BUDGET BULLETIN
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INFORMED BUDGETEER (PART 2):

WE'RRRRRE OFF TO SEE THE WIZARD (Continued)

- Despite the feeble track record on enacting tax-gap-closing proposals that the President has already put on the table, the hearing held by the Senate Finance Committee (April 14, 2007) served largely to allow congressional inquisitors to excoriate the Treasury for not putting more proposals on the table to close the tax gap by larger amounts. The Finance Committee chairman directed the Secretary of the Treasury to come back within 90 days and submit a plan to achieve 90 percent voluntary tax compliance by 2017.

- On August 2, 2007, the IRS submitted a report – *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* – to comply with the chairman's directive. The report essentially summarizes the efforts the IRS is already pursuing under current law to reduce noncompliance and suggests that simplifying the tax code will reduce tax avoidance. It does not include any legislative proposals to change the law in the significant ways that the multiple hearings have indicated are needed to prevent and deter illegal behavior that is the cause of the tax gap. http://www.treas.gov/press/releases/reports/taxgapreport08022007.pdf

You Have No Power Here in the Caymans…Be Gone, Before Someone Drops an Ugland House on You, Too!

- Tax Gap or Tax Haven/Shelter? Reprising the floor debate from March 20, the Budget Committee chairman, on May 17, 2007, slides from discussing the tax gap to a chart of the Ugland House: "we have the tax gap, which back in 2001 was estimated to be $345 billion a year [*Editor's note: actually, it was $290 billion net in 2001 because $55 billion of owed taxes were eventually paid*]. . . .That is the difference between what is owed and what is paid. . . .But that is not the only source of revenue without a tax increase. The second area of opportunity to get revenue with no tax increase is the explosion and the abuse of offshore tax havens. I have shown this building down in the Cayman Islands many times on the floor. This 5-story building is the home to 12,748 companies." http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2007_record&page=S6221&position=all

Source: Senate Budget Committee Democratic Staff

- The Ugland House was identified in a *Bloomberg Markets* article (August 2004) entitled, "$150 Billion Shell Game" (http://www.law.wayne.edu/mcintyre/text/in_the_news David_Evans_offshore.pdf). The article describes how multinational corporations use transfer pricing to shield their profits from taxes by shifting a share of their profits into tax havens. As a matter of law, **this practice is legal** under U.S. Treasury regulations issued in January 1996 (61 FR 21955) and in a subsequent update to those regulations. (http://www.irs.gov/pub/irs-regs/td9088.pdf)

- For example, one form of transfer pricing – called a cost sharing arrangement (CSA) – permits two or more companies to share the cost of developing intellectual property. Each party shares the risk and profits associated with the project in proportion to what each party contributes to the project.

- A CSA typically involves one party contributing intellectual property and a second party paying the first party for the value of the intellectual property in the form of a "buy-in" payment. The *Bloomberg Markets* article describes how the Coca-Cola Company (the first party) produces its soft drinks overseas and sells its products abroad through its subsidiary (the second party) in a CSA by providing the subsidiary with its secret formula (the intellectual property) in exchange for a buy-in payment.

- Critics of tax havens have argued that CSAs can be easily abused if a U.S. firm underprices the initial buy-in payment, thereby allowing the overseas subsidiary (organized in a jurisdiction with a lower tax rate than the United States) to recognize an above-market rate of return and a disproportionate share of the project's profits in order to avoid paying higher U.S. taxes.

- In August 2005, the Treasury proposed a new set of regulations to address such abuses. The new regulations seek to prevent the buy-in firm from realizing more than a market-risk rate of return, thereby limiting realization of excessive profits that would then be shifted into the lower tax jurisdiction. It shouldn't surprise anyone that the IRS received a lot of comments on these proposed regulations, and there is no announced date yet for when it will issue final regulations to prevent this abuse. http://www.irs.gov/pub/irs-regs/144615021.pdf; http://www.rsmmcgladrey.com/RSM-Resources/Publications/Transfer-Pricing/January-2006/cost-sharing/

- Certainly it appears that some taxpayer behavior has evolved ***legally*** to result in a lower payment of taxes than what otherwise may have been intended and expected (which is pretty much the definition of a tax haven or tax shelter) as successive tax laws were layered on to the tax code. If the government wants to remedy what it decides are unintended results, it first needs to understand the tax-sheltering behavior and then enact changes in law to take away those sheltering opportunities. Towards that end, during a Finance Committee hearing on May 3, the chairman directed the Government Accountability Office to go investigate "what is going on at the Ugland House." (http://finance.senate.gov/sitepages/hearing050307.htm ; see http://finance.senate.gov/sitepages/hearings.htm for webcast.)

I do believe in spooks! I do believe in spooks! I do, I do, I do, I do, I do, I do believe in spooks!

- In continuing floor debate on the budget resolution with the ranking members of the Budget and Finance committees, the Budget Committee chairman spent a lot of time and energy conflating the problems of the tax gap and havens/shelters as well as describing a mirage of easy offsets associated with it all:

> I do remember words from the Wizard of Oz: brains, courage, and heart. That is what we need here. I believe we have the brains in this country to

go after a tax gap that is well over $400 billion a year now. That is $2 trillion over 5 years. . . . when we put together the tax gap, tax havens, tax scams, abusive tax shelters, there is a ton of money there. Just in this offshore area alone,… the Investigations Subcommittee [of the Committee on Homeland Security and Governmental Affairs; http://hsgac.senate.gov/_files/TAXHAVENABUSESREPORT8106FINAL107.pdf] says $100 billion a year is being lost… Look, we are talking about a tax gap over this period alone of $2 trillion. Fifteen percent of that would be $300 billion. . . . Come on. We can't capture 15 percent – 15 percent – of the tax gap and the tax haven abuses and the tax shelter scams?. . . . If we were able to increase our compliance from 86 percent to 89 percent, we would raise the total amount of revenue that is in the budget I have proposed. . . . We can do this. We need a lot more confidence in ourselves. We need to be a little optimistic. You know what. America can do this.

- Certainly confidence and optimism are useful qualities, but they are not substitutes for actual legislation. Dreaming up a figure of $2 trillion (or sometimes $2.5 trillion) over five years (out of a one-year guess at a number of $290 billion), and then clicking one's ruby slippers together three times in hopes of getting 15 percent of that, will not accomplish anything.

One Step Forward, Two Steps Back ("Of course, people do go both ways")

- In fact, the two concrete actions that Congress has taken (since enacting only three of the President's proposals to close the tax gap) would actually make it harder to reduce the tax gap.
- On October 10, 2007, the House passed a bill (H.R. 3056) to repeal the IRS' ability (enacted three years ago and implemented beginning March 2006) to hire private debt collectors to collect tax revenue that the IRS would otherwise not ever collect. On the Senate side, the reported Financial Services Appropriations bill for 2008 (H.R. 2829) includes a similar repeal provision, but the Senate has not yet voted on this bill.
- If this repeal is eventually enacted, it would actually lose $607 million in revenue over the next five years (although it would save about $150 million in spending because the IRS would not have to pay the collection agents, and it would take away another $150 million in resources the IRS would have been able to devote to its efforts to improve tax compliance). http://www.cbo.gov/ftpdocs/83xx/doc8392/hr3056.pdf
- As part of the same bill, the House also voted to delay for one year the implementation of government withholding. The Tax Increase Prevention and Reconciliation Act of 2005 (enacted in May 2006) included a provision that requires a three percent withholding on certain payments made by government entities to persons providing property or services to the federal government, effective beginning in tax year 2011.
- Two years ago, JCT estimated the provision would increase revenue by $7.0 billion over the 10-year period 2006-2015 (http://www.house.gov/jct/x-18-06.pdf). The House's recent vote to delay implementation of that measure to close the tax gap will lose $44 million (http://www.house.gov/jct/x-99-07.pdf), indicating the House must not think that going after this part of the tax gap is very important.

"I've Got a Plan . . . And You're Going To Lead Us"

- So rather than wishing really hard and hoping "America can do this," it is actually the members of the House Ways and Means Committee and the Senate Finance Committee who will have to write legislation – real words on the page – that would change current law to reduce current illegal taxpayer noncompliance (tax gap) or to change legal taxpayer avoidance behavior (tax havens/shelters).
- The chairman of the Finance Committee has outlined his own "proposals" to reduce the tax gap: improve taxpayer services, improve regulation of tax preparers, improve the use of technology to detect fraud, and use more fully current statutory authority.
- For each one of his "proposals," the federal government either could already be doing it or would have to spend more money to implement it (but the 2008 budget resolution did not set aside any funds for these activities). None of these proposals have been committed to legislative language, and so have not been scored by JCT and CBO to assess how much additional revenue they would yield. More importantly, none of them would change current law to prevent underreporting of income or to make illegal those tax havens and shelters that are legal under current law.
- To summarize: despite the budget resolution's promise of easy money from closing the tax gap and tax shelters, little to no progress has been made towards fulfilling this promise. Instead, Congressional action to date has been in the other direction: Congress has failed to enact 97 percent of the President's tax gap proposals; the House has voted to take away the private-debt-collector tool the IRS is using to increase tax revenue; and the House has voted to delay implementation of a withholding tool that would increase compliance.
- Meanwhile, the search for offsets to pay for measures that would otherwise increase the deficit, such as fixing the AMT by the end of the year, grows more desperate. The chief tax policy writer in the House, the chairman of the Ways and Means Committee, has proposed permanent repeal of the AMT. He does not use the tax gap, tax loopholes or tax shelters to pay for repeal; instead, he adds two new, higher, individual tax brackets to the code (with much of the increased revenue coming from small businesses who file tax returns as individuals).
- The key players in the Senate (along with their counterparts in the House) are the chairman of the Budget Committee (who cites closing the tax gap and eliminating tax shelters as ways to increase revenue without raising taxes) and the entire Finance Committee (of which the Budget chairman is a member), which often reminds everyone of its jurisdiction over the nation's tax laws. So, like Dorothy, if they want to find their heart's desire, they won't have to "look any further than [their] own back yard."

Editor's Note: This double issue of the *Budget Bulletin* marks a return from a temporary hiatus. Budgeteers who have missed being informed should expect to see new *Bulletins* on a more regular schedule.