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Tax Prosecutions: More Jail Time and Penalties?

Recent publicity about the "tax gap"—the difference between what the Internal Revenue Service (IRS) thinks taxpayers should be paying and what it collects—has resulted in a call for enhanced penalties for tax offenses.

While the proposals appear to be aimed at enhancing deterrence of tax crimes, the government may be misplacing its focus and endorsing ineffective public policy. Evidence establishes that investing in the IRS results in high returns for the government. Over the past decade, however, Congress and the Executive Branch have reduced funding to the IRS. This, in turn, has caused a decline in the number of audits and resulting prosecutions, which affects both deterrence and revenues.

Thus, rather than increasing the already substantial penalties associated with tax crimes, the Legislative and Executive branches may be better served by focusing on the long-term decrease in the enforcement of criminal tax laws.

Historical Factors

In 1998, the Senate Finance Committee held hearings at which taxpayers detailed numerous instances of abuse at the hands of the IRS. Some of the harshest criticism was aimed at the agency's criminal investigation division, as witnesses complained that the investigators used excessive techniques and were out of control.[1]

As a result, Judge William Webster was appointed to assemble a task force and perform an independent review of the criminal investigation division's operations. In a report issued in April 1999, the Webster Commission concluded that the division had "drifted from its primary mission of investigating potential violations of the federal internal revenue laws concerning legal source income." As a result, the criminal investigation division underwent a major reorganization. Although the downward trend in enforcement predated the Senate Hearings and Webster Commission Report, these events undoubtedly impacted the IRS enforcement efforts.

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Relevant Statistics

Statistics collected by the Transactional Records Access Clearinghouse (TRAC), a data-gathering, research and distribution organization associated with Syracuse University, clearly documents the decline in the number of cases investigated by the IRS and brought by the Department of Justice. In 1986, the total number of prosecutions charging tax violations as the lead offense, whether initiated by the IRS or the DOJ, was about 1,500. Since then, the numbers have decreased steadily, falling to around 600 total tax prosecutions in 2004—less than 40 percent of the total number of prosecutions 18 years earlier.[2]

The decline in tax prosecutions coincides with a substantial increase in the number of tax returns filed each year and a significant decrease in the number of audits performed by the IRS—a common precursor to a criminal investigation and/or prosecution. Between 1996 and 2004, the total number of individual and business tax returns rose approximately 10 percent (from approximately 156,750,000 to approximately 175,000,000). The number of audits, however, declined from approximately 969,000 in 1996 to approximately 284,000 in 2004. Combined, these trends mean that the number of audits conducted per 1,000 returns filed dropped from 6.1 in 1996 to 1.6 in 2004.[3]

This decline applies to both individual and corporate returns.[4] In 1996, 16.7 out of every 1,000 individual tax returns filed were audited. This number fell to 7.7 in 2004.[5] In 1996, approximately 21 percent of corporations with assets between $50 million and $100 million had their tax returns audited. This figure rose to approximately 27 percent for corporations with assets between $100 million and $250 million, and approximately 48 percent for corporations with assets greater than $250 million. By 2004, these percentages had dropped to 12 percent, 16 percent and 38 percent, respectively.[6] Moreover, the TRAC Report noted that even when a company is audited, the number of hours devoted to these audits has decreased. Despite the fact that the largest corporations controlled 90 percent of all corporate assets and received 87 percent of all corporate income, the data revealed that, over the last five years, the average number of hours devoted to each audit of these organizations declined by approximately 20 percent.[7]

In part, the decline in enforcement may be explained by a decline in IRS personnel, specifically, audit staff. In 1986, there were more than 26,000 employees assigned to the IRS Office of Examination Staff. By 2000, the last year for which figures are available, the number had decreased to approximately 20,000 employees.[8]

IRS Oversight Board

The decline of enforcement has not gone unnoticed. In response to the concerns put forth during Senate hearings, and later documented by the Webster Commission, Congress passed the IRS Restructuring and Reform Act, which created the IRS Oversight Board (the board). The board is a nine-member independent body charged with overseeing the IRS in its "administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction." The board reviews and approves the IRS's strategic plans and its budget requests, and evaluates IRS efforts to monitor its own performance.

In its 2001 Annual Report, the board noted the significance of IRS enforcement efforts. "The IRS provides service to all taxpayers by ensuring that tax laws are administered fairly for all taxpayers.

Metrics for this objective assess the IRS's ability to ensure all taxpayers are reporting and paying their fair share of taxes and enforcement is equitable across all segments of the taxpayer population, while protecting the rights of individual taxpayers."[9] That same report noted a steady decline in tax enforcement results, finding that although the number of tax returns filed increased by 18 percent between 1988 and 2000, the number of tax returns examined decreased by 60 percent during the same period.[10]

The board's 2004 Annual Report sounded the same alarm. "Since 1996, the number of enforcement personnel at the IRS required to effectively combat tax evasion has shrunk by 36 percent while workload has greatly increased. The effect of this disparity in trends is painfully obvious." Noting that examination rates for individuals were "just starting to rebound," the report found that audit rates for most businesses continued to fall and "[m]ost disturbing of all, the amount of money which taxpayers legitimately owe, but won't pay and which goes uncollected, is a staggering $300 billion."[11]

By 2006, the board believed it was witnessing a turnaround in the area of enforcement, stating that "[a]lthough its current portfolio of activities is insufficient to address in a meaningful way the $290 billion annual net tax gap, it forms a solid foundation upon which to build." In beginning the turnaround, the board noted that the IRS had identified four distinct tax enforcement goals: (1) discourage and deter noncompliance, with emphasis on corrosive activity by corporations and high-income individual taxpayers; (2) assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law; (3) detect and deter domestic and offshore-based tax and financial criminal activity; and (4) discourage and deter noncompliance within tax-exempt organizations. In order to achieve these goals, the board called on Congress and the administration to "re-evaluate the budgetary processes and procedures used for appropriating money for the IRS" in recognition that an increase of the IRS budget produces "a positive return on investment."[12]

Legislative Response

The board is not alone in calling for the Legislative and Executive branches to re-evaluate and increase the IRS budget. Indeed, in 2005, President George W. Bush proposed adding $490 million to the IRS budget, with $300 million devoted to enforcement efforts.[13] While this seemed significant to some, others recognized that a large amount of the proposed increase would be consumed by routine payroll increases. Those critics noted: "What isn't so easy to understand is why the Bush administration and Congress aren't falling all over themselves to give the IRS more money. Tax enforcement pays for itself many times over, and it would seem to be a good way to cut the deficit."[14]

Rather than pursuing increased revenues through enforcement, Congress recently signaled its view that "the tax gap" can be closed by raising the civil and criminal penalties associated with tax offenses. On Feb. 1, 2007, the Senate passed the S.349, the Small Business and Work Opportunity Act of 2007 (the Senate Bill), which proposed increasing the penalty for attempted tax evasion from five years of imprisonment and a $100,000 fine for individuals (and a $500,000 fine for corporations), to 10 years in prison and a $500,000 fine for individuals (and a $1 million fine for corporations). Similarly, the Senate proposed increasing the penalties for willfully making false statements to the IRS from the current penalty of three years in prison to five years in prison, with the fines tracking the increase in the monetary penalties for tax evasion (i.e., rising from $100,000 for individuals and $500,000 for corporations to $500,000 for individuals and $1 million for corporations).[15] Finally, while the willful failure to file a tax return is currently a misdemeanor, subject to one year of imprisonment and a $25,000 fine (or a $100,000 fine for corporations),[16] the Senate Bill proposes to punish the failure to file as a felony where: (1) a taxpayer fails to file tax returns for three or more consecutive tax years and (2) the aggregate tax liability exceeds $100,000. The Senate Bill also proposes doubling all interest and civil penalties applicable to transactions involving certain offshore financial agreements.

In response to the Senate Bill, the American Bar Association Section on Taxation submitted comments arguing that the changes "would tend to discourage rather than encourage voluntary compliance."[17] Rather, the committee noted that because "commonly used charging and sentencing options already provide broad flexibility in enhancing the criminal sanctions for any failure to file that involves egregious conduct," the increased penalties are unnecessary and may actually discourage nonfilers from bringing themselves into compliance. Moreover, because the IRS typically pursues criminal prosecution in tax cases only when there is a pattern of wrongdoing lasting at least three years,[18] the committee argued that most prosecutions involve multiple counts thereby providing sufficient flexibility to impose severe sanctions where warranted.

Although an early version of the House counterpart to the Senate Bill also contained these proposed changes, they eventually were dropped from the version that passed the House on Feb. 16, 2007.[19] Which version will ultimately be adopted remains to be seen.

Making Good Policy?

While increasing penalties is consistent with society's overall fervor in punishing white-collar offenses, it is unclear whether the increase in penalties, without a parallel increase in the likelihood of detection, will in fact serve a deterrent effect. Existing penalties are already severe. Between 2000 and 2006, the average length of incarceration for tax offenders increased each year except one, reaching an average length of 22.5 months in 2006.[20] For most white collar offenders, the thought of spending even two days in prison would serve a substantial deterrent effect. But deterrence also depends on the perceived likelihood of detection.

The Internal Revenue Manual provides that "penalties exist to encourage voluntary compliance."[21] Although penalties also serve to bring additional revenues into the Treasury and indirectly fund enforcement costs, "these results are not reasons for creating or imposing penalties."[22] There is no evidence that the enhanced penalties proposed in the Senate Bill will serve the primary purpose of voluntary compliance. Rather, by focusing on improving enforcement of the current statutory scheme, the government can enhance deterrence and reduce the tax gap.

1. "Senate Panel Hears Stories of Alleged IRS Abuses," AllPolitics at CNN.com (April 28, 1998).
2. Transactional Records Access Clearinghouse, TRAC-IRS, "Total Federal Tax Prosecutions According to U.S. Attorneys, Fiscal Year 1981-2004" (available at http://trac.syr.edu/tracirs/highlights/current/title26fil.html).
3. Id. "IRS Examination of Returns for Business Income and Other Taxpayers" (available at http://trac.syr.edu/tracirs/highlights/current/business.html); "IRS Face-to-Face Audits of Federal Income Tax Returns Filed by Corporations" (available at http://trac.syr.edu/tracirs/highlights/current/corporations.html).
4. As referred to here, "audit" is a broad term that encompasses face-to-face audits and audits by correspondence, whether performed by a revenue agent, tax auditor or other IRS employee.
5. Id. "Audits of Income Tax Returns Filed by Individuals" (available at http://trac.syr.edu/tracirs/highlights/current/individual.html).
6. Id. "IRS Face-to-Face Audits of Federal Income Tax Returns Filed by Corporations" (available at http://trac.syr.edu/tracirs/highlights/current/corporations.html). The data also shows that, although there was an increase in the "coverage" or number of large corporate audits in 2004 and 2005, this number declined to approximately 34 percent in 2006. See TRAC-IRS Report, "Easier Times for Biggest Corporations" (available at http://trac.syr.edu/tracirs/index.html).
7. TRAC-IRS Report, "Easier Times for Biggest Corporations" (available at http://trac.syr.edu/tracirs/index.html).
8. TRAC-IRS, "IRS Office of Examination Staff" (available at http://trac.syr.edu/tracirs/highlights/current/irsaudstaff.html).
9. IRS Oversight Board Annual Report 2001 at p. 11.
10. Id. at p. 18.
11. IRS Oversight Board Annual Report 2004 at p. 1.
12. IRS Oversight Board Annual Report 2006 at pp. 17-21.
13. John W. Snow, Secretary, U.S. Department of the Treasury, "Misleading Statistics on IRS Audits," Washington Post Editorial (April 20, 2004).
14. Albert B. Crenshaw, "Letting Cheaters Prosper," The Washington Post (April 18, 2004).
15. 26 USC §§7201 and 7206
16. 26 USC §7203.
17. The committee's comments are available at: http://www.abanet.org/tax/pubpolicy/2007/iIncreasesincivilandcriminalpenaltiesins349smallbusinessandworkpportunityactof2007house.pdf.
18. See, e.g., *Loftin & Woodard, Inc. v. United States*, 577 F2d 1206, 1239 (5th Cir. 1978) (finding that claim of tax fraud was not supported by two year "pattern" of understatement).
19. Linda Beale, "House Passes H.R. 976," ataxingmatter blog (Feb. 16, 2007).
20. Statistics were taken from the Sentencing Commission's Sourcebooks of Federal Sentencing Statistics from 2000 to 2006, available at http://www.ussc.gov/annrpts.htm.
21. Internal Revenue Manual §20.1.1.2.
22. Id. at §20.1.1.2.1.

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