Statement of Robert S. McIntyre
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Before the Senate Budget Committee
January 23, 2007

I'm Robert McIntyre, director of Citizens for Tax Justice. Founded in 1979, CTJ is a nonprofit tax policy research and advocacy group that fights for fair and adequate taxes at the federal, state and local levels. I appreciate the opportunity to appear before the Budget Committee today, to discuss the federal "tax gap" — a polite word for tax cheating that is costing honest taxpayers hundreds of billions of dollars every year.

One impetus for this hearing, I assume, is the need to address our government's huge budget deficits. From fiscal 2002 through 2006, on-budget federal deficits totaled $2.4 trillion, including $836 billion borrowed from the Social Security Trust Fund and spent on other government programs. Over those five years, a staggering 25 percent of all non-Social Security outlays were financed with borrowed money.

The largest cause of these enormous deficits has been the remarkable drop in personal income taxes, which fell from 10.1 percent of the gross domestic product in fiscal 2000 to an average of only 7.3 percent of the GDP in fiscal 2002 through 2006 — a 28 percent drop. In fact, income tax revenues have been at or near their lowest levels as a share of the GDP in 55 years. Obviously, this sharp decline in personal income tax revenues stems mostly from the huge tax cuts enacted during the Bush administration. Equally obviously, President Bush will block any attempt to scale back his tax cut program so long as he remains in the White House.

But there is a way to begin to address our revenue shortfall that perhaps Democrats and Republicans can agree upon: collect taxes that are legally due, but that go unpaid due to tax evasion and abusive avoidance.

Non-Social Security Receipts & Spending, Fiscal 2000 to Fiscal 2006

$-billions Fiscal years	On-budget Receipts	On-budget Spending	Deficit (–) or Surplus (+)	% of spending paid for with borrowing
2000	$ 1,545	$ 1,458	$ +87	*none*
2001	1,548	1,516	+32	*none*
2002	1,272	1,654	–381	**23.1%**
2003	1,265	1,794	–529	**29.5%**
2004	1,345	1,913	–568	**29.7%**
2005	1,569	2,071	–501	**24.2%**
2006	1,798	2,232	–434	**19.4%**
2002-06			**$ –2,414**	**25.0%**

Addendum: Social Security (off-budget)

	Receipts	Spending	Surplus
2000	$ 480	$ 330	$ +150
2001	508	347	+161
2002	515	357	+158
2003	524	363	+161
2004	535	380	+155
2005	577	402	+175
2006	608	422	+186
2002-06			**$ +836**

Sources U.S. Treasury Department (compiled by Citizens for Tax Justice).

Personal Income Taxes*

Fiscal Years	$-billion	% of GDP	Versus 2000	Rank** 1952 on
2000	$ 978.4	**10.1%**	—	1
2001	967.2	**9.6%**	–5%	2
2002	825.5	**7.9%**	–21%	26
2003	755.3	**7.0%**	–31%	**54**
2004	767.0	**6.6%**	–34%	**55**
2005	878.0	**7.1%**	–29%	**52**
2006	991.9	**7.6%**	–25%	**44**
Addendum: 2002-06 average		**7.3%**	**–28%**	

*Personal income taxes net of refundable credits.
**55 is lowest year. (1965 was 53rd.)

Sources: Office of Management and Budget; U.S. Treasury Department; Congressional Budget Office.

The Nature of the Tax Gap

The IRS offers a measure of the tax gap, which pegs it at around $300 billion annually. But that measure is largely based on old or limited research, and thus leaves out some of the most important things. In particular, it only touches on the widespread tax evasion and avoidance by corporations and wealthy individuals — often using offshore tax-sheltering schemes. It's that part of the tax gap that I want to focus on particularly in my testimony today. (A 2005 paper that goes into the background of these issues at greater length is available on our web site at www.ctj.org/pdf/epishel.pdf.)

When it comes to paying taxes, wage-earners, as we know, are generally very honest. That's not because of any inherent moral superiority, but rather because income and employment taxes are collected or withheld as wages are earned. Compliance is also quite good in the case of interest and dividends, because of information reporting. In contrast, those who earn other kinds of non-wage income or have the means to purchase high-priced, albeit shady tax advice have vast opportunities to avoid or evade taxes. And sadly, many of them take advantage of those opportunities. These are the Americans who need help in complying with their tax responsibilities.

Far too many corporations, investors and business owners are tempted to understate their gross business receipts and/or overstate their expenses, move their investments or profits offshore, fail to report their capital gains accurately, and so forth. Not all succumb, of course. Even for those who do, the actual means for making income disappear for tax purposes is probably often a mystery. That doesn't absolve the tax cheats and aggressive avoiders from blame: they're the demand side of the equation. But without the supply side, the ethically-challenged lawyers, accountants and banks that set up the shelters, the demand would go unrequited.

The majority of us who honestly pay our taxes have a major stake in getting the tax dodgers to ante up — hundreds of billions of dollars a year, in fact, although no one knows the exact amount for sure. We probably can't collect all of that, but IRS Commissioner Mark Everson indicated last year that $50-100 billion a year in additional revenues could be fairly easily collected from tax cheats if the IRS had the resources and the tools.

Everson's estimate may be too modest, given what he's apparently not counting. Tax experts Joseph Guttentag and Reuvan Avi-Yonah point out that "no one, including the IRS, has a good estimate of the size of the [United States'] *international* tax gap," since keeping these kinds of illegal offshore schemes from being discovered by the IRS is the key to making them work. Guttentag and Avi-Yonah suggest that $50 billion a year is a reasonable guess about the level of U.S. tax evasion in the international area that could be "eliminated overnight" with the right policy changes, and note that IRS consultant Jack Blum thinks upwards of $70 billion a year is more likely.[1]

Proposals for Improved Enforcement

With all this money at stake, what do we need to do to collect some of it?

Well, as much as possible, we need to lift the veil of secrecy about what the tax evaders are doing. We need to clarify or change the tax laws to make tax-evasion schemes indefensible from a legal standpoint. We need to find further ways to deter the tax-evasion advisors and financial firms that facilitate tax cheating. Perhaps most important, we need to give the IRS the resources to enforce the laws.

To be sure, these will not be easy tasks to accomplish. There are well-organized, well-financed lobbying organizations that will fight such reforms — led by the accounting firms, banks and lawyers that now make billions of dollars a year facilitating tax evasion and avoidance. But there are also leaders in Congress who have taken on the Tax Cheaters Lobby. In the Senate, the good guys include Carl Levin and Norm Coleman, who have been instrumental in exposing some of the worst tax-sheltering activities by the big accounting firms; Byron Dorgan, who has fought against corporate offshore sheltering for decades; and

[1] Joseph Guttentag and Reuben Avi-Yonah, "Closing the international tax gap," *Bridging the Tax Gap*, Economic Policy Institute, 2005, pp. 101 & 107.

Charles Grassley, who as Senate Finance Committee Chairman held some excellent hearings on tax evasion and sponsored excellent legislation to curb egregious cheating.

Here are some specific suggestions (which are not meant to be comprehensive):

A. Crack down on Offshore Income Shifting and Non-Reporting:

Last year's Levin-Coleman hearings highlighted how serious this problem is by showing how three high-profile American tax cheats evaded taxes on billions of dollars in income through offshore tax dodges. This is a worldwide concern, not just one for the United States, as we recently learned from news stories about how the Rolling Stones and U-2's Bono have shifted their song-writing profits out of the United Kingdom to dodge billions of pounds in taxes. So, we and other nations need to cooperate to force comprehensive sharing of information among countries, especially from tax havens. The Tax Cheaters Lobby is especially afraid of this kind of reform, because offshore hiding is at the heart of many tax evasion schemes. Many foreign governments would welcome a cooperative crackdown on international bank secrecy — in fact, the U.S. was leading an effort to achieve that until the Bush administration pulled the plug on such cooperation soon after it took office in 2001.

To address offshore tax cheating, Senators Levin and Coleman have proposed the following (quoted from their 2006 report):

> **1. Presumption of Control.** U.S. tax, securities, and anti-money laundering laws should include a presumption that offshore trusts and shell corporations are under the control of the U.S. persons supplying or directing the use of the offshore assets, where those trusts or shell corporations are located in a jurisdiction designated as a tax haven by the U.S. Treasury Secretary.
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> **2. Disclosure of U.S. Stock Holdings.** U.S. publicly traded corporations should be required to disclose in their SEC filings company stock held by an offshore trust or shell corporation related to a company director, officer, or large shareholder, even if the offshore entity is allegedly independent. Corporate insiders should be required to make the same disclosure in their SEC filings.
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> **3. Offshore Entities as Affiliates.** An offshore trust or shell corporation related to a director, officer, or large shareholder of a U.S. publicly traded corporation should be required to be treated as an affiliate of that corporation, even if the offshore entity is allegedly independent.
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> **4. 1099 Reporting.** Congress and the IRS should make it clear that a U.S. financial institution that opens an account for a foreign trust or shell corporation and determines, as part of its anti-money laundering duties, that the beneficial owner of the account is a U.S. taxpayer, must file a 1099 form with respect to that beneficial owner.
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> **5. Real Estate and Personal Property.** Loans that are treated as trust distributions under U.S. tax law should be expanded to include, not just cash and securities as under present law, but also loans of real estate and personal property of any kind including artwork, furnishings and jewelry. Receipt of cash or other property from a foreign trust, other than in an exchange for fair market value, should also result in treatment of the U.S. person as a U.S. beneficiary.
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> **6. Hedge Fund AML Duties.** The Treasury Secretary should finalize a proposed regulation requiring hedge funds to establish anti-money laundering programs and report suspicious transactions to U.S. law enforcement. This regulation should apply to foreign-based hedge funds that are affiliated with U.S. hedge funds and invest in the United States.
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> **7. Stock Option-Annuity Swaps.** Congress and the IRS should make it clear that taxes on stock option compensation cannot be avoided or deferred by exchanging stock options for other assets of equivalent value such as private annuities.

8. Sanctions on Uncooperative Tax Havens. Congress should authorize the Treasury Secretary to identify tax havens that do not cooperate with U.S. tax enforcement efforts and eliminate U.S. tax benefits for income attributed to those jurisdictions.[2]

To the Levin-Coleman reform list in the international area can be added the following:

9. Not only deny all deductions for transfers to tax havens that refuse to disclose activity by U.S. residents automatically, but also make it illegal for U.S. financial companies to deal with uncooperating tax havens. Some argue that we would need to get every other non-tax-haven real country on board with this type of proposal, or otherwise people will route their transactions through real countries into the tax havens. But as noted, other countries are likely to be eager to join us in this effort. In fact, the OECD's new model treaty envisions this result.

10. Repeal so-called "deferral" of taxes on the profits earned by American-owned foreign corporations. This reform was proposed by President Kennedy back in the early 1960s and by John Kerry in his 2004 presidential campaign. "Deferral," which is really closer to exemption of income that is styled as foreign, is at the heart of offshore tax avoidance. People and companies that actually have overseas activities and pay taxes on them abroad have little to fear from the end of deferral because they get a tax credit for the foreign income taxes they pay. But without deferral, schemes that allow people and companies to artificially shift U.S. profits offshore will largely be stymied. As a bonus, American companies would no longer have a tax incentive to move U.S. jobs to low-tax foreign countries.

11. Replace our current "transfer pricing" system of allocating corporate profits among jurisdictions with a more easily enforceable formula approach. Currently, the IRS has the impossible task of trying to police billions of imputed intracompany transactions in order to allocate profits among countries. A simpler formula approach, already used by most American states and long promoted by Sen. Byron Dorgan, holds out the potential for putting serious curbs on what has developed into a major tax evasion/avoidance industry.

12. Adopt the Joint Committee on Taxation Staff Proposals Regarding Deductions and Credits with Respect to Untimely Returns of Nonresident Aliens and Foreign Corporations. This proposal would reverse a federal court decision (currently on appeal) that allows foreign corporations doing business in the United States to avoid filing required tax returns. The change would impose potentially severe penalties on such corporations that fail to file.

13. Adopt the Joint Committee on Taxation Staff Proposals Regarding Offshore Earnings Stripping. This proposal would increase disclosure and eliminate an unwarranted "safe-harbor" rule that allows corporations to shift U.S. profits offshore. It would also discourage corporate "inversions" into paper foreign corporations.

B. Require Information Reporting on Capital Gains.

Right now, small investors in mutual funds get all their capital gains reported, but better-off investors who work through stockbrokers do not. As a result, untold billions of dollars in capital gains go unreported and untaxed. A recent report to Senator Grassley by the Joint Committee on Taxation staff spelled out how such reporting could work, not only for stock

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[2] Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, Tax Haven Abuses: the Enablers, the Tools, and Secrecy, http://hsgac.senate.gov/_files/taxhavenabuses8106final.pdf, Aug. 1, 2006, p. 10.

capital gains but also for capital gains in auction sales of collectibles and similar items.[3]

C. Consider Enacting a Tough "Economic Substance" Rule.

Since the 1940s, courts have sometimes been willing to disallow tax-shelter schemes if they lack "economic substance." But what exactly "economic substance" means has never been completely clear. Senator Grassley has proposed to clarify and codify the economic substance rule. We support such as effort as long as the rule is defined very strictly: If tax avoidance is the primary purpose of a scheme, then it should be disallowed. In contrast, Senator Grassley's bill requires only a "substantial" non-tax purpose (among other important restrictions).[4]

D. Clarify the Law Governing Self-employment Taxes on Subchapter S Corporation Owners.

Sole proprietors and active partners are generally subject to self-employment taxes on all of their earnings. But many Subchapter S corporation owners are taking advantage of ambiguity in the IRS regulations to claim that most of their earnings are exempt from self-employment tax. The same recent report by the Joint Committee on Taxation staff cited in "B" above spells out how the rules could be changed to close this scandalous loophole.[5]

E. Help Small Businesses Comply Through Expanded 1099 Information Reporting.

According to the GAO, independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. GAO also notes that payments made by businesses to corporations for services are generally not required to be reported on information returns, and that the Taxpayer Advocate Service supports requiring information reporting on payments made to corporations.[6] Expanding such reporting would almost certainly help improve small business compliance.

F. Continue to Increase Penalties on Tax-Evasion Facilitators.

Those who assist tax evasion in the (sadly reasonable) hope that they will not be caught should be penalized very severely when they are apprehended. Further increases in penalties might help deter bad behavior.

G. Tax Simplification.

A simpler tax code, in which the IRS is not put in charge of dozens of non-tax related programs, would free up the IRS to better do its real job: collect taxes fairly and accurately. It would also make it much easier for well-intentioned taxpayers to comply with the law, and make it harder for those not so inclined to evade taxes.

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[3]Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," Aug. 3, 2006.

[4]In general, Sen. Grassley's economic substance reform "provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such trans-action and the transaction is a reasonable means of accomplishing such purpose." It goes on to further define the meaning of this general rule. Senate Report 108-11, "CARE Act of 2003," S. 476, Feb. 27, 2003, pp. 78-79.

[5]Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," Aug. 3, 2006.

[6]GAO, "Testimony Before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate," July 26, 2006.

H. Sharply Increase IRS Funding.

This may be the most important step of all.

In recent years, the IRS has gotten a lot of publicity for its crackdown on some particularly egregious tax evasion activities, including the Walter Anderson case and the so-called "Son of BOSS" tax dodge — one of the many complicated shelters marketed by major accounting firms. These and other shocking exposes have helped raise public ire against tax cheats, so much so that President Bush even bragged in his fiscal 2006 budget proposal that he was proposing a big increase in IRS enforcement funding.

So have we turned the corner on combating tax evasion by corporations and the wealthy? Hardly. Consider how severely the IRS's ability to curb tax sheltering and evasion — or even to know how much is occurring — has been reduced over the past decade by Congress:

- From 1994 to the present, the overall IRS budget has been slashed by more than a fifth, both as a share of the economy and in terms of the number of IRS employees compared to the total U.S. population.
- In the enforcement area, the cutbacks have been even more severe. The Inspector General for Tax Administration reported that the IRS's "enforcement staff declined from 25,000 at the beginning of FY 1996 to 16,000 at the end of FY 2003, a 36 percent decrease."
- IRS audit rates, of both businesses and individuals, declined precipitously, especially for upper-income tax returns. In 1996, the IRS audited 210,000 returns of people reporting more than $100,000 in income. By 2001, the number had fallen to only 92,000 — even as the number of returns with incomes above $100,000 jumped by 80 percent.
- In the mid-nineties, a misled Congress even prohibited the IRS from doing any research on tax evasion.

Very recently, the IRS has finally been permitted to do some limited research on tax evasion, but that research remains inadequate. Audit rates have begun to climb again, but they're still well below where they were a decade ago. Although a small portion of the IRS's resources has been moved away from taxpayer assistance and into enforcement, the IRS's enforcement staff remains more than a third below what it was a decade ago, despite the explosion in aggressive tax shelters and outright fraud since then. As for the President's supposed increases in the IRS budget, they haven't been enough even to keep up with wage growth.

The results of these cutbacks have been illustrated not just in the IRS's failures to control tax evasion, but even in some of its ostensible successes. For example, last September, the IRS settled a major transfer-pricing/intangible-property case with GlaxoSmithKline, in which the British-based drug company agreed to pay $3.4 billion in back taxes covering the 1989-2005 period.[7] This was trumpeted as the biggest single tax settlement in history. The bad news, however, as the *Washington Post* reported, is that "Glaxo estimated that the matter could have cost it as much as $15 billion."[8] As Senator Byron Dorgan pointed out (in the *Post* story), "One of the messages" from the Glaxo settlement "might be that you can settle for substantially less than you allegedly owe."

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[7]"Glaxo to Settle Tax Dispute With IRS Over U.S. Unit for $3.4 Billion," by Robert Guy Matthews and Jeanne Whalen, *The Wall Street Journal*, September 12, 2006.

[8]"Glaxo To Pay IRS $3.4 Billion, Tax Settlement Is Biggest in Agency's History," by David S. Hilzenrath, *The Washington Post*, Sept. 12, 2006.

Likewise, the *New York Times* reported on January 17, 2007 that a survey of 50 IRS corporate auditors found that every one felt that "large companies were being allowed to pay far less than they owed" in taxes due to insufficient IRS resources to fully pursue cases. "It's catch and release," one auditor told the *Times*, about how little tax-cheating corporations were forced to pay when their illegal activities are detected. "They are giving away the store," another auditor complained.[9]

So all of the substantive changes outlined earlier (and others not mentioned) are important. But none of them will do the trick unless we have enough tax police to use the disclosure and enforce the laws. So the most essential step that needs to be taken is simply to give the IRS more resources.

Just to return to the staffing levels of a decade ago would require a 50 percent increase in the IRS enforcement budget. Given the increase in tax sheltering since then, phasing in a doubling of the resources devoted to tax enforcement would not be an unreasonable goal. Fortunately, we don't have to worry about the cost. On the contrary, increasing the IRS budget is one kind of government spending that actually increases revenues.

With additional funding, the IRS could devote more resources to international tax evasion, partnership document matching, capital gains under-reporting, serious research and an array of other critical enforcement activities. According to IRS estimates, it could collect from $5 to more than $30 for every dollar spent on improved enforcement.[10] If enforcement changes deter people and companies from even attempting abusive tax sheltering activities, then the rate of return could be even higher.

In this light, it might be appropriate to change the congressional budget rules as they apply to the IRS. After all, if IRS were treated like other agencies, its "offsetting receipts" would make its $11 billion budget appear to be a negative $2.2 trillion! Given that, the National Taxpayer Advocate proposes rethinking the IRS's budget treatment in her 2006 annual report to Congress.[11]

Conclusion

The stakes in tax evasion are very high, and the forces in favor of maintaining the status quo are well-financed and very politically connected. But it's our money the tax cheats are stealing. On behalf of honest taxpayers, CTJ calls on federal lawmakers do something about it.

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[9]"Agents Say Fast Audits Hurt I.R.S.," by David Cay Johnston, *The New York Times*, Jan. 17, 2007.

[10]According to the National Taxpayer's Advocate, "On a budget of about $10.6 billion, the IRS currently collects about $2.24 trillion a year. That translates to an average return-on-investment (ROI) of about 210:1. . . . [F]ormer Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional $296.4 million, the agency could collect $9.47 billion. That translates to a return on investment of 32:1." *National Taxpayer Advocate's 2006 Annual Report to Congress*, Dec. 31, 2006, pp. 442 & 444.

[11]"The National Taxpayer Advocate makes the following recommendations: Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: 'What level of funding will maximize tax compliance, particularly voluntarily compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?' and then set the IRS funding level accordingly, without regard to spending caps." *National Taxpayer Advocate's 2006 Annual Report to Congress,* Dec. 31, 2006, p. 445.