**PREPARED TESTIMONY OF**
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**BEFORE THE SENATE**
**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**
**COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS**
**ON**
**COLLECTING TAXES FROM CIVILIAN CONTRACTORS**
**JUNE 16, 2005**

## INTRODUCTION AND SUMMARY

Chairman Coleman, Senator Levin, and distinguished members of the Subcommittee, I want to thank you for the opportunity to testify before your Subcommittee today on collecting taxes from civilian contractors. I testified before this Subcommittee last year on Department of Defense (DoD) contractors who owed taxes. With the Subcommittee's support, we have made good progress on bringing these delinquent taxpayers into compliance. As with the DoD contractors from last year's hearing, it is unfair for hardworking, honest contractors to be placed at a disadvantage because their competitors are avoiding paying taxes.

Our working equation at the Internal Revenue Service (IRS) is Service plus Enforcement equals Compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes. This is not an issue of Service OR Enforcement, but Service AND Enforcement. As you know, IRS service lagged in the 1990s. In response, we took important and necessary steps to upgrade service; to name just a couple areas, we significantly improved the answering of taxpayer telephone inquiries and electronic filing of tax returns. Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. After 1996, the number of IRS revenue agents, officers, and criminal investigators dropped by over 25 percent.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four Servicewide enforcement priorities.

## ENFORCEMENT PRIORITIES

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year – double the number from 2000.

- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.

- In 2004, the number of audits of the largest businesses – those with assets of $10 million or more – finally increased after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past twelve months.

We have continued our program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. In May 2004, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed, plus payment of a penalty. I am pleased with the response to the offer. So far, $3.7 billion in taxes, interest and penalties have been collected from the 1,231 taxpayers who are participating in the settlement initiative. The typical taxpayer payment was almost $1 million, with 20 taxpayers paying more than $20 million each and one paying over $100 million.

In February 2005, we announced a second important settlement initiative – this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. It is now more likely non-compliant taxpayers will have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like “How much am I going to have to pay the lawyers and expert witnesses to litigate this thing?” Moreover, going to court is a public matter. Damage to one’s reputation is a potential factor.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the U.S. working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions that, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global economy, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

The government stepped up its use of civil injunctions in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars, or through other means. Since that time, the courts have issued injunctions against more than 100 abusive scheme promoters. They have issued injunctions against 17 abusive return preparers – all permanent injunctions. And an additional 49 suits have been filed by the Justice Department seeking injunctions – 28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer's name while retaining control;
- Misusing "corporation sole" laws to establish phony religious organizations;
- Using frivolous "Section 861" arguments to evade employment taxes;
- Claiming personal housing and living expenses as business expenses;
- Filing tax returns reporting "zero income"; and
- Misusing the Disabled Access Credit.

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice for an injunction action, and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners, including return preparers. The vast majority of these practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax

shelters. The IRS standards set forth detailed requirements for what an independent opinion about a tax shelter must say.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted, and the President signed into law, the American Jobs Creation Act of 2004. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement priority is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity. Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year.

We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters – both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that in the past, our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway.

Our fourth enforcement priority is to discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, certain credit counseling agencies. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

Some shelter promoters use tax-exempt organizations to create abusive shelters. In some cases, the organization receives a fee for allowing the promoter to exploit its

tax-free status. A tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status.

It is heartening to see leading members of the nonprofit community taking steps to address abuses. I particularly want to salute the Independent Sector, which recently delivered a constructive report to the Senate Finance Committee. The report states that "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be as enthusiastic about confronting abuses and the erosion of professional ethics as the nonprofit community. An interesting point to note is that the report supports mandatory electronic filing of annual information returns by all nonprofits.

The focus on problems with compliance we are now encountering in the tax-exempt sector should not overshadow the inspiring work the charitable community does day-in and day-out. The overwhelming majority of these organizations try hard to comply with the letter and spirit of the tax law. But where tax abuse is present in the sector, we intend to address it. We are augmenting our resources in the nonprofit area. By the end of September, we will have increased the number of our personnel who audit tax-exempt organizations by over 30 percent from two years earlier. If we do not act expeditiously, there is a risk that bad actors who abuse tax benefits for charities will tarnish those charities that do good work. If that happens, Americans may be more reluctant to give and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within our Fiscal Year (FY) 2006 budget request.

## COLLECTING TAXES FROM DELINQUENT CONTRACTORS

Let me now turn to the Government Accountability Office (GAO) report and collecting taxes from delinquent civilian contractors.

Let me say upfront that I agree with GAO that we must continue to enhance the use of the Federal Payment Levy Program (FPLP) as a tool to deal with contractors who abuse the federal tax system. I will discuss in the body of my testimony the steps already taken to enhance the FPLP and increase the number of tax debts available for levy. Regarding the 50 cases identified by GAO, our Criminal Investigation Division is in the process of reviewing these cases to determine whether there is evidence of potential criminal tax evasion or failure to pay that would warrant opening a formal criminal investigation. In addition, my headquarters collection leadership has reviewed each case, validated that FPLP inclusion or exclusion decisions were correct, and directed local executives to become involved to ensure appropriate case direction and action.

When I appeared before this Subcommittee in February 2004 to discuss collecting taxes from DoD contractors, I spoke about the establishment of a joint task force that would make recommendations on short-term operational improvements, mid- and long-term operational changes, and potential statutory proposals that could improve the collection of taxes from federal contractors. In March 2004, the IRS, the Financial Management Service (FMS), and DoD established the Federal Contractor Tax Compliance Task Force (FCTC), which also included representatives from the General Services Administration (GSA), the Office of Management and Budget (OMB), and the Department of Justice.

I am pleased to report that since that time, the task force has made several recommendations and has implemented actions to ensure federal contractors pay their taxes and that we take appropriate enforcement actions, including levies, to collect unpaid taxes. The collaborative efforts of the federal agencies represented on the FCTC task force have already resulted in tremendous benefits as evidenced by the improved program results. I will discuss these results later in my testimony.

The FCTC provides an excellent forum to identify opportunities for continued improvement, work cross-agency implementation plans, and expedite resolution of issues. While much of the initial work of the task force focused on DoD issues, most recommendations and planned future actions benefit both the DoD and civilian contractor programs. We will continue to use this task force to address the issues that GAO identifies in its most recent report and to pursue further enhancements to the FPLP.

We agree, as GAO discusses in its report, that there are challenges to collecting unpaid taxes of contractors paid using purchase cards. As GAO notes, the purchase card program yields significant savings and efficiencies for the governmentwide procurement system. However, due to the complexity of the purchase card payment process, vendors are paid in a manner that prevents the offset of other debts, including taxes. We will partner with FMS and the other agencies through the FCTC to conduct further analysis of this issue. Members of the task force from FMS, the IRS, and the Defense Finance and Accounting Service have already held initial meetings with GSA.

In its report, GAO indicates that hundreds of millions of dollars could be collected if all unpaid taxes were made available for levy. This figure includes debts that cannot legally be levied due to statutory safeguards or that are excluded from the program for operational reasons. For example, GAO notes that many cases were excluded from levy, or levy was delayed, because taxpayers had not yet been afforded their Collection Due Process rights. Collection Due Process, referred to as CDP, is a statutory provision of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA ‘98), the purpose of which is to ensure taxpayers are fully informed about their liability, the delinquency, and the government’s intention to pursue enforcement action. It provides taxpayers an opportunity to have his or her case reviewed by the IRS Office of Appeals and to have the case reviewed by a court if no resolution can be reached.

Protecting all taxpayer rights, including CDP rights, is a cornerstone of our collection process, even when it means collection action is delayed.

I believe all federal contractors should be held to high standards. Compared to contractors in the private sector, for instance, federal contractors face stiffer penalties and more regulations involving equal opportunity and other laws. Contractors receiving taxpayer dollars should not cheat these very same taxpayers by passing their tax bills onto them. While we recognize that taxpayers may have legitimate differences with the IRS regarding their tax obligations, there are specific mechanisms for addressing those differences. Simply ignoring, or actively evading, one's tax obligations should not be acceptable.

**FEDERAL PAYMENT LEVY PROGRAM**

As part of the overall collection process, we agree that the FPLP can become a more effective tool to collect delinquent federal taxes owed by businesses and individuals who receive federal payments, including the cited civilian contractors. We continue to explore additional ways to take full advantage of the FPLP and speed the collection of delinquent taxes.

The FPLP program provides an automated process for serving tax levies and collecting unpaid taxes through FMS. The FMS uses its Treasury Offset Program (TOP) to match certain types of federal payments against federal tax debt records. As a result, the program applies a portion of these federal payments to the outstanding tax liabilities. The Administration has proposed improving the FPLP program by allowing FMS to retain directly a portion of the levied funds as payment for FMS's fees.

I would now like to outline the steps we have taken to enhance the FPLP. The IRS removed many of the operational exclusions that had prevented tax debts from being available for levy through the FPLP. Consequently, as of April 2005, $98 billion in tax debts were included in the FPLP, an increase of over $28 billion from the prior year. Total FPLP collections in FY 2005 through May exceeded $126 million, compared to $66 million during the same period of FY 2004. A similar comparison for collections from federal contractors shows an even more significant increase – $26 million through May 2005, compared to $8.1 million through May 2004. From civilian contractors, we have collected $14 million in FY 2005, compared to $6.7 million in the same period of FY 2004.

We have taken several steps to improve the timing of the CDP notice. We implemented a monthly data exchange with the DoD that enables issuance of the CDP notice at the time of contract award rather than after a contract payment is made. As a result, the IRS will be in a position to levy an increased number of contractor payments without a delay. Through May 2005, we have accelerated over 7,000 CDP notices. This process will be expanded later this year to all federal contractors awarded contracts over $2,500 when the GSA Federal Procurement Data System – Next Generation replaces the existing DoD system.

In addition, working with the Treasury Department, we are considering whether to recommend a legislative proposal to allow a post-levy CDP process on federal payments to contractors. This change could further improve our ability to levy earlier on an increased number of contractor payments. We are also working to change our business tax collection process to combine the CDP notice with the final notice, making more debts ready for levy at the time of inclusion in the TOP. These changes provide an opportunity for taxpayer relief and appropriate judicial review, while improving our efficiency in the collection process. This will also enhance our ability to improve the timeliness of the FPLP levy process.

On April 15, 2005, we implemented the recently enacted 100 percent levy provision on certain DoD contracts paid through the largest DoD payment system. The remaining DoD vendor payment systems will be implemented in July 2005. Full implementation of this provision has been complicated because it only permits a 100 percent continuous levy in the case of payments for “goods and services” and does not appear to apply to payments made for other kinds of property. We will continue to partner with FMS on full implementation of this provision.

We agree with GAO and this Subcommittee that the Central Contract Registration (CCR) database should be a repository for correct Taxpayer Identification Numbers (TINs), which may then be used by all federal agencies for making payments to contractors (and, where required, for information reporting to the IRS on these payments). We also support the Subcommittee’s efforts to improve the accuracy of federal contractor names and TINs. In order to increase the number of name and TIN matches with FMS, in January 2006, the IRS will begin sending FMS up to ten additional historical business control names for each account to be matched against payment data. We are also developing, in conjunction with DoD, a TIN-verification system that will require contractors interested in doing business with the federal government to consent to validation of their name and TIN as a condition of registration in the CCR. Implementation of this process is planned for October 2005. If, after the program is up and running, we identify problems that cannot be addressed under current law, we will consider whether to recommend statutory changes that should be made to further enhance the TIN-validation process. Ensuring accuracy of TINs in the CCR will improve our ability to match tax debts and payments for levy and increase the collection of contractor’s unpaid taxes, as well as enhance the accuracy of information reporting.

GAO notes that we have only recently decided to match individual tax debts against vendor payment files. That match will begin in November 2005. The approach we took to making this decision illustrates the great care we have taken since the inception of FPLP to ensure that our automated levy process can sufficiently distinguish among taxpayers and does not mistakenly seize a payment to collect a debt owed by another taxpayer. We decided to go forward with this change only after we determined that the risk of a wrongful levy occurring was extremely low. As we review other categories of

cases excluded from FPLP, we expect to proceed with the same care in order to protect all individuals and businesses to whom federal payments are being made.

We are also reviewing cases in our exclusion categories to identify potential coding errors in our systems that may prevent or delay cases from entering the FPLP. Some of the potential coding errors cited by GAO result from systems and coding implemented to ensure no taxpayer's rights are violated, and no taxpayer is levied inappropriately. We are reviewing our processes to identify systemic and manual corrections that may be needed.

While we have taken significant actions to increase the dollars available for levy, as GAO acknowledges in its report, a substantial amount of tax debt ($71 billion) is excluded from the levy program for statutory reasons. These excluded debts include those for taxpayers who are in bankruptcy, have an installment agreement, or have not yet received their appeal rights prior to levy. The IRS must continue to honor these statutory taxpayer rights as enacted by Congress. Another $99 billion is excluded from the levy program due to IRS policy including, as an example, tax debts of taxpayers who are experiencing a financial hardship. We continuously evaluate these policy exclusions to ensure that they are no broader than necessary.

**COLLECTION CHALLENGES AND EARLY PREVENTION**

Over the last year, we have taken several steps to improve our collection efforts on complex cases like the 50 cases cited by GAO. We have reorganized our SB/SE Operating Division in a manner that provides top-down executive leadership focused on the collection function. The Internal Revenue Manual has been revised to provide clearer guidance on when to file notices of federal tax lien, to place greater emphasis on field contact with delinquent taxpayers, and to require additional managerial oversight and direction on specific cases. We are providing revenue officers with several new training opportunities to improve the quality and effectiveness of field casework. These include new training on maximizing effective contacts and actions on cases involving continued trust fund tax non-compliance, training designed to refine investigation and research techniques, and training to promote better analysis of the financial condition of a delinquent taxpayer. Field managers have access to training "toolkits" for use in improving the quality of work in their groups. Subjects include financial analysis, streamlined procedures for seeking injunctions, and working employment tax cases in which taxpayers have little or no assets from which to collect. We recently stood up a web site to support the use of on-line research to research taxpayers' ability to pay. All of these efforts are enhanced by a new system of structured consultation between managers and revenue officers. We hope this will help revenue officers leverage the knowledge of their field managers throughout the life of a collection case.

The complexities found in the 50 contractor cases cited by GAO illustrate both the limits of an automated levy program and the need to fully fund the Administration's enforcement budget request. These types of cases can only be sufficiently addressed through hard work by our field collection function. The Administration's budget request

must be fully funded in order to keep revenue officers on the front line and give them the tools they need. I am committed to improving our use of available electronic research techniques to improve nonfiler case creation processes and to help detect the kind of inter-related tax delinquencies cited in the report.

**TAXPAYER PROTECTION AFFECTING ACCOUNTS ELIGIBLE FOR FPLP**

Although we are examining ways in which the FPLP can be made more effective, important statutory protections limit the number of outstanding accounts that may be eligible for referral to the FPLP at any given time. In general, these provisions prohibit levy action when a taxpayer takes actions either to attempt to resolve an outstanding tax liability or to challenge a collection action such as a proposed levy.

When enacted in 1997, the use of the new continuous levy authority, as with all levies, was generally limited under the Internal Revenue Code only by certain notice provisions, such as the notice and demand for payment under section 6303 and the notice of intent to levy under section 6331(d)(1). These automated notices gave taxpayers the opportunity to pay prior to levy and the opportunity to propose alternative payment arrangements but did not erect significant barriers to collection should a taxpayer neglect to do so.

In RRA '98, Congress added additional taxpayer protections that can significantly postpone use of the federal payment levy:

- Section 6330 generally prohibits the use of any levy (including continuous levies by FMS as part of the FPLP) unless the IRS has notified the taxpayer of his or her right to a CDP hearing. If the taxpayer requests a CDP hearing, then the proposed levy cannot proceed until the resolution of that hearing, which may involve judicial review. The IRS must give taxpayers an opportunity to respond to the CDP notice, and suspends levy action during this period, even if the taxpayer ultimately does not request a CDP hearing.

- Section 6331(k) generally prohibits levy action when a taxpayer has proposed to compromise a tax liability or seeks to enter into an installment agreement (IA). A taxpayer may appeal the rejection of an offer in compromise (OIC) or proposed installment agreement to the IRS Office of Appeals, and the prohibition on levy continues while this appeal is pending.

- Section 6331(*i*) prohibits the making of levies during the period that a taxpayer's refund suit for a divisible tax (such as employment taxes) is pending in federal district court. Thus, if such a suit were pending with respect to employment taxes relating to a particular employee and a particular tax period, the IRS generally could not commence a levy to collect from that employer. In some cases, the IRS will be prohibited from collecting unpaid taxes not directly involved in the refund action, such as taxes relating to other tax period or different employees.

Some of the other statutory provisions that affect the eligibility of an account for FPLP include those relating to Innocent and Injured Spouse claims and Taxpayer Assistance Orders by the National Taxpayer Advocate. Military personnel serving in a designated combat zone are further excluded.

Mr. Chairman, the IRS has and must continue to honor these statutory taxpayer rights. Although these provisions may limit the accounts that may be eligible for the FPLP, Congress enacted these provisions to provide important protections to taxpayers. Although we are continually examining how we can make all of our operations, including the collection process, more efficient, the changes we make cannot be at the expense of taxpayer protections.

At the same time, we are aware that some taxpayers are abusing the safeguards enacted by Congress and are using these provisions to improperly delay and impede tax administration. Some taxpayers, for example, are basing offers to compromise a liability or CDP hearing requests on frivolous arguments that are utterly lacking in merit. Although we deal with these frivolous submissions, doing so takes time and provides these taxpayers with protection from levy in the interim. This not only is a waste of IRS resources but also is unfair to the vast majority of taxpayers who do their best to pay their fair share and to those taxpayers who are using these procedures as a legitimate attempt to address their tax obligations.

Pending legislation (H.R. 3) will permit IRS to levy despite CDP or OIC filings or applications for installment agreements in cases where it can be shown the CDP, OIC, or the IA request is frivolous. This provision also increases the penalty for filing frivolous tax returns from $500 to $5,000, and expands this penalty to apply to OICs, CDP requests, and other documents.

**CONCLUSION**

Mr. Chairman, the IRS welcomes the findings and recommendations made by the Government Accountability Office. We will work with the Subcommittee, the Financial Management Service, the GAO and all other affected parties to deal with these specific contractor cases and to improve and revise the way we work future cases.

The FPLP is an effective automated process for serving tax levies and collecting unpaid taxes. We will continue to work with the FCTC to pursue further enhancements to the FPLP. The FCTC provides an excellent forum to identify opportunities for continued improvement, work cross-agency implementation plans, and expedite resolution of issues.

Lastly, I once again urge the Congress to support the Administration's FY 2006 budget request for the IRS. It is critical to ensuring that we have an effective enforcement program and to maintaining the public's confidence in the fairness of our system. Thank you, and I would be happy to answer any questions you have.