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BEFORE
SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
COMPANY FORMATIONS: MINIMAL OWNERSHIP INFORMATION IS COLLECTED AND AVAILABLE

NOVEMBER 14, 2006

Good afternoon, Chairman Coleman, Ranking Member Levin, and other Members of the Permanent Subcommittee on Investigations. I am Steve Burgess, Director of Examination for the Small Business/Self Employed (SB/SE) division of the Internal Revenue Service. I am accompanied this morning by Robert A. Northcutt, the Acting Director of SB/SE's Abusive Transactions Office. He has first-hand knowledge of some of the issues that will be discussed this afternoon and he will join me in responding to your questions.

It is my pleasure to appear before you today to discuss a critical issue relating to our ability to enforce our nation's tax laws adequately --- the need for transparency of beneficial ownership of legal entities so that taxpayers cannot conceal such interests for the purpose of evading tax obligations or facilitating other financial fraud and money laundering.

In August, this Subcommittee held a hearing on offshore tax shelters and released a report that discussed the billions of dollars being lost to the United States Treasury by corporate and individual taxpayers seeking to hide income in foreign tax havens or shelter income by claiming it was earned in low tax jurisdictions.

At that hearing, Commissioner Everson commented that, by their very nature, offshore abusive tax avoidance transaction (ATAT) arrangements are designed to conceal the identity of the taxpayers and to shield their ownership of assets and income from detection.

That hearing received significant press coverage. As a result, many people may have been astonished to learn that corporate and individual taxpayers could so easily "go offshore" to avoid reporting and payment of their Federal taxes and exploit the financial secrecy laws deliberately created in certain foreign jurisdictions to attract foreign business.

As I will discuss today, and as this committee is already well aware, it is not just the secrecy laws in these foreign tax havens that can be exploited by persons to evade taxes or conceal criminal transactions. Within our own borders, the laws of some states regarding the formation of legal entities have significant transparency gaps which may even rival the

secrecy afforded in the most attractive tax havens. This domestic transparency gap is an impediment to both U.S. law enforcement and the enforcement of tax laws in other countries.

Need for Transparency

A key component of our ability to enforce tax laws in almost any area is the availability of information regarding the transaction in question. This is especially true in a global environment where the transaction in question may involve multiple corporate entities, both foreign and domestic.

Not only must information about the transaction itself be available, but relevant information about the parties to the transaction must be available, as well. A critical element in evaluating and understanding transactions is to identify the beneficial owners of the corporations in question. The "beneficial owner" is the person who ultimately owns or exercises effective control over the legal entity. This would include an individual, a foundation, or a group of individuals represented by an investment advisor or mutual fund, for example.

The lack of transparency possible in corporations, trusts, limited liability companies (LLCs), and other entities enables countless numbers of taxpayers to hide their noncompliance behind a legal entity. This noncompliance would include such things as the non-filing of proper returns and the hiding of taxable income.

A huge industry exists that uses the internet and other channels to promote "asset protection" over the internet and through other channels. While "asset protection" is a common and generally legitimate estate-planning strategy, the term has also become a buzz phrase that attracts individuals interested in facilitating tax fraud, non-compliance with tax and other laws, financial crimes, and even terrorist financing.

Privacy and protection against personal liability have long been important and necessary components for the formation of corporations and the operation of a successful market economy. However, once formed this same privacy and secrecy can be used to shield the owner's identity in such a manner that it will often impede a government investigation to the point where the investigation must be discontinued.

Corporate Formation

In accordance with our federal system of government, state laws govern the legal formation of business entities within their boundaries, as well as the informational and reporting requirements imposed on such entities. While requirements vary from state to state, in each instance a minimal amount of information is required in order to form the new entity. Generally, information concerning the beneficial ownership of the entity is not required.

According to a report from the Government Accountability Office (GAO) on company formations in April, 2006, only four states --- Alabama, Arizona, Connecticut, and New Hampshire --- request some ownership information. Even in these states, however, the requirement applies solely with respect to the formation of LLCs.

State officials and agents told the GAO that collecting company ownership information could be problematic. According to the report,

> "Some state officials and agents noted that collecting such information could increase the cost of company filings and the time needed to approve them. Some officials said that if they had additional requirements, companies would go to other states or jurisdictions. Finally, officials and agents expressed concerns about compromising individuals' privacy because owner information disclosed on company filings would be part of the public record, which has not historically been the case for private companies."

It is important to note that large, publicly traded companies whose securities are registered with the Securities and Exchange Commission (SEC) are already subject to federal disclosure requirements regarding beneficial ownership. New requirements imposed by states would likely have a greater impact on private companies and smaller companies that do not currently file with the SEC.

This competition among states for corporate registrations has created what some have characterized as a "race to the bottom" in terms of establishing minimal information and verification requirements in corporate formation and reporting. According to the Money Laundering Threat Assessment, issued jointly by several federal law enforcement agencies late last year, a handful of U.S. states offer company registrations with cloaking features --- such as minimal information requirements and limited oversight --- that rival those offered by offshore financial centers. The three states cited as the most accommodating for the organization of these legal entities are Delaware, Nevada, and Wyoming.

From an IRS perspective, non-compliant taxpayers, including non-filers, fraudulent taxpayers, abusive promoters and under-reporters, have taken advantage of certain state laws, particularly in Nevada. Nevada has laws that may be used to help hide the identity of the non-compliant taxpayers; these laws are perceived by some taxpayers as available to facilitate taxpayer non-cooperation with the IRS; and non-compliant taxpayers may take advantage of an established industry for forming and servicing corporate entities.

Wyoming has similar laws. In fact, Wyoming incorporators advertise that a Wyoming corporation can offer the same benefit of "asset protection" as Nevada but at a lower cost and without the perceived stigma of a Nevada corporation.

Bearer Shares and Nominee Officers

Bearer shares and nominee officers are particularly effective and popular in establishing an anonymously owned entity. Bearer shares are issued by the corporation upon formation

and actually deem ownership of the corporation to the holder of the share. To determine ownership, one must actually find who has physical possession of the shares. Nevada and Wyoming are the only states that permit bearer shares.

Nominee officers also make it easy for non-compliant taxpayers to establish a corporation and remain completely anonymous. While most states require that corporate officers have some meaningful relationship to the corporation, Nevada and Wyoming do not require this. An internet search of "Nominee Officer" will reveal hundreds of businesses offering Nevada and Wyoming entities, the owners of which are never reported to the state. A single nominee can serve as all of the officers for a Nevada or Wyoming corporation. The nominee officer is reported to the State, but is essentially just a name on a piece of paper. Corporate owners, who wish to remain anonymous, can hold the title of vice president, which is not reported to the State, and hire a nominee to hold the other offices. With relative ease, corporate owners can shift income to another, similarly formed entity, and the only available information regarding that entity will be the nominee and the nominee's address. These nominees are often resident agents (or abusive promoters) who primarily forward mail to a P.O. Box. If asked, many nominees claim they do not know the identity of the owner. If the entity had been established by another promoter, using bearer shares and nominee officers, they could be telling the truth.

IRS Investigations

There are approximately 250 resident agents in Nevada that each service 185 or more corporations. The largest of these serves nearly 30,000 entities. The IRS has authorized several investigations under Section 6700 of the Internal Revenue Code (IRC) into promoters of Nevada corporations and resident agents. These investigations have revealed widespread abuse, as well as problems in curtailing that abuse.

It should be noted that the promoters themselves are generally not engaged in overtly abusive activity subject to penalties under Section 6700. The activities they undertake on behalf of their clients are consistent with the state laws under which they operate. However, many of their clients are engaged in fraudulent activity in violation of tax, money laundering, and other laws.

For example, our office, as a result of several promoter investigations has obtained client lists that are being used as a source for potential non-filer audits. An initial sampling of the client lists showed that anywhere from 50 to 90 percent of those listed are currently, or have been previously, non-compliant with Federal tax laws. These included non-filers, under-reporters and those who exploit "Corporation Sole" statutes. Used as intended, Corporation Sole statutes enable religious leaders — typically bishops or parsons — to be incorporated for the purpose of insuring the continuation of ownership of property dedicated to the benefit of a legitimate religious organization. However, some promoters facilitate a particularly abusive scheme whereby they exploit legitimate laws to create sham, one-person, non-profit religious corporations.

We have also seen instances where a promoter advises its clients to place their stock ledger and bearer shares in an offshore entity, thereby further ensuring their anonymity and thwarting a Nevada requirement that the resident agents know the location of the stock ledger. If asked who owns a particular entity, the resident agent can say that all he/she knows is that it is owned by an entity in an offshore country.

While the non-compliance rates found in the client samples of the promoters we have investigated (50 to 90 percent) are probably not the norm across all Nevada corporations, even if non-compliance is a fraction of those numbers the potential loss to the Treasury is still considerable. There are over 650,000 active and inactive entities in Nevada.

It is important to remember that this is for only one state.

Moving Forward

We are looking at a number of strategies to target the widespread tax non-compliance by many of the shell companies represented by resident agents and promoters. One of the key elements of this is the establishment of an Issue Management Team (IMT) similar to teams we have formed in other significant areas of potential non-compliance. There are several things that the IMT might pursue.

First, the Service has authorized audits for a small number of taxpayers in Nevada who are non-filers. As part of this, we are contemplating mass audits of non-filers that would produce a list of non-filer and non-compliant participants. This list would be categorized from the most egregious (high income non-filers, corporation sole, fraud, etc.) to the least egregious taxpayers as a means to plan efficient and effective audits. This audit list would be compiled from promoter audits, the Nevada Secretary of State database, and possible John Doe summonses.

Second, we are also looking at additional promoter investigations. Even if the promoters themselves are not found to be in violation, accessing their client lists could provide valuable information. Criteria for selection of promoters for such investigations could include the size of the entity, the existence of corporation sole, the number of inactive corporations, the company's own compliance data, etc. Once authorized, the investigations could concentrate on securing a client list to determine levels of non-compliance and conducting audits to determine whether the promoter made any overt abusive statement in the formation and administration of the corporations.

Third, the Service will consider "John Doe summonses" to resident agents. The summonses would be similar to the ones issued to credit card companies related to the use of offshore credit cards. Nevada resident agents and incorporation companies provide a legitimate service to a group of unknown "Does" whom the Service has reason to believe are using these valid services to abuse the tax system. The John Doe summons could request the identity of individuals who are paying for resident agent services or who have paid for the formation of a Nevada corporation. This information should reveal ownership

of active and inactive Nevada Corporations which the Service suspects could include a large amount of non-filers and abusive schemes.

Fourth, we are coordinating our efforts with those of other Federal agencies. As indicated in the GAO report, the lack of corporate transparency is a problem for many governmental agencies including the FBI, the Financial Crimes Enforcement Network (FinCEN) in the Department of the Treasury, and the Department of Homeland Security.

Finally, we understand that Nevada may be changing its approach to these types of entities. The president of the Nevada Resident Agent Association may support legislation in the 2007 legislative session that outlaws nominee officer services. Some political leaders in the state have also indicated that they may address the nominee officer issue.

Information Sharing With Trading Partners

Foreign governments that are trying to enforce their own tax laws are often stymied by the use of shell corporations in the United States for which beneficial ownership information is difficult to obtain. Most of the tax treaty requests for exchange of information involving U.S. shell companies (LLCs and Corporations) are received from Eastern European countries and the Russian Federation. These U.S. shell companies, organized mainly in Delaware, Nevada, Arkansas, Oklahoma, and Oregon, are used extensively in Eastern Europe and the Russian Federation to commit Value Added Tax (VAT) fraud.

The IRS has received requests from other treaty countries relating to U.S. shell companies; however, the number of these cases has not been tracked in countries other than Eastern Europe and the Russian Federation due to the low volume. Of the 306 Eastern European and Russian requests relating to U.S. shell companies made in 2002, 40, 26, and 18 percent were from Russia, Lithuania, and Latvia, respectively. In 2003, 63 percent of the 440 requests were from Russia, and 14 and 13 percent were from Lithuania and Latvia, respectively. Of the 363 requests in 2004, 37, 23, 14, and 14 percent were from Russia, Latvia, Lithuania, and the Ukraine. In 2005, 77 percent of the 561 requests were made by Russia, 9 percent by the Ukraine. Of the 369 requests made in 2006, 64 percent were from Russia and 7 percent were from the Ukraine.

The IRS is generally unable to determine the "beneficial owner" of these U.S. shell companies. However, the IRS has pursued for its tax treaty partners all legal means available in the U.S. to obtain information on the broker and reseller of the U.S. shell companies. The IRS checks its internal records to determine whether the U.S. shell company has an Employer Identification Number and files U.S. tax returns, searches for information on a nationwide commercial service, and frequently obtains information from Secretary of State websites.

The IRS also requests information from the U.S. Company Formation Agents (Agents) by Information Document Requests and summonses. The Agent is usually able to supply a limited amount of information that reveals the client who commissioned the creation of the U.S. shell company along with contact names, addresses, billing information, emails, and

other information regarding the shell companies, brokers, and resellers. In most cases, the clients are foreign agents (foreign resellers) that pay for the formation of large numbers of U.S. shell companies for sale to other foreign persons.

While the IRS is often unable to provide its treaty partners with beneficial ownership information regarding U.S. shell companies, it encourages its treaty partners to pursue the leads that are provided by making exchange of information requests to the country where the foreign reseller is located. However, the country of the foreign reseller usually does not have an exchange of information program with the country attempting to verify the transaction and obtain beneficial ownership information.

Since Russia, Latvia, Lithuania, and the Ukraine are the main countries affected by this type of tax fraud, they continue to express their concern that the U.S. Limited Liability Company (LLC) regime is an offshore haven used to falsify VAT transactions.

Potential Solutions

I understand that the Subcommittee is interested in developing solutions to this problem, and, in discussions with the Subcommittee staff, several suggestions were advanced that may be worthy of consideration. Included among these is the development of model state laws that would make the ownership and control of all corporations more visible, at least for law enforcement.

It has also been suggested that perhaps the IRS could collect more information. Specifically, one idea is to add a line to the application (Form SS-4) that must be completed prior to the issuance of an Employee Identification Number (EIN). Currently, Form SS-4 requires the name and tax identification number (such as the Social Security number) of the principal officer if the business is a corporation, or general partner if it is a partnership, or owner if it is an entity that is disregarded as separate from its owner (disregarded entity), such as a single member LLC. The additional line would ask for the name of the beneficial owner(s) of the corporation seeking the EIN. This would apply to all corporations seeking an EIN. Since this information is already required of publicly traded companies, as stated above, this would likely increase the burden of reporting more significantly for private and smaller companies.

While this sounds like a relatively simple solution, it would not fully address the problem. Some companies do not request or need EINs. For example, a single member LLC with no employees would not need an EIN. In addition, some EINs become inactive after a certain period, dropping off the IRS database. For example, U.S. shell companies being used in foreign criminal activity are sometimes inactive in the United States. In addition, ownership information on LLCs owned by foreign individuals or entities would only be available if the LLC obtained an EIN for income that was subject to tax in the United States.

In addition, the IRS is not always notified when the ownership changes. In the instance of bearer shares, beneficial ownership changes each time the shares are passed from one person to another.

There is also an issue relating to the IRS' inability to share data with other Federal agencies. As part of the administration of federal tax laws, IRS investigators can use IRS data in their investigations of tax and related statutes, but access by other federal and state law enforcement is restricted by 26 U.S.C. § 6103. For example, in order for other federal law enforcement officials to access IRS information provided by taxpayers (or their representatives) a federal court must issue an ex parte order. The agency requesting the information must show that it is engaged in preparation for a judicial, administrative or grand jury proceeding to enforce a federal criminal statute or that the investigation may result in such a proceeding.

That said, there are several examples of tax information sharing currently authorized by the Internal Revenue Code. For example, there are additional provisions currently in the tax code providing for disclosure, in certain limited situations, of such information relating to criminal or terrorist activities or emergency circumstances. Additionally, state law enforcement officials can access IRS information for enforcement of state tax laws. Law enforcement officials can also obtain IRS information with the taxpayer's consent.

Summary

Mr. Chairman, the issue of disguised corporate ownership is a serious one for the IRS in terms of its ability to enforce the tax laws and in our efforts to reduce the tax gap. Our experience has shown us that the clearer the transaction and the identity and role of the parties to that transaction, the higher the rate of compliance with the tax laws and the anti-money laundering statutes.

Unfortunately, the lack of transparency caused by states not requiring sufficient beneficial ownership information upon the formation of a legal entity allows individuals who are intent on tax fraud, money laundering, and even terrorist activities to operate under a veil of secrecy that can frustrate the best efforts of law enforcement. We even see instances where we are unable to provide the full assistance requested by our tax treaty partners as they attempt to enforce the tax laws in their own countries.

The IRS has formed an Issue Management Team to address this matter. We will be going after both the promoters and their clients. We want to continue to work with FinCEN, the FBI, the Department of Homeland Security, and other Federal agencies. We also want to work with the states, both in sharing information and in making sure they recognize the risks of allowing the formation of corporations using techniques such as nominee officers and directors and bearer shares.

I appreciate the opportunity to be here this afternoon and Robert and I will be happy to respond to any questions.