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TAX LITIGATION ISSUES

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IRS Struggles to Equalize Enforcement Efforts

Our tax system is overwhelmingly dependent on self-reporting. It relies on a healthy mix of taxpayer honesty and fear of the consequences of being caught cheating. Effective and even-handed enforcement of the tax laws is a critical component of this system. Thus, "fair and uniform application" of enforcement mechanisms is one of the Internal Revenue Service's primary strategic goals following passage of IRS Restructuring and Reform Act of 1998 (the "1998 Act"). But the IRS now finds itself battling the charge that it audits a disproportionately high number of low and middle income taxpayers. A recent article in The New York Times[1] details statistical evidence showing that the working poor are more likely to be audited than the wealthy, and highlights many of the obstacles the IRS faces in detecting tax evasion by non wage earners, who tend to be more affluent.

Some of those obstacles were created by Congress, which vilified the IRS in hearings during 1997 and 1998; passed the massive 1998 Act; and decimated the IRS budget leaving the IRS with far less money for audits and criminal enforcement than it had just five years ago. Last year, only about 500 out of a quarter of a billion taxpayers were prosecuted for tax crimes on legally earned income[2] — hardly a major disincentive for lucrative tax evasion. Other obstacles to auditing the wealthy stem from the fact that their tax returns tend to be more complex than those of more modest means and that cheating by wage earners is far easier to detect because the IRS computer system is able to match income reported by wage earners with W-2 information provided to the IRS by employers. Despite these limitations, the IRS is taking steps to enhance its enforcement efforts against higher earners. It is launching a program to match partnership K-1 forms with income reported on partners' individual tax returns. It has also vigorously pursued promoters of tax scams and return preparers in an effort to cut off the source of various tax evasion schemes and has undertaken more coordinated and sophisticated publicity of those enforcement efforts to enhance their deterrent effect.

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Congressional Role

Allocation of the IRS' enforcement resources is a function of both administrative and legislative priorities. Following congressional hearings into abuses by the Criminal Investigation Division and the recommendations of the commission headed by former director of the CIA and FBI, William Webster, during 1998 and 1999, the IRS underwent a major reorganization, aimed at fostering a fairer, more customer friendly IRS. Laboring under reduced audit staffing, new statutory requirements imposed on auditors, and the need to divert auditors to customer service functions, the IRS has conducted far fewer audits since passage of the 1998 Act. At the same time, technological advances have permitted the IRS to verify much of the information reported by lower-income taxpayers through computerized comparison of reported income with information provided to the IRS by third parties. The result is that while fewer high-income taxpayers are audited, lower-income taxpayers are subject to much more thorough scrutiny. In its rush to disarm the IRS, Congress has thus curtailed use of the tools that are most effective in uncovering abuses by wealthier taxpayers, leaving the IRS to rely more heavily on less costly techniques more suited to ferreting out cheating by wage-earners and lower income taxpayers.

Moreover, even as it has passed legislation which effectively causes the IRS to focus more on lower income taxpayers, Congress has separately appropriated funds for detecting fraud in the Earned Income Tax Credit program, singling out the working poor for special scrutiny. But even though Congress has made the IRS's job more difficult, its allocation of scarce auditing resources is hard to explain, and appears skewed against taxpayers of modest means.

Audit Data

During the fiscal year ended Sept. 30, 2001, the IRS collected approximately $2 trillion in

tax revenues.[3] It estimates that approximately 98 percent of its tax collections result from voluntary compliance with the tax laws and that 2 percent result from what it terms "direct" enforcement actions, such as additional assessments after audit or levying the assets of a delinquent taxpayer.[4] Collection activities produce not only a direct benefit, in terms of additional revenues, but serve an important deterrent function as well, with voluntary compliance increasing along with direct enforcement efforts.[5]

The IRS conducted examinations of 730,000 individual tax returns last year, or 0.58 percent of the more than 127 million individual income tax returns filed last year. While the audit rate for individual returns in 2001 was slightly higher than in the previous year (0.49 percent), it was significantly lower than in all other years since 1997, when the overall audit rate was 1.28 percent. The chances of being audited are not evenly distributed among all taxpayers, and, in fact, bear an inverse relationship to the amounts that the IRS can expect to collect as a result of those examinations. Of the more than 55 million taxpayers with total positive income of less than $25,000 filing nonbusiness returns in 2001, 413,000 were audited. By comparison, the remaining 63 million taxpayers with income over $25,000 were subject to fewer than 185,000 audits. The IRS thus conducted more than twice as many audits of taxpayers in the lowest bracket as it did of those in the remaining three. Taxpayers filing non-business returns with a "total positive income" of $25,000 or less had a three-fold greater chance of being audited than did taxpayers in the $25,000-$100,000 range, and were also more likely to be audited than were taxpayers with income of over $100,000.[6] Those claiming the Earned Income Tax Credit, available only to the working poor, stood a one in 47 chance of being audited, while the odds of being audited for those in the highest income bracket was only 1 in 145.[7] Similarly, taxpayers filing business returns reporting receipts of $25,000 or less were more than twice as likely as taxpayers filing business returns in any other bracket to have their returns audited.

One explanation for the higher audit rates for low income taxpayers seems to be that such audits are easier and can be done faster, which would mean that audit resources devoted to the working poor are not that much greater than those devoted to wealthier taxpayers. But, these audit rates cannot be explained by their yield to the IRS in additional collections. Audits of those reporting income or receipts of under $25,000 resulted in average additional recommended taxes of $3,000 per audit for nonbusiness filers and even less for those filing business returns. Additional taxes after audit averaged lower for only one group — nonbusiness filers reporting $25,000-$50,000 of income, for whom additions were approximately $2,600. For every other category of individual taxpayer, the average additional recommended taxes after audit ranged from $3,600 to $16,700. Thus, those subjected to the highest audit rates were both the lowest earners and the least profitable audit targets.

Document Matching

Lower income taxpayers are subject to even greater relative scrutiny than is indicated by these figures . This is because the IRS audit statistics do not reflect the document matching system used by the IRS to compare information reported on tax returns with that provided to the IRS by third parties, such as employers and banks. The IRS currently uses this third-party information to verify wage, interest and dividend payments reported on individual income tax returns. The impact of this computerized verification process again falls disproportionately on low and middle income taxpayers most of whom are wage earners whose employers provide third-party income verification to the IRS. Ninety percent of the income of taxpayers with income under $100,000 can be verified through document matching, whereas only 65 percent of the income for taxpayers reporting income over $100,000 can be verified in this manner. Moreover, itemized deductions, used predominantly by higher income taxpayers, are not susceptible to verification through document matching in most instances, and thus document matching will not result in detection of false deductions taken by such taxpayers. IRS Commissioner Charles O. Rossotti has recognized that "[t]o the extent that the IRS uses more and more document matching and less and less auditing, the effect may be perceived as, and will in fact be unfair because higher income taxpayers will not have their returns verified to the same degree as middle income taxpayers."[8]

Partnership Income

While the document-matching program is quite effective at identifying discrepancies in wage or interest and dividend reporting, the IRS recognizes that those are the types of income that are least likely to be inaccurately reported.[9] It has thus set its sights on income distributed to taxpayers from pass-through entities such as partnerships, trusts and S-Corporations. By the IRS's own estimates, as much as 20 percent of partnership income goes unreported,[10] with studies showing reporting inaccuracies in 15 percent of the returns reviewed.[11] Total losses from unreported partnership income are in the tens of billions of dollars annually.[12]

In an effort to capture some of this unreported income from pass-through entities, starting this year, the IRS will begin to match income reported on K-1 forms issued by partnerships with amounts reported on individual returns. However, as The New York Times article points out, the scope of the planned K-1 review is quite limited. Not only does the program not apply to trusts or S-Corporations, but only a fraction of returns reporting partnership income will be examined, and only those K-1's reporting income will be included in the review, leaving those reporting losses to the concededly imperfect honor system. In addition, it appears that the IRS does not have funding to support the investigation of those cases in which discrepancies are found.[13] Furthermore, the K-1 review contemplated by the IRS will only detect cheating or errors at the individual return level and provides no assurance that the business entities themselves, often closely controlled by the taxpayers, have accurately reported their income and expenses. The only way to verify the information reported on a K-1 is through a costly audit of the business entity, which is increasingly unlikely as IRS audit resources are already stretched thin.

Enforcement Strategies

The budgetary and statutory ax has fallen most heavily on the Criminal Investigation Division, as demonstrated by the steady decline in the number of criminal investigations initiated and referrals for prosecution over the past

five years. In 1997, 5,300 investigations were initiated and 3,800 cases were referred for prosecution. For 2001, those numbers fell to 3,300 investigations initiated and 2,300 prosecution referrals. And of those 2001 prosecution referrals, most were for money-laundering or narcotics-related financial crimes, with fewer than a quarter for legal source tax offenses.

One of the systemic problems identified by the Webster Commission was the Criminal Investigation Division's "mission drift" away from tax enforcement toward drug trafficking and money-laundering task forces. In response, the IRS has implemented organizational changes designed to enhance its investigation of "legal source" tax crimes. As part of its five-year Strategic Plan, the IRS has recently established Lead Development Centers, which are intended to obtain greater consistency with the IRS' overall compliance strategy. These centers are designed to develop and process leads from each of the operating divisions and to interface with the Criminal Investigation field offices, various task forces and the Financial Crimes Enforcement Network.[14] In connection with its reorganization, the IRS has assigned fraud specialists to work with each of its operating divisions to assist revenue agents in the field with identifying cases that are appropriate for referral for criminal investigation.

The IRS has also aimed its limited enforcement resources at specific categories of tax offenses. In recent testimony before the Senate Finance Committee, Commissioner Rossotti explained that "[i]dentifying and combating actively promoted tax schemes is [the IRS's] highest compliance priority," because of the substantial sums involved and because the confidence of the average taxpayer in the tax system is undermined when "more wealthy or unscrupulous taxpayers are allowed to get away with not paying."[15] Among the schemes with which the IRS is most concerned are foreign and domestic abusive trusts[16] employment tax fraud and, as discussed above, fraud in connection with the Earned Income Tax Credit. It has focused its enforcement efforts on promoters of these schemes and those who prepare large numbers of fraudulent returns, pursuing criminal charges against the individual taxpayers only when there is evidence of willful, as opposed to unwitting involvement with the fraudulent activity.

In connection with these targeted enforcement efforts, the IRS has sought to obtain records relating to off-shore credit cards. While such credit cards are not illegal, the IRS has identified them as a major tool of tax evaders, providing ready access to money hidden from tax authorities in off-shore accounts. It estimates that there are as many as two million taxpayers with such accounts, only a small fraction of which are reported. Because many of these accounts are held in countries with bank secrecy laws, they have, until now, escaped detection. But recently the IRS has successfully obtained John Doe summonses against three of the largest credit card companies — Visa, Mastercard and American Express — requiring them to provide identifying information for card users issued by banks in as many as 20 countries identified as tax havens.[17] While the IRS has overcome a substantial hurdle by simply obtaining access to these records, it remains to be seen whether it will devote the resources to developing the deluge of tax evasion cases these records are expected to yield.[18]

"Identifying and combating actively promoted tax schemes is [the IRS'] highest compliance priority."

Facing a shrinking budget, and substantial reductions in criminal referrals, the Criminal Investigation Division has launched a concerted campaign to publicize those cases it does bring, in order to maximize their deterrent effect. Mark Matthews, chief of the Criminal Investigation Division, has called the IRS' deterrence mission the largest in all of federal law enforcement, stressing that the need to publicize tax prosecutions as broadly as possible is essential not just to deter potential cheaters, but also to "assure the vast majority [of taxpayers] who are honest that the IRS is investigating those who intentionally evade their obligations."[19] To that end, CID has made extensive use of the Internet, posting on its Web site detailed summaries of significant cases. It has also created various Web pages focusing on specific areas of concern, intended both to educate the public, deter specific illegal activity and provide background for reporters to enhance media coverage of its criminal cases.[20] It is thus particularly ironic that just as the IRS is directing substantial efforts toward enhancing publicity for its deterrent effect, the greatest publicity it has received reveals that wealthy taxpayers are less likely than the average taxpayer to come under IRS scrutiny.

(1) David Cay Johnson, "Affluent Avoid Scrutiny on Taxes Even as I.R.S. Warns of Cheating," N.Y. Times, April 7, 2002.

(2) See Internal Revenue Service Strategic Plan, 2000-2005, Publication 3744, p. 57; Internal Revenue Service Data Book 2001, Publication 55B, Table

(3) Data Book 2001, Foreword.

(4) Strategic Plan, p. 30.

(5) Id.

(6) IRS Data Book 2001, Table 10. The audit data contains two sets of statistics for taxpayers with TPI under $25,000: One set for those who filed forms 1040A, and a separate for those filing other returns.

(7) "Affluent Avoid Scrutiny," N.Y. Times, April 7, 2002.

(8) Letter from Charles O. Rossotti, Commissioner, Internal Revenue Service to Senator Charles E. Grassley, Chairman, Committee on Finance, March 26, 2001.

(9) Strategic Plan, p. 29.

(10) "Affluent Avoid Scrutiny" N.Y. Times, April 7, 2002.

(11) Strategic Plan, p. 53.

(12) "Affluent Avoid Scrutiny" N.Y. Times, April 7, 2002.

(13) Id.

(14) See Mark Matthews, "What has Changed for IRS Criminal Investigation and our Relationship with the Department of Justice," United States Attorneys' Bulletin, March 2001.

(15) Testimony of Charles O. Rossotti before the Senate Finance Committee, April 11, 2002.

(16) See our previous article, "IRS Attacks Abusive Tax Shelters," N.Y.L.J. (9/20/01).

(17) In re John Does, No. CV. 02-0046 Misc. (N.D. Cal. 3/27/02). In connection with an earlier John Doe summons issued in the Southern District of Florida, Mastercard has already turned over more than 1.7 million records to the IRS relating to people who may have tax liabilities in the United States and who hold credit cards in certain tax havens and American Express has agreed to do the same.

(18) See Dan Ackman, "The IRS Two-Million-Man March," Forbes.com, 3/26/02.

(19) Mark Matthews, "New IRS Publicity Strategy," United States Attorneys' Bulletin, July 2001, Vol 49, No. 4.

(20) See, Presentation by Mark Matthews, Chief, Criminal Investigation Division to National Ass'n of Enrolled Agents Educational Foundation, National Tax Education Institute, July 11, 2001, reprinted in CCH, Tax Practice & Procedure, October-November 2001.

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