Statement of Senator Carl Levin (D-Mich)
For the Subcommittee on Federal Financial Management,
Government Information, and International Security
hearing on
Deconstructing the Tax Code:
Uncollected Taxes and Issues of Transparency

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The most recent IRS estimate of the nation's "tax gap" – the difference between the amount of taxes owed by taxpayers and the amount collected – is a staggering $346 billion. I commend Chairman Coburn and Ranking Member Carper for their ongoing effort to get to the bottom of the many reasons for this massive tax gap. It is a subject that merits urgent attention from Congress, not only because it shortchanges the U.S. Treasury, but because it forces honest American taxpayers to pick up the tab.

Those who abuse the tax system shortchange the men and women who serve in our military, the children who attend our schools, and the millions who rely on Social Security. Tax cheats make it harder to maintain our highways, protect our borders, advance medical research, and inspect our food. They also deepen the deficit ditch that threatens the economic well-being of our children and grandchildren.

Even in Washington, $350 billion is a huge amount of money. It is larger than the budgets last year of the Departments of Agriculture, Commerce, Education, Interior, Justice, Labor, State, Veterans Affairs, and the Environmental Protection Agency <u>combined</u>. The tax gap is so huge that it would force each individual U.S. taxpayer to pay more than $2,500 in extra taxes annually to make up for those who are dodging Uncle Sam.

Over the past four years, Senator Coleman and I, as Chairman and Ranking Member of the Permanent Subcommittee on Investigations, have conducted extensive investigations that provide insight into two major ways that some Americans are exploiting the system to dodge taxes -- offshore tax haven schemes and abusive tax shelters.

Last month, we released a bipartisan report that blows the lid off of offshore tax haven abuses using shell corporations, phony trusts, and fake economic transactions to help some people dodge millions of dollars in U.S. taxes. Before that, we released a bipartisan report with case histories showing how accountants, lawyers, bankers, and other tax professionals develop dubious tax shelters and hawk them to Americans across the country. Briefly, here's what we have found.

<u>Offshore Tax Haven Abuses</u>

Experts Joe Guttentag and Reuven Avi-Yonah estimate that offshore tax haven abuses by <u>individuals</u> cost the U.S. Treasury between $40 billion and $70 billion every year in taxes that are owed but not collected. On top of that, the IRS has estimated that <u>corporate</u> offshore tax evasion in 2001 totaled about $30 billion. Put together, that means up to $100 billion per year is being lost to offshore tax abuses.

Offshore tax haven countries have, in effect, declared economic war on honest U.S. taxpayers by giving tax dodgers a way to avoid their tax bills and leave them for others to pay. Offshore tax havens attract these tax dodgers not only by charging them low or no taxes, but also by shrouding their financial transactions in a "black box" of secrecy that is extremely difficult to penetrate. They sell secrecy to attract customers.

This legal black box allows tax dodgers to hide assets, mask who controls them, and obscure how their assets are used. An army of "offshore service providers" – lawyers, bankers, brokers, and others – then joins forces to exploit the black box secrecy and help clients skirt U.S. tax, securities, and anti-money laundering laws. Many of the firms concocting or facilitating these schemes are respected names here in the United States.

These schemes require the secrecy of tax havens because they can't stand the light of day. Our investigation laid out six case studies that illustrated the scope and seriousness of the problem. In one case, two U.S. citizens moved about $190 million in untaxed stock option compensation offshore to a complex array of 58 offshore trusts and corporations, and utilized a wide range of offshore mechanisms to exercise direction over these assets and hundreds of millions of dollars in investment gains. These untaxed earnings were then used to provide loans, finance business ventures, acquire real estate, and buy art, furnishings and jewelry for the personal use of the family members.

Much of this elaborate scheme involved an offshore bank and administrative services firm for offshore entities, both housed in this building in the Cayman Islands, the Ugland House. Believe it or not, this pretty waterfront building is the official address of 12,748 companies. Just having a post office box here enables these shell companies to shift profits that otherwise should be reported as taxable income in the country where it's actually earned.

In another case study, two offshore shell corporations engaged in fake stock transactions, seeming to trade stock back and forth as if it were fantasy baseball to create the illusion of economic activity. The shell corporations pretended to run up hundreds of millions of dollars in fake stock losses and then used these phantom losses to offset about $2 billion in real capital gains; the result was $200 million in lost tax revenues to the Treasury. This offshore scheme, shown in this chart, would be comical because of its complexity but for the sobering fact that these tax haven abuses are eating away at the fabric of the U.S. tax system, and undermining U.S. laws intended to safeguard our capital markets and financial systems from financial crime.

Congress could act to shut down these offshore abuses. One step we could take would be to change how the government views transactions in secrecy tax havens. We should shift the burden of proof so that those who move assets offshore or engage in offshore transactions have to prove that income claimed there is not taxable; i.e. that there are real economic transactions, involving real gain or loss, or at least economic activity.

Another simple step would be to require third-party reporting by U.S. financial institutions on a Form 1099 for accounts opened by foreign trusts or corporations where the money is beneficially owned by a U.S. taxpayer.

Congress also needs to dig further into transfer pricing activities. Transfer pricing is an accounting method supposedly requiring that related multinational entities engage in transactions at arm's length to ensure the proper reporting of taxable income. "Supposedly" is the operative word. IRS Commissioner Everson has said that transfer pricing manipulations are one of the most significant challenges that the Service faces, and I don't doubt that one bit. Earlier this month the IRS settled a transfer pricing dispute with drug giant Glaxo SmithKline for $3.4 billion. The size of this settlement with just one company indicates that it's worth looking to see if there are ways to improve the relevant portions of the tax code. Treasury has proposed regulations in this area, and I urge the Administration to finalize those rules in as strong a form as possible. I also hope that these and other international tax dodging issues are some of the first we take up in the next Congress.

Abusive Tax Shelters

In addition to offshore shenanigans, there are plenty of homegrown tax shelters being used to dodge taxes. In 2003 and 2004, the Permanent Subcommittee on Investigations conducted an in-depth investigation into the widespread involvement of accounting firms, banks, investment advisors, and lawyers in the development, marketing and implementation of abusive tax shelters. We held hearings and reports laying out how these tax shelters are developed and sold to Americans across the country.

Again, Congress can crack down on these abusive tax shelters and offshore schemes if it has the will to do so. One big step would be enactment of S. 1565, the Tax Shelter and Tax Haven Reform Act, which Senator Coleman and I introduced last year. This bipartisan bill would, for the first time, impose real penalties for those who promote abusive tax shelters or knowingly aid and abet taxpayers to understate their tax liability. It would enable the IRS to work with the SEC and bank regulators to clamp down on bankers, securities firms, and lawyers involved with tax haven and tax shelter scams. It would also authorize the Treasury Secretary to issue a list of tax havens that don't cooperate with U.S. tax enforcement and eliminate U.S. tax benefits for income in those jurisdictions. The ability to tax profits that are in fact attributable to U.S. taxpayers but have been camouflaged using these uncooperative tax havens would hand our government a mighty club to combat tax haven abuses.

Adequate IRS Enforcement

Another key step to reducing the tax gap would be to give the IRS the funds it needs to go after tax dodgers. For every dollar invested in the IRS's budget, the service yields more than four dollars in enforcement revenue. Beyond the additional revenues collected, increased IRS enforcement deters those who might otherwise have dodged their tax obligations and reassures honest taxpayers that compliance with the law is not a chump's game. I hope that Congress will follow the Senate Appropriations Committee's lead and enact the President's full request for the IRS's 2007 budget. I also encourage Treasury and the President to consider asking for more IRS enforcement dollars in the 2008 budget request.

I can’t think of many better investments to recover revenues wrongfully lost to the U.S. Treasury and to build respect for the law and respect for the honest Americans who play by the rules and meet their tax obligations.

Again, I commend Chairman Coburn and Ranking Member Carper for their efforts on this important topic. I look forward to the testimony today.