United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

March 2007

TAX ADMINISTRATION

Additional Time Needed to Complete Offshore Tax Evasion Examinations

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Highlights

Highlights of GAO-07-237, a report to the Committee on Finance, U.S. Senate

March 2007

TAX ADMINISTRATION

Additional Time Needed to Complete Offshore Tax Evasion Examinations

Why GAO Did This Study

Much offshore financial activity is not illegal, but numerous illegal offshore schemes have been devised to hide or disguise the true ownership of income streams and assets. IRS studies show lengthy development times for some offshore cases, which suggests that time or the lack thereof could be an impediment to effectively addressing offshore schemes.

GAO was asked to (1) compare offshore and nonoffshore examination cases and determine whether the 3-year statute of limitations reduces offshore assessments, (2) compare enforcement problems posed by offshore cases to those where Congress has previously granted an exception to the statute, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore cases. To address these objectives, GAO analyzed IRS data, reviewed examination files and other documents, and interviewed IRS officials and others in the tax practitioner and policy communities.

What GAO Recommends

To provide IRS with additional flexibility in combating offshore schemes, Congress should consider a longer statute period for taxpayers involved in offshore activity. In e-mailed comments on a draft of this report, IRS expressed agreement that a longer statute makes sense and should enhance compliance.

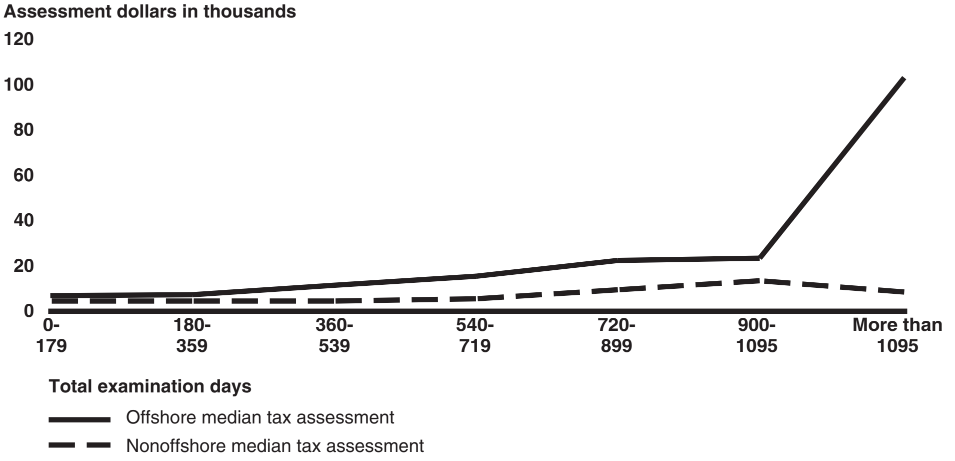
www.gao.gov/cgi-bin/getrpt?GAO-07-237.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Examinations involving offshore tax evasion take much more time to develop and complete than other examinations for reasons such as technical complexity and the difficulty of obtaining information from foreign sources. When examinations are completed, the resulting median assessment from an offshore examination is almost three times larger than from other types of examinations. However, due to the 3-year statute, the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open one at all, despite evidence of likely noncompliance. Although data were not available to measure the effect of the statute on assessments, IRS agents and managers told GAO that overall assessments for offshore cases are lower than they would be if IRS had more time to work these cases.

Median Assessment Amount by Number of Examination Days, Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Some offshore examinations exhibit enforcement problems similar to those where Congress has granted a statute change or exception in the past. For example, Congress changed the statute for certain abusive tax shelters that involved technical complexity and dilatory tactics on the part of taxpayers.

Through discussions with IRS officials and others in the tax practitioner and policy communities, GAO identified advantages and disadvantages to such an exception. Advantages included increased flexibility for IRS to direct enforcement resources to egregious cases of noncompliance and a possible deterrent to future noncompliance. Disadvantages included increased uncertainty and lack of closure for taxpayers. Our commenters also discussed design options to mitigate some of the disadvantages of a statute extension, such as making an exception apply to all taxpayers having offshore accounts/entities, and thereby, mitigating taxpayer uncertainty and lack of closure.

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Abbreviations

AIMS	Audit Information Management System
ATS	abusive tax shelter
FTB	California Franchise Tax Board
IBC	international business corporation
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LAO	California Legislative Analyst's Office
LDC	Lead Development Center
LLC	limited liability corporations
LLP	limited liability partnership
SB/SE	IRS Small Business/Self Employed division
TIGTA	Treasury Inspector General for Tax Administration

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

March 30, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

In recent years, the Internal Revenue Service (IRS) has observed a significant increase in offshore activity among U.S. taxpayers. More and more taxpayers have been observed attempting to "expatriate" their income and assets. Making investments or doing business internationally is legal, but numerous schemes have been devised in which the true ownership of income streams and assets has been hidden or disguised using offshore activity, which is not legal. Some schemes can be as simple as taking unreported income and personally traveling to a tax haven country and depositing the cash into a bank account. Other schemes are more elaborate, involving numerous domestic and foreign trusts, partnerships, nominees, foreign financial accounts, offshore credit/debit cards, and multilayered transactions. Like all forms of noncompliance, offshore schemes add to the tax gap—the difference between taxes owed and taxes paid on time—and shifts more of the tax burden onto compliant taxpayers. Such schemes also can fuel a perception that the tax system is not equitable and can erode honest taxpayers' faith in the voluntary compliance system. When IRS discovers an offshore scheme, it has 3 years from when the tax return was filed in which to work on uncovering the scheme and assessing any additional tax. This is known as the 3-year statute of limitations on assessments.

In recognizing the serious problem posed by offshore tax evasion, you asked us to identify any impediments that may exist to better combating these schemes. An IRS study shows lengthy examination times for some offshore examinations, which suggests that time or the lack thereof could be an impediment to effectively addressing offshore schemes. This report focuses on this possible impediment. Our objectives were to (1) compare the length of and recommended assessments yielded by offshore and nonoffshore examinations and determine whether the 3-year statute of limitations reduces recommended offshore assessments, (2) determine whether or not enforcement problems posed by offshore examinations are similar to enforcement problems that led Congress to grant exceptions to the statute in other situations, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore examinations.

To do our work, we (1) analyzed IRS data, reports, publications, and other documentation providing insight into the characteristics, complexity, and size of the offshore tax evasion problem;[1] (2) compared IRS data on the amount of time required to complete examinations involving an offshore component[2] with those lacking such a component and the recommended assessments from those examinations; (3) reviewed selected IRS files to illustrate examinations of returns involving offshore components; (4) researched the history of the federal statute of limitations for assessments to include legislation proposed between 2003 and 2006 that included references to either offshore tax evasion or the statute of limitations; (5) interviewed representatives of California's taxing authority, the California Franchise Tax Board (FTB), and reviewed documents related to a recent change in California's statute related to certain abusive tax shelters; (6) interviewed revenue agents and managers with expertise in offshore cases to develop an understanding of IRS enforcement activities; and (7) interviewed IRS officials and others in the tax practitioner and policy communities about their views on extending the examination period for returns involving offshore schemes. We assessed the reliability of the IRS data that we used and found that it was sufficiently reliable for our purposes. The universe of IRS examinations with an offshore component included individual taxpayers, smaller and larger corporations, and other taxable entities. The database of all nonoffshore examinations we used for comparison similarly included a full range of taxpayers. Details on our methodology can be found in

[1] Tax evasion is any method of willfully avoiding or reducing taxes that is not permitted by law. Tax evasion is distinguished from "tax avoidance" which denotes the legal interpretation of the tax laws to legitimately minimize tax liability. In this report, we use the term "tax evasion" to describe the target of the actions IRS takes to (1) identify underreported or unreported tax liabilities, either as a result of tax evasion or abusive transactions or claims subject to disallowance under existing law, and (2) assess the correct amount of taxes owed by the taxpayer and any penalties that may apply. Separate from the assessment of taxes owed by the taxpayer, tax evasion is itself a crime punishable under IRC 7201.

[2] IRS assigns a "project code" to those examinations whose main component is offshore tax evasion, and for the purposes of this review, those case files with one of six offshore project codes are considered offshore tax evasion.

appendix I. We did our work from June 2005 through February 2007 in accordance with generally accepted government auditing standards.

Results in Brief

Identifying possibly noncompliant returns, gathering appropriate evidence, and completing an examination takes much more time for IRS for tax returns involving abusive offshore transactions than other types of returns. Where IRS is able to complete examinations involving abusive offshore transactions, they generally result in larger assessments than other types of examinations. IRS officials told us that because the same 3-year statute of limitations that applies to nonoffshore examinations applies to offshore examinations, the additional time needed to complete an offshore examination means that IRS sometimes has to end offshore examinations before the examination is complete, and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance. Although data were not available to measure the effect of the statute of limitations on assessments, IRS revenue agents and their managers told us that overall assessments for offshore examinations are lower than they would be if IRS had more time to work these examinations.

Some offshore examinations exhibit enforcement problems similar to those where Congress has granted a change or exception to the statute in the past. For example, the issues that led to the creation of the statute exception for certain abusive tax shelters are similar to those exhibited by offshore examinations. Past statute changes and exceptions provide precedent for changing the statute for offshore examinations.

Through discussions with IRS officials and others in the tax practitioner and policy communities, we identified both advantages and disadvantages of extending the statute of limitations. Among the advantages were increased flexibility for IRS to direct enforcement resources to egregious cases of noncompliance and a possible deterrent effect against future noncompliance. Disadvantages included increased uncertainty and lack of closure for taxpayers as well as increased taxpayer perceptions of unfairness unless an extension to the statute for assessments is matched by an extended refund period. Our commenters also discussed design options to mitigate some of the disadvantages of the statute extension, such as making an exception apply to all taxpayers having offshore accounts/entities, and thereby, mitigating taxpayer uncertainty and lack of closure. Maintaining symmetry between the statutes for assessments and refunds was also mentioned as mitigating taxpayer perceptions of unfairness about extending the statute for assessments.

In this report, we suggest that Congress make an exception to the 3-year civil statute assessment period for taxpayers involved in offshore financial activity. In comments on a draft of this report, IRS officials commented that a longer statute for offshore examinations makes sense and should enhance compliance. IRS also provided comments on several technical issues and legal issues, which we incorporated in this report where appropriate.

Background

It is perfectly legal for U.S. taxpayers to hold money offshore. It is illegal, however, for a taxpayer to not disclose substantial offshore holdings, to not report income earned in the United States and "hidden" through offshore arrangements, and to not report income earned offshore to IRS on the taxpayer's tax return. If U.S. taxpayers own an offshore business such as a foreign corporation, they are required to disclose that holding to IRS on their tax return. When applied to abusive transactions, IRS generally uses the term "offshore" to mean a country or jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders.[3] When referring to a financial institution, "offshore" refers to a financial institution that primarily offers its services to persons domiciled outside the jurisdiction of the country in which the financial institution is organized.

Abusive offshore schemes are often accomplished through the use of limited liability corporations (LLC), limited liability partnerships (LLP), international business corporations (IBC), and trusts, foreign financial accounts, debit or credit cards, and other similar instruments. According to IRS, the schemes can be complex, often involving multiple layers and multiple transactions used to hide the true nature and ownership of the assets or income that the taxpayer is attempting to hide from IRS.

IRS has multiple programs and techniques used to select potentially noncompliant tax returns for examination. One source is a computer model designed to predict returns that, if audited, would be most likely to result in additional taxes owed. Other sources that prompt an examination include referrals from inside or outside IRS, information from third parties, and indications of fraud or noncompliance from other audits.

[3] IRS officials noted that although many enforcement problems occur in certain foreign jurisdictions that are characterized by strict financial privacy regimes, the term "offshore" broadly includes the activities of U.S. taxpayers in all foreign transactions.

Once IRS has identified a return for an examination, the classification process begins. Classification is the process of determining whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted. IRS guidance on classification states that classification should be conducted by an experienced examiner.

Examination is the accumulation of evidence for evaluating the accuracy of the taxpayer's tax return. Examiners gather facts to correctly determine a taxpayer's tax liability. Evidence can include the taxpayer's testimony and books and records as well as the examiner's own observations and documents from third parties. Methods for accumulation of evidence include analytical tests, documentation, inquiry, inspection, observation, and testing. IRS procedures call for examiners to pursue an examination to the point where a reasonable determination of correct tax liability can be made. In turn, examiners prepare audit reports, which should contain all information necessary to ensure a clear understanding of the adjustment, if any, and document how the tax liability was computed. These reports serve as the basis for assessment actions. An assessment records the taxpayer's liability due.[4]

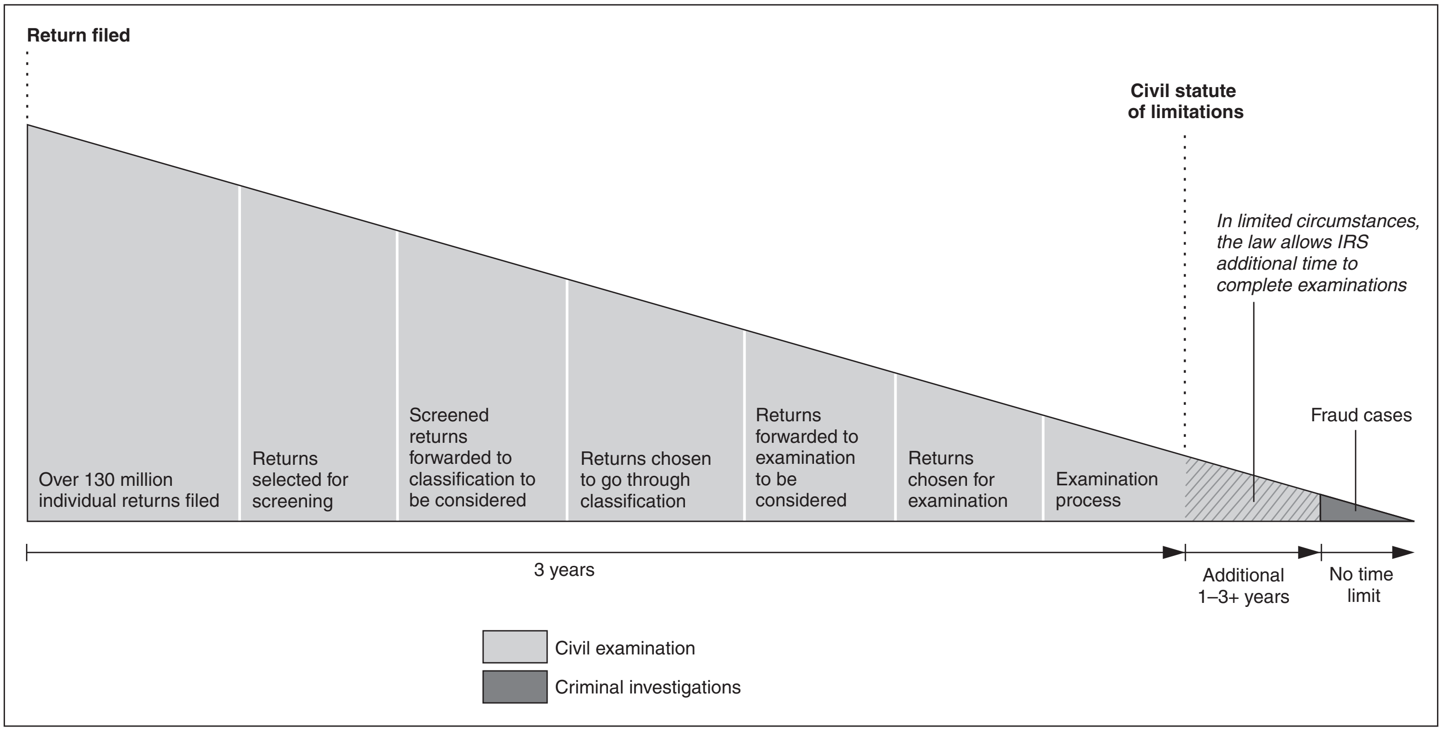
IRS examinations are generally of one of three types—correspondence, office, or field. The simplest examinations usually cover one to two tax issues handled by a lower-graded examiner through correspondence. More complex examinations are done by meeting with taxpayers or their representatives in IRS offices. The most complex examinations are done through revenue agent field visits to taxpayer locations. Only about 16 percent of all IRS examinations from 2002 through 2005 were conducted through field examinations, but 98 percent of offshore examinations were of this type. About three-fourths of nonoffshore examinations are handled through correspondence.

IRS does not classify every return that is filed, nor does it examine every case file that is classified, even if IRS determines that examining the tax return would likely yield an assessment of additional taxes owed. Figure 1 provides a notional representation of the process of taking the over 130 million individual income tax returns that were filed in fiscal year 2004

[4] Analyses in this report involve recommended assessments at the close of the examination. Recommended assessment amounts can be reduced if the taxpayer takes his or her case to IRS Appeals or to Tax Court.

through the steps that lead to audits of a much smaller number of those returns.

Figure 1: Notional Representation of IRS Audit Selection Process


Return filed
Civil statute of limitations
In limited circumstances, the law allows IRS additional time to complete examinations
Fraud cases
Over 130 million individual returns filed
Returns selected for screening
Screened returns forwarded to classification to be considered
Returns chosen to go through classification
Returns forwarded to examination to be considered
Returns chosen for examination
Examination process
3 years
Additional 1–3+ years
No time limit
Civil examination
Criminal investigations

Source: GAO analysis of IRS data.

In most cases, the law gives IRS 3 years from the date a taxpayer files a tax return to complete an examination and make an assessment of any additional tax. For example, if a taxpayer filed a tax return on April 15, 2000, IRS had until April 15, 2003, to finish any examination of that return and make an assessment of additional taxes owed by the taxpayer. This statute of limitations for assessments is in effect for all examinations with exceptions allowing longer periods for certain taxpayer actions or omissions such as fraud or substantial understatement of gross income (in excess of 25 percent of the amount of gross income stated on the return). Taxpayers may also waive the 3-year assessment limitation through written consent.

Offshore Examinations Take Longer Than Other Examinations, so the 3-Year Statute Can Lead to Lower Assessments Than Would Otherwise Be Possible

In general, it takes longer for IRS to identify and examine tax returns involving abusive offshore transactions than IRS needs in nonoffshore cases because of the added complexity of examining offshore transactions. Where IRS is able to complete examinations involving abusive offshore transactions, they generally result in larger assessments than other types of examinations. IRS has policies in place to avoid violating the statute of limitations, and IRS enforcement personnel told us that these policies, in conjunction with the longer time needed to complete offshore examinations, mean some cases are never opened in the first place while others are not fully worked because the time allowed under the current statute is running out. As a result, they said, overall assessments for offshore cases are lower than they would be if IRS had more time to work these cases.

Offshore Cases Take Longer for IRS to Develop and Examine

IRS officials told us that cases involving offshore tax evasion present special, time-consuming challenges that other types of cases do not. Tax evasion, both domestic and offshore, often involves schemes with many layers of deception. IRS officials told us that for domestic tax evasion, revenue agents are able to issue summonses to domestic financial institutions to uncover the layers of deception the taxpayer created to hide the source and existence of the funds. In offshore cases, IRS generally does not have summons power over offshore financial institutions, and is often unable to determine the owner of an offshore account or business, or determine the source of the funds. Even in cases where IRS is able to determine information about offshore funds, an IRS manager told us that this process of discovery is much more time consuming than for nonoffshore cases.

Unlike much nonoffshore tax evasion, most possible offshore tax evasion cases are not discovered through IRS's computerized analysis of tax returns, but rather through investigations of promoters of offshore schemes. Officials told us that several divisions of IRS forward leads on the promoters of offshore schemes they discover to revenue agents, who develop the cases in order to discover the extent of the promoter's use of offshore schemes. This process takes far longer than computer analysis-based methods of identifying potential noncompliance.

After developing information that a promoter of offshore schemes illegally sold schemes to help taxpayers avoid their tax liability, IRS can refer that information to the Department of Justice, which can then file a complaint in the United States District Court requesting the court to issue an injunction against the promoter. In some cases, the injunction will compel the promoter to disclose the clients who purchased the scheme. IRS officials told us that it can take years to get a client list from a promoter and, even with a client list, there is still much work that IRS needs to do before the clients of the offshore schemes can be audited. For example, IRS officials told us that they may only get limited information about the clients of offshore promoters, and often that information is limited to a name and perhaps the city and state where the client lives, so considerable time may be spent finding the individuals listed by the promoter.

Time spent developing information on a return before putting it into the queue for examination shortens the time available to close the examination before the 3-year civil statute of limitations expires. Table 1 compares the median number of days spent in development for offshore and nonoffshore examinations from 2002 to 2005.[5] As shown in the table, the median offshore case took 184 more calendar days than the median nonoffshore case to move from filing to examination. Comparing just field examinations, which constituted over 98 percent of offshore examinations in fiscal years 2002 through 2005, the difference in median development time was 96 days. Some examinations lead to additional examinations of the same taxpayer's returns, such as when a revenue agent identifies noncompliance on one return and then reviews prior year returns looking for the same problem, or when a taxpayer files a new return while an examination is underway. To avoid overstating development time, this comparison includes only the number of days between the start of the examination and the filing date of the last return filed before the examination began.[6]

[5] A small number of examinations take an especially short or an especially long time to develop and complete. Because of this, we generally use medians in this report as the representation of the central tendency of the data we analyzed.

[6] Because we chose to count development time for only the return filed immediately before the examination start date, the median development time information in table 1 understates development time for examinations that were in fact prompted by an earlier return from the same taxpayer. This makes our estimate of development time conservative for both offshore and nonoffshore examinations.

Table 1: Median Development Days by Examination Type, Fiscal Years 2002–2005

Examination type	Median days in development, all examinations	Median days in development, field examinations only
Offshore	504	504
Nonoffshore	320	408

Source: GAO analysis of IRS data.

Note: Medians in this table are not based on analysis of all examinations. Our calculations included only one examination where a single taxpayer is the subject of two or more related examinations.

Once offshore cases are developed and moved into examination, the examinations take longer than nonoffshore cases. Considering all types of examinations together, the median offshore examination took 90 more days than the median nonoffshore examination. Considering field examinations alone, the median offshore field examination was 70 days longer than the median nonoffshore field examination, as shown in table 2. IRS officials told us that this is due to examination complexity and the difficulty of identifying and obtaining information from foreign sources.

Table 2: Median Examination Days by Examination Type, Fiscal Years 2002–2005

Examination type	Total number of examinations	Median number of days, all examinations	Number of field examinations only	Median number of days, field examinations
Offshore	6,720	275	6,597	279
Nonoffshore	4,134,870	185	653,239	209

Source: GAO analysis of IRS data.

The total time that elapses between a return being filed and IRS's closing of the examination of that return is referred to as total cycle time and provides another type of comparison between offshore and nonoffshore cases. As shown in table 3, the median offshore examination took almost 500 more calendar days overall to close than the median nonoffshore examination, a 126 percent difference. The median offshore case took 82 percent of the statute time versus 36 percent for nonoffshore cases. Considering just field examinations, the median cycle times for offshore and nonoffshore examinations were closer in length, but the median offshore examination was still 194 days longer, a difference of 28 percent.

Table 3: Median Total Cycle Time by Case Type, Fiscal Years 2002–2005

	All examinations		Field examinations only	
Case type	Median cycle time, in days	Percentage of statute time used by IRS to close case	Median cycle time, in days	Percentage of statute time used by IRS to close case
Offshore	896	82	896	82
Nonoffshore	397	36	702	64

Source: GAO analysis of IRS data.

Note: The median day figures in tables 1 and 2 are drawn from different populations, so they do not add up to the median day figures in table 3.

Completed Offshore Examinations Yield Larger Recommended Assessments Than Other Examinations

About half of all offshore examinations resulted in a recommended assessment of additional taxes due compared to approximately 70 percent of nonoffshore examinations. While less frequent, assessments from all types of offshore examinations—correspondence, office and field—had a median that was nearly 3 times larger than from nonoffshore examinations. Considering just field examinations, recommended assessments from offshore examinations also had a median that was much larger than nonoffshore examinations, though by a smaller margin, as shown in table 4.

Table 4: Median Assessments by Examination Type, Fiscal Years 2002–2005

	All examinations		Field examinations only	
Examination type	Number of examinations resulting in an assessment	Median assessment, in dollars	Number of examinations resulting in an assessment	Median assessment, in dollars
Offshore	3,247	7,933	3,166	7,848
Nonoffshore	2,899,957	2,877	359,272	4,529

Source: GAO analysis of IRS data.

While yielding larger assessments, the greater amount of time spent on offshore examinations means that their yield per hour of direct examination time is lower.[7] Considering all types of examinations

[7] Direct examination hours are different from total cycle time or examination days in that they do not include time between actions by IRS, such as time spent waiting for a response from the taxpayer or from a financial institution.

together, including both those that resulted in an assessment and those that did not, offshore examinations yielded less per hour of direct examination time than nonoffshore examinations because the number of hours spent on those examinations is nearly 4 times longer, on average. From 2002 to 2005, IRS examiners spent an average of 46 hours on all types of offshore examinations, compared to an average of only 12 hours for all types of nonoffshore examinations. Considering only field examinations, average hours per examination were 47 for offshore examinations versus 62 for nonoffshore examinations, and the difference in dollars per hour of direct examination time is greater.[8]

Table 5: Assessment Dollars per Examination Hour by Examination Type, Fiscal Years 2002–2005

	Total dollars per hour of examiner time, all examinations	Total dollars per hour of examiner time, field examinations only
Offshore	1,084	1,073
Nonoffshore	2,156	2,824

Source: GAO analysis of IRS data.

Note: Unlike table 4, table 5 considers all examinations, including those that did not result in an assessment.

To Prevent Violating the Statute of Limitations, IRS Does Not Pursue Some Likely Offshore Tax Evasion

IRS has strict policies to prevent examinations from going past the statute of limitations because if an assessment is not made within 3 years, the statute of limitations bars IRS from making any assessment at all. Such instances mean the loss of revenue to IRS and inefficient use of IRS examination resources. IRS policies specify that statute expiration dates for all tax returns be properly determined, that all records be annotated with these dates, and that the cases be closely monitored to prevent accidentally running out of time. Revenue agents and managers told us that IRS strongly emphasizes the importance of keeping track of these dates and avoiding allowing an examination to go past the statute date.

While the 3-year statute of limitations applies in most cases, some exceptions exist under current law. For example, an assessment may be made after the 3-year point if the tax return is false or fraudulent or if

[8] The average of direct time charges on nonoffshore field examinations is affected by a small number of examinations that are both very time intensive and result in very high recommended assessments. We used averages in this comparison because hours per nonoffshore examination are influenced by the large number of very short correspondence examinations, resulting in a median of only 1 hour per case.

there is a sufficiently large omission of gross income. Taxpayers may also agree to waive their statute rights.

In the rare cases where IRS personnel allow an examination to go past the statute without meeting one of the current exceptions to the statute (a "barred statute"), the responsible agent and his or her manager must prepare a Barred Statute Report and face possible disciplinary action because of the examination time spent with no possibility of making an assessment. IRS data for fiscal years 2005 and 2006 showed 39 barred statutes associated with examinations where a manager made an initial determination to recommend a disciplinary action. As shown in table 6, most of these barred statutes ultimately resulted in some type of disciplinary action.

Table 6: Disposition of Cases When a Disciplinary Action Stemming from a Barred Statute Was Initially Recommended, Fiscal Years 2005–2006

Disciplinary action	2005	2006	Total
No action, withdrawn, closed	3	1	**4**
Counseling, admonishment, reprimand	20	11	**31**
Suspension, removal, resignation	3	1	**4**
Total	**26**	**13**	**39**

Source: GAO analysis of IRS data.

Note: These disciplinary actions include all types of examination cases, both offshore and nonoffshore.

IRS has created guidance for continuing offshore examinations past the 3-year point. This guidance permits agents to request permission to carry on the examination past the 3-year point based on their judgment that, given additional time, they will be able to ultimately prove that the examination meets one of the following three conditions:[9]

1. The return is false or fraudulent. IRS defines false or fraudulent as the preparation and filing of false income tax returns by claiming inflated personal or business expenses, false deductions, unallowable credits, or excessive exemptions.

[9] Other exceptions to the statute are in law. These three exceptions are specified in this guidance for carrying an examination past the 3-year statute date without first definitively proving that one of the statute exception conditions applies. IRS may also continue an examination past the 3-year point when taxpayers agree to waive their statute rights.

2. There is a sufficiently large omission of gross income (in excess of 25 percent of the amount of gross income stated on the return) under IRC 6501(e), in which case the tax may be assessed at any time within 6 years after the return is filed.

3. The taxpayer failed to notify the Secretary of the Treasury of certain foreign transfers under IRC 6501(c)(8), in which case the statute of limitations is 3 years from the date IRS receives the required information.[10]

A conclusion to continue an examination beyond the statute must be approved in writing by IRS managers, based on the revenue agent's documentation of the rationale and calculations to support this conclusion. In addition, IRS must have made a timely and proper request to the taxpayer to obtain a consent agreement to extend the statute. The taxpayer's refusal to extend the statute or lack of response must be documented. If this guidance is followed, no disciplinary action will be taken against the IRS managers and agents if the examination ultimately does not prove to meet one of the three conditions for making an assessment after 3 years.

The IRS guidance allowing some examinations to go past the normal statute period based on the revenue agent's judgment that an assessment will be possible after the 3-year point recognizes the limited time available to agents to finalize case-specific facts when the 3-year statute is about to expire. The IRS guidance also notes that the Credit Card Summons project examinations are generally likely to involve unreported income or fraud as well as failure to file information returns reporting foreign transfers. The guidance also states that other offshore examinations share many of the same challenges as Credit Card Summons project examinations including complex examinations and securing documents located outside the United States.[11]

[10] This exception is limited to just certain transfers associated with foreign corporations, partnerships and trusts. The exception is further limited to specific issues related to transactions with these foreign entities, such as the organization or reorganization of foreign corporations and the acquisition of their stock.

[11] At the time of our review, IRS had six offshore projects—Credit Card Summons, Offshore Transactions, Offshore Compliance Initiative Project, Foreign Trusts, Amended Returns with Offshore Voluntary Compliance Issues, and the Offshore Compliance Project.

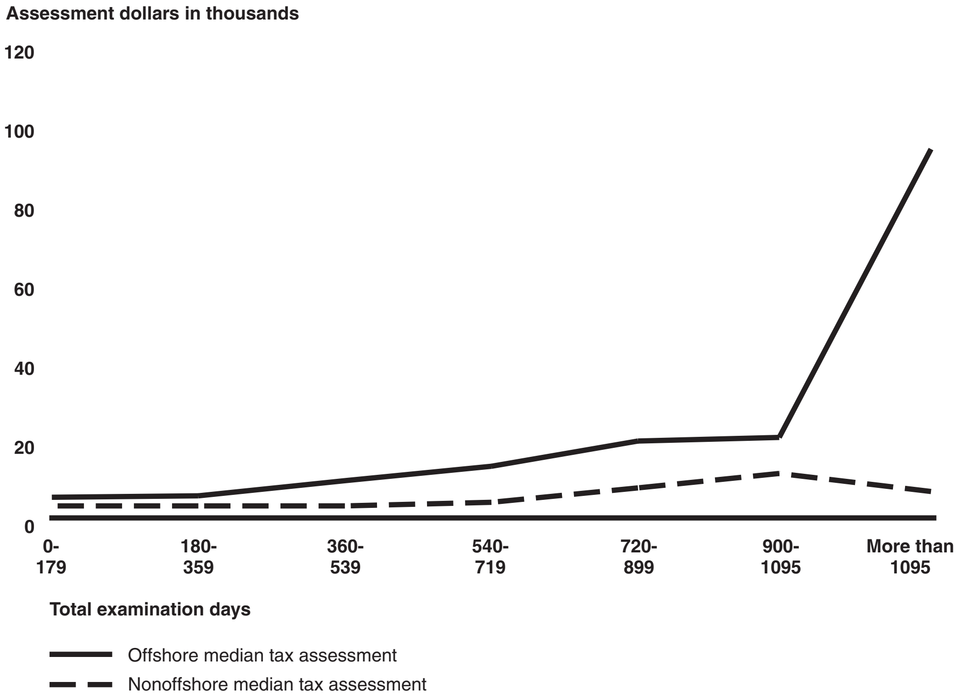
IRS managers told us that this procedure for continuing examinations beyond the statute is cumbersome, time-consuming, and some agents are reluctant to use the procedure because of concerns about barred statutes. Revenue agents told us that this reluctance stems from the culture of IRS examiners where agents are instructed from the time they are hired to never let an examination go past the statute of limitations for any reason. Despite subsequent assurances from IRS guidance, however, revenue agents told us that ingrained reluctance to letting the statute of limitations pass is still paramount.

All of the examinations allowed to extend past the statute date under this guidance represent a gamble on the part of IRS that the examination will ultimately meet one of the exceptions to the statute and an assessment will be allowed under the law. IRS records show that 1,942 offshore examinations were taken past the 3-year statute period from fiscal years 2002 through 2005. IRS ultimately made assessments on 63 percent of these examinations and these assessments were significantly higher than assessments from all other types of examinations, with a median assessment of about $17,500 versus about $5,800 from offshore examinations that were closed within the 3-year statute of limitations and $2,900 from all nonoffshore examinations closed within 3 years.[12] IRS databases do not allow systematic analysis of the approximately 700 examinations that did not result in an assessment, so we do not know if these were accurate returns or if the discovered tax evasion just did not rise to the level of fraud or substantial understatement of income.

For those examinations that closed with an assessment, longer examinations did not change the median assessment amount significantly for nonoffshore examinations. On the other hand, offshore examinations produced much larger median assessments than both shorter offshore examinations and all nonoffshore examinations when the examinations themselves took 3 years or more, as shown in figure 2. A similar relationship is found for field examinations alone, as shown in figure 3.

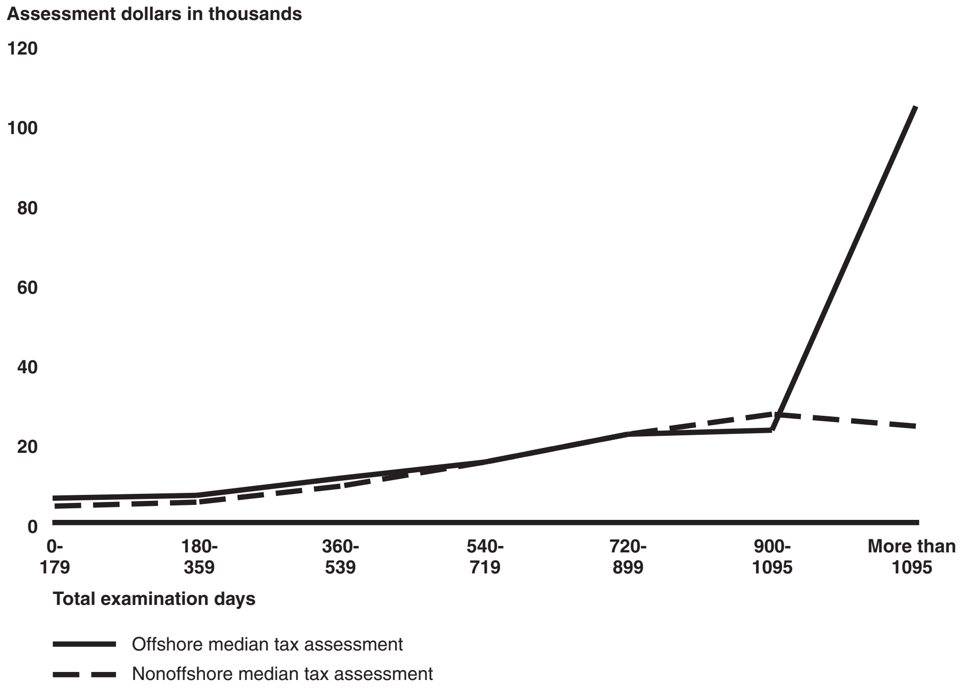
[12] Considering only field examinations, median assessments from offshore examinations during this period that resulted in an assessment were very similar—about $17,300 from examinations that took longer than 3 years and $5,800 from examinations closed in less than 3 years. For nonoffshore examinations, field examinations that took longer than 3 years had a median recommended assessment of about $14,000 and those closed within 3 years had a median recommended assessment of about $3,900.

Figure 2: Median Assessment Amount by Number of Examination Days, All Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Figure 3: Median Assessment Amount by Number of Examination Days, Field Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Similarly, our analysis of assessment dollars generated per hour of examination time (including examinations both with and without assessments) showed that the yield increased markedly for offshore examinations that take more than 3 years. While average assessment dollars per hour of direct offshore examination time are about half of the average for nonoffshore examinations, the reverse is the case for examinations that go over three years—$6,458 per hour for offshore examinations compared to $3,432 per hour for nonoffshore examinations. The comparison is nearly the same for field examinations alone—$6,465 per hour for offshore field examinations and $3,454 per hour for nonoffshore field examinations.

Revenue agents and managers told us that some developed case files are not opened for examination because insufficient time remains under the statute to make the examination worthwhile. They said that managers and agents have leeway in deciding which examinations to work because there are usually more developed case files waiting for agents than there are agents to work them. IRS wants agents to work examinations with a good likelihood of leading to meaningful assessments; managers told us they look for examinations that have both apparent noncompliance and sufficient time remaining within the statute to fully develop the apparent issues. Revenue agents and IRS managers told us that, in order to avoid violating the statute, they will often choose case files to examine with more time remaining under the 3-year statute of limitations over case files with less time remaining but with more likely or more substantial possible assessments. As a result, they explained that not all case files in the unassigned inventory of case files developed for examination are selected for examination and many case files are "surveyed," or closed without examination.[13]

Two IRS policies could contribute to closing a developed offshore case without an examination. One of these policies requires sorting the unassigned inventory to identify the areas most in need of examination. This policy includes statute year and statute date among the attributes used in sorting unassigned inventory. A second policy requires that an examiner not begin an examination or requisition any return for audit without management approval if fewer than 12 months remain on the statutory period for assessment. As described earlier, offshore examinations typically require more time to develop than nonoffshore examinations, and as a result, offshore examinations in the queue for examination would typically be nearer the end of the assessment period than nonoffshore examinations. IRS managers explained that this attribute of offshore examinations can lead to leaving offshore cases in the queue until the statute period ends and then closing the case without an examination.

Agents and managers also said that they often choose to end an ongoing examination nearing the end of the 3-year assessment period without making a complete assessment rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary action. IRS agents and managers told us that they face difficult choices as an examination nears the end of the 3-year assessment period and the examination is incomplete. On the one hand, the examination can be discontinued. This choice is the safest for individual IRS agents and managers because it avoids the possibility of a Barred Statute Report and

[13] Survey decisions can be made at several levels of management and may also be made by individual agents.

disciplinary actions. However, this choice also results in an assessment that does not accurately reflect the extent of a taxpayer's compliance or noncompliance with tax laws because the examination is incomplete. Continuing the examination can result in an accurate assessment, but only if the examination demonstrates one or more of the exceptions to the statute described earlier. If the examination does not ultimately demonstrate fraud or another basis for an exception, IRS managers and agents wasted IRS resources because they are barred from making an assessment. Revenue agents told us that they believed that in some cases there is "money being left on the table" in the form of unexamined issues that could have led to assessments if there had been sufficient time to examine them.

Even where there is sufficient time to work an examination, only a few years where a taxpayer was using a particular scheme may be open to examination and the early years of a scheme may be past their statute date before the examination even begins. For example, if IRS is examining a taxpayer's 2005 tax return and discovers a significant understatement in the income that the taxpayer reported, the agent can examine some of the taxpayer's previous returns, but unless the revenue agent and manager suspect fraud, in which case there is not a statute of limitations, IRS must abide by the 3-year statute of limitations on assessments and not examine some prior years that taxpayers held money offshore illegally. A senior IRS official told us that this is a particularly significant problem because it is often in the first years of an offshore scheme where the taxpayer moves the most money offshore and the most egregious tax evasion takes place, so IRS is missing out on significant assessments by not being able to look back at previous tax returns.

IRS revenue agents are not able to accurately estimate likely possible assessments for case files or tax years that are unexamined. Similarly, in cases where an examination is started and subsequently closed without some issues being examined due to the statute of limitations, it is not possible to estimate the likely assessment from unexamined issues.

As mentioned earlier, however, we found that 1,942 offshore examinations were allowed, either by IRS decision or by a voluntary statute extension signed by the taxpayer under examination, to exceed the 3-year statute of limitations. Of those, more than 700 were closed without an additional tax assessment. IRS officials told us that many of the offshore examinations that go past the 3-year statute of limitations are very difficult to work due to complex financial arrangements and that even with significantly more time, some particularly complex and well-hidden offshore schemes would remain very difficult to uncover. IRS data did not show the reasons that the 700 offshore examinations that went past the 3-year statute of limitations were closed without an assessment.

Some Offshore Examinations Present Enforcement Problems Similar to Those Where Congress Granted Changes to the Statute

Some offshore examinations exhibit compliance problems similar to those where Congress granted a change or exception to the statute in the past. Offshore examinations take longer than nonoffshore examinations for IRS to develop and examine for reasons such as technical complexity and the difficulty of obtaining information from foreign sources, and as a result, IRS may not complete assessments of all taxes owed. These problems are similar to problems giving rise to other changes and exceptions to the statute at both the federal and state levels over the years. These changes and exceptions provide precedent for changing the statute for offshore examinations.

Offshore Enforcement Problems Are Similar to Those Justifying Past Changes to the Statute

Offshore examinations present IRS with various enforcement problems. As discussed above, offshore examinations take longer to develop and examine. IRS officials told us that this is due to the examinations' complexity and difficulty in identifying and obtaining information from foreign sources. Agents and managers also said that they often choose to end an ongoing examination nearing the end of the 3-year assessment period without making a complete assessment rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary actions. Further, agents and managers explained that some taxpayers or their representatives employ dilatory, uncooperative tactics when dealing with IRS. In addition, we previously testified[14] that the use of offshore schemes can also pose a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance if honest taxpayers believe that significant numbers of individuals are not paying their fair share of the tax burden.

We reviewed 12 IRS offshore case files and found examples of (1) technical complexity, (2) difficulty in identifying and obtaining information from foreign sources, and (3) taxpayers or their representatives employing dilatory, uncooperative tactics when dealing with IRS. We also found a wide variety of offshore examinations, from

[14] GAO, *Internal Revenue Service: Enhanced Efforts to Combat Abusive Tax Schemes—Challenges Remain*, GAO-02-618T (Washington, D.C.: Apr. 11, 2002).

very simple examinations to much more complex examinations that had been under examination for years. In order to obtain illustrative examples of offshore examinations, we reviewed examinations that took a shorter than average number of days to complete, about an average number of days, and a longer than average number of days. We reviewed case files in two locations and our reviews included both completed examinations and examinations still in progress. These examinations included some that had no changes to the taxpayer. The two examinations described below include one that took a relatively low number of days and one that took a longer than average number of days.

In the first examination, the taxpayer was identified as holding an offshore credit card in a country considered to be a tax haven. The taxpayer maintained that he did not have an offshore credit card. IRS used a summons to obtain records of a domestic rental car transaction that would identify the holder of the offshore credit card. While the name shown on the rental car records was similar to the taxpayer's name, it was not the taxpayer's name. After reviewing the rental car records, the revenue agent concluded that the taxpayer was not the holder of the offshore credit card. The examination had no other issues and resulted in no change in the amount of tax owed by the taxpayer. In conducting this examination, the revenue agent

- sent 4 pieces of correspondence to the taxpayer,
- conducted 1 interview with taxpayer,
- notified the taxpayer of third-party contact, and
- used 1 summons to obtain domestic rental car records; the summons was returned 33 days after it was issued.

In the second examination, the taxpayer had a number of businesses in the United States and in other countries, including at least one business in a tax haven country. It appeared that some of the taxpayer's businesses paid consulting fees to other businesses the taxpayer owned, and consulting fees were paid into an offshore account in a tax haven country through which the taxpayer received funds via a credit card.

IRS found it difficult to determine how much money was in the taxpayer's offshore tax haven business and how the money got there. The money in that business, IRS told us, is the lynchpin of the entire examination, which was still underway at the time of our review. During the 4 years that the examination had been underway, IRS opened examinations on the taxpayer's spouse and on other businesses in other tax years. IRS has not been able to find where some of the money is going, although officials are confident that more is being hidden as the taxpayer had other businesses that made payments to the business in the offshore tax haven country. Over the 4 years of this examination, there have been at least

- 5 powers of attorney,
- 20 summonses,
- 39 contacts with the taxpayer's power of attorney,
- 23 document requests,
- 5 missed appointments by taxpayer or taxpayer's representative,
- 1 statute extension,
- 2 interview requests denied,
- 5 meetings with taxpayer's representative,
- 4 postponed appointments,
- 4 third-party contacts, and
- 2 occasions on which the taxpayer refused to supply information.

The scheme began, as far as IRS can tell, in the late-1990s, but examinations of some early years of the taxpayer's scheme were statutorily barred. This means that, when the examination eventually closes, IRS will not be able to assess any additional taxes on at least some tax years that IRS agents found the taxpayer was holding money offshore unless they determine that fraud was committed.

Enforcement problems exhibited in the 12 cases we reviewed are similar to enforcement problems justifying changes and exceptions to the statute at both the federal and state levels over the years. For example, the statute was recently changed at both the federal and state levels to address specific compliance problems, such as dilatory tactics on the part of taxpayers and the use of technically complex transactions. The following details on legislative actions illustrate instances where changes and exceptions to the statute were granted at both the federal and state levels because of enforcement problems similar to those exhibited by offshore examinations such as (1) time constraints on IRS; (2) taxpayers delaying examinations through dilatory, uncooperative tactics on the part of taxpayers; and (3) failure of taxpayers to provide required information.

Historical Changes and Exceptions

The Revenue Act of 1934[15] provided the current 3-year statute. In making the change in 1934 from 2 to 3 years, the Senate Report noted that experience showed that the 2-year period was "too short in a substantial

[15] Chapter 277, 48 Stat. 683, May 10, 1934.

number of large cases, resulting oftentimes in hastily prepared determinations, with the result that additional burdens are thrown upon taxpayers in contesting ill-advised assessments. In other cases, revenue is lost by reason of the fact that sufficient time is not allowed for disclosure of all the facts."

As discussed above, Congress has also provided exceptions to this 3-year assessment period. For example, the exception for filing a false or fraudulent return dates back to the Revenue Act of 1916.[16] Where this exception applies, the assessment can be made at any time. Similarly, the exception for significant omissions of gross income dates back to the Revenue Act of 1934. Where this exception applies, the tax may be assessed at any time within 6 years after the return is filed. According to the legislative history for the 1934 Act, this provision was added to enlarge the scope of the existing exception allowed for false or fraudulent returns while limiting the exception where a taxpayer may have made an honest mistake and it would be unfair to keep the statute open indefinitely. The exception to the statute of limitations for failure to report certain foreign transactions dates back to the Taxpayer Relief Act of 1997.[17] This exception was included and grouped along with certain other changes designed to simplify formation and operation of international joint ventures.

Recent Federal Exception to the Statute

More recently, Congress changed the statute to provide IRS with additional time to make assessments in the case of unreported listed transactions.[18] With the American Jobs Creation Act of 2004,[19] Congress extended the statute for unreported listed transactions for 1 year after the earlier of (1) the date the information required to be reported is provided or (2) a material advisor meets the requirements for providing a list of investors in the listed transaction.

[16] Chapter 463, 39 Stat. 756, Sept. 8, 1916.

[17] Pub. L. No. 105-34, Aug. 5, 1997.

[18] Listed transactions are the same as, or substantially similar to, a transaction specifically identified by IRS as a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. IRS listed 31 such transactions as of January 2007.

[19] Pub. L. No. 108-357, Oct. 22, 2004.

Listed transactions are complex transactions that manipulate parts of the tax code or regulations and are typically buried among "legitimate" transactions reported on tax returns. Because the transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters are promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. They may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult. The transactions are marketed to wealthy individuals, large corporations, and small business taxpayers. Section 6111 of the Internal Revenue Code requires the promoter or other tax shelter organizer to report such transactions with IRS. Further, Department of the Treasury regulations[20] require promoters to maintain lists of investors who have entered into the transactions and investors to disclose the transactions into which they have entered.

In a March 2006 report, for example, the Treasury Inspector General for Tax Administration (TIGTA) described a type of listed transaction called Son of Boss (Bond and Option Sales Strategies).[21] According to TIGTA, this transaction used flow-through entities, such as partnerships, and various financial products to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. TIGTA further explained that the losses generated from the transactions were often reported among "legitimate" items in several parts of the tax return. TIGTA concluded that taken together, these characteristics, especially the use of flow-through entities, made it very difficult for IRS to detect the Son of Boss abusive tax shelter through its traditional process of screening returns individually for questionable items. TIGTA noted that examinations of abusive tax shelters can take significant amounts of time even for the most experienced examiners because such shelters often involve complex, technical transactions that

[20] Treas. Reg. Sec. 301.6112-1 and Treas. Reg. Sec. 1.6011-4.

[21] Treasury Inspector General for Tax Administration, *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters*, 2006-30-065 (Washington, D.C.: Mar. 31, 2006).

take on different variations and require examining multiple flow-through entities to make a proper tax determination.

At the time of our review, IRS representatives stated that sufficient time had not elapsed to determine to what extent, if any, the 1-year extension for unreported listed transactions improved examination effectiveness. An IRS analyst explained, however, that the 1-year extension resulted in increased disclosures of previously undisclosed listed transactions. This analyst stated that 35 taxpayers made 74 separate disclosures about previously unreported listed transactions and that 8 of these 74 disclosures were duplicates.

California Statute Change

At the state level, California recently extended its statute from 4 to 8 years for taxpayers that invest in an abusive tax shelter (ATS) transaction. Such transactions include IRS listed transactions and other schemes of particular importance to California. According to the California Legislative Analyst's Office (LAO), the key feature of these transactions is that they have no true economic purpose but exist solely for reasons of tax avoidance. Among their characteristics is the use of (1) pass-through entities such as partnerships, (2) third party facilitators, and (3) offshore accounts or facilitators. The LAO further explained that ATS transactions can be quite difficult to identify and often even harder to understand, even for trained tax auditors.

As with IRS, California experienced increased disclosure as a result of extending its assessment period from 4 to 8 years for taxpayers involved in ATS transactions. A California FTB manager stated that the newly enacted 8-year statute had not been applied because most tax shelter examinations are closed within the normal 4-year period or by requesting voluntary waivers. It should be noted that California's assessment period is 1 year longer than the federal 3-year assessment period. The FTB manager also cited two sources of examinations in which the normal 4-year statute had expired but taxpayers were willing to work to resolve their tax shelter issues. These sources were the Self Compliance Letters[22] and the

[22] During 2005, the California FTB formed several new units to reduce the tax gap. Among these new units was the Abusive Tax Shelter Unit, which was formed to identify returns with abusive tax shelters and to foster self-compliance. According to a California FTB manager, this unit instituted a new approach to addressing potential participants in abusive transactions. Based on disclosure information, investor lists, and tax returns, she explained that the unit contacts taxpayers with a self-compliance letter to solicit amended returns that reverse the potentially abusive issues.

California Tax Shelter Resolution Initiative.[23] The California FTB used a self compliance letter to solicit amended returns from taxpayers for at least 1 year in which the 4-year statute had expired. This letter cited the 8-year statute. At the time of our review, 13 taxpayers filed amended returns, which reported tax and interest of about $2.3 million. Additional penalties may apply to these 13 taxpayers. Another 48 taxpayers agreed to file amended returns with estimated taxes and penalties of about $7 million. Under the California Resolution Initiative, the FTB was accepting applications and drafting closing agreements with another 181 taxpayers who had at least 1 tax year for which the 4-year statute had either expired or was about to expire.

Legislative Reports Discuss Reasons for Change

The justification for extending the statute for unreported listed transactions at the federal level and for ATS transactions in California generally involved qualitative factors. A House of Representatives Report[24] accompanying the American Jobs Creation Act of 2004 states that "some taxpayers and their advisors have been employing dilatory tactics and failing to cooperate with IRS in an attempt to avoid liability because of the expiration of the statute of limitations. The Committee accordingly believes that it is appropriate to extend the statute of limitations for unreported listed transactions."

While not enacted, Senate bill 476 (CARE Act of 2003) included a provision similar to the provision of the American Jobs Creation Act of 2004 that extended the statute for unreported listed transactions. A Senate Report[25] accompanying Senate bill 476 states that "…extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will afford IRS additional time to discover the transaction if the taxpayer does not disclose it." Similarly, the California LAO stated that the time extension for ATS transactions will allow the FTB to "more fully

[23] The California Tax Shelter Resolution Initiative provided analogous tax treatment for California taxpayers participating in, or intending to participate in, IRS's Settlement Initiative for an array of transactions, including 16 listed transactions and 5 other transactions that IRS considered potentially abusive. Taxpayers had until January 23, 2006, to submit their settlement applications to IRS. To participate in the California initiative, California taxpayers must have participated in the IRS initiative. They had until March 31, 2006, to file an election to participate in the California initiative. Both the IRS and California initiative required payment of taxes owed and interest. Both also provided penalty waivers and allowed transaction costs such as professional and promoter fees.

[24] House Report 108-548—*Pt. 1 American Jobs Creation Act of 2004* (June 2004).

[25] Senate Report 108-11—CARE Act of 2003 (Feb. 27, 2003).

develop cases that represent ATS activity and result in a greater sustainment rate at the appeal level."

In addition to affording more time for IRS to discover undisclosed transactions, the Senate report accompanying Senate bill 476 also stated that "extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will encourage taxpayers to provide the required disclosure…." In analyzing the legislation that extended the California assessment period from 4 to 8 years, the California FTB noted that "some taxpayers will continue to engage in tax avoidance transactions until the risks and costs of engaging in the transactions are significantly increased."

More generally, tax evasion by some taxpayers can affect the perceptions of other compliant taxpayers about the fairness and equity of our tax system. In its report accompanying Senate bill 476, the Senate Committee on Finance stated that the committee "is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax. Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system." Similarly, the California LAO concluded that tax avoidance "by some taxpayers shifts the relative tax burden towards taxpayers already in compliance. This principle of fairness has ramifications for the tax system itself. A perception that the tax system is not equitable could result in noncompliance and tax avoidance by an increasing proportion of taxpayers."

Precedent Exists for Changing the Statute for Offshore Examinations

The Supreme Court found that statutes of limitations find their justification in necessity and convenience. According to a Supreme Court opinion, statutes of limitations are practical and pragmatic devices to spare the court from litigation of stale claims, and the citizen from being put to his defense after memories have faded, witnesses have died or disappeared, and evidence has been lost.[26] The opinion goes on to say that statutes of limitations are by definition arbitrary. Historically, the assessment statute of limitations has varied in length. For example, the Revenue Act of 1919[27] set the statute of limitations for tax assessments at 5

[26] Chase Securities Corp. v. Donaldson, 325 U.S. 304, May 21, 1945.

[27] The Revenue Act of 1919, ch. 18, 40 Stat. 1057, February 24, 1919.

years. The statute was changed to 2 years in 1932.[28] The current 3-year statute stems from the Revenue Act of 1934.[29] As described above, Congress granted changes and exceptions to the statute over the years to address various types of enforcement problems. Given the similarities between the enforcement problems exhibited by offshore examinations and the enforcement problems giving rise to past changes and exceptions to the statute, precedent exists for changing the statute for offshore examinations.

Changing the Statute Would Necessitate Weighing Advantages and Disadvantages

Changing the statute for offshore examinations would necessitate weighing advantages and disadvantages. If Congress wishes to change the statute for examinations where offshore compliance is the major issue, certain design options, such as limiting any examination and possible assessment to those issues attributable to offshore transactions or only suspending the statute while IRS is waiting for taxpayer responses to IRS data requests, might mitigate some of the disadvantages of the statute extension.

Advantages and Disadvantages of Changing the Statute

Changing the statute for examinations in which offshore transactions are a major enforcement problem will require weighing both advantages and disadvantages. In addition to advantages, such as fairness or deterrence, mentioned earlier as justification for extending the statute for unreported listed transactions and ATS transactions, interested parties from various organizations that represent taxpayers or work with tax issues mentioned other advantages and disadvantages for an exception to the statute for offshore examinations. For example, they mentioned the ability of IRS to look back at several tax years once an offshore scheme is identified as an advantage of such an exception. On the other hand, they mentioned that such an exception would further complicate the tax code by adding another provision that would most likely include complicated criteria addressing offshore transactions. Table 7 summarizes their views on such an exception in general.

[28] The Revenue Act of 1932, ch. 209, 47 Stat. 169, June 6, 1932.

[29] The Revenue Act of 1934, ch. 277, 48 Stat. 683, May 10 1934.

Table 7: Views of Interested Parties in General on Changing the Statute for Offshore Examinations

Advantages	Disadvantages
• Increases perceptions of fairness • Enhances deterrent effect • Allows IRS to look back at several tax years once a scheme is identified	• Complicates tax laws by adding complex criteria • Creates another precedent for future exceptions • Increases uncertainty and lack of closure • Increases recordkeeping costs • Increases difficulty of marshalling a defense as memories fade and records disappear • Duplicates tools already available to IRS (e.g., fraud, consent agreements, etc.) • Increases IRS focus on old returns, which may not be a good use of IRS resources • Increases perceptions of unfairness unless matched by an extended refund period

Source: GAO analysis of comments by interested parties from various organizations that represent taxpayers or that work with tax issues. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, National Society of Tax Professionals, and the Department of the Treasury (IRS Small Business/Self Employed division, Taxpayer Advocate Service, IRS Office of Chief Counsel, and Department of the Treasury Office of Tax Policy).

In commenting on an exception to the statute for offshore examinations, these interested parties also pointed out advantages and disadvantages for various design options that could be used to implement such an exception. These options relate to (1) the scope of an exception and (2) the way in which IRS is afforded additional time to address the enforcement problems presented by offshore examinations. Scope refers to (1) which taxpayers will be subject to the exception and (2) the extent to which the exception allows IRS to examine a tax return. The way in which IRS is afforded additional time refers to (1) an extension to the statute, such as for an additional 3 years from the filing date of a tax return or (2) a suspension of the statute pending resolution of a compliance problem, such as slow taxpayer response to IRS records requests. A suspension is triggered by a specified event or action. Table 8 presents the views of these interested parties on the advantages and disadvantages of these design options.

Table 8: Views of Interested Parties on Design Options for Changing the Statute for Offshore Examinations

Design option	Advantages	Disadvantages
Exception applies to all taxpayers having offshore accounts/entities	• Increases simplicity when compared to a case-by-case approach • Increases certainty when compared to a case-by-case approach	• Includes taxpayers having legitimate reasons for offshore accounts/entities • Requires clear criteria defining factors such as offshore account and offshore entity
Exception applies on a case-by-case basis	• Exempts taxpayers having legitimate reasons for offshore accounts/entities	• Requires clear criteria defining applicability • Requires safeguards to prevent unwarranted application • Uncertainty for taxpayers as to whether they are covered
Exception applies to entire tax return	• Maximizes potential for assessment	• Expands examination beyond offshore issues • Creates perceptions of unfairness
Exception applies to offshore issues only	• Limits examination to offshore issues	• Requires safeguards to prevent scope expansion to nonoffshore issues
Exception in the form of a statute extension	• Increases time to identify participants • Increases time to develop examination • Increases time for examination	• May ineffectively identify offshore scheme participants • Fails to guarantee information needed for assessment will be provided within the extended time
Exception in the form of a statute suspension	• Focuses on a specific problem • Increases time to address a specific problem	• Requires clear criteria for triggering event • Requires triggering event to occur before additional time allowed

Source: GAO analysis of comments by interested parties from various organizations that represent taxpayers or that work with tax issues. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, National Society of Tax Professionals, and the Department of the Treasury (IRS Small Business/Self Employed division, Taxpayer Advocate Service, IRS Office of Chief Counsel, and Department of the Treasury Office of Tax Policy).

If Congress wishes to change the statute for examinations where offshore compliance is a compliance problem, several of the design options mentioned by interested parties might mitigate some of the disadvantages of a statute exception for such examinations. To help clarify their suggestions, we also developed some hypothetical examples to illustrate their points. Specific suggestions that we heard included the following:

- Making an exception apply to all taxpayers having offshore accounts/entities may mitigate concerns about taxpayer uncertainty and lack of closure.
- Limiting any examination and possible assessment only to those issues attributable to offshore transactions might mitigate concerns about unfairly exposing taxpayers to open-ended IRS examinations or "fishing expeditions" that could result in assessments for issues unrelated to offshore transactions. For example, an examination triggered by a taxpayer possessing an offshore credit card could enable the IRS to examine depreciation expense for the plant and equipment used in the taxpayer's domestic business, which the taxpayer might perceive as unfair.

- Suspending the statute until a specific issue is resolved, such as taxpayers not responding promptly to IRS requests for records, might mitigate concerns about an across-the-board extension of the 3-year assessment period.
- Specifying a length of time for an initial extension, such as 1 year, and requiring a court or review board's approval for any subsequent extensions might also mitigate taxpayer concerns about potential IRS abuse of an exception to the statute for offshore examinations. This option might allay concerns about unwarranted application by IRS of a case-by-case exception to the statute.
- Establishing a materiality test might mitigate concerns that IRS would focus on taxpayers having insignificant issues. This test could be, for example, (1) any amount greater than a percentage of a specific amount shown on a tax return such as 20 percent of total assets for taxpayers operating a business or (2) any amount greater than an absolute dollar amount such as any amount greater than $10,000. This option might allay concerns about including all taxpayers, particularly those having legitimate offshore transactions that are not substantial in value.
- Limiting the exception to a case-by-case approach might mitigate concerns about taxpayers being unfairly subjected to an extended assessment period when they have legitimate offshore transactions. For example, an exception to the statute could be limited to taxpayers identified on client lists of known promoters of offshore schemes. This option might allay concerns about including all taxpayers, particularly those having legitimate reasons for offshore transactions.
- Maintaining symmetry between the statute for assessments and the statute for refunds by matching any exception to the statute for assessments with the same exception to the statute for refunds might mitigate taxpayer concerns about the unfairness or one-sidedness of an exception to the statute for assessments. If the statute was suspended until taxpayers respond to IRS request for records, for example, the statute for refunds should also be suspended until the taxpayers respond to the request.
- Assuring access to IRS appeals procedures and to the Tax Court might mitigate taxpayers' concerns about the potential for IRS abuse as well as provide due process should they decide to challenge IRS's use of such an exception to the statute. For example, procedures requiring TIGTA to investigate any taxpayer allegations of denial of due process could be mandated.

Conclusions

As with all forms of tax evasion, it is important that IRS pursue offshore tax evasion because it adds to the tax gap, increases the tax burden on honest taxpayers, and poses a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance when honest taxpayers come to believe that other people are getting away with not paying their fair share. Offshore tax evasion is special, though, in that the examinations that IRS pursues typically take much longer to develop and examine because of the inherent difficulty in identifying and obtaining information from foreign sources, the often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and the technical complexity of the examinations.

Nevertheless, the statute of limitations that applies to offshore examinations is the same as applies to all returns. This leads to some suspected tax evasion that IRS identifies going unexamined when revenue agents and managers choose not to start work on offshore examinations because there is too little time remaining under the statute or choose to cut work off early in order to avoid a barred statute. There are exceptions that permit IRS to continue examinations past the 3-year point and still make assessments, but in many offshore examinations IRS has only 3 years to complete its work. Furthermore, taking an examination past the 3-year point in anticipation of finding fraud or one of the other exceptions permitted under the statute represents a gamble by IRS that the investment of additional examination resources will ultimately result in an assessment being allowed under the law.

Past Congresses have recognized the need for statute exceptions in the face of similar compliance and enforcement obstacles. In the case of the statute exception for unreported listed transactions, Congress delegated to IRS the responsibility for defining the specific circumstances triggering the exception. A statute exception for offshore examinations that balances the additional layers of difficulty for IRS in detecting and examining offshore cases with fairness to taxpayers involved in legitimate offshore financial activity would strengthen IRS's efforts to combat offshore tax evasion. Additional time to complete examinations would give IRS greater flexibility in choosing which examinations to open and when to close them. This would likely lead to fewer examinations where revenue agents abandon the pursuit of apparent noncompliance simply because they are running out of time.

Matter for Congressional Consideration

In order to provide IRS with additional flexibility in combating offshore tax evasion schemes, Congress should make an exception to the 3-year civil statute of limitations assessment period for taxpayers involved in offshore financial activity. Similar to Congress's approach to unreported listed transactions, Congress may wish to establish a process wherein IRS would identify the types of offshore activity to which a statute exception would apply.

Agency Comments and Our Evaluation

We received e-mail and oral comments from IRS's SB/SE division and the IRS General Counsel's office about a draft of this report. The officials making comments noted that a longer statute for offshore examinations makes sense and should enhance compliance. They also discussed how the offshore-to-nonoffshore comparisons in the draft of this report were typically made for all types of examinations, rather than only of field examinations. They observed that field examinations are by far the most common type of examination used for offshore tax evasion cases and suggested that a comparison of just field examinations would also be useful to the reader. We agreed and we changed our discussion of offshore-to-nonoffshore examinations to include comparisons both of all types of examinations collectively and field examinations alone. Also in their comments, IRS officials clarified other technical and legal issues, which we incorporated in this report where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. Copies will be made available to others upon request. This report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.

Michael Brostek

Michael Brostek
Director, Tax Issues
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Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to (1) compare the length of and recommended assessments yielded by offshore and nonoffshore examinations and determine the effect of the 3-year statute of limitations on recommended offshore assessments, (2) determine whether or not enforcement problems posed by offshore examinations are similar to those where Congress has previously granted an exception to the statute, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore examinations.

To compare the length of and recommended assessments yielded by offshore and non-offshore examination cases and determine the effect of the statute of limitations on offshore assessments, we examined the Internal Revenue Service (IRS) Audit Information Management System Reference (AIMS) database, which holds all IRS's data about completed examinations. The database included a variety of taxpayers, including individuals, businesses, and corporations, including large corporations. We analyzed fiscal years 2002 through 2005, the most recent years for which IRS had data at the time of our evaluation. We grouped all examinations maintained in the AIMS database by whether they were offshore examinations (as determined by the project code under which all examinations are categorized) or not offshore examinations. We found that there were both offshore and nonoffshore examinations represented among all of the types of taxpayers in AIMS with the exception of excise tax examinations, which were only found in the nonoffshore subset. We used the AIMS data to analyze the number of days cases spent in both development and examination and the recommended assessments from both offshore and nonoffshore examinations. We further subdivided the data to compare only field examinations, because these were the most common type of offshore examination. To assess the reliability of the AIMS data, we reviewed AIMS documentation, and conducted electronic testing of key variables. Based on this work, we determined that the AIMS data were sufficiently reliable for our purposes.

We spoke with 17 IRS revenue agents and managers with expertise in the offshore area about their experience in conducting and closing offshore examinations. We also examined 12 offshore examination case files to gain an understanding of the circumstances that IRS revenue agents face in dealing with noncompliant taxpayers. We spoke with IRS representatives to gain an understanding of how cases are identified for examination, and to determine the process by which an offshore case is developed and examined. In addition, we reviewed various IRS documents related to the statute of limitations on assessments, including exceptions to the statute.

To determine whether or not enforcement problems posed by offshore cases are similar to those where Congress granted an exception to the statute in the past, we identified enforcement problems posed by offshore examinations. To do so, we examined IRS's AIMS database, examined case files and spoke with IRS representatives. We also identified enforcement problems where Congress granted an exception to the statute in the past. To do so, we researched the history of the federal statute of limitations for assessments. We also reviewed legislation proposed between 2003 and 2006 that included references to either offshore tax evasion or the statute of limitations. This included the American Jobs Creation Act of 2006 and other legislative proposals related to the statute. In addition, we reviewed reports prepared by the Treasury Inspector General for Tax Administration and California state agencies related to tax avoidance issues and the statute. We supplemented these reviews with discussions with representatives of the California Franchise Tax Board.

To identify advantages and disadvantages of granting an exception to the statute for offshore examinations, we interviewed representatives of various organizations to obtain views on mandating an exception to the statute for offshore examinations. Such an exception would afford IRS more time to develop and examine offshore examinations. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, and National Society of Tax Professionals. We also interviewed representatives of various organizations within the Department of the Treasury to obtain their views. These organizations included the IRS Small Business/Self Employed division, the Taxpayer Advocate Service, the IRS Office of Chief Counsel, and the Department of the Treasury Office of Tax Policy.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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In addition to the contact named above, David Lewis, Assistant Director; Perry Datwyler; Evan Gilman; Shirley Jones; John Mingus; and Jeff Schmerling made key contributions to this report.

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