offshore credit cards, offshore banking, and Belize Trusts. "Start an account for only \$200."
www.joyfoundation.com	The Joy Foundation (Florida)	The Joy Foundation. Earn an Associates Degree in avoiding income taxes. Multi level marketing program. Join for \$1,680. Also sells books through Amazon.com.
www.wealth4freedom.com	Capital Strategies (Florida)	Same website as The Joy Foundation. Presumably a dealer/associate.
www.pure-trust.com	Lamb & Associates (California)	Recently merged with pre-paid legal services website.
http://home.swbell.net/ministry/	International Fellowship of Churches and Ministers (Texas)	"Education - Ordination - Church Charters - Irrevocable Pure Trusts and Shore-ends". Purchase a church charter for \$300 and "Free your church, yourself, your business from undue tax burden."
www.freedomtrustgroup.com	Freedom Trust Group (South Carolina)	Sells software so that buyer can produce an "unlimited number of all five different types of common-law irrevocable contracts of Pure Trusts." Also sells International Business Corporations.
www.trusterprises.com	Trust Enterprises (California)	The CPA who started the current movement by obtaining a letter from the IRS saying that a "Pure Trust Organization has no tax requirements."
www.mysticbird.com	The Phoenix Group (Oregon)	Sells "Contractual Business Entities." "The IRS is very aware of what a "pure common law trust" (CBE) is, and understands that they are exempt from statute."
www.successlinks.com	Institute of Global Prosperity (Florida)	Audio tape and seminar package to set up offshore accounts, trusts, Internal Business Corporations, and Limited Liability Companies.

APPENDIX B

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PREPARED STATEMENT OF HON. CHARLES O. ROSSOTTI

Mr. Chairman and Distinguished Members of the Committee, I am pleased to discuss the IRS' 2001 tax filing season, our FY 2002 budget request and the initiatives we are undertaking on behalf of America's taxpayers.

INTRODUCTION: A PLAN FOR TODAY AND THE FUTURE

Mr. Chairman, last year when I came before you, I said we had a clear direction and had taken some important steps to improve the IRS. Now, for the first time I can tell you that we have a real plan that lays out how we will build on the four-

dition we have laid to make the IRS everything the American public has a right to expect it to be.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of the IRS Restructuring and Reform Act of 1998 (RRA 98) and reflects the new and modernized IRS. The strategic plan shows how the IRS can dramatically improve service to taxpayers and ensure fairness and compliance with our tax laws. Moreover, the Agency will meet these goals while continuing to shrink in size relative to the economy.

The greatest challenge presented by the IRS strategic plan is that we must continue to administer the world's largest and most complex tax system while simultaneously reengineering and improving how the Agency works at its most basic level. In other words, we must operate effectively and modernize at the same time.

Mr. Chairman, I want to emphasize the importance of this two-pronged, or dual approach of strategies to improve performance over the next two years while modernizing the Agency in the longer term. Let me illustrate how this approach is now working. In conjunction with our mission and goals, we developed 10 major strategies. For each of these strategies, operational priorities and improvement projects for FY 2001 and 2002 were defined and responsibilities assigned for carrying them out. Some of our major strategies include:

Meet the Needs of Taxpayers. Each year, the IRS has millions of interactions with taxpayers who need information or assistance to file their returns or pay what they owe. The taxpayer should always receive quality service from the IRS that is helpful based on his/her particular situation and need. Taken together, the fundamental changes underway in all aspects of our operations will provide taxpayers accurate and prompt information to assist them in filing, paying, and resolving issues in a time and manner convenient for them. In the short-term, we will implement this strategy through actions such as expanding phone-hours, adding more convenient locations and providing additional assistants during peak hours.

Reduce taxpayer burden. One of the themes underlying improved IRS's business practices is to shift from addressing taxpayer problems well after returns are filed to addressing them early in the process, and in fact preventing problems wherever possible. Over the next two years, we will make substantial progress to reduce taxpayer burden although much more will be possible through our longer-term business system modernization efforts. Increasing our partnerships with states and practitioners will be a major part of this strategy. In the short-term, we can make improvements, such as expanding our Voluntary Compliance Agreement Program and providing specific information over the Internet to taxpayers groups. The new IRS "Small Business Self-Employed Community" web page is an excellent example of this strategy.

Broaden the use of electronic interactions. Electronically-filed returns improve service for taxpayers and boost productivity by reducing errors, speeding refunds, and reducing labor costs. We will enhance technology to allow filing of a full range of returns, eliminate requirements for separate signature documents, tailor marketing and education programs to attract taxpayers and practitioners with varying needs, and broaden the number of payment options. Customer education and assistance programs provided through the IRS web site, such as the distribution of forms and publications and answers to tax law questions, are growing rapidly. We are making excellent short-term progress on this strategy. Examples include the elimination of paper signatures for e-filed returns and dramatically increasing the number of forms that can be filed electronically.

Address key areas of non-compliance. Research indicates that there are major non-compliance problem areas. These include abusive tax shelters and trusts as vehicles for managing assets and for wealth transference. Unpaid employment and withholding taxes by businesses have also increased and overpayment of refunds due to erroneous return claims is high. We will make progress in combating key areas of noncompliance over the next two years as demonstrated by our recent actions on illegal offshore trust programs. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s (schedules filed by partnerships, trusts and S-corporations to provide information on income/losses distributed by business entities, to individual partners, beneficiaries and shareholders).

Stabilize traditional non-compliance areas. Regardless of how successful we are in preventing taxpayer errors, intervention through examination and collection actions and investigations is necessary when noncompliance or non-payment is found or suspected to be occurring. Since we have limited resources, it is essential that we apply these resources where they will be of most value.

More focused and rapid intervention can enormously improve the effectiveness and efficiency of our activities, while improved case management tools can improve the quality and speed of cases and ensure that taxpayer rights are observed. The recent funding of the STABLE (Staffing Tax Administration for Balance and Equity) initiative is key to the IRS stemming and turning around the decline in collection and exam activities.

These major compliance improvements will require, however, a fundamental redesign of our most complex business processes. They are also very dependent on new technology from our Business Systems Modernization program (BSM). Therefore, our strategy is to stabilize and improve traditional compliance programs in the near term, while working through BSM for long-term and fundamental improvements.

Over the past year, the IRS also made steady progress on three key modernization programs. In response to RRA 98, the new customer-focused organization is currently being implemented, and a top management team is in place for each of the four Operating Divisions and functional units. We also approved balanced measures for much of the new organization and have slated approval of measure for the remaining organizational units for the current fiscal year. Both of these programs should start delivering benefits now.

The third piece of modernization, the Business Systems Modernization program (BSM) is off to an excellent start. The Enterprise Architecture plan, which is the roadmap for modernizing the Agency's business systems and supporting information technology networks, was approved earlier this year. BSM is just beginning to deliver tangible improvements; it will deliver a growing number of benefits with each succeeding year for the remainder of the decade. Each of these programs is discussed in detail later in the testimony.

Mr. Chairman, I want to stress that this dual approach will require sustained support from the Congress and the public, as the change will take time and will inevitably include setbacks along the way. It will also require investments, especially for business systems modernization, and adequate funding for current operations, such as customer service and compliance.

PROGRESS MADE: INITIAL SUCCESSES UPON WHICH TO BUILD

Mr. Chairman, I would like to discuss some of the progress the IRS has made over the past year, particularly as it relates to how we are making it easier for all taxpayers to file their returns and pay their taxes and how we are ensuring the fairness of our tax administration system.

Checkbox Initiative

Beginning this filing season, Paid Return Preparers can use the Third Party Authorization Checkbox on all Form 1040 Series returns with the exception of TeleFile. This checkbox indicates the taxpayer's desire to allow the IRS to discuss the tax return and attachments with the preparer while the return is being processed. This provides for a significant reduction in paperwork for millions of taxpayers. It also addresses a problem with which we have been grappling for years.

Including a checkbox on the family of 1040 returns is a direct response to requests from our external stakeholders, such as the South Florida Citizen Advocacy Panel (CAP), National Society of Accountants, National Association of Tax Practitioners and National Association of Enrolled Agents.

The checkbox designation should enable practitioners quickly to resolve questions concerning the processing of the taxpayer's return. It should also reduce the number of contacts necessary to resolve processing questions and eliminate the need for the submission of paperwork for a Power of Attorney, which is not required to resolve simple problems with a taxpayer's account. Our initiative also addresses the practitioner groups' concern that this designee not be afforded post-assessment correspondence or representation.

Mr. Chairman, the IRS calculates that taxpayers will save an estimated 75,000 hours initially by not having to prepare a third party authorization disclosure form (Form 8821). Additional time will be saved because processing issues will be resolved immediately, thereby eliminating unnecessary post-filing contacts. However, we recognize that the net burden reduction, as currently calculated, will be somewhat smaller because there will be an increase in burden for reading and understanding Forms 1040 instructions for the new checkbox authority.

We further expect over a million taxpayers to use the checkbox feature in lieu of filing Form 2848 (Power of Attorney and Declaration of Representative). Therefore, taxpayers will save an estimated 1.9 million hours initially by not having to prepare Form 2848. Once again, the net burden reduction will be less because we must as-

sume there will be an increase in the burden for reading Forms 1040 instructions and understanding the new checkbox authority.

The burden reduction that will result from the checkbox initiative is even greater when one considers the 8 million notices related to math errors and return preparation that were issued in 2000. Twenty-seven percent of these notices were related to returns prepared by paid preparers. The IRS estimates that taxpayers will save approximately 779 thousand hours by referring notices to their designees rather than responding to the IRS in writing or by telephone. Similarly, we estimate that taxpayers will save more than a million hours related to correspondence by allowing IRS to resolve issues by contacting their designees.

Redesigned Notices

As part of its continued effort to improve its correspondence to taxpayers, the IRS began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. The new notices should: (1) reduce the number of times taxpayers need to contact the IRS; (2) be easier to understand; and (3) facilitate resolution of inquiries. The combined yearly volume of these six notices is about 10.5 million.

Following RRA 98's directions, the new notices also contain more information, including: (1) the formula for how the IRS computes the penalty or interest; (2) the section of law from which the penalty or interest is based; and (3) a table that details account information under each penalty or interest section to specific periods that the charges apply. Members of the Citizen's Advocacy Panel reviewed the notices before we released them in October 2000.

Despite extensive testing, some of the first notices sent out were missing information. The IRS has since corrected errors in the programming for these notices and mailed explanations to taxpayers as appropriate.

We are continuing our redesign efforts on 23 additional notices. We plan to release four of the notices in 2002 and the remaining 19 in 2003.

Change of Address

Due to a licensing agreement between the IRS and the U.S. Postal Service, taxpayers who move after filing their tax returns should receive future correspondence from the IRS on a more timely basis.

Under this arrangement, the IRS will use the Postal Service's National Change of Address (NCOA) database to update the addresses in its own Master File of taxpayer data. This address updating process should also provide quicker resolution of undelivered refund problems.

The IRS will check the names and old addresses in the NCOA weekly update files against the names and addresses in the IRS database. Where there is an exact match, the IRS will update its file with the taxpayer's new address. According to the Postal Service, there are about 800,000 address changes each week.

In addition to helping IRS get refunds to taxpayers, this new program will permit the IRS to make earlier contacts with them to resolve issues such as delivery of a returned refund, possible unreported income, examination of a return, or collection of unpaid tax. The delay in delivery that can result from a letter going to an old address, then being forwarded, may cause a taxpayer's reply and a subsequent IRS letter to cross in the mail. Unraveling such situations can be time-consuming and frustrating for both the taxpayer and the IRS.

Stabilization of Compliance Activities

Earlier this year, Congress approved the staffing plan for the STABLE (Staffing Tax Administration for Balance and Equity) initiative. The funding was included in the Fiscal 2001 Appropriations bills.

The STABLE staffing plan reflects the new modernized IRS and represents a careful judgment as to how these additional resources, together with our internal management improvements, can best be used to improve our service to taxpayers and compliance effectiveness.

The two principles that guided the budget request were, first, allocate incremental resources directly to staffing front line positions. Second, these additional resources will provide a balanced improvement between service and compliance programs. With the increased staffing levels, we expect the IRS to be able to slightly increase levels of service and to stabilize the level of exam and collection activity while complying with the taxpayer rights provisions of the RRA.

Our overarching goal is to achieve the greatest possible improvements in both taxpayer service and compliance efforts by determining how best to use the STABLE resources in conjunction with the base FY 2001 budget request. We believe that STABLE achieves this goal.

In our reorganization effort over the last two years, we have carefully studied the use of nearly every position in the IRS. One of the key findings in this analysis is that the use of compliance personnel such as revenue agents and revenue officers on “details” to taxpayer service duties during the filing season is not efficient. This practice, while necessary as a short term solution to inadequate service, takes highly trained and high graded personnel away from important exam and collection casework during a substantial part of the year, causing reduced levels of productivity and delays in completing cases.

Another key finding of the study is that the IRS provided very minimal levels of activity in assisting taxpayers to understand their tax obligations and avoid mistakes in filing, especially in the small business areas. Many stakeholders groups have stressed that this problem causes errors later in the process, which are expensive for both taxpayers and the IRS.

In our new structure, instead of increasing the number of expensive and scarce compliance personnel, we have provided for additional positions in taxpayer service and education. A significant portion of the STABLE resources will be used to fill these positions. By hiring staff to perform these service and educational functions, we can avoid the need to use more expensive compliance personnel on details during the filing season, thus allowing us to accomplish two objectives efficiently: increase our level of taxpayer education and taxpayer service and increase the number of staff years actually applied to exam and collection casework.

With this approach to the STABLE staffing, together with our reorganization and technology improvements, we expect to show measurable improvements in our key programs in FY 2001. Because of the time required to hire and train people, we will not achieve the full impact until FY 2002. Some of the improvements we expect in key areas in FY 2001 are:

- Increase the level of service on our toll free telephone service from approximately 59.1 percent in FY 2000 to approximately 63.4 percent in FY 2001, while also improving our quality measures.
- Reverse the downtrend of the last five years in compliance, increasing the number of overdue accounts closed by our telephone and field collectors by 8.6 percent.
- Increasing the number of exams of individuals conducted in person by about 6.2 percent, while also improving quality.

In examination, we will focus on the areas with the greatest risk of underreporting of income. For example, the number of exams of higher income individuals and corporations will increase more rapidly than the average.

This additional staffing will allow us more quickly to resolve innocent spouse claims, offers in compromise cases and collection due process cases we completed—key taxpayer rights included in RRA 98. We will also increase our commitment to pre-filing assistance to taxpayers through communication and education programs and pre-filing agreement programs. These areas are of particular importance and concern for the small business community.

Targeting Our Resources

We must promote fairness by combating key areas of non-compliance. To this end, the IRS must apply its limited resources where they will be of the most value. Some of the special problem compliance areas include: underreporting, non-filing and abuse of trusts and passthroughs; abusive corporate tax shelters; accumulations of unpaid trust fund taxes; and erroneous refund claims.

Abusive corporate tax shelters continue to be an important compliance initiative for the IRS. From the information that IRS and Treasury receives from a variety of internal and external sources, we know that there are a significant number of transactions that have no legitimate business or economic purpose other than reducing taxes.

These abusive corporate tax shelters could seriously undermine the tax system if all corporations believe they must engage in these transactions to keep up with the competition.

We have a coordinated effort with Treasury to deal with this problem and our Office of Tax Shelter Analysis (OTSA) plays an important role in it. The IRS does not want to impede normal tax planning, and through the OTSA, we have available a means to separate the real problems from quite legitimate transactions. In addition, a “Tax Shelter Hotline” and our commitment to issue more guidance in this area will help us respond to abusive transactions on a more timely basis.

Promoters of abusive tax shelters are also using offshore tax entities in their tax schemes to unlawfully reduce or eliminate taxes. Last month, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants and made four arrests as part of a series of inves-

tigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

I want once again to express my appreciation for the fine work done by our Criminal Investigation Division, the United States Attorneys offices in Boston and San Francisco, the Tax Division of the Department of Justice, and the Costa Rican law enforcement authorities. Last week's historic enforcement activities send an unmistakable signal about IRS' commitment to pursue investigations of promoters and their clients who would try to move money off-shore to evade taxes.

It further represents the IRS' continuing efforts to combat tax compliance problems caused by those who promote and participate in the use of trusts and offshore schemes designed to evade U.S. taxes.

Frauds Alerts: Buyer Beware

In February 2001, The Internal Revenue Service issued a nationwide alert to taxpayers, warning them not to fall victim to a number of tax scams that are being promoted. These schemes take several shapes, ranging from promises of special tax refunds to illegal ways of "untaxing" yourself. Taxpayers were told that they could report suspected tax fraud to the IRS by calling 1-800-829-0433.

One of these illegal tax schemes involves telling employers that they do not have to withhold federal income tax or employment taxes from the wages paid to their employees. Using a bogus interpretation of the Tax Code, the con artists are selling the unsuspecting and the unscrupulous a phony and illegal scheme that in the long run will cost these employers a huge tax bill that can include stiff penalties and jail time.

In addition to this warning, the IRS devoted a special consumer alert to this problem. We told working men and women that if they have concerns that their employer is failing to withhold these taxes to call our toll-free number at 1-800-829-1040. We are also asking our stakeholder groups to help us get the word out about this problem.

Taxpayers can get more information on how the IRS is combating this bogus withholding scheme by going to our web site at www.irs.gov and clicking on the "Small Business and Self Employed Community" page. From there, taxpayers can click on "tax schemes" and get all the necessary information. Taxpayers can also link to the IRS' Criminal Investigation home page and get a very detailed description of its employment tax enforcement program, including a breakdown of cases and a number of significant convictions of those who thought they could get away with evading their tax responsibilities.

I want to stress that IRS Criminal Investigation works closely with all parts of the Agency to investigate and refer for prosecution individuals and companies who have willfully failed to file or pay employment taxes. In the past three years, 127 individuals were sent to federal prison, a halfway house or home detention on employment tax issues. Nearly 86 percent of those sentenced for evading employment taxes served an average of 17 months in confinement and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

Revenue Protection Strategy

The IRS revenue protection efforts in 2001 will again identify and look at certain tax returns before issuing refunds. In addition to identifying questionable refunds, the IRS will continue its emphasis on improving compliance with the Earned Income Tax Credit (EITC) provisions of the Internal Revenue Code, including the use of our dependent database to identify questionable issues relating to incorrect claims on dependent exemptions, filing status and EITC credits.

The Earned Income Tax Credit Preparer Outreach Program will also continue. As part of this program, IRS revenue agents will visit tax professionals nationwide prior to January 2001, to provide individual assistance and to answer any questions about EITC. Some of the visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met.

2001 Filing Season

The IRS is delivering a very successful filing season as it continues to meet the mandates that Congress set forth in RRA 98 and the challenges of modernization.

By continually managing this change and risk in an orderly and integrated fashion, I am pleased to report that as we approach the home stretch, the 2001 tax filing season has been smooth and almost error free. The 2001 filing season continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

Projected net collections for FY 2001 will exceed the \$1.9 trillion collected last year. During FY 2001, we also project to receive 215.4 million returns, including over 130.3 million individual returns, and expect to issue over 96.8 million indi-

vidual refunds. As of March 9, 2001, the average dollar amount per refund is up over 5 percent over last year, and the average refund is \$1,823.

Electronic Tax Administration

Mr. Chairman, RRA 98 mandated that at least 80 percent of returns be filed electronically by 2007. Reaching this and the other Electronic Tax Administration (ETA) goals is an enormous challenge, but well worth the effort.

The IRS' overarching goal is to conduct most of its internal and external transactions by electronic means. To meet this objective, we must make it not only technologically possible, but also attractive to the public to make a permanent change from paper to electronic means. Indeed, a robust ETA system helps form the foundation of a modernized IRS. It is key to easing taxpayer burden and can provide multiple benefits to taxpayers, practitioners and our tax administration system.

Let me also stress that during the past year, the IRS completed a sweeping set of changes and upgrades to add an extra layer of protection for the millions of taxpayers using the e-file program. We have strengthened our system's security and we will remain vigilant to keep our e-filing processes the safest possible.

The 2001 filing season statistics continue to demonstrate that an increasing number of taxpayers are taking the advantage of these initiatives and filing taxes electronically. Through March 15, 2001, over 29.3 million individual taxpayers filed using one of the three e-file options; a 10 percent increase over the same period last year.

- Nearly 21.7 million taxpayers e-filed their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), an 11.2 percent increase over the same period last year.
- Approximately 4.2 million taxpayers filed their tax returns on-line via their home computer through a third party transmitter. On-line filing is running 37 percent ahead of last year and as of March 15, is already approaching the 2000 total volume of 5 million.
- Almost 3.5 million taxpayers filed their returns over the telephone using the award winning TeleFile system. Oklahoma and Georgia joined Kentucky and Indiana in the Federal/State TeleFile option.
- Overall, 11 million taxpayers chose to file both their federal and state tax returns simultaneously in a single electronic transmission. This year, 35 states and the District of Columbia are participating in the program.

Mr. Chairman, let me also note that paper and electronic return preparation and filing are also offered through IRS local offices as well as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. Taxpayers who cannot afford either to pay a professional tax preparer or buy a personal computer and tax software may also go to local IRS offices to have their returns prepared. The tax software we use in our offices is competitively procured in the open market. Through this method, the IRS both electronically prepares and files simpler returns for lower-income taxpayers at their request.

New in ETA for the 2001 Filing Season

In order to improve our ETA program and ease taxpayer burden, the IRS listened to taxpayers, industry and practitioners. We heard that we must make electronic filing more attractive and remove barriers. Let me briefly discuss our efforts this filing season to meet these concerns.

First, the IRS is working to address the frustration that taxpayers and practitioners experience when they find they cannot file some forms electronically. For the 2001 filing season, we added 23 additional forms to the 1040 e-file program. These include Form 2106-EZ for un-reimbursed employee business expenses; the Form 2688 application for additional extension of time to file; and Form 8379 for injured spouse claims.

We plan to roll out the remaining 38 forms and schedules for the 2002 filing season. This means we will open e-file eligibility to 99.1 percent of all taxpayers, potentially adding 3.8 million new e-filers to the growing rolls. Equally important, it means that preparers will be able to go essentially 100 percent electronic for all of their customers by 2002.

Second, the IRS is making electronic filing paperless by eliminating the requirement for a separate paper document with the e-file return. In 2000, the IRS successfully tested the use of a Personal Identification Number (PIN) code as the taxpayer's signature, eliminating the need to file the paper jurat. This year's program extended the option to taxpayers nationwide, with some exceptions, and permits them to select a PIN, and then file electronically without any paper. So far, 4 million taxpayers have chosen this option.

Third, this filing season, more electronic payments options have been made available to taxpayers, such as accepting debit payments through TeleFile and accepting credit cards for Forms 1040ES, estimated tax payments, and Forms 4868, extensions of time to file. As of March 10th, 22,718 payments averaging \$3,177 were made via credit card and another 24,064 payments averaging \$1,026 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.

Fourth, our e-Services project under BSM will help us conduct most transactions with taxpayers and their representatives in an electronic format. By 2002, the e-Services' goals are to: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

Fifth, contributing to this year's successful e-filing season is IRS' new marketing campaign, "40 Million People Already Know e-file is the Way to Go." In conjunction with its advertising agency, and as authorized by RRA 98, the IRS developed a fully integrated campaign with TV, radio and print advertising. As the e-file program matures, our data- and market-driven marketing campaign is shifting away from merely promoting awareness of e-file to emphasizing its value, such as saving taxpayers time.

ETA Also Easing Business Taxpayer Burden in 2001

A strong ETA program must embrace the needs and expectations of all taxpayers, including business taxpayers. In 2001, the IRS continues to make progress serving the electronic tax administration needs of this important sector.

For example, beginning last April, employers could file their Form 941 on line, saving time and paperwork. And for the first time, companies and payroll service provider will be able to file both the Quarterly 941 and Annual 940 (*Employer's Annual Federal Unemployment Tax Record*) electronically. A direct debit payment was also made available through Form 941 TeleFile

Another major ETA initiative eases the information-reporting burden for employers. Providers of certain information statements, including W-2s, now have the option of giving taxpayers the information electronically, instead of on paper.

These new rules were a direct response to requests we received from lenders, educational institutions, employers and stakeholders who wanted the option to deliver these statements in an electronic format. Under the new option, providers will save the cost of processing, printing and mailing paper statements. And recipients will receive the information faster and more efficiently without the worry of mailing delays or lost statements.

The Electronic Federal Tax Payment System (EFTPS) also continues to be a runaway success. In 2000, EFTPS topped all of its 1999 numbers for new enrollments, dollars and transactions. It processed more than 63 million federal tax payments—a 14 percent increase over the previous year year. And EFTPS also received a staggering \$1.5 trillion—a 15 percent increase over the previous year. Payroll companies, tax practitioners and financial institutions have been instrumental in helping us grow this program and the use of electronic payments.

Why has EFTPS been so successful? Over the years, EFTPS has delivered a high level of service and accuracy. It consistently exceeds industry standards, and delivers a 99.9 percent accuracy rate for payments appropriately applied.

We developed the system with a focus on being able to handle significant volume with accuracy, integrating checks and balances to make sure information is correct and verified at each step of the process. EFTPS delivers a level of precision that can be compared to stringent banking and financial transaction standards for accuracy.

This year, we are conducting an exciting new pilot program to test our new Internet-based application for businesses to pay federal taxes on line. This new feature, EFTPS-OnLine, allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Using EFTPS-OnLine, businesses will be able to schedule future payments through the Internet and cancel payments if necessary. They will also have access to on-line help and "how-to" pages with step-by-step instructions.

One of our primary EFTPS priorities is security and it continues with our new Internet feature. EFTPS-OnLine uses the strongest available security and encryption technology to ensure taxpayer privacy and protection. After evaluating the pilot results, we plan to make EFTPS-OnLine available to all business taxpayers and to individuals taxpayers who are required to make estimated quarterly payments.

There are currently more than 3 million taxpayers enrolled in EFTPS and with the addition of the new Internet feature, we expect that number to continue to grow.

Web-Based Help

The Internet continues to offer exciting new opportunities for easing taxpayer burden and improving service. The IRS web site, the *Digital Daily* (www.irs.gov), has already received almost 1.3 billion hits this fiscal year. According to the "Lycos 50," since almost the beginning of the year, the IRS has consistently ranked among the top 10 user searches. As of March 21, 2000, it came in as Number 6.

Anyone with Internet access can receive: tax forms, instructions, and publications; the latest tax information and tax law changes; tax tables and rate schedules; and hypertext versions of all taxpayer information publications, including the very popular Publication 17, "Your Federal Income Tax;" all TeleTax topics; answers to the most frequently asked tax questions; a library of tax regulations; and the weekly Internal Revenue Bulletin that contains all the latest revenue rulings, revenue procedures, notices, announcements, proposed regulations and final regulations. However, to ensure that taxpayer privacy is protected, our web site will not provide or receive individual taxpayer data until adequate safeguards are in place.

Since coming on line in January 1996, taxpayers have downloaded over 412.9 million forms, publications and products. Through February 2001, there have been over 103 million downloads as compared to 51.5 million for the same period in 2000—an increase of almost 100 percent.

The IRS web site also has a W-4 Calculator in its "Tax Info for You" section. In addition, the expanded use of online customer service technologies provides greater taxpayer access to IRS' help while on the Digital Daily.

Earlier this year, the IRS launched its new user-friendly "Small Business and Self-Employed Community" web page that can be accessed from our web site. It was developed by our Small Business/Self-Employed Operating Division specifically to benefit the millions of small business owners, the self-employed and start-up businesses who often confront more complex tax issues than taxpayers who have their taxes withheld by an employer.

This convenient "one-stop shopping" for assistance can provide most, if not all, of the immediate products and services that a small businessperson needs, such as a section on common problems, a calendar of important tax deadlines, helpful tax hints, forms and publications and a direct link to stakeholder sites, such as the National Association of Home Builders and the National Restaurant Association.

I mention these two associations because for the first time ever, the IRS is providing industry-specific tax information for the construction and restaurant industries. For example, if a food server wants to know the deadline for reporting tips, he or she can go to our site and in two clicks, learn that Form 4070 should be filled out and turned into the employer by February 12th.

In the near future, we will add more of these targeted areas to the web site, such as for the automotive and oil and gas industries. We will also add a Smart Q&A Wizard that will make it easier for taxpayers to search our growing database of frequently asked questions and get the information they need.

The IRS web site will continue to evolve and improve in design, content and features. The biggest leap in the future will be from its current state as an information source to include a transactional-based portal.

CD-ROMs

The Federal Tax Forms CD-ROM contains more than 600 tax forms and instructions for the current tax year, an archive of forms and instructions dating back to 1992 and some 3,000 pages of topic-oriented tax information. Users can electronically search, view-on-screen, or print any of the items contained on the CDs. The two-issue subscription is conveniently available through the *Digital Daily* for \$21. If ordered by fax, mail, or telephone, the cost is \$26 (includes postage and handling).

In conjunction with the Small Business Administration, the IRS also produced the latest edition of the joint small business CD-ROM, "Small Business Resource Guide: What You Need to Know About Taxes and Other Topics." It has consistently received highly favorable reviews from small businesses and external stakeholders. The Year 2001 version of the CD-ROM is being made available free of charge, one-per-customer, by calling our toll-free number at 1-800-TAX-FORM. It can also be ordered on the IRS web site.

The CD-ROM provides an array of helpful information for business operators, including actions to take before going into business and tax filing and reporting responsibilities when starting, expanding, closing and selling a business. In addition, it includes all of the business tax forms, publications and instructions for e-filing.

The CD-ROM also allows users with Internet access to link to other helpful federal and state web sites.

Telephone Assistance

Throughout the 2001 filing season, the IRS will provide telephone assistance 24 hours a day/7 days a week at 1-800-829-1040. After April 16, we continue to offer around-the-clock service for refund and account callers, and service will be available for tax law assistance Monday through Saturday from 7:00 AM until 11 PM.

For the filing season through March 9, approximately 65 percent of the taxpayers who wanted to talk to a customer service representative got through, compared to 61.7 percent last year at this time. In addition, 10.5 million of taxpayers used our automated services to get information such as refund status, an increase of 132 percent since last year, and the trend has been upward. In the last four weeks, the level of service averaged 68.9 percent. The upward trend in phone service is encouraging and shows that our investments in training, management and technology are beginning to pay dividends. However, I concur with Treasury Secretary O'Neill's characterization of IRS's current level of phone service as "unacceptable." We still have along way to go before we can be satisfied with the quality of our phone service.

The IRS will continue to implement many process and systems enhancements to improve both the convenience and the quality of telephone communications. These changes are major, affecting approximately 14,000-15,000 employees in more than 20 locations around the country. With the benefit of new call routing technology and new software planning tools, we are realigning the work assignments and training of many of these assistants so that the employees will have the right specialized training and knowledge to answer taxpayers inquiries efficiently and accurately. We will make increasing use of the technology to direct taxpayer call more accurately to the right assistant, and enable taxpayers in many cases to make uses of "self-service" applications, either through the phone or the Internet.

As these changes take place, the average complexity of calls answered by the Customer Service Representatives (CSRs) will continue to increase as: more of the simpler calls are routed to automated services; alternative language services are expanded; and CSRs handle topics previously referred to compliance personnel.

During FY 2001, the IRS will introduce and test a new series of measures consistent with industry standards to improve monitoring of the delivery of the service experience and utilization of resources. The current measurement system will be maintained concurrent with this new effort through 2002 to allow IRS to solicit external expertise to validate and assess the new measures and develop an implementation plan. IRS will solicit external expertise to validate and assess the new measures and develop an implementation plan.

Earlier this year, the IRS also inaugurated its San Patricio, Puerto Rico call site. Now that the center is fully operational, it will be able to take the majority of the Spanish-speaking traffic. Our Spanish-speaking customer service representatives in the States will still play a critical role, but creating this center will allow us to make the best use of all of our bilingual assistants. By staffing this call site, we have made real progress in reducing the current deficit of Spanish speaking customer service representatives..

Forms By Fax and Phone

Taxpayers can receive more than 150 frequently used tax forms 7 days a week, 24-hours-a-day from IRS TaxFax. Taxpayers can request up to three items per-call. Taxpayers use their fax machine to dial the service at 703-368-9694. The only cost to the taxpayer is the cost of the call. Taxpayers can also request forms and publications by calling 1-800-TAX-FORM.

Recorded Tax Information

TeleTax has 148 topics available 24 hours a day using a Touch-tone phone. Taxpayers can call (toll-free) 1-800-829-4477 to hear recorded information on tax subjects such as earned income credit, child care/elderly credit, and dependents or other topics, such as electronic filing, which form to use, or what to do if you cannot pay your taxes. As of March 9, 2001, over 2.6 million have taken advantage of the service so far this filing season. Nearly 2.97 million taxpayers used TeleTax for the comparable period last year.

Automated Refund Information

In FY 2000, more than 13.79 million taxpayers used the Automated Refund Information system on TeleTax to check on the issuance of their refund checks. As of March 9, 2001, the number stands at over 23.8 million—up 73 percent from, last year. Taxpayers may call 1-800-829-4477 to check on their refund status Monday

through Friday from 7 AM to 11:00 PM if using a touch-tone phone, or 7:30 AM to 5:30 PM for rotary or pulse service.

Taxpayer Assistance Centers

While many taxpayers prefer to use the telephone and the Internet to communicate with the IRS, our modernization studies and experience with the highly successful "Problem Solving Days" showed that some taxpayers need to meet in person with IRS representatives to get the assistance they need.

For those taxpayers who prefer to visit an IRS office, walk-in service is available at more than 400 locations nationwide. At many sites, walk-in service will be offered on 12 Saturdays between January 27 and April 14. So far this filing season, we have served over 3.37 million taxpayers at all Taxpayer Assistance Centers—a 4.54 percent decrease from last year.

The Saturday Service sites were selected based on their weekend accessibility, year-round operational status, and high traffic volume. They include non-traditional locations, such as shopping malls, community centers and post offices.

With the help of the additional personnel provided for by the STABLE initiative, we are broadening the services available in our local offices so that taxpayers who wish to come in person will be able to resolve most tax account issues. We have defined a new job category called Tax Resolution Representatives. These employees will have the training and authority to provide "one-stop service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

We also believe that by energizing the VITA return preparation program and relocating these activities at the Taxpayer Assistance Centers, the IRS will be able to focus on simple account and collection issues. In 2001, the Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division will work with more than 17,000 volunteer sites across the country to assist an estimated 4.6 million taxpayers. We will also work to better track the impact and benefits of the volunteer program.

SERIOUS CHALLENGES REMAIN

Mr. Chairman, in spite of the progress the IRS has made since the enactment of RRA 98, it is clear that we are still not providing the level and quality of service that taxpayers deserve, nor are we collecting the taxes due efficiently.

As previously discussed, the level of phone service—while improving—is still unacceptable and not on a level with what taxpayers receive in the private sector. We cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them. In fact, nearly all of our business processes operate too slowly, inaccurately and inefficiently. Many of our notices are still confusing and poorly written. Achieving the 80 percent electronic filing goal by 2007 will be very difficult.

The IRS is also deeply concerned about the continued drop in audit and collection activity. In fact, the GAO testified before the Senate Finance Committee in February 2000 that the current level of IRS enforcement activity is too low. Clearly, the declines we have witnessed in the past few years must stop or the fairness and effectiveness of our tax system will be undermined. The risks of these declines are not simply the dollar value of the taxes left uncollected. The greatest risk is that the average taxpayer who honestly pays taxes loses confidence if the IRS fails to act effectively and efficiently to collect from those who do not pay what they owe.

To help address these problems, the President's budget includes follow-on funding for the STABLE initiative, begun earlier this year. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years.

Mr. Chairman, the drop in exam and collection activity in FY 2000 was caused by several factors, including the long-term decline in staffing, the need to assign compliance staff to customer service duties during the filing season, and added RRA 98 responsibilities.

Between FY 1992 and 2000, the Agency's workforce fell by 17 percent while the number of tax returns filed (including supplemental documents, such as Forms 1040X, 4868, 2688, 1120X and 7004) increased 13 percent to 230 million. RRA 98 also created very significant additional resource demands on the IRS Exam and Collection staffs. Expanded programs, such as the innocent spouse provisions, offers in compromise and due process in collection required more than 4,200 IRS staff annually for administration. Other provisions, such as the requirements for notifications of third parties, tacked on more time to complete each exam and collection case. More than 30 additional steps have been added to the completion of an exam.

RRA 98 also had some very profound indirect impacts on IRS operations. Two provisions, in particular, have greatly affected the time required to conduct many ac-

tivities. They are: Section 1203, commonly known as the “ten deadly sins” provision, and Section 1204, which broadly prohibited use of enforcement statistics in setting goals or making personnel evaluations at any level in the IRS.

Section 1203 caused a great deal of concern, caution, and hesitation among front-line employees and their managers with respect to taking enforcement action. And Section 1204, prohibiting use of enforcement statistics, caused a great deal of confusion and hesitation among managers to use any quantitative data to evaluate operations or to direct employees with respect to matters of time and efficiency. The effect of Section 1204 has been magnified by the extensive number of investigations and disciplinary actions of managers that was undertaken in 1998 and 1999 for misuse of statistics. In addition, uncertainty over the reorganization, which flattened the organization and eliminated management layers, caused some temporary loss of focus. The effect of all these factors was to increase the time it takes to complete cases, reducing the number of cases completed per FTE by 20 to 30 percent.

In its March 2001 financial audit of the IRS’ Fiscal Year 2000 Financial Statements, the GAO pointed out the continued problem with the IRS’ management of unpaid tax assessments. The GAO found that the IRS’ “inability to actively pursue significant amounts in outstanding taxes owed to the federal government continue to hinder IRS’s ability to effectively manage unpaid assessments.”

The GAO report pointed to a much larger and fundamental weakness that threatens the IRS’ mission: the pressing need to overhaul IRS’ systems and processes. The IRS core data systems that record taxpayers’ tax accounts are fundamentally deficient. The IRS will never be able to perform its mission without replacing these systems. The solution to these problems is not simply to do more of everything in the way it has always been done. Instead the solution is to modernize the IRS to do things more efficiently and effectively.

Replacing virtually the entire technology infrastructure in the next 10 years, while also delivering short-term service improvements demanded by taxpayers, employees, and the Congress, remains an enormous challenge fraught with risk. But we have no choice; we must move ahead for the good of America’s taxpayers and the good of our Nation. The President’s budget includes close to \$400 million in investments to modernize the IRS’ outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America’s taxpayers and to ensure that compliance programs are administered efficiently.

Mr. Chairman, there have also been some questions as to whether the “audit rate” as publicly reported by the IRS understates the ability of the IRS to verify the accuracy of individual tax returns. Simply focusing on the audit rate does substantially understate the IRS’ capacity to find errors in returns, especially in certain kinds of returns. In my many press interviews in the past few years in which this topic has come up, I have consistently made this point, often citing our computer matching program as an example of a technique that the IRS uses in addition to traditional audits.

With the use of document matching and other return verification techniques for more that will eventually be enabled by new technology, it is my view that there is no need to return to the levels of individual audit coverage that existed even five years ago, which was three times the FY 2000 level. The IRS strategic plan and budget proposals as presented to the IRS Oversight Board do not call for this approach. However, our strategic plan sets forth an approach in the short run to stabilize our level of traditional compliance activities, such as individual audits, at or slightly above current levels and to focus them on the areas where they are most required. In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities.

The IRS has for many years relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular classes or types of potential errors. With respect to Information Returns Processing, or document matching as it has often been called, this technique is very effective for verifying income items reported by third parties, including wages, interest, dividends and miscellaneous payments. It can also be used to verify gross sales of assets, but cannot be used to verify the gain or loss on such sales since we have no third-party reporting on the cost basis of assets. It is also of limited value in verifying some deductions, such as mortgage interest.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching represented about \$1.2 trillion in FY 1998, or 19.7% of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

The significance of verifying income and deduction items through audits is illustrated by the fact that the average in-person audit of an individual return results in an assessment of approximately \$9,540, while the average assessment from a document matching case is \$1,506. In FY 2000, the IRS closed 277,212 in-person audits of individual returns and assessed \$2.4 billion from this program; in the document matching program in FY 2000, the IRS closed 1,353,545 cases and assessed \$2.1 billion.

With respect to the question of why document matching cases are not considered audits, the technical reason is that Section 7605(b) of the tax code generally limits the ability of the IRS to require a taxpayer to submit books and records for inspection by the IRS more than once. Since document matching cases do not require the taxpayer to submit books and records to the IRS, a document matching case does not preclude a subsequent audit. Revenue Procedure 94-68 specifically defines IRS taxpayer contacts, including document matching, which are not considered audits for the purpose of Section 7605(c). More generally, it is my understanding that some years ago the IRS proposed to change the definition of an audit to permit inclusion of the document matching cases in the overall reported number of audits and this proposal was criticized as possibly inflating IRS's statistics.

Notwithstanding these previous issues, all of IRS statistics, including the number of document matching cases, are publicly reported and it is our goal to make these reports as informative and meaningful as possible.

TURNING THE CORNER

Although overcoming these weaknesses is an enormous challenge, the IRS has achieved the first modernization milestones. If we continue to build on these initial successes, taxpayers and our tax administration system can begin to realize the benefits of modernization.

Organizational Modernization

Following RRA 98's directions, the IRS designed and has made substantial progress in implementing a new organizational structure. It closely resembles the private sector model of organizing around customers with similar needs. The IRS created four customer-focused operating divisions to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communication and Liaison.

The modernized IRS organization was officially inaugurated, or "stood up," on October 1, 2000 and a top management team is in place for each of the operating divisions and business units. However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will require another two years through FY 2002.

In the short-term, the reorganization should be largely invisible to taxpayers and tax practitioners. In the long-term, they will see the positive changes that modernization is intended to produce. The new organization will place a greater emphasis on pre-filing services and early resolution of complex issues. More resources will be devoted to pre-filing activities, such as education and outreach to help taxpayers comply with the tax law and get their tax returns right the first time. Post-filing activities will be geared to problem prevention with targeted enforcement activities for non-compliance. Most importantly, the focus and clear assignment of responsibility will result in faster action to fix problems and improve the way that business is done.

Business Systems Modernization Program

The Problem

For an organization so critically dependent on technology, IRS' systems are woefully obsolete and inefficient. The facts cannot be disputed. The IRS is saddled with a collection of computer systems developed over a 35-year period. The most important systems that maintain all taxpayer records were developed in the 1960s and 1970s.

In an age of faster and more powerful computers, taxpayers are shocked to hear that their most important personal financial data is stored and updated once a week on magnetic tape. Our jury-rigged system of computers poses other problems. As *Money Magazine* observed in its April 2001 edition, "overlying new software onto old has created a hodge-podge of data bases, many of which do not talk to one another."

other. Until our consolidation as part of the Y2K program, there were 147 mainframes and 8,700 software products.”

The effect of this obsolete technology on service to taxpayers and productivity also cannot be disputed. As compared to what the private sector can offer, the IRS’ services are wholly unsatisfactory.

Many credit card companies and banks provide their customers with real-time account information; their phone representatives can often make adjustments on the spot. However, due to our archaic technology, IRS employees often do not have access to current taxpayer account information. Adjustments to a taxpayer’s account may not take effect for up to 16 days because of delays in updating files and data among different systems cannot be synchronized. Payments and notices cross in the mail, often generating more notices and frustration.

Indeed, the IRS has only a 40 percent rate for correctly resolving an account problem over the phone the first time e.g., a payment is not posted to a taxpayer’s account or taxpayer does not understand why he or she received a bill for an estimated penalty. Our overall account quality is improving but in this filing season is still only 70 percent

While the IRS Web site has proven to be an extraordinarily valuable source of information for taxpayers, we cannot yet use the Internet to provide taxpayers information about their returns or their tax accounts, or to exchange messages to resolve issues.

Inadequate technology and the concomitant lack of accurate data also seriously hamper our ability to identify and collect unreported or unpaid taxes. Individual audits are not started until 14–20 months after a return is filed. When they are started, the information available to our auditors is limited, extending the time to complete the audits and increasing the burden on the taxpayer. Collection of outstanding balances of individual and business taxes is extremely slow, usually taking years rather than months as in the commercial world.

The Opportunity

By taking full advantage of proven best business practices and new technology, we can greatly improve performance on all three of our strategic goals. The IRS can improve service to taxpayers and reduce their burden. The IRS can improve compliance and its collection activities, ensuring that the tax laws are fairly administered. And we can do this with limited increases in staff resources. Taxpayers will reap the benefits in a number of key areas, such as speed, access and accuracy. Let me briefly illustrate how this works in each of these three areas.

Nearly all taxpayers will be able to file and pay electronically, regardless of the type of form or tax. Taxpayers filing electronically and having correct returns would receive refunds in their bank accounts within 2 to 3 days.

We will emulate the best business practice of providing service to customers at times and through channels convenient to them, whether it is by phone, letter or on-line.

The level of phone service would increase to 90 percent. (Level of service measures the relative success rate of taxpayers who call the IRS through toll-free services and wish to speak to an operator. It excludes calls routed to automated systems.) We would expand web-based services to include exchange of information and resolution of accounts through the Internet. First time resolution of account inquiries would double from 40 to 80 percent. Taxpayers would receive consistent and accurate answers to their questions regardless of the communications channel they chose. IRS employees would also have access to comprehensive taxpayer histories, thereby increasing the accuracy of the information and the transactions contained in them.

We also will provide more ways for taxpayers to resolve some issues by themselves, without requiring assistance from IRS staff. At the same time as we create the ability for taxpayers to check on such things as the status of their refunds and tax deposits through the automated systems on the telephone or the Internet, some in-person service requirements may be reduced. We are already beginning this process through such exciting initiatives as the EFTPS (Electronic Federal Tax Payment System) OnLine program. It allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. And we have barely touched the full potential of electronic tax administration

The effect on our compliance activities would also be profound. Third party matching data would be made available earlier. Assembling all available data about a taxpayer case for our employees will avoid the need to get duplicate data from taxpayers. With the advent of many new best private sector practices, such as risk-based compliance techniques, the IRS also has the opportunity to allocate its compliance resources more efficiently, both in specific cases and around patterns of non-

compliance. And when intervention is called for, we can use analytically-based techniques to assist in determining the appropriate action.

Most individual tax returns would be selected for audit within the same year and those audits will be completed more rapidly. "No change" determinations would be cut substantially.

The collection time for outstanding balances would be reduced to an average of six months. Improved systems will allow us to identify much more quickly which taxpayer accounts need attention from either telephone or in-person collectors. They will provide much more complete and accurate information to the collectors before they even deal with the taxpayer, and computer tools will assist them in closing cases.

These changes will also greatly increase our ability to "leverage" staff and use them more effectively and efficiently, while reducing the amount of time we take from taxpayers.

Our ability to ensure protection of taxpayer rights will be increased by building into the computer tools used by our employees the correct notifications and other protections prescribed by law.

The Solution

As I discussed in the introduction to my testimony, we are making substantial progress on the short-term improvement projects that support our major strategies. The other part of that dual approach is the Business Systems Modernization (BSM) program. It was established to take the IRS to the next level and make longer term, fundamental changes to our business processes and practices while managing the inherent risks of the process. Over the remainder of this decade, it will deliver the major benefits to taxpayers and our tax administration system that modernization and RRA 98 are all about. And that process has already begun.

Earlier this fiscal year, the IRS Executive Steering Committee approved the Enterprise Architecture. It is the roadmap for modernizing the Agency's business systems and supporting information technology networks. The Enterprise Architecture (Version 1.0) will guide the agency's business and technology improvements in the coming years. The approval of the architecture marks a major milestone in our progress towards the goals of Business Systems Modernization and will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS.

The IRS previously published a blueprint in 1997. It was the first comprehensive view of modernized tax systems and guided the IRS in efforts to update technology. The new Enterprise Architecture reflects the lessons learned since 1997 and incorporates elements of the IRS reorganization into the four new customer-oriented operating divisions. It is an evolving document designed for constant use, with updates scheduled for spring and fall 2001 and regular updates thereafter. This new blueprint will ensure that IRS business systems' technology is compatible. And it will enable IRS employees to do their jobs better and provide taxpayers better service.

Because of the scale, complexity and risk of BSM, we can only carry out the plan by defining manageable projects, which are subject to a disciplined methodology. Each of these projects will be carried out through a step-by-step "enterprise life-cycle" in which successively greater amounts of detail are defined. The process requires that a vision and strategy phase be completed as a first step, prior to commencing tasks such as infrastructure development, information systems delivery, or process-reengineering. The final milestone in the cycle is an initial "deployment" of a project as an operational system. The IRS' Enterprise Program Management Office manages this process.

Also key to BSM's success, is the Tax Administration/Internal Management Vision and Strategy Project. Through the project, we have instituted a practice that ensures the Operating Division Commissioners and staff develop and take ownership of a process and systems modernization approach that is consistent and integrated with the overall vision of the future IRS. The project's ultimate goal is to create an enterprise-wide view of tax administration that is reflected in BSM.

The Business Systems Modernization Organization (BSMO) has now identified all the major initiatives for the next several years that link directly to our major strategies. Moreover, BSMO defined the major dependencies between and among projects and created a sequencing plan for their initiation, development, and deployment. It has also estimated the costs associated with each initiative and developed multi-year spending estimates consistent with this program. It now has a strategy for achieving the major goals of business systems modernization. The following are some of the key projects we will be working on during the next three years and beyond.

- **Deployment of the Customer Communications 2001 Project**—The Customer Communications Project is the first deployment of a business capability under the BSM effort. It is now in final testing before deployment in the third fiscal quarter. The IRS will greatly improve the efficiency and effectiveness of IRS' Automated Call Distributors (ACDs) and provide customer service levels on a par with the private sector. Hardware and software improvements will be made to the telephone system that is used to receive, route and answer more than 150 million taxpayer telephone calls each year. At a later date, Internet access capabilities will be added. This project will deliver direct benefits by increasing the number of calls that can be answered with available staff and will be a critical foundation element for subsequent projects, since virtually all major systems require communication with taxpayers.
- **Development of the Customer Relationship Management Exam (CRM Exam) Project**—Development has already begun. Through CRM, the IRS tackles some of the most complex tax calculations, including carryback/carryforward, the Alternative Minimum Tax, and Foreign Tax Credit. This initiative will enhance the revenue agent's capabilities, reduce exam time, produce consistent results and reduce the burden on taxpayers who must deal with the IRS on these complex tax issues.
- **Development of the Security and Technology Infrastructure Releases (STIR)**—The design for STIR was approved and development was initiated. This project provides the essential underlying security infrastructure for the planned 2002 project deployments of the Customer Account Data Engine (CADE), Customer Communications (2002), and e-Services and Customer Account Management System. Development, testing and first release are expected by October 2001.
- **The Customer Account Data Engine.** (CADE) is the cornerstone of the data infrastructure. It is designed to provide a modern system for storing, managing, and accessing records of taxpayer accounts. CADE will create applications for daily posting, settlement, maintenance, refunds processing, and issue detection for taxpayer accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems. CADE is scheduled to be released in stages, beginning first with simple tax returns being moved into the new CADE system, followed by increasingly complex taxpayer returns. As more taxpayer account information is moved into the new CADE system through these staggered releases, other modernized applications will be put in place to provide the interfaces necessary for IRS employees, and affected taxpayers, to access and carry out transactions. System development, testing and initial deployment are expected to be completed by January 2002.
- **Development of the Enterprise Data Warehouse/Custodial Accounting Project (EDW/CAP)**—Today, the IRS has a variety of dedicated research databases, and also uses its operational databases for operations research/analysis. The timeliness, consistency and standardization of the data in these separate systems do not support integrated analysis and corporate-wide decision making. The inconsistent and redundant data in stovepipe systems can result in inconsistent management and reporting data. Through EDW/CAP project, the IRS will develop an integrated enterprise data warehouse to support organizational data needs, such as those that are critical to managing our new compliance initiatives. For example, it will provide a single integrated data repository of taxpayer account and payment/deposit information, fully integrated with the general ledger. And it will identify payment and deposit information at the point of receipt. The operating divisions will be given access to pertinent revenue, assessment, disbursement, and seized asset information. In addition, it will provide the IRS with the capability to maintain financial controls over the \$2 trillion of tax revenue received annually.
- **The e-Services project** will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in electronic format, as required by RRA 98. By 2002, the e-Services will: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

An important aspect of e-Services project is that it will be one of the first projects to provide a practical and limited application to define and test the design of our critical security infrastructure for sending and receiving taxpayer data internally and externally.

- **Customer Account Management (Individual Assistance and Self-Assistance Operating Models).** In today's environment, taxpayers are often unable to receive timely and accurate responses to requests and inquiries. These operating models will provide improved technology and business processes that will enable the IRS to: better manage customer service functions; maintain and utilize customer data to improve taxpayer interactions with the IRS; provide comprehensive account and tax law assistance to taxpayers and practitioners; and manage the case work flow of customer inquiries. There is a separate release strategy for each of the operating models based on the customer segment that benefits the most from the new capabilities.
- **Tax Education (Direct and Indirect) Operating Models.** These models address improving business processes and operational systems within the pre-filing business area (i.e. before a return is filed). In the past, there has been minimal investment in pre-filing activities, such as making educational materials, information and forms more readily available. With the organizational modernization, pre-filing activities will become more prominent. The Tax Education Operating Models will help taxpayers reduce or eliminate errors before they become compliance problems by developing proactive and targeted educational materials that are available 24/7 in various formats from web-based products to published documents. Utilizing third-party partnerships, the IRS will develop and make available in plain language reliable educational information, guidance and advice.
- **Individual Assistance Operating Model for Reporting Compliance.** The current compliance environment has produced a number of problems, such as extended cycle times, reduced coverage and decreased customer and employee satisfaction. This project will have a significant impact on the present Reporting Compliance operational environment by providing: (1) robust, issue driven compliance planning that utilizes outcome-based improvement to ensure fair and effective selection of cases; (2) highly automated decision engines for risk-based case selection, treatment assignment and resource allocation to decrease cycle time; (3) electronic case files with pre-identified issues to support productivity gains and increased coverage; (4) case working tools, workflow management and remote access to critical data; and (5) new technology and processes to establish collectability, secure payments and facilitate payment agreements at the closure of cases. The IRS will deliver these new capabilities through four releases by 2006.
- **Filing and Payment Compliance Operating Model.** This is an end-to-end strategy to resolve collection issues quickly and fairly. It augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights at all times is an important component of this strategy. Taxpayers who are able to resolve their cases with no direct IRS contact are provided various self-correct options. Field or Collection Call center staff will assist taxpayers who need help to resolve their delinquent tax cases. They will have access to real-time data to ensure that appropriate actions are taken and taxpayer rights are protected. The operating model will decrease cycle time to approximately six months. We will deliver this operating model through four releases by 2007.

Establishing a Balanced Measurement System

All federal agencies must have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall modernization program is establishing balanced performance measures that support and reinforce the IRS' mission and strategic goals. However, because of past IRS experience with measurements and RRA 98 requirements (Section 1204), developing appropriate measures is an especially sensitive and difficult task.

Critical to our efforts was establishing measurements based on what we needed and wanted to measure, rather than using what is most easily measured. Our balanced measurement system was designed to measure the progress we are making to achieve our three strategic goals: (1) service to each taxpayer; (2) service to all taxpayers and (3) productivity through a quality work environment.

Also critical is ensuring that measures are aligned at all levels, from the top of the organization to the front-line employee. This does not mean that all of the organization's levels and components have precisely the same measurements. Obviously, this would be impossible. Rather, it means that the measures or evaluations are aimed at encouraging the type of behavior that will advance the organization's overall strategic goals, and do not encourage inappropriate behavior.

In developing measures for each organizational level, it is important that each component of the balanced measurement system reflect responsibility at that level. At the top of the organization, management has control over strategies and allocation of resources. However, at the mid-level, managers have less control over these variables, but do exercise control over the effectiveness of training, coaching and guidance of employees. And at the individual level, each employee has control over his or her work and self-development.

In the balanced measures system being implemented, there will be quantitative measurements keyed to each of the three strategic goals (service to each taxpayer; service to all taxpayers and productivity through a quality work environment) at both the strategic level and the operational level. In general, quantitative measures will not be used at the individual employee level.

In September 1999, we issued a Balanced Measures Regulation to formally establish our new performance management system. The publication of the regulation, which followed a public comment period, set forth our structure for measuring organizational and employee performance.

At the strategic level, our measures are designed to gauge overall performance on accomplishing the mission and strategic goals. This level is meaningful for the IRS as a whole, or for those parts of it that are responsible for providing a full range of services to large sets of taxpayers.

We began identifying specific strategic measures in FY 2000 and will refine and finalize these measures in FY 2001. Experience has shown that the development of good performance measures is an evolving process that improves with time. Accordingly, we anticipate there may be changes to the specific measures. We expect, however, that the strategic intent behind these measures will remain firm.

At the operational management level, our measures are focused on successfully executing our core business functions within the organizational units. At this level, we derive the balanced measures of organizational performance as follows: customer satisfaction, business results and employee satisfaction. This can be easily contrasted with measuring at the individual level.

All quantitative measurements assess organizational performance, not individual performances. It is impossible to capture in any quantitative measurement system all that is important in evaluating an individual. As of January 2000, we redefined the system for setting and measuring performance expectations for nearly all managers and executives to align with the balanced measurement system.

For front-line employees, we do not use quantitative measurements to evaluate performance, except in certain submissions processing functions. In most cases, it is not practical to quantify the performance of an individual employee in a meaningful and appropriate way. Instead, we incorporate the desired activities and behavior consistent with the strategic goals into the "critical elements" of each employee's position description.

We began to implement the balanced measures system at the operational level in 1999, starting with the three functions, Customer Service, Examination, and Collection, that most directly affected large numbers of taxpayers and employees. We implemented the operational measures for these functions within the existing organizational structure and have now transferred these measures to the new organization.

Since that time, we approved additional balanced measures for Large and Mid-Size Business, Tax Exempt and Government Entities, Taxpayer Advocate Service, Information Systems, Criminal Investigation, Appeals, and for additional Submission Processing and Customer Service product lines within the Wage and Investment and Small Business/ Self Employed Operating Divisions. We have slated balanced measures for the remaining organizational units for approval in fiscal year 2001. In the interim, we are using 64 indicative measures and workload indicators in our annual performance plan as we complete our measures development.

However, we still have work to do. We must agree on a final set of Agency-wide strategic measures and then begin implementing a comprehensive suite of strategic measures covering all taxpayer segments. Most importantly, we must continue to learn how to use balanced measures as a tool to achieve a high level of performance for all three of our strategic goals.

Development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

CLEAN FINANCIAL OPINION AS REPORTED BY LAWRENCE W. ROGERS, FORMER IRS
CHIEF FINANCIAL OFFICER AND CURRENTLY, ACTING DIRECTOR FOR ADMINISTRATIVE
ACCOUNTING, SYSTEMS AND POLICIES

Mr. Chairman, due to the combined efforts of the IRS and the General Accounting Office, I am pleased to report that the GAO rendered an "unqualified" or clean opinion on the IRS' FY 2000 Financial Statements. This includes both the Revenue and Administrative accounts.

The GAO's opinion means that the IRS properly accounted for \$8.3 billion in appropriated funds; over \$2 trillion in revenues collected; and over \$190 billion in refunds. In his message opening the FY 2000 Treasury Accountability Report, Secretary O'Neill stated that "Good stewardship of taxpayer resources is a responsibility I take very seriously." At the IRS, we also want to ensure that every manager and employee takes that responsibility seriously.

In fact, the success on the financial opinions can be greatly attributed to the hard work and dedication of the IRS staff; the significant improvements made to IRS' internal controls; and management focus placed on the financial audits. I would also be remiss if I did not recognize the hard work of our GAO auditors who provided us with such excellent advice.

Congress, too, has played an important role in insuring that the financial audit is an important factor when evaluating agency performance. And we thank you for your strong, vigorous and continued leadership in this area. In last year's appropriations hearings, the Chairman of the House Appropriations Subcommittee on Treasury, Postal Service, and General Government also stressed the importance of a clean financial audit for IRS. Planning is already underway to insure that we maintain the same level of commitment for the FY 2001 and all future audits.

To achieve the clean financial opinion, the IRS made significant improvements in several areas. Specifically, we:

- Implemented reconciliation procedures for IRS fund balances and ensured prompt review/reconciliation was performed;
- Revised our reporting and disclosure for the statement of net cost to properly classify IRS programs;
- Improved management of property and equipment (P&E) inventories;
- Improved our review and management of suspense accounts;
- Reduced the number of computer security weaknesses;
- Addressed issues related to safeguarding taxpayer data; and
- Improved our ability to substantiate unpaid assessments.

However, long-standing inadequacies in our financial reporting systems must still be addressed through the broader efforts to modernize the IRS' systems and organization as mandated by RRA 98. The ultimate key to better financial management at the IRS is improved technology. A complete description of our efforts and response to the GAO report may be found in Appendix A.

BUDGET SUPPORT FOR MODERNIZATION

The IRS modernization program, and particularly, Business Systems Modernization, is at a critical juncture. The President's budget request funds two major initiatives that will greatly help the IRS. First, the budget includes close to \$400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Second, the President's budget also includes follow-on funding for the STABLE initiative, begun in 2001. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years. Further > details on the President's request on the IRS will be included in the formal > budget transmission to occur next week.>

Mr. Chairman, in conclusion, I believe that the IRS is on the right track. We have demonstrated both the ability to make some short-term improvements in service, and more importantly, the ability to produce a viable and cogent strategic plan that will guide our efforts to make changes in the entire way we do business and provide service to taxpayers. With your continued support and support of the American people, I am convinced more than ever that we can succeed.

GAO Findings

The IRS believes that the GAO report is generally accurate and we have submitted a number of specific comments that we believe expand upon the information contained in the report, rather than challenge its findings.

Management of Unpaid Tax Assessments

First, to address the issues related to Trust Fund Recovery Penalty (TFRP) processing (e.g., delays in posting, related tax liabilities, etc.) an IRS task group was established to review and recommend necessary changes. This group developed programming requirements to design an automated TFRP system that allows for systemic links. Phase I initial programming has been completed. Phase II will be implemented in FY 2002 to systematically accept downloads of data and cross-reference payments received for assessments made.

Controls over Refunds

The GAO observes that the IRS does not always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims. The IRS believes that this observation should be placed in the proper context.

The IRS has succeeded in several of its initiatives to prevent erroneous EITC refunds from being issued. Specifically, the IRS: (1) used its dependent database to identify questionable issues relating to EITC; (2) implemented the new legislation requiring re-certification before the taxpayer can claim EITC on the current tax year due to improperly claiming EITC in the previous year; (3) banned taxpayers from claiming EITC for either two or ten years after the tax year where there was a determination that the taxpayer's claim was due to intentional disregard of the rules and regulations, or fraud; and (4) implemented an automatic freeze on refunds where there is an open examination.

The results of our efforts are clear. Since 1999, the IRS worked over 55,000 re-certification cases. Our case reviews also resulted in 7,680 two-year bans and 62 ten-year bans for processing year 2000, and 337 two-year bans and two 10-year bans for processing year 2001 (as of mid-February).

Property and Equipment (P&E)

The IRS agrees with most of the GAO's comments regarding Property and Equipment. However, we do not believe that the report puts into proper perspective the substantial progress IRS achieved during FY 2000. We believe it is important to highlight the fundamental changes in the P&E management of IRS.

Prior to October 1999, there were multiple information systems organizations in IRS besides the Chief Information Officer (CIO). This was a major contributing factor to the lack of accountability and commitment in maintaining an accurate and complete Information Technology (IT) inventory, thus, resulting in the long-standing property material weakness.

Today, the IRS has one information systems organization with total responsibility for the IT inventory. Since October 1999, the Information Systems organization has made significant progress in improving how the inventory is managed and maintained.

To implement the GAO recommendation that "systems and controls be in place for FY 2000," the IRS devoted P&E employee resources to undertake and accomplish the task. The IRS had already established the Financial and Management Controls Executive Steering Committee (FMC ESC). It is chaired by IRS Deputy Commissioner Bob Wenzel and is the major coordination point in the IRS for improving financial management systems. The FMC ESC established the Property Subcommittee, consisting of executives of the offices of the CIO, Chief Financial Officer (CFO), and Procurement. This Subcommittee met weekly and made decisions to ensure systems and controls for P&E were developed and functioning for FY 2000 and the future. This Subcommittee will continue to function until all property issues are resolved.

The IRS also established the Asset Management Modernization Project Office whose full time job is to implement industry "best practices" and deploy new automation tools. A complete discussion of these and other improvement projects can be found in our response letter.

In summary, we believe that through the major automation and process improvements I have outlined, the IRS significantly reduced the long-standing material weaknesses identified by GAO. With continued executive support and dedicated staff resources, the momentum attained to date can be sustained, and the underlying deficiencies in IRS' property management eliminated.

Manual Tax Receipts and Taxpayer Information

On October 30, 2000, the IRS established a Subcommittee on Security under the FMC ESC. The Subcommittee provides an agency-wide senior executive forum to address, and to make decisions on, security policies and priorities. It focuses on efficiently and effectively implementing and communicating these policies and priorities throughout the IRS. The Director of the Office of Security is the Chair of the Subcommittee.

Computer Security

Recognizing the critical need to enforce federal law and regulations concerning privacy and non-disclosure of confidential tax information, the IRS created the Office of Security to establish and enforce standards and policies for all major security programs including, but not limited to, physical security, data security, and systems security. The OS provides the IRS with a proactive, independent security group that is directly responsible for the adequacy and consistency of security over all IRS' operations.

Our security approach is consistent with GAO's September 1996 report, *Information Security: Opportunities for Improved OMB Oversight of Agency Practices*, which noted that, "Such a program can provide senior officials a means of managing information security risks and the related costs rather than just reacting to individual incidents."

Using a security framework, we are setting priorities for resources and we are measuring and demonstrating success in improving the overall security posture of the IRS. We are also taking a proactive approach by conducting security reviews at the computing centers and campuses. Our Office of Security works closely with local and Headquarters management to develop solutions, monitor implementation, and conduct on-going reviews to ensure weaknesses do not recur.

Revenue Reporting and Distribution

In its report, GAO notes that there are continued weaknesses in fundamental internal controls. To address this issue, the IRS implemented procedural changes to ensure expedited processing of million-dollar returns. We also provided procedures to monitor timely posting of returns and to identify taxpayers who had not yet filed their returns. This will ensure processing prior to the end of the certification period.

The GAO also noted there was a delay in posting to the Highway Trust Fund and the Airport and Airway Trust Fund in the amounts of \$346 and \$34 million, respectively. There are three reasons why amounts received in a quarter are certified in a subsequent quarter: (1) late filed returns; (2) processing delays (lack of documentation, etc); and (3) subsequent activities. In the above cases, we needed additional documentation and returns were filed late. It should be noted that there is no penalty for late filing provided the taxpayer has submitted his or her payment on time.

IRS' Structuring of Installment Agreements and Compliance with the Internal Revenue Code

The IRS has made considerable improvements on the structuring of installment agreements. In FY 1999, twenty percent of the unpaid cases examined were non-compliant with the Code. In FY 2000, the non-compliant percentage dropped to two percent. To ensure that agreements are compliant, the IRS issued guidance to its employees. We are also developing training on processing new installment agreements.

Furthermore, the IRS is revising its guidelines to reemphasize the necessity of ensuring that installment agreements cover all outstanding taxes. If this cannot be accomplished, the case will then be handled in accordance with Offer-in-Compromise procedures. The IRS will also continue to monitor and enforce the guidelines on installment agreements.

Federal Tax Liens

The GAO has noted significant improvement in the IRS' processing of federal tax liens. To better refine the processing of liens, the IRS: (1) issued guidance to its employees and provided additional training; (2) instituted monitoring and enforcement of the processing guidelines for liens; and (3) centralized the control of the federal tax lien process to one site. Previously, the process had been decentralized to each of the 33 IRS districts.

Long-Term Efforts

A major concern shared by the IRS and taxpayers is privacy and security, both internal and external. Let me restate the IRS' commitment to recognizing taxpayer privacy to the maximum extent possible in all Service initiatives. Given the vulner-

ability of modern electronic information systems to cyber attacks, hacking, and natural disaster, we are focusing resources on risk management processes, secure messaging and authentication, physical security, cyber attack response capability and disaster recovery measures.

The IRS will make substantial progress in improving its stewardship of assets over the next two years, although much more will be possible through our longer-term business system modernization efforts. The following are some of the ways we will implement this strategy.

Privacy

The IRS will incorporate privacy protection principles into all of its programs and policies. We will enhance the privacy impact assessment methodology, applying it to all stages of a system's development and requiring it as a part of a system's certification.

Security

The IRS will establish a Critical Infrastructure Plan to ensure that information systems critical to the financial security of the United States survive. The IRS will also continue to work with the computing centers to enhance their physical security to Level V, the Department of Justice's highest physical security designation. In addition, we will assist service and computing centers in conducting integrated disaster recovery exercises. Furthermore, the IRS will review the state of its security and focus on providing solutions to identified vulnerabilities and completing security certifications of sensitive systems. The IRS will bring the Computer Security Incident Response Center to full operational capability and will provide oversight of selected IRS program areas to ensure practices are consistent with policy and guidance.

Property Management (IT)

The IRS will enhance and enforce policies and procedures to ensure accountability for use of information technology (IT) property. There will also be a transition from the current internally developed IT property tracking system (Integrated Network and Operations Management System—INOMS) to a Commercial Off-the-Shelf (COTS) solution. The IRS will connect the IT asset system with the non-IT property management so there is one comprehensive property system throughout the IRS.

Financial Systems

The IRS will implement a Joint Financial Management Improvement Program (JFMIP) approved financial management system. We will select a COTS product that best satisfies our internal management needs through an enterprise resource-planning product. Our first phase of implementation will be replacement of the core financial system, with planned future implementation of other internal management modules.

Strategic Plan

The Strategic Plan stresses that the IRS must demonstrate effective stewardship of the assets and information entrusted to it by improving our internal processes for information management, financial management, and asset management.

Conclusion

To summarize, the Internal Revenue Service is committed to improving financial management. We view all of these actions as necessary to build upon current processes and systems to provide the best financial information possible that meets statutory and policy requirements. Additionally, it must be stressed that the long-term solution to many of the issues identified through the audit process can only be addressed by the design and implementation of new or enhanced automated systems that will be developed over the next several years.

PREPARED STATEMENT OF ROBERT L. SOMMERS

TRUST SCAMS ON THE WEB

INTRODUCTION

I created my Tax Prophet website (<http://www.taxprophet.com/>) in March 1995, to educate the general public regarding U.S. tax laws. I discuss the tax consequences of specific transactions and how taxpayers may reduce their tax liabilities.

Although most e-mail I receive involves questions about the Internal Revenue Code, I also hear from a persistently vocal minority, one claiming that our tax laws are unconstitutional and that it is possible to substantially reduce, if not completely eliminate, taxes via a “pure trust.”

In response to this nonsense, I created the Tax and Trust Scam Bulletin Board (<http://www.taxprophet.com/hot/Trustscam.htm>) as a resource for people being pressured by these phony trust promoters, but who at that time had no source of opposing information.

This Bulletin Board is a public service designed to combat consumer fraud perpetrated against the public. Admittedly, the most likely participants of these phony trusts are anti-government rebels who deserve little sympathy for their culpable tax evasion. However, trust scam artists prey equally on unsuspecting seniors, the uneducated wealthy, and many citizens who would love to enjoy what they believe are legal ways to save on their taxes. Who among us wouldn't? The goal of the Bulletin Board is not to convince hard-core tax protesters or anti-government types that they are wrong; rather, it is to provide those who are being duped with badly needed accurate and current information.

HOW A TRUST SCAM FUNCTIONS

The Decades-Old Pure Trust Scam

The “pure trust” has been around since the late 1950s. They are called “pure trusts” because the trust is allegedly based on the constitution's guarantee of freedom of contract, rather than on specific state or federal laws.

One of the earliest decisions involving pure trusts was the 1968 California case *People vs. Lynam*, 261 Cal App 2d 490 (1968), in which the court ruled that the pure trust was a fraud under California law. In an earlier case, *People ex. Rel. Mosk v Lynam*, 253 Cal App 2d 959 (1967), a California Appellate Court held that advertising the benefits of a pure trust to avoid income taxes amounted to false and deceptive advertising practices. The court enjoined the defendants from promoting “pure trust” plans for managing personal assets.

The defendant employed the identical arguments that “pure trust” hucksters are still promoting today. According to the *Mosk v Lynam* court:

- The statements to the effect that no state can regulate pure trusts because such trusts are guaranteed by the United States Constitution are untrue and misleading.
- Since beneficial certificates are issued by the trust, and since the trust may operate as a substitute for a voluntary association or corporation, the trust would be subject to regulation by the state. [citation omitted].
- With reference to the purported “guarantee” by the United States Constitution, Lynam [the defendant] stated in his deposition that immunity from state regulation was guaranteed by that clause of the United States Constitution which protects contracts from abrogation. No contract contrary to public policy, however, is protected by that clause.
- The statements to the effect that income accruing to the trust is not taxable to the trust (as an entity) are untrue and misleading.

Lack of Expertise

The “masterminds” of these trusts appear to have no formal education in either tax law or accounting. Typically, they don't provide any legal analysis or case law in support of their assertions or discuss the counter-arguments to their positions. It is just hard sell all the way. They rely on the barest technical compliance with trust law, which of course, can still be illegal: When challenging trust arrangements, the IRS and courts scrutinize the substance, not merely the form, of all transactions.

Distinguishing a Phony Trust from A Legitimate Estate Planning Trust

What makes this particular scam popular is that legal, properly-drafted revocable trusts offer a variety of estate planning opportunities and can eliminate probate fees and costs, and minimize estate taxes. However, they never save the taxpayer income taxes—in any way. These promoters deliberately confuse legitimate trusts with fraudulent ones, claiming that prominent families (the Rockefellers, Kennedys or Fords) have established family trusts to minimize inheritance taxes, protect assets and maximize privacy. These legal trusts, however, are usually funded by gifts or sales of property; or the person creating the trust remains liable for all income and estate taxes under the grantor trust rules (generally IRC Sections 671–679).

In contrast, every taxpayer caught using these trusts has been charged with all taxes owing, plus interest, and usually penalties.

Why These Trusts Do Not Work

The IRS and courts look to the *substance* of the transaction, not its *form*. When all is said and done, if a taxpayer enjoys the benefits of his property, he is taxed as the owner. It does not matter that he placed his property into a trust with his great aunt as trustee and created reams of paperwork attempting to hide his ownership.

The courts and IRS look to the *results, not the methods*. These tax scam artists invariably fail to address the critical issue: After the paper shuffle, who winds up with the beneficial use and enjoyment of the property? If it is the taxpayer, then all the intermediate documentation is ignored and the taxpayer is responsible for the tax consequences.

How to Spot a Fraudulent Trust

Scam trust packages use names such as “Pure Trust,” “Unincorporated Business Organization” (UBO), “Common Law Trust,” “Constitutional Trust,” “Complex Trust” and “Pure Equity Trust.” Employing fear tactics, these hucksters suggest that taxpayers are probably paying more than their fair share of taxes; that without their seminar instruction, taxpayers may lose all their assets as a result of litigation or medical expenses; or that their heirs will have to sell assets to pay for inheritance taxes. Often, they obtain a minister or other cleric as a client, then work on the rest of the church members. Star athletes or other public figures are sometimes present to lend an aura of excitement and respectability to the pitch.

Trust scam hucksters claim their seminars and instructional materials teach taxpayers how to transfer their business, investments and residence assets into trusts to protect against the claims of creditors. They may also “guarantee” that their program will virtually eliminate taxation of self-employment earnings and significantly reduce their income tax liability, usually by deducting inflated expenses between trusts or deducting personal expenses as “business” expenses. Among their claims, they often promise that taxpayers can protect their assets from liabilities, deduct their children’s tuition as “scholarships” and eliminate estate taxes at death. But here is the real prize: these trusts allow clients to maintain control of assets transferred to the trust, unlike legal irrevocable trusts that require an independent trustee.

An Illustration

Sham trust promoters often design their bogus documents as a three-trust scam. Here is how the arrangement supposedly works (see the diagram attached hereto as Exhibit “A”):

1. *Trust One* (Business Trust) contains business assets (allegedly transferred to this trust on a tax-free basis). When the business trust generates income, it is subject to self-employment taxes.
2. *Trust Two* (Siphon Trust) is created to lease or sell equipment, services and inventory to the business trust at inflated prices, thereby siphoning-off the income generated in the business trust which would otherwise be subject to self-employment taxes.
3. *Trust Three* (Personal Residence Trust). All income generated by the siphon trust (and any remaining income in the business trust) is then distributed to the personal residence trust which contains the taxpayer’s personal residence. The trust uses an inflated depreciation deduction for the residence to offset part of the income distributed to it. The taxpayer now lives tax-free in the residence as a “caretaker.” As part of the caretaker’s package, the trust pays for medical and educational expenses, then deducts those payments as business expenses to further offset income.

Of course, none of this is remotely legal. The tax code does not permit tax-free transfers of property in exchange for trust units. A residence may not be depreciated unless it is used in legitimate rental activity that produces rental income; taxpayers never can claim they are caretakers of their own residences; and any personal deductions for medical or educational expenses must meet stringent code requirements.

Courts typically dismiss these trusts as bogus since they are devoid of economic substance and are entirely an income tax-avoidance device. Also, if the taxpayer directly or indirectly controls the trust, courts might apply “grantor trust” provisions to tax the income directly to the taxpayer, in any event.

Viewing the Tax Law with “Tunnel Vision”

Trust scam promoters appear to have no appreciation of the number of judicial doctrines that stress substance over form. For instance, one of their favorite claims is that the pure trust is a constitutional trust created under the freedom to contract (Article I, Section 10 of the U.S. Constitution). If the freedom to contract had no restrictions, then presumably it would be legal to hire a contract killer. Of course, the freedom to contract does not apply when a contract is contrary to public policy.

Likewise, trust scam promoters often rely on IRS Revenue Rulings which govern specific transactions. But these Revenue Rulings do not apply to sham transactions or to a series of transactions that can be collapsed under the “step-transaction” doctrine. The step transaction doctrine holds that a transaction involving a series of pre-arranged and inter-related steps, which are undertaken for tax purposes and lack economic substance, may be analyzed as a whole. The focus is on the end result—the intermediate steps within the transaction may be ignored.

Tax Protesters vs. Pure Trust Scam Artists

Traditionally, the authors and promoters of illegal tax protester schemes asserted the U.S. government is not legitimate and the Internal Revenue Code is illegal or unconstitutional as applied to them. Noted for a militia-type attitude, their original tactics employed a philosophy of “untaxing” yourself (renouncing the right to receive government benefits such as social security) and thus becoming a “sovereign citizen” who was beyond the reach of the U.S. tax system. Thus, IRS would look for the obvious: Those who did not file or pay their income taxes.

The pure trust scam artists, however, have taken a different tack: They claim taxes are legal, and for, say, \$20,000 they’ll help you reduce or eliminate your tax burden, by setting up your “pure trust.” The documents usually make no logical sense but are just a mishmash of trust concepts combined with anti-tax rhetoric. Under the traditional pure trust approach, tax returns are filed, but income disappears through a series of phony deductions. The scam artists believed that IRS would not audit trust tax returns. This approach became obsolete when IRS released *Notice 97-24*, announcing a nationwide crackdown on bogus trusts.

Recently, the tax protesters have discovered the virtues of selling the pure trust. They have modified their position and now explain that a person no longer must “untax” himself, but rather that the pure trust be formed in a “foreign” jurisdiction, while the individual remains eligible to receive government benefits—It’s a “have your cake and eat it too” approach.

But because forming a legitimate foreign trust is expensive, not to mention the fact that the clients would lose control of their assets, these savvy tax protesters have devised a theory—based on a frivolous interpretation of the Internal Revenue Code—that classifies all 50 states as “foreign” to the U.S. government. And here is the bonus: The “foreign” trust could reside in the same state as the taxpayer!

Thus, by creating a trust that is classified as “foreign” under U.S. tax laws, the income received would be “foreign source,” therefore, the trust would not file tax returns. Distributions made to the taxpayer would be considered tax-free foreign-source gifts or foreign-earned income that, supposedly, would be excludable under IRC Sec. 911. Of course, none of this actually works under our tax laws.

In this way, the tax protesters devised a scheme to hide the income and existence of these trusts from IRS yet still operate openly in the U.S. as a “foreign trust” which is allegedly not subject to tax reporting or filing requirements.

Tax Scams and the Internet

An internet search for the terms “pure trust” will produce dozens of unique websites advertising these schemes. Some websites have existed for years. The sheer volume of such websites touting the pure trust lends legitimacy to the concept. After reading several of these sites, the average citizen could—and may—believe there is truth in their claims.

A typical trust-scam artist uses the pitch, “If this were illegal, don’t you think the government would arrest me? They haven’t, therefore, what I’m telling you must be legal.”

In addition to creating an atmosphere of legitimacy, the web allows, by sheer numbers, the trust-scam artist to reach a worldwide audience. Similar schemes are cropping up in Australia and Canada, with a scope extending to other countries. Because each trust scam is designed to extract a huge fee before any bogus documents are even produced, unless the government moves quickly to shut down these scams, the damage is done to unsuspecting consumers long before any tax returns are filed

or audited. Often there are no tax returns filed, so large sums of wealth are slipping below the government's radar screen.

Since trust scam operations rely on keeping one step ahead of the IRS, a sham trust promoter might use the other tax fraud websites as a resource to update and fine-tune his swindle. For instance, the "foreign jurisdiction" argument is being refined and used in a variety of illegal contexts because of its prevalence on the web. A trust scammer can now point to the number of tax "experts" on the web saying essentially the same thing he is touting, another technique to buttress his scam's legitimacy.

Finally, the e-mail portion of the web is vital to the trust promoters since it allows them to spam (send thousands of unwanted e-mails touting their trust fraud) for free. It is the combination of having a website and the use of spam that makes the web such an effective marketing tool for trust scammers.

MEASURES TO PREVENT THE PROLIFERATION OF TRUST SCAMS ON THE WEB

Create A Strike Force

First, the IRS needs a federal strike-force committed to consistently monitoring the websites and activities of trust-scam artists. One to two employees should be searching for new trust scams on the web first thing each and every morning. At midmorning, they should report the new activities, and by noon there should be a meeting to decide whether a suspicious website promotes tax fraud. The decision should be made by early afternoon.

If a website is promoting tax fraud, immediate action must be taken. I cannot emphasize this enough. The entire website should be downloaded and preserved as evidence. Once this is accomplished, the person or company who manages the website (usually known as the webmaster) and the ISP (the internet service provider) should be notified and given a set time, say 12 hours, to remove the website.

Within the strike force, several attorneys experienced in these matters would be authorized to appear in federal court to stop the sites. An attorney should be notified when the notice to cease and desist has gone to the web site. If the site is not down within the prescribed time, legal proceedings should commence immediately.

The strike force should also report to other government agencies combating fraud i.e. SEC, FDA, so that a coordinated crackdown on fraud can be initiated.

Finally, the strike force should be monitoring e-mail spamming by trust scam artists. This is easily done because several groups follow and report on Internet spamming. A two-pronged approach aimed at finding trust scam websites and those touting their trust frauds through spamming, would be extremely effective in stopping this activity.

Resource Center—Fight Propaganda with Education

IRS must provide a comprehensive web-based resource center involving trust scams. Every court case should be categorized and listed with links to the actual case. Every DOJ and IRS press release should be posted at the website as well. Also, legal briefs and arguments used in court cases against these groups should be available. The website should contain an e-mail subscription list and a newsletter discussing current trust scams matters. These should be sent to the press and others who request them.

A crucial element of the IRS website should be a list of suspect websites along with links to actions taken against the site (press releases, legal proceedings). A list of trust scam spammers should also be maintained.

Instructional materials, such as "How to Spot an Illegal Trust," "New Scams: How They Work and Why They are Illegal," should be essential parts of the web site. Links to other news stories and publications should be provided as well.

The website should be designed and promoted in the same manner as the IRS's recent website devoted to Small Businesses (<http://www.irs.ustreas.gov/smallbiz/index.htm>) which could be used as a model. Links to the trust scam resource center should appear on the home pages of each IRS website. Instructions to the Form 1040 should contain a paragraph stating that using trusts to avoid income taxes is illegal.

IRS Needs a Public Relations Offensive

IRS spokespersons need to counter the trust scam artists whenever they appear in any media. The IRS approach needs to be simple and direct: These scams do not work, they are illegal and IRS will come after you if you use them. IRS should avoid arguments as to the scammer's philosophy or logic. Taxpayers are impressed by results—IRS does not accept these arguments—rather than philosophical debates.

Another aspect of the PR offensive should be targeted articles and advertisements in industry-specific publications. For instance, if a doctor or dentist is convicted of

a trust scam crime, an article should appear in the professional publications (American Medical Association or American Dental Association) monthly magazines warning these professionals not to engage in this conduct. In other words, IRS needs to leverage its court victories by making sure those within the same profession or industry get the message. IRS might speak at annual conventions or have a booth at trade shows, dealing with trust scams within the profession.

A PR offensive should be directed at the trustees of these trusts since the trustees could be a family friend or relative who is unaware of the serious risk he or she is taking by acting as a trustee of the fraudulent trust. This can be accomplished through general business and finance television programs, magazines and newspaper stories.

CONCLUSION

Trust scams have existed for more than four decades. Recently, they have moved from the realm of the snakeoil salesman to the world-wide reach of the Web. This is a growing problem, both from a consumer protection and revenue loss viewpoint. The mere existence of these websites reinforces the legitimacy of the trust scammer's claims and undermines the confidence of honest taxpayers in the system.

IRS has the tools to combat this problem before it spirals further out of control. A simple three-pronged approach is feasible: (1) the identification of these websites and the swift action to shut them down (2) the design of a comprehensive resource center composed of information pertaining to trust scams; and (3) a concentrated PR effort in the media, including IRS spokespersons confronting trust scammers in the media.

If IRS considers the cost of audit and collections personnel chasing down trust scams once they have entered the tax system, eliminating these websites at the earliest moment becomes cost-effective as well.

RECOMMENDED ANTI-FRAUD WEBSITES

Quatloos (<http://www.quatloos.com/>) by Jay D. Adkisson—the leader in using the Web to expose tax and financial scams and frauds.

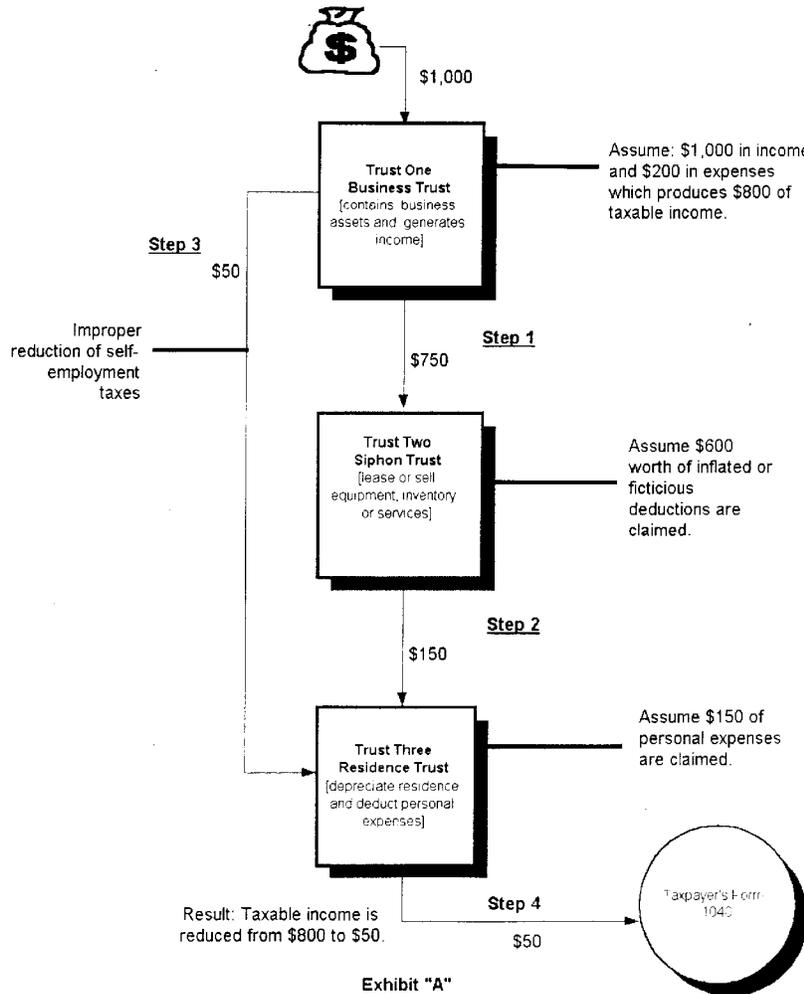
Why You Shouldn't "Trust" Trust Educational Services (formerly National Trust Services) (<http://pweb.netcom.com/~rogermw/nts.html>) by Roger M. Wilcox, who claims he got burned by National Trust Services ("NTS") to the tune of \$9,500 for a worthless trust. An excellent analysis and critique of the trust scam business from the victim's perspective.

The Tax protesters FAQ (<http://evans-legal.com/dan/tpfaq.html#liable>) by Daniel B. Evans. Mr. Evans has taken the time and trouble of refuting dozens of tax protester arguments by providing case law citations. An invaluable resource for those dealing with these arguments.

The Tax protester Hall of Fame (<http://www.geocities.com/CapitolHill/2278/>) a list of cases with descriptions dealing with tax-protester arguments.

The Militia Watch Dog Website, *"Trusts and the Untrustworthy, Pure Trusts and the Patriots for Profit"* (<http://www.militia-watchdog.org/puretrust.htm>). Mark Pitcavage, Ph.D., describes the historical development of the "pure trust" and the involvement by militia groups.

Three-Trust "Pure Trust" Scam



PREPARED STATEMENT OF HUGH G. STEVENSON

Mr. Chairman, I am Hugh Stevenson, Associate Director of the Division of Planning and Information in the Federal Trade Commission's Bureau of Consumer Protection. I am pleased to be here today to testify about the FTC's efforts to combat fraud on the Internet.¹

As one of the transforming events of our time, the advent of the Internet already has had a profound impact on the marketplace. The Internet has the potential to

¹The views expressed in this statement represent the views of the Commission. My responses to any questions you may have are my own and are not necessarily those of the Commission or any Commissioner.

deliver goods and services more conveniently, faster, and at lower prices than traditional marketing methods. Moreover, at an ever increasing rate, it is stimulating the development of innovative products and services barely conceivable just a few years ago, and enabling consumers to tap into rich sources of information that they can use to make better-informed purchasing decisions.

These developments promise enormous benefits to consumers and the economy. There is real danger, however, that these benefits may not be fully realized if consumers identify the Internet with fraud operators. Fraud on the Internet is an enormous concern for the Commission, and it has prompted a vigorous response using all the tools at the Commission's disposal, including law enforcement and education. The Commission appreciates the Subcommittee's interest in our Internet fraud program, and the Congress' support for funding both the development of our fraud database, Consumer Sentinel, and the creation of our toll-free consumer helpline. The Commission welcomes this opportunity to describe its Internet program and the challenges the agency is confronting.

I. INTRODUCTION AND BACKGROUND

A. The FTC and its Law Enforcement Authority

The FTC is the federal government's primary consumer protection agency. While most federal agencies have jurisdiction over a specific market sector, the Commission's jurisdiction extends over nearly the entire economy, including business and consumer transactions on the Internet.²

Under the Federal Trade Commission Act,³ the agency's mandate is to take action against "unfair or deceptive acts or practices" and to promote vigorous competition in the marketplace. The FTC Act authorizes the Commission to halt deception through civil actions filed by its own attorneys in federal district court, as well as through administrative cease and desist actions.⁴ Typically these civil actions seek preliminary and permanent injunctions to halt the targeted illegal activity, as well as redress for injured consumers. Where redress is impracticable, Commission actions generally seek disgorgement to the U.S. Treasury of defendants' ill-gotten gains. As discussed below, these tools have proven to be effective in fighting a broad array of fraudulent schemes on the Internet, in spite of the sheer size and reach of the Internet.

B. The Growth of Ecommerce and Internet Fraud

The growth of the Internet and ecommerce has been explosive. The number of American adults with Internet access grew from about 88 million in mid-2000 to more than 104 million at the end of the year.⁵ Just this past holiday season, consumers spent an estimated \$10.8 billion shopping on the Internet—a greater than 50 percent increase over the \$7 billion they spent online during the same period in

²The FTC has limited or no jurisdiction over specified types of entities and activities. These include banks, savings associations, and federal credit unions; regulated common carriers; air carriers; non-retail sales of livestock and meat products under the Packers and Stockyards Act; certain activities of nonprofit corporations; and the business of insurance. *See, e.g.*, 15 U.S.C. §§ 44, 45, 46 (FTC Act); 15 U.S.C. § 21 (Clayton Act); 7 U.S.C. § 227 (Packers and Stockyards Act); 15 U.S.C. § 1011 *et seq.* (McCarran-Ferguson Act).

³15 U.S.C. § 45(a). The Commission also has responsibilities under more than 45 additional statutes, *e.g.*, the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*, which establishes important privacy protections for consumers' sensitive financial information; the Truth in Lending Act, 15 U.S.C. §§ 1601 *et seq.*, which mandates disclosures of credit terms; and the Fair Credit Billing Act, 15 U.S.C. §§ 1666 *et seq.*, which provides for the correction of billing errors on credit accounts. The Commission also enforces over 35 rules governing specific industries and practices, *e.g.*, the Used Car Rule, 16 C.F.R. Part 455, which requires used car dealers to disclose warranty terms via a window sticker; the Franchise Rule, 16 C.F.R. Part 436, which requires the provision of information to prospective franchisees; and the Telemarketing Sales Rule, 16 C.F.R. Part 310, which defines and prohibits deceptive telemarketing practices and other abusive telemarketing practices.

⁴15 U.S.C. §§ 45(a) and 53(b).

⁵Pew Internet and American Life Project, *More Online, Doing More* (reported at <http://www.pewinternet.org/reports/toc.asp?Report=30>) (stating that comparing figures gathered in tracking survey in May and June with figures gathered between Thanksgiving and Christmas, the number of American adults with Internet access grew from about 88 million to more than 104 million in the second half of 2000).

1999.⁶ Total ecommerce sales for 2000 were an estimated \$25.8 billion, .8 percent of all sales.⁷

Unfortunately, but not surprisingly, the boom in ecommerce has opened up fertile ground for fraud. The Commission's experience is that fraud operators are always among the first to appreciate the potential of a new technology to exploit and deceive consumers. Long-distance telemarketing attracted con artists when it was introduced in the 1970's. They swarmed to pay-per-call technology when it became available in the late 1980's. Internet technology is the latest draw for opportunistic predators who specialize in fraud. The rapid rise in the number of consumer complaints related to online fraud and deception bears this out: in 1997, the Commission received fewer than 1,000 Internet fraud complaints through Consumer Sentinel; a year later, the number had increased eight-fold. In 2000, over 25,000 complaints—roughly 26 percent of all fraud complaints logged into Consumer Sentinel by various organizations that year—related to online fraud and deception. The need—and challenge—is to act quickly to stem this trend while the online marketplace is still young.

C. The FTC's Response to Protecting Consumers in the Online Marketplace

Stretching its available resources to combat the growing problem of Internet fraud and deception, the Commission has targeted a wide array of online consumer protection problems. This effort has produced significant results. Since 1994, the Commission has brought 170 Internet-related cases against over 573 defendants. It obtained injunctions stopping the illegal schemes, and ordering more than \$180 million in redress or disgorgement,⁸ and obtained orders freezing millions more in cases that are still in litigation. Its federal district court actions alone have stopped consumer injury from Internet schemes with estimated annual sales of over \$250 million.⁹

CHALLENGES POSED BY INTERNET FRAUD

The Commission faces a host of novel challenges in its efforts to combat fraud and deception online. Because it is both global in its reach and instantaneous, the Internet lends itself well not only to adaptations of traditional scams—such as pyramid schemes and false product claims—but also to new high-tech scams that were not possible before development of the Internet. In addition, the Internet enables con artists to cloak themselves in anonymity, which makes it necessary for law enforcement authorities to act much more quickly to stop newly-emerging deceptive schemes before the perpetrators disappear. And because the Internet transcends national boundaries, law enforcement authorities must be more creative and cooperative to successfully combat online fraud. These novel challenges are discussed in greater detail below.

A. Combating Internet Fraud Requires New Methods of Collecting and Analyzing Information

The Commission is developing new methods of collecting and analyzing information about both the offline and online marketplace, drawing upon the power of new technology itself. A central part of this effort is Consumer Sentinel, a web-based consumer fraud database and law enforcement investigative tool.¹⁰ Consumer Sentinel receives Internet fraud complaints from the FTC's Consumer Response Center ("CRC"), which processes both telephone and mail inquiries and complaints.¹¹ For

⁶Jupiter Communications, Inc., *Online Holiday Sales Increased by 54 percent this Holiday Season, Despite Dot Com Closures and Soft Offline Purchase* (Jan. 17, 2001) (estimating Nov. and Dec. 2000 online sales of \$10.8 billion, compared to \$7 billion for those months in 1998) (reported at www.jup.com/company/pressrelease.jsp?doc=pr010117). The Census Bureau of the Department of Commerce estimated that in the fourth quarter of 2000, not adjusted for seasonal, holiday, and trading-day differences, online retail sales were \$8.686 billion, an increase of 67.1 percent from the 4th quarter of 1999 (reported at www.census.gov/mrts/www/current.html).

⁷*Id.*

⁸To date the Commission has collected more than \$55 million in redress for victims of Internet fraud and deception.

⁹These figures are based on estimated annual fraudulent sales by defendants in the twelve months prior to filing the complaint. Fraudulent sales figures are based on, among other things, financial statements, company records, receiver reports, and deposition testimony of company officials.

¹⁰See www.consumer.gov/sentinel.

¹¹The CRC now receives over 12,000 inquiries and complaints per week. They cover a broad spectrum—everything from complaints about get-rich-quick telemarketing scams and online auction fraud, to questions about consumer rights under various credit statutes and requests for educational materials. Counselors record complaint data, provide information to assist consumers in resolving their complaints, and answer their inquiries.

those consumers who prefer the online environment, an electronic complaint form at www/ftc/gov, first available in May of 1998, permits consumers to channel information about potential scams directly to the CRC and the fraud database.

The Commission provides secure access to this data over the Internet, free of charge, to over 300 U.S., Canadian, and Australian law enforcement organizations—including the Department of Justice, U.S. Attorney’s offices, the Federal Bureau of Investigation, the Securities and Exchange Commission, the Secret Service, the U.S. Postal Inspection Service, the Internal Revenue Service, the offices of all 50 state Attorneys General, local sheriffs and prosecutors, the Royal Canadian Mounted Police, and the Australian Competition and Consumer Commission. Consumer Sentinel is a dynamic online law enforcement tool to use against all types of fraud, especially online fraud.¹²

The central role that Consumer Sentinel plays in the Commission’s law enforcement is exemplified by “Operation Top Ten Dot Cons,” the Commission’s latest broad “sweep” of fraudulent and deceptive Internet scams. In a year-long law enforcement effort, the FTC and four other U.S. federal agencies,¹³ consumer protection organizations from 9 countries,¹⁴ and 23 states¹⁵ announced 251 law enforcement actions against online scammers. The FTC brought 54 of the cases.¹⁶ The top 10 scams, identified through analysis of complaint data in the Consumer Sentinel database, were:

- Internet Auction Fraud
- Internet Service Provider Scams
- Internet Web Site Design/Promotions (“Web Cramming”)¹⁷
- Internet Information and Adult Services (unauthorized credit card charges)
- Pyramid Scams
- Business Opportunities and Work-At-Home Scams
- Investment Schemes and Get-Rich-Quick Scams
- Travel/Vacation Fraud
- Telephone/Pay-Per-Call Solicitation Frauds (including modem dialers and videotext)¹⁸
- Health Care Frauds

The Consumer Sentinel data enabled the FTC and the other enforcement agencies that joined us in this project both in the U.S. and abroad to identify not only the top ten types of scams, but also the specific companies generating the highest levels of complaints about each of those types of scams. These companies became the targets for the law enforcement actions that comprised Operation Top Ten Dot Con. Finally, Consumer Sentinel data enabled the Commission and its partners to obtain and develop evidence against these targets from individual consumers whose complaints had been included in the database.

Consumer Sentinel first went online in late 1997. Since then, the Commission has upgraded the capacity of the Consumer Sentinel database and enhanced the agen-

¹²In 1998, the Interagency Resources Management Conference Award recognized Consumer Sentinel as an exceptional initiative to improve government service.

¹³U.S. agencies participating included the Commodity Futures Trading Commission, the Department of Justice, the Securities and Exchange Commission and the United States Postal Inspection Service.

¹⁴Participants in “Operation Top Ten Dot Cons” included consumer protection agencies from Australia, Canada, Finland, Germany, Ireland, New Zealand, Norway, the United Kingdom and the United States.

¹⁵Cases were brought by the Attorneys General of Arizona, Colorado, Florida, Illinois, Iowa, Indiana, Louisiana, Maryland, Massachusetts, Michigan, Missouri, Nevada, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, and Washington State. Consumer protection offices in West Virginia, and Wisconsin also took action, as did the Louisiana Department of Justice, the Oklahoma Department of Securities, and the Washington State Securities Division.

¹⁶The SEC’s contribution to this project consisted of 77 cases.

¹⁷“Web cramming” is a type of unauthorized billing scam. Web crammers call their victims—often small businesses—and offer a “free” Web page; then they start billing the victims, typically on their monthly telephone statements, without authorization. In many cases the small business victims are not even aware that they have a web site or are paying for one.

¹⁸Telephone/Pay-Per-Call Solicitation Frauds are schemes that exploit the telephone billing and collection system to charge consumers for telephone-based entertainment programs (“audiotext” in industry parlance) or other so-called “enhanced services” that are not telecommunications transmission but are often billed on consumers’ telephone bills. Modem dialers and videotext schemes, like the operation attacked in *FTC v. Verity International*, No. 00 Civ. 7422(LAK) (S.D.N.Y. 2000), described *infra*, are ones that, unbeknownst to a consumer, cause his or her computer modem to disconnect from his or her usual Internet service provider, dial an expensive international telephone number, and reconnect to the Internet at a remote location overseas, charging the consumer as much as \$5.00 or more per minute for as long as the consumer continues online.

cy's complaint-handling systems by creating and staffing a new toll-free consumer helpline at 1-877-FTC-HELP, and adding several new functions to Consumer Sentinel. The first of these new functions, the "Top Violators" report function, allows a law enforcement officer to pull up the most common suspects and schemes by state, region or subject area. The second new function, "Auto Query," enables an investigator to create an automatic search request. This automatic search can be set to run daily, weekly or monthly, and if new complaints come in to Consumer Sentinel that match the search criteria, Consumer Sentinel will automatically alert the investigator via email. Third, the "Alert" function enables law enforcers to communicate with each other and minimize duplication of their efforts, and a fourth new function performs a search of Commission court orders online. In 2000, Consumer Sentinel received over approximately 100,000 consumer complaints.¹⁹ Currently the database holds over 300,000 consumer complaints.²⁰

The Commission's efforts to improve consumer complaint collection and analysis through the Consumer Response Center and Consumer Sentinel are complemented by a proactive program to uncover fraud and deception in broad sectors of the online marketplace through "Surf Days." Surf Days use new technology to detect and analyze emerging Internet problems. While Consumer Sentinel provides data on broad trends and the volume of complaints prompted by particular Internet schemes, Surf Days allow the Commission to take a "snap shot" of a market segment at any given time. The Commission also uses Surf Days to reach new entrepreneurs and alert those who unwittingly may be violating the law.

On a typical Surf Day, Commission staff and personnel from our law enforcement partners—often state attorneys general, sister federal agencies or private organizations like the Better Business Bureau—widely "surf" the Internet for a specific type of claim or solicitation that is likely to violate the law. When a suspect site is identified, the page is downloaded and saved as potential evidence, and the operator of the site is sent an email warning that explains the law and provides a link to educational information available at www.ftc.gov. Shortly thereafter, a law enforcement team revisits the previously warned sites to determine whether they have remedied their questionable claims or solicitations. The results vary, depending on the targeted practice of the particular Surf Day. In each of these efforts, between 20 to 70 percent of the Web site operators who received a warning come into compliance with the law, either by taking down their sites or modifying their claims or solicitations. Sites that continue to make unlawful claims are targeted for possible law enforcement action.

To date, the Commission has conducted 26 different Surf Days targeting problems ranging from "cure-all" health claims to fraudulent business opportunities and credit repair scams.²¹ More than 250 law enforcement agencies or consumer organizations around the world have joined the Commission in these activities; collectively, they have identified over 6,000 Internet sites making dubious claims. The law enforcement Surf Day has proven so effective that it is now widely used by other government agencies, consumer groups and other private organizations.

B. Traditional Scams Use the Internet to Expand in Size and Scope

Out of the 170 cases brought by the Commission against Internet fraud and deception, over half have targeted old-fashioned scams that have been retooled for the new medium. For example, the Commission has brought 28 actions against online

¹⁹Consumer Sentinel has also been upgraded and expanded to provide participants access to the Identity Theft Data Clearinghouse, the central repository for federal identity theft complaints.

²⁰The FTC recently has signed an agreement with the Department of Defense to collect consumer complaint from men and women serving in the military through a project called "Soldier Sentinel."

²¹The FTC has coordinated or co-sponsored the following Surf Days, listed by date of their announcements: Pyramid Surf Day (Dec. 1996), Credit Repair Surf (April 1997), Business Opportunity Surf Day (April 1997), Coupon Fraud Surf Day (Aug. 1997), North American Health Claims Surf (Oct. 1997), HUD Tracer Surf Day (Nov. 1997), International Surf Day (Oct. 1997), Kids Privacy Surf Day (Dec. 1997), Junk E-mail Harvest (Dec. 1997), Privacy Surf (March 1998), Textile and Wool Labeling Surf (Aug. 1998), Y2K Surf (Sept. 1998), International Health Claims Surf (Nov. 1998), Investment Surf Day (Dec. 1998), Jewelry Guides Surf (Jan. 1999), Pyramid Surf Day II (March 1999), Green guide Surf (April 1999), Coupon Fraud II Surf Day (June 1999), Jewelry Guides Surf II (January 2000), Scholarship Services Surf (January 2000), GetRichQuick.com Surf (March 2000), False or Unsubstantiated Lice treatment Claims Surf (April 2000), Credit Repair Surf II (Aug. 2000), Childrens' Online Privacy Protection Act Compliance Surf (Aug. 2000), False Claims of Authenticity for American Indian Arts and Crafts Surf Day (Oct. 2000), and TooLate.Com [Surf on Online Retailers' Compliance with the Mail or Telephone Order Merchandise Rule] (Nov. 2000).

credit repair schemes, 25 cases against deceptive business opportunities and work-at-home scheme, and 11 cases against pyramid schemes.

It is no surprise that the Internet versions of traditional frauds can be much larger in size and scope than their offline predecessors. A colorful, well-designed Web site imparts a sleek new veneer to an otherwise stale fraud; and the reach of the Internet allows an old-time con artist to think—and act—globally, as well.

Pyramid schemes are the most notable example of a fraud whose size and scope are magnified by the Internet.²² By definition, these schemes require a steady supply of new recruits. The Internet provides an efficient way to reach countless new prospects around the world, and to funnel funds more efficiently and quickly from the victims to the scammers at the top of the pyramid. As a result, the victims are more numerous, the fraud operator's financial "take" is much greater, and the defense is typically well-funded and fierce when the FTC brings suit to stop a pyramid scheme operating online.

Despite the extensive resources required to pursue an online pyramid case, the Commission has asserted a strong enforcement presence, obtaining orders to pay more than \$70 million in redress for victims,²³ and pursuing millions more in ongoing litigation. In one case, *FTC v. Fortuna Alliance*, the Commission spent two years in litigation and negotiations and finally obtained a court order finding the defendants in contempt, and a stipulated final order enjoining the defendants from further pyramid activities and requiring them to pay \$5.5 million in refunds to over 15,000 victims in the U.S. and 70 foreign countries.²⁴ More recently, in *FTC v. Five Star Auto Club, Inc.*,²⁵ the Commission prevailed at trial against another pyramid scheme that lured online consumers to buy in by claiming that an annual fee and \$100 monthly payments would give investors the opportunity to lease their "dream vehicle" for "free" while earning between \$180 and \$80,000 a month by recruiting others to join the scheme. The court issued a permanent injunction shutting down the scheme, barring for life the scheme's principals from any multi-level marketing business, and ordering them to pay \$2.9 million in consumer redress.

C. Scams Are Increasingly High-Tech

Although most Internet fraud stems from traditional scams, the number of schemes uniquely and ingeniously exploiting new technology is multiplying. These are the most insidious schemes because they feed on the public's fascination with—and suspicion of—new technology. Their ultimate effect can only be to undermine consumer confidence in the online marketplace. To combat this type of high-tech fraud, the Commission has supported staff training and given its staff the tools to be effective cyber-sleuths.

Recognizing that most of its attorneys and investigators need to be Internet savvy, the Commission has hosted beginner and advanced Internet training seminars and held sessions on new technology, investigative techniques, and Internet case law. The Commission also makes this training available to personnel of other law enforcement agencies. In the past year, the Commission has presented Internet training seminars in seven U.S. cities and in Toronto, Canada, and Paris, France. In addition to FTC staff, these sessions trained approximately 800 individual participants from other law enforcement agencies. These participants represented twenty different countries including the U.S. twenty-six states, twenty-two federal agencies, and fourteen Canadian law enforcement agencies. Among those who have participated are representatives from the offices of state Attorneys General, the Department of Justice and U.S. Attorneys, the Securities and Exchange Commission, the FBI, and the Postal Inspection Service.

In addition to providing regular Internet training, the Commission also provides its staff with the tools they need to investigate high-tech fraud. The FTC's Internet Lab is an important example. With high speed computers that are separate from

²² Pyramid operators typically promise enormous earnings or investment returns, not based on commissions for retail sales to consumers, but based on commissions for recruiting new pyramid members. Recruitment commissions, of course, are permitted on an endless supply of new members. Inevitably, when no more new recruits can be found, these schemes collapse and a vast majority of participants lose the money they invested.

²³ To date, the Commission has collected about \$42.6 million in these cases.

²⁴ *FTC v. Fortuna Alliance, L.L.C.*, No. C96-799M (W.D. Wash. 1996). See also, *FTC v. JewelWay International, Inc.*, No. CV97-383 TUC JMR (D. Ariz. 1997) (\$5 million in redress for approximately 150,000 investors); *FTC v. Nia Cano*, No. 97-7947-CAS-(AJWx) (C.D. Cal. 1997) (approximately \$2 million in redress); *FTC v. FutureNet*, No. 98-1113GHK (AIJx) (C.D. Cal. 1998) (\$1 million in consumer redress); *FTC v. Five Star Auto Club, Inc.*, 97 F. Supp. 2d 502 (S.D.N.Y. 2000). (\$2.9 million in consumer redress); *FTC v. Equinox International Corp.*, No CV-S-990969-JBR-RLH (D.Nev.1999) (pyramid promoted through many devices, including some use of the Internet; \$50 million in consumer redress).

²⁵ *FTC v. Five Star Auto Club, Inc.*, 97 F. Supp. 2d 502 (S.D.N.Y. 2000).

the agency's network and loaded with the latest hardware and software, the Lab allows staff to investigate fraud and deception in a secure environment and to preserve evidence for litigation.

The Commission has used its training and tools to stop some of the most egregious and technically sophisticated schemes seen on the Internet. For example, the FTC's lawsuit against Verity International, Ltd.,²⁶ was prompted by the influx of hundreds of complaints in the last week of September 2000 through the CRC and logged in Consumer Sentinel. Investigation showed that high charges on consumers' phone lines were being initiated by "dialer" software downloaded from teaser adult web sites. Many line subscribers had no idea why they received bills for these charges. Others discovered that a minor in their household—or another person who did not have the line subscriber's authorization—accessed the Web sites and downloaded the dialer software. The dialer program allowed users to access the "videotext" adult content without any means of verifying that the user was the line subscriber, or was authorized by the line subscriber to incur charges on the line for such service. Once downloaded and executed, however, the program actually hijacked the consumer's computer modem by surreptitiously disconnecting the modem from the consumer's local Internet Service Provider, dialing a high-priced international long distance call to Madagascar, and reconnecting the consumer's modem to the Internet from some overseas location, opening at an adult web site. The line subscriber—the consumer responsible to pay phone charges on the telephone line—then began incurring charges on their phone lines for the remote connection to the Internet at the rate of \$3.99 per minutes. The court has ordered a preliminary injunction in this matter, and litigation continues.²⁷

Earlier, in *FTC v. Carlos Pereira d/b/a atariz.com*,²⁸ the Commission attacked a world-wide, high-tech scheme that allegedly "pagejacked" consumers and then "mousetrapped" them at adult pornography sites. "Pagejacking" is making exact copies of some one else's Web page, including the imbedded text that informs search engines about the subject matter of the site. The defendants allegedly made unauthorized copies of 25 million pages from other Web sites, including those of Paine Webber and the Harvard Law Review. The defendants made one change on each copied page that was hidden from view: they inserted a command to "redirect" any surfer coming to the site to another Web site that contained sexually-explicit, adult-oriented material. Internet surfers searching for subjects as innocuous as "Oklahoma tornadoes" or "child car seats" would type those terms into a search engine and the search results would list a variety of related sites, including the bogus, copycat site of the defendants. Surfers assumed from the listings that the defendants' sites contained the information they were seeking and clicked on the listing. The "redirect" command imbedded in the copycat site immediately rerouted the consumer to an adult site hosted by the defendants. Once there, defendants "mousetrapped" consumers by incapacitating their Internet browser's "back" and "close" buttons, so that while they were trying to exit the defendants' site, they were sent to additional adults sites in an unavoidable, seemingly endless loop.

Using the new tools available in the Internet Lab, the Commission was able to capture and evaluate evidence of this "pagejacking" and "mousetrapping." In September 1999, the Commission filed suit in federal court and obtained a preliminary order stopping these activities and suspending the Internet domain names of the defendants. Since then, the Court has entered default judgments against two defendants and a stipulated permanent injunction against a third, barring them from future law violations. A fourth defendant, Carlos Pereira, has evaded law enforcement authorities in Portugal.

D. Online Scams Spread Quickly and Disappear Quickly

One hallmark of Internet fraud is the ability of perpetrators to cover their tracks and mask their locations and identities. Using anonymous emails, short-lived Web sites, and falsified domain name registrations, many fraud operators are able to strike quickly, victimize thousands of consumers in a short period of time, and disappear nearly without a trace.

To stop these swift and elusive con artists, law enforcement must move just as fast. The FTC's Internet Rapid Response Team was created for this very purpose. It draws heavily upon complaints collected by the FTC's Consumer Response Center

²⁶ *FTC v. Verity International, Ltd.*, No. 00 Civ. 7422 (LAK) (S.D.N.Y. 2000)

²⁷ Other modem hijacking cases include *FTC v. Audiotex Connection, Inc.*, No. CV-97-0726 (DRH) (E.D.N.Y. 1997) (final stipulated injunction halting the unlawful practice and order that 27,000 victims receive full redress totaling \$2.14 million); *FTC v. RJB Telcom, Inc.*, No. CV 00-2017 PHX SRB (D. Az. 2000); *FTC v. Ty Anderson*, No. C 00-1843P (W.D. Wa. 2000).

²⁸ *FTC v. Carlos Pereira d/b/a atariz.com*, No. 99-1367-A (E.D. Va. 1999).

and the Consumer Sentinel system. The team constantly reviews complaint data to spot emerging problems, conduct quick but thorough investigations, and prepare cases for filing in federal courts. Based on such data review, FTC staff had completed the investigations and was in court successfully arguing for an *ex parte* temporary restraining order and asset freeze in *FTC v. Verity International, Ltd.* within a little more than a week after the first complaints begin coming in to the Consumer Response Center.

In another exemplary effort of the Rapid Response Team, *FTC v. Benoit*,²⁹ the Team quickly moved against defendants who allegedly used deceptive emails or “spam” to dupe consumers into placing expensive international audiotext calls.³⁰ The defendants allegedly sent thousands of consumers an email stating that each recipient’s “order” had been received and that his or her credit card would be billed \$250 to \$899. The email instructed consumers to call a telephone number in the 767 area code if they had any questions. Most consumers did not realize that 767 was the area code for Dominica, West Indies. When consumers called the number expecting to reach a customer representative, they were connected to an audiotext entertainment service with sexual content and charged expensive international rates.

Even though a string of telephone carriers could not identify who operated the audiotext number in question, the Internet Rapid Response Team constructed a compelling case in about three weeks. The Commission quickly obtained a federal court order to stop the scheme and freeze any proceeds of the fraud still in the telephone billing system.

E. Effective Remedies Are More Difficult to Achieve in the Global Online Market

The globalization of the marketplace poses new and difficult challenges for consumer protection law enforcement. Anticipating this development, the Commission held public hearings in the fall of 1995 to explore business and consumer issues arising from technological innovation and increasing globalization. Over 200 company executives, business representatives, legal scholars, consumer advocates, and state and federal officials presented testimony, and the Commission published a two-volume report summarizing the testimony and the role of antitrust and consumer protection law in the changing marketplace. As reported in, “Anticipating the 21st Century: Consumer Protection in the New High-Tech, Global Marketplace,” there was a broad consensus that meaningful consumer protection takes: (1) coordinated law enforcement against fraud and deception; (2) private initiatives and public/private partnerships; and (3) consumer education through the combined efforts of government, business, and consumer groups.³¹ These principles have guided FTC policy regarding the Internet ever since.

In addition to gathering information through hearings and workshops, the FTC has gained practical knowledge about the effects of globalization and ecommerce through its litigation. In this respect, the Commission has found that pursuing Internet fraud often involves a difficult and costly search for money that has been moved off-shore. For example, in *FTC v. J.K. Publications*,³² the Commission obtained an *ex parte* temporary restraining order, a preliminary injunction and an asset freeze against defendants that allegedly made unauthorized charges of \$19.95 per month on consumers’ credit or debit cards for purported Internet services. Based upon evidence gathered by Commission staff, the defendants may have charged over 900,000 consumers a total of \$45 million for unordered or unauthorized Internet services. According to the receiver appointed in this case, the defendants moved millions of dollars to the Cayman Islands, Liechtenstein, and Vanuatu in the South Pacific. The Commission continues to litigate this case, and the receiver continues to attempt to locate defendants’ foreign assets and repatriate them to the U.S.

In *FTC v. Fortuna Alliance*, one of the pyramid schemes described above, the Commission found that the defendants had transferred \$2.8 million to Antigua, West Indies. With the assistance of the U.S. Department of Justice’s Office of Foreign Litigation, the Commission obtained an order from an Antiguan court freezing those funds and a stipulated final judgment in U.S. court that required the defend-

²⁹*FTC v. Benoit* (previously *FTC v. One or More Unknown Parties*), No. 3:99 CV 181 (W.D.N.C. 1999). In the course of the litigation, Commission attorneys were able to identify the operators of the scheme.

³⁰“Audiotext” services are telephone-based entertainment or information services.

³¹See Bureau of Consumer Protection, Federal Trade Commission, *Anticipating the 21st Century: Consumer Protection in the New High-Tech, Global Marketplace*, iii (May 1996), and *Looking Ahead: Consumer Protection in the Global Electronic Marketplace* (September 2000).

³²*FTC v. J.K. Publications*, No. 99-000-44ABC (AJWx) (C.D. Cal. 1999).

ants to repatriate that money for consumer redress. In the process, however, it cost \$280,000 in fees alone to litigate the case in foreign court.³³

In addition to fraud proceeds moving off-shore quickly, fraudulent online operators may be beyond the reach of the Commission and U.S. courts, practically if not legally. There is now limited recognition of civil judgments from country to country. Even if the Commission were to bring an action and obtain a judgment against a foreign firm that has defrauded U.S. consumers, the judgment might be challenged in the firm's home country, and the ability to collect any consumer redress might be frustrated. In light of this possibility, U.S. law enforcement must look for more effective remedies available under U.S. law and must work more cooperatively with law enforcement officials in other countries. To that end, the FTC has executed co-operation memoranda with agencies in Canada, the United Kingdom, and Australia.³⁴

The Commission's actions in *FTC v. Pereira* represent significant strides in the right direction. In that case, the Commission realized that the defendants "pagejacking" and "mousetrapping" scheme had operated through Web sites registered with a U.S.-based company. Thus, in its request for a temporary restraining order and preliminary injunction, the Commission asked that the registrations for these Web sites be suspended, thereby effectively removing the defendants and their deceptive Web sites from the Internet, pending a full trial. At the same time, the Commission reached out to its international colleagues in Portugal and Australia. The Australian Competition and Consumer Commission (ACCC) proved especially helpful in providing information about the defendants and their business operations in Australia. The ACCC also began its own investigation, executed a number of search warrants, and began pursuing potential legal action against the defendants in that country.

III. CONSUMER AND BUSINESS EDUCATION

Law enforcement alone cannot stop the tide of fraudulent activity on the Internet. Meaningful consumer protection depends on education as well. Consumers must be given the tools they need to spot potentially fraudulent promotions, and businesses must be advised about how to comply with the law. The FTC's consumer and business education program uses the Internet to communicate anti-fraud and educational messages to reach vast numbers of people in creative and novel ways quickly, simply and at a low cost. As more consumers and businesses come online, use of the Internet to disseminate information will grow.

A. Fraud Prevention Information for Consumers

More than 200 of the consumer and business publications produced by the FTC's Bureau of Consumer Protection are available on the agency's Website in both text and .pdf format. Indeed, the growth in the number of our publications viewed online between 1996 and 1999 (140,000 vs. 2.5 million) tells the story of the Internet's coming of age as a mainstream medium and highlights its importance to any large-scale dissemination effort. Those 2.5 million page views are in addition to the 6 million print publications the FTC distributes each year to organizations that disseminate them on the FTC's behalf.

B. Link Program

In addition to placing publications on its own Web site, the FTC actively encourages partners—government agencies, associations, organizations, and corporations with an interest in a particular subject—to link to its information from their sites and to place banner public service announcements provided by the FTC on their sites. Links from the banners allow visitors to click through to the FTC site quickly to get the information they're looking for exactly when they want it. Examples of the varied organizations that have helped drive traffic to the valuable consumer information on www.ftc.gov are Yahoo!, American Express, Circuit City, AARP, North American Securities Administrators Association, the Alliance for Investor Education, the Better Business Bureau, CBS, motleyfool.com, the U.S. Patent and Trademark Office, Shape Up America!, the National Institutes of Health, and the Arthritis Foundation.

³³ In this case, the Department of Justice's Office of Foreign Litigation paid \$50,000 up front, and the U.S. court ordered the defendants to pay the remaining \$230,000 in fees. In other cases, the Commission may have to bear all or most of the cost of litigating in foreign court.

³⁴ The Commission is increasingly cooperating with international colleagues in a number of venues. Among them is the International Marketing Supervision Network, a group of consumer protection agencies from the 30 countries that are members of the Organization for Economic Cooperation and Development.

C. “Teaser” Pages

Too often, warning information about frauds reaches consumers *after* they’ve been scammed. For the FTC, the challenge is reaching consumers *before* they fall victim to a fraudulent scheme. Knowing that many consumers use the Internet to shop for information, agency staff have developed teaser sites that mimic the characteristics that make a site fraudulent and then warn the reader about the fraud. Metatags embedded in the FTC teaser sites make them instantly accessible to consumers who are using major search engines and indexing services as they look for products, services and business opportunities online. The teaser pages link back to the FTC’s page, where consumers can find practical, plain English information. The agency has developed more than a dozen such teaser sites on topics ranging from fraudulent business opportunities and wealth-building scams to weight loss products, vacation deals and investments.³⁵ Feedback from the public has been overwhelmingly positive: visitors express appreciation—not only for the information, but for the novel, hassle-free and anonymous way it is offered.

D. Consumer.gov.

Following its vision of the Internet as a powerful tool for consumer education and empowerment, the FTC organized a group of five small federal agencies in 1997 to develop and launch a Web site that would offer one-stop access to the incredible array of federal consumer information. On the theory that consumers may not know one federal agency from another, the information is arranged by topic area. Federal agencies have responded well to *consumer.gov*. The site now includes contributions from 170 federal agencies. Consumers also find it useful, with over 182,500 visits to the site recorded in the first half of FY 2001.

Visitors to *consumer.gov* find special initiatives, too: The President’s Council on Y2K Conversion asked the FTC to establish a Y2K consumer information site; the Quality Interagency Coordination Task Force requested a special site on health care quality; and the U.S. Postal Inspection Service asked that *consumer.gov* house the site to support the **kNOw Fraud** initiative, an ongoing public-private campaign initiated with the sending of postcards about telemarketing fraud to 115 million American households in the fall of 1999.³⁶ The FTC continues to maintain the site.

E. Business Education for Online Marketers

As part of its mission, the FTC provides guidance to online marketers on how to assure that basic consumer protection principles apply online. Many of these entrepreneurs are small, start-up companies that are new to the Internet and to marketing in general and are unfamiliar with consumer protection laws. The Commission’s publication, *Advertising and Marketing on the Internet: Rules of the Road*, is designed to give practical, plain-English guidance to them.³⁷ FTC also has used a variety of other approaches to get its messages out to the business community, from posting compliance guides, staff advisory letters and banner public service announcements on the Web to speaking at industry and academic meetings and conferences, using the trade press to promote the availability of information on the agency site, and holding workshops on online issues and posting the transcripts. Most recently, on January 30 of this year, the Commission, in cooperation with the Electronic Retailing Association presented “Etail Details” a case-driven Internet marketing seminar for Internet retailers, marketers, and suppliers on applying off-line rules and regulations online. The seminar was designed to ensureetailers understand and comply with FTC rules regardingetailing.

IV. CONCLUSION

The Commission has been involved in policing the electronic marketplace for six years—before the World Wide Web was widely used by consumers and businesses. So far, we have kept pace with the unprecedented growth of the electronic marketplace by targeting our efforts, making innovative use of the technology, and

³⁵The titles of the teaser sites are: Looking for Financial Freedom?; The Ultimate Prosperity Page; Nordicalite Weight Loss Product; A+ Fast Ca\$\$h for College; EZTravel: Be an Independent agent; EZTravel: Certificate of Notification; EZToyz Investment Opportunity; HUD Tracer Association; CreditMenders Credit Repair; NetOpportunities: Internet is a Gold Mine; National Business Trainers Seminars; VirilityPlus: Natural Alternative to Viagra; ArthritiCure: Be Pain-Free Forever.

³⁶The original *consumer.gov* team received the Hammer Award, presented by the Vice President to teams of federal employees who have made significant contributions to reinventing government.

³⁷There has been an astonishing growth in page views of this publication in the past year: from 33,448 vies in FY 1999 to 110,473 in FY 2000.

leveraging our resources. We have done all this with limited resources, and without retreating from our important consumer protection work in traditional markets.

The Commission greatly appreciates the opportunity to describe its efforts to combat fraud on the Internet.

COMMUNICATIONS

STATEMENT OF WE THE PEOPLE FOUNDATION FOR CONSTITUTIONAL EDUCATION, INC.

Government officials have refused to respond to our repeated requests to discuss allegations and answer questions raised by tax researchers who assert that:

(1) There is no law or regulation that requires most citizens to file a tax return, pay income tax, or have money withheld from their pay;

(2) The 16th Amendment (the "income tax" amendment) was illegally and fraudulently ratified in 1913.

We The People Foundation has previously published, in the USA TODAY and the Washington Times, the story of how it has invited officials from the White House, the IRS and both chambers of Congress to send experts to conferences and symposiums held in Washington at the National Press Club and Crystal City Hilton to discuss and explain the evidence and findings by numerous tax researchers and show where they are in error.

The Senate is now convening its Finance Committee and has invited Commissioner Rossotti to a hearing about tax schemes, scams and fraud. We believe they have invited the right man for this subject, if only they ask him the right questions, since tax researchers allege the IRS has been conducting fraudulent operations and perpetrating an enormous hoax.

We are concerned the hearings may turn into an attempt to label and portray the tax researchers and employers as people who are running scams, cons, and deceptions, when, on the contrary, the evidence is convincing that the shoe is on the other foot, and it's the IRS that is operating a monumental scam, disobeying the laws, and extorting money from people who do not owe it. Recent reports of the Commissioner's conflict of interest in personally profiting greatly from his position, his quid pro quo actions, and the pattern of abusing IRS audits for purposes of reprisals only add to questions about the integrity of the IRS, and lend even more credence to allegations of fraudulent operations.

We suggest the Committee should hear from some of the individuals whose writings and actions have prompted this rather sudden hearing. A few of them have been pictured in our full-page messages published in the USA Today and in the Washington Times, including tax researchers, former IRS agents, and employers who have stopped withholding.

We again respectfully request the Senate to please identify its most knowledgeable people and have them meet with the tax researchers in a public forum to discuss and debate the issues with the researchers, show where they are in error, embarrass them, and put the whole matter to rest. So far, the only response has been steel-fisted threats of stronger enforcement of laws that apparently do not exist.

EXPLANATIONS NEEDED:

We suggest the senators ask the Commissioner to explain how it is that:

- Commissioner Rossotti, despite having made major changes in IRS organizational structure and lines of responsibility, has failed to publish reorganization plans and lines of delegated authority, in utter disregard of the Federal Register Act, not to mention the public.
- IRS personnel throughout the agency routinely suppress evidence and refuse to comply with Treasury Department regulations that compel production of documents, records, and identity of witnesses, thereby covering up exculpatory evidence and denying due process and informational rights of the people.
- IRS personnel throughout the agency consistently fail and refuse to establish the nature of actions against people (including identification of taxing and liability statutes and regulations), provide lawful evidence of liability, and disclose existence of competent first-hand witnesses.

- IRS managers and personnel in the office of the Treasury Inspector General for Tax Administration (TIGTA) do not discipline or prosecute IRS personnel who fail or refuse to comply with mandates or prohibitions of the Internal Revenue Code, Treasury regulations, and agency policy. Complaints to TIGTA go into an administrative black hole and the complaining party does not hear anything about them again, showing complicity by TIGTA in the misconduct complained about.
- The consistent pattern of behavior evidences a systemic conspiracy to deprive the American people of substantive rights and to otherwise ignore mandates and prohibitions, in defiance of the 1998 IRS Restructuring and Reform Act. Evidence shows that the noncompliance is choreographed at the highest levels of the agency. The complaints noted above warrant investigation by legislative and administrative oversight committees, boards, and officers.

The American people are perfectly entitled to pursue and exercise their First Amendment rights to redress of grievances in all possible forums. The senators should question the Commissioner how it is that:

- The IRS is not an agency of the U.S. government, according to court papers filed by the U.S. Attorney (check our web site).
- The IRS gathers and maintains file on federal judges.
- The IRS has undertaken large-scale campaigns to “instruct” federal judges on the need to convict and administer heavy punishments in tax cases involving defendants who question whether the law requires them to file returns and pay income taxes; these behaviors indicate a conspiracy to deny citizens of justice and an independent judiciary.
- The IRS instructs its employees that the 16th Amendment says that everyone must pay income taxes, when the Amendment says no such thing.

The senators should ask the Commissioner to explain the following points; but for some of these points, it is the Congress itself that should also explain how it is that:

- Section 1461 and 7701 of the Code establish that the only person made liable to withhold and pay the income tax is a withholding agent, who is any person required to withhold under IRC 1441–1443, which all pertain to nonresident aliens and foreign entities.
- The index to the Code (U.S. Code Annotated) has only two entries that crossreference “income tax” and “citizens:” one for citizens departing the country, the other for citizens living abroad. But the index has several PAGES of entries cross-referencing “aliens” and “income tax,” including all the familiar terms, such as “deductions,” “exemptions,” “gross income,” and “withholding.” Are we to believe this is merely due to careless indexing?
- Form 1040 has never been authorized by OMB to be used under section 1 of the IRC. The only form ever approved under section 1 is Form 2555, titled “Foreign Earned Income.”
- Researchers have pointed out that a statement of citizenship, in duplicate, from a worker has always served to relieve an employer of duty to withhold income taxes from the worker’s pay, under IRC 1.1441–5 and Publication #515 (wording recently altered in 2001—why?).
- Researchers point to the Internal Revenue Manual’s instructions that the Criminal Investigation Division is under the direction of the international branch of the IRS and is only authorized to enforce criminal statutes applicable to taxes for U.S. citizens residing in foreign countries and nonresident aliens required to file federal income tax.
- Researchers have noted that IRS revenue officers are authorized by law to conduct only civil enforcement under subtitle E (alcohol, tobacco, and firearms), not under subtitle A (income taxes). Among assertions by former IRS agents is that virtually everything a revenue officer does is outside the law.
- IRC 6020(b), invoked by the IRS when it assesses income tax on individuals who have not filed a 1040, does not authorize them to assess income tax on individuals. Delegation Orders from the Commissioner to IRS employees authorizing them to execute returns for persons required to file, but who didn’t, do not include Forms 1040 or 2555 on the list of authorized returns.
- Regulations implementing the statutes governing tax liens and levies are under the jurisdiction of the Bureau of Alcohol, Tobacco, and Firearms, not the IRS.
- Social Security officials have confirmed that there is no law that requires a citizen to get a social security number, for an employer to get an employer identification number, or for either of them to participate in social security and pay employment taxes under subtitle C, unless they want to participate in the social security program. No law requires an employer to insist on getting a W4 from a worker, nor for a worker to fill it out. Without a social security number, a worker can have no taxable income, according to the Social Security Adminis-

tration. On 2/20101, in an EEOC case in the Norfolk area, a worker prevailed in a Title VII Civil Rights action after being fired for not providing a social security number, when the employer only needed to notify the IRS that one had been requested. (See “SSA letters” and “EEOC letter” at our website.)

- IRC 3402 imposes withholding only upon “wages” as defined exclusively at I RC 3401(a); and IRC 3401(a)(8)(A) reveals that remuneration paid to U.S. citizens living and working in the U.S. is excepted from the definition of “wages” that are subject to withholding under IRC 3402. The only way it can be “wages” is under IRC 911, i.e., remuneration in U.S. possessions.
- Senator Inouye, in a letter responding to an inquiry by a constituent who was a tax consultant, stated, “Based on research performed by the Congressional Research Service, there is no provision that specifically and unequivocally requires an individual to pay income taxes.” (See “Inouye letter” at our website.)

The above examples are evidence tax researchers assert as proof the income tax is not, and never was, meant by law to apply to the income of most U.S. citizens who live and earn their money in the 50 states. It’s inconceivable that the above evidence just happened by chance. The burden is on the IRS to explain, but they remain silent, except for more frequent announcements threatening crackdowns.

There should also be explanations given as to how it is that:

- An attorney for Sen. Orrin Hatch in 1985 offered a fortune to Bill Benson not to publish his research on the illegal and fraudulent ratification of the 16th Amendment and to turn over all of his 17,000 certified, notarized documents proving it.
- The highest federal courts cannot decide whether the income tax is a direct tax or an excise. The Supreme Court reversed itself years ago, and the circuit appeals courts are about evenly, but strongly, divided, as are the state supreme courts. The courts can’t even agree about what statute makes one liable. If our highest judges can’t figure out questions as basic as what kind of tax it is, how can they rule on finer points such as crucial arguments about “gross income?”
- According to former New York Federal Reserve Bank chairman Beardsley Ruml and the Grace Commission, the income tax is not needed to run the government, since it is financed by a central bank monetary system that is not convertible into gold or any commodity. The government funds operations by borrowing money into existence. The income tax is used as a vehicle for redistribution of wealth and to control the inflation inherent in the central bank monetary system.
- Why have such deliberate attempts been made to disguise the truth of the law by means described under “Historical Comparisons,” below.

PERSPECTIVE ON THE 861 POSITION

The “861 argument” deals with “gross income” from which “taxable income” is derived. One can start with CFR 1.1–1, which tells us “that Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States.” That sounds all encompassing, but two sentences later it says, “The tax imposed is upon taxable income” (i.e., gross income minus deductions). So “income” is qualified to mean “taxable income,” which, in turn, depends on what “gross income” is. Incidentally, if one goes to Section 1 of the Code, it says, “There is hereby imposed on the taxable income of...” and it proceeds to identify married individuals, surviving spouses, heads of households, unmarried individuals, estates and trusts. It says “taxable” income right there at the beginning. (Note that there’s no information about who is actually liable for payment of the tax, e.g., the payer or the payee.)

The next step is to look at the definition of “gross income,” found in IRC 61 or Section 1.61 of the Code of Federal Regulations (“CFR”). CFR 1.61–1(a) defines gross income as “all income from whatever source derived, unless excluded by law.” IRC 61 defines gross income as “all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Ahmony...(15) Income from an interest in an estate or trust.”

Tax researchers assert that “items” of income in IRC 61 are not the same as “sources” of income. CFR 1.861–1 says: “Section 861 et seq. and the regulations thereunder, determine the sources of income for purposes of the income tax.” The specific sources are listed in CFR 1.861–8(f)(1). They are: (1) overall limitation to foreign tax credit; (2) international and foreign sales corporations; (3) nonresident alien individuals and foreign corporations engaged in trade or business within the

U.S.; (4) foreign base company income; and (5) a list of fifteen other operative sections—all foreign. This leads to the conclusion that the term “gross income” does not apply to the income of most citizens but to the incomes of nonresident aliens and U.S. citizens earning money abroad, a conclusion no longer very surprising after considering all the other evidence presented above.

It is this “foreign/international” interpretation of the law regarding gross income (IRC 61 and IRC 861) that makes it consistent with the numerous sections of laws and regulations and other documents discussed above. Otherwise, the part of the law that deals with gross income would be in conflict with all those other parts. At this point then, it should be incumbent on the IRS to prove that this interpretation is incorrect, since it is THEIR interpretation of gross income that is inconsistent with those other parts of the internal revenue law and regulations.

Researchers were aware of the inconsistency for many years and realized that something had to be wrong. The development of computer technology and online access to the Code and regulations allows the use of search engines, and Internet communications enables researchers to exchange information with one another more easily than ever before, no matter where they are located in the country. Tax research “science,” as other sciences, deals with, and tries to bring order to, a vast body of chaos that is loathe to give up its secrets. In some respects, it might even be said to rival sciences that try to solve the mysteries of heart disease or cancer. And the “disease” metaphor is perhaps not inappropriate in discussing the income tax system and IRS operations.

If the “items” of gross income in CFR 1.61 are not the same as “sources,” and the “sources” are found in CFR 1.861–8(f)(1), it means that the sources of gross income have been separated from the definition of gross income in CFR 1.61 by several thousand pages. That is hard to believe, if one assumes that the officials and lawyers who wrote the regulations wanted them to be understandable and accurately interpreted. However, one does not have to browse through the Code or regulations for very long to realize there is probably no document in the world that is written and organized in such a convoluted, labyrinthine manner, as if the intent were to exhaust anyone trying to decipher it. Indeed, tax professionals, legislators, and even the IRS Commissioner have said they can’t understand it. Carving order from chaos is what tax researchers have been doing with income and employment tax parts of the Code and regulations.

HISTORICAL COMPARISONS: EVIDENCE OF INTENT TO DECEIVE AND DEFRAUD

The Code and regulations undergo revision from time to time in order to incorporate additions to the law and corresponding regulations that implement the law. Even though the application of the laws may not change, the revision may entail rearrangements of sections and changes in words or phrases. Researchers have examined some of the ways this process has affected the Tax Code and regulations over time by looking at earlier versions. Their findings are revealing and very disturbing, especially with regard to gross income, but also regarding changes in other sections of the income tax laws and regulations that will be discussed below. Here are a few examples.

Hiding the Constitutional Limitations.

The 1939 version of the regulations used the term “net income” for what in recent years is called “taxable income.” Section 29.21–1 defined “net income” as follows: “Meaning of net income. The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law ...enter into the computation of net income as defined by section 21.” The term “fundamental law” refers to the Constitution, as numerous court rulings have shown. Therefore, some income was exempt from income tax by statute (i.e., a law passed by Congress) and some was exempted by the Constitution (passed by the people). This admits that some income not exempted by statute is nonetheless exempted from federal taxation by the Constitution (i.e., Congress does not have the authority to tax it).

In 1939 and 1945, CFR 29.22(a)–1 corresponded to today’s CFR 1.61. Its definition of gross income was virtually the same (see 2nd paragraph under PERSPECTIVE, above); and then referred to Section 22(b). The regulations under CFR 22(b) stated that some income was exempted by statute, and then said, “No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government...” The regulations also used the term “fundamental law” when referring to the Constitution.

Again, some income was explicitly acknowledged to be constitutionally not taxable. Clearly, this demonstrates that Congress’s power to lay and collect taxes does not extend to everything and the lawmakers knew it. There is, however, jurisdiction to regulate commerce with foreign nations, and this is the basis for, and consistent

with, the interpretation of the income tax laws and regulations upon which the “861” position is based. It is also consistent with the other provisions of the Code and regulations discussed above under CONTEXT.

In 1954, the Code and regulations underwent considerable rearrangement, based on a reorganization plan of 1950, although the law and its application were not substantially changed. Several aspects of this rearrangement helped disguise and conceal what had previously been easy to see in earlier versions. With regard to the references to constitutional restrictions on taxing power, the 1954 regulations deleted any phrases referring to income that is, under the Constitution or fundamental law, not taxable by the government. Readers are left with the impression that the phrase “unless exempted by law” is synonymous with “unless exempted by statute,” since that is a common meaning. Again, there were no changes to the law or the Constitution that would necessitate deleting the reference to the Constitution; it was done for no other credible reason than to obscure the Constitutionally-limited application of the income tax, but without making the regulation technically incorrect—only deceiving and misleading. The regulations, at CFR 1.861–8(b)(1), STILL say that the “items” of gross income that make up “classes of gross income” may include income that is EXCLUDED for federal income tax purposes, and then lists what is “not exempt,” and it is all international and foreign commerce (CFR 1.861–8T(d)(2)(iii)).

Disguising the Taxing of Nontaxpayers.

The 1939 Code said “gross income includes income, gains, and profits derived from salaries, wages, and compensation for services...” According to many researchers, what was taxable were gains and profits DERIVED from salaries and wages (i.e., what the employer derived, not what the worker made). Salaries or wages are one of the costs of operating a business. Income is the profit or gain derived from capital, labor, or both. The words “salaries” and “wages” were deleted from the definition of gross income after World War II. Why?

In any case, virtually all researchers agree that most citizens do not have gross income within the meaning of IRC 61, so what they are paid is not gross income, and, therefore, is not taxable income. Researchers have noted that a W–2 statement does not say the wages it reports are gross income. It’s merely a statement of how much the worker has been paid. They note that it is workers themselves who turn their wages into gross income when they “voluntarily” sign their 1040s under penalty of perjury, which they are coerced into doing in order to get some small portion of it back as a refund. The IRS is perfectly happy to accept such a sworn statement from workers, since they can say it absolves them of blame, and they will mail out 1040s to them again next year.

The minutes of Senate subcommittee hearings on taxation held during 1942, which have since been declassified, reveal very clearly and explicitly that the subcommittee, in consultation with tax experts from the Brookings Institution [sic], desired to devise a tax that would “mop up” consumer money from the rapidlyexpanding war workforce, withholding it from citizens before they even received it, explicitly and especially targeting nontaxpayer citizens, in order to get the maximum amount of money “up-front.” (The main goal was to prevent inflation from so much consumer money for so few consumer goods, since production was aimed at non-consumer war materiel. The war itself was financed, not by income tax, but by money from the Fed, a highly inflationary mechanism of creating money out of thin air and pouring it into the economy.) To read some pages of the subcommittee minutes, see “Subcommittee minutes” at our web site.

Concealing History by Removing Footnote References.

The Code contains many footnotes and references to allow readers to search back and trace the origins and evolution of laws and regulations, since this often clarifies intent. IRC 61 (a) on gross income used to have a footnote informing readers that it came from Section 22(a) of the 1939 Code and that the law hadn’t been changed. The footnote said, “Source: Sec. 22(a), 1939 Code, substantially unchanged.” That footnote was in the 1954 version at least up to the 1982 edition, but then it vanished, making it difficult for tax professionals to understand how the wording has been deceptively altered, leading to misapplication of the law. Constitutional limitations discussed above were thus hidden.

Deletion of the footnote has also made it much more difficult to notice and understand the close connection between IRC 61 and IRC 861 (or CFR 1.61 and CFR 1.861), especially as CFR 1.861 is now thousands of pages distant from CFR 1.61, and in the earlier versions, the section was not numbered 861, but 119. In pre-1954 versions, the “gross income” regulations under Section 22(a) mentioned the taxable sources as income of nonresident aliens and foreign corporations doing business in

the U.S. and its possessions and profits of citizens, residents, and domestic corporations derived from foreign commerce. The same sources were described in the regulations under IRC 119 "Income from sources within the United States."

The 1921 version was even more clear (and the law hasn't materially changed since then). It said explicitly "that in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States." (IRC 262 applied if at least 806 of a citizen's gross income was from a U.S. possession.)

In 1954, while the law still hadn't materially changed, the regulations were changed so that the "foreign" sources were omitted from the "gross income" description in CFR 1.61(a), but remained in the regulations as CFR 1.861 (renumbered from the regulations previously under IRC 119). Wording was put in those regulations stating that they "determine the sources of income for purposes of the income tax," and they stated that it was the foreign sources noted above that were the sources. These sources today are the ones listed in 26 CFR 1.8618(f)(1) and are listed above in the third paragraph under PERSPECTIVE.

More Deception.

Further evidence of intent to deceive can be seen in the regulation before and after 1954. Before 1954, the subsection dealing with deductions contained explicit wording that deductions were to be applied to the income of nonresident aliens and foreign corporations doing business within the U.S. After 1954, that entire phrase was omitted, making it appear that the application was to the income of citizens. Yet the law did not change. The very next paragraph provided an example. Before 1954, the example was: "A nonresident alien individual engaged in trade or business within the United States..." After 1954, it said: "A taxpayer engaged in trade or business..." The change remains technically correct, since the tax applies to nonresident aliens, but the text now gives the impression it means citizens. Incidentally, we should note that "taxpayer" is a legal term, defined in the Code, that means someone required by law to file and pay an internal revenue tax. Someone who pays property or sales taxes is a taxpayer, not a taxpayer.

Masterpiece of Obfuscation.

Another change regarding CFR 1.861 that can only be seen as an intent to deceive occurred in 1978. CFR 1.861-8, which contains the key list of sources, went from less than one page before 1978 to more than forty pages. There was no underlying change in the law or even in the substance of the regulation, but the regulation became a maze of new phrases, such as "statutory groupings," or "operative sections," or "specific sources" that require much more effort to sort out, but lead to the same conclusion as before. There can no other explanation for such a masterpiece of regulatory obfuscation but the intent to confuse, obscure, deceive and defraud. Those who claim that IRC 861 is not relevant to citizens should explain why officials would go to such great lengths to obfuscate what would otherwise be a relatively little used part of the Code. If it didn't apply to most citizens, such a masterful job of creating confusion would be a waste of lawyerly talent.

It's well worth the government's while to have the cleverest lawyers and officials try to keep playing with the wording of the income tax Code and regulations to further disguise the true meaning of the law without actually changing it, in order to make it appear that most citizens are required to file and pay even if they aren't. The payoff to the government is enormous—several hundred billion dollars a year.

THE DUCK TEST AND CONCLUSION

What can one make of this pattern of alterations that disguise the true law? Is the income tax operating as a hoax? Let's apply the duck test: if it looks like a duck, waddles like a duck, and quacks like a duck, it must BE a duck.

Thomas Jefferson said it better: "Single acts of tyranny may be ascribed to the accidental opinion of a day; but a series of oppressions, begun at a distinguished period, and pursued unalterably through every change in ministers [administrations], too plainly proves a deliberate systematic plan of reducing us to slavery."

Tax researchers assert that the evidence presented in this message is proof that the income tax does not apply to most U.S. citizens. Has it raised doubt in your mind? Here is what the Supreme Court has said about doubt. "In the interpretation of statutes levying taxes it is the established rule not to ...enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." (Gould v. Gould, 245 U.S. 151 (1917)). "[S]ettled rules of statutory construction ...teach...that if doubt exists as to the construction of a taxing statute, the doubt

shall be resolved in favor of the taxpayer” (Hassett v. Welch, 303, U.S. (1938)). Shouldn’t these court rulings be applied to the income tax?

LARKEN ROSE’S LETTER TO THE ATTORNEY GENERAL

March 6, 2001

JOHN ASHCROFT, *Attorney General*,
U.S. Department of Justice,
950 Pennsylvania Avenue,
Washington, D.C.

Dear MR. ASHCROFT: Though my wife and I run a small business, and receive income from that business, 1996 was the last year for which we filed a federal income tax return or made any federal income tax payments.

While in the past I had always believed the federal income tax to be immoral and unconstitutional, we did not stop paying in “protest” of any law. On the contrary, we stopped filing and paying because we took the time to examine the law itself, to determine what it required of us. After extensive personal research, I came to a rather disturbing conclusion:

While the federal income tax is entirely valid and constitutional, it does not apply to the income of most Americans. I do not just mean it cannot apply to such income; I mean the law itself shows that it does not apply to such income. During my research into the law, not only did I find abundant evidence proving my conclusions, from the actual federal income tax statutes and regulations (past and present), but I also believe I have substantial documentation proving an ongoing and deliberate attempt by some in the federal government to conceal the truth, and to intentionally deceive and defraud the American public.

The organization over which you now preside has participated (whether knowingly or not) in the biggest extortion racket in the history of mankind.

The enforcers of the law, both at the IRS and the DOJ, have been enforcing a non-existent law when they demand income tax returns and payments from United States citizens who live and work exclusively within the 50 states. . .

I am enclosing a brief summary of the legal basis for my decision not to file or pay, as well as a more in-depth explanation of the results of my research—a report entitled “Taxable Income” (10/23/00 revision)—which documents the strictly limited application of the federal income tax. ** I am well aware of the many unfounded “tax protester” theories which are based upon “creative interpretations” or twisted logic, and I agree that many such arguments are “frivolous” and without merit. My findings, in contrast, are based entirely on what the federal income tax statutes and regulations themselves say (and have said since long before I was born) .

. . . I have repeatedly attempted to get government officials, including IRS officials, to refute what I have found, to show me where I have made a mistake.

While many have asserted that my conclusions are incorrect, they produce no evidence to support that assertion. In fact, the so-called “experts” have routinely contradicted each other when trying to explain away the many citations I am relying on, and have consistently contradicted what the Treasury regulations say in plain English. (I would be happy if someone in the Department of Justice wants to try to show me where I may be in error.)

. . . This fraud must end, and your attention to it is paramount.

By signing below, I hereby declare (under penalty of perjury) that I have not filed any federal income tax return for the 1997 year or any subsequent year, nor have I paid any federal income taxes for those years. During those years, I received sufficient income that, if my income had been subject to the federal income tax, both payments and returns would have been required by law. If you believe my conclusions of law are in error, and my actions illegal, I hereby publicly and openly invite the Department of Justice to prosecute me.

I believe you have a moral and legal obligation, not only to immediately cease the baseless tax-related prosecutions of those U.S. citizens who are not actually subject to the federal income tax (i.e., most Americans), but also to initiate an investigation into the Department of the Treasury, and possibly some members of Congress, for ongoing attempts to intentionally deceive and defraud the people of the United States. . .

Sincerely,

LARKEN ROSE

cc: Charles O. Rossotti, Commissioner, Internal Revenue Service

*This letter has been edited. The full-length letter can be found on Mr. Rose's web site: www.taxableincome.net.

**The brief summary is titled "Legal Basis for Not Filing / Not Paying," and can also be found on Mr. Rose's web site along with the full-length version. Both versions are a free download.

[EDITOR'S NOTE: Additional material accompanying this statement was retained in the committee files.]

