

Law and Order: Tax Squad

By David Cay Johnston



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David Cay Johnston received the Pulitzer Prize for his coverage of tax policy while at *The New York Times*. He now teaches at Syracuse University College of Law and is the author of three books about taxes — *Free Lunch*, *Perfectly Legal*, and *The Fine Print*.

Johnston discusses why it is a bad idea to cut dollars from tax enforcement, and he is skeptical that declining numbers of criminal tax prosecutions are the result of increased voluntary compliance.

With the automatic spending cuts from sequestration looming on March 1, Washington is suddenly alive with proposals to quickly cut spending and eliminate some middle-income deductions to avoid the supposedly politically unacceptable idea of raising any more tax rates.

But there is an alternative to cutting spending, raising rates, or taking away deductions — an option that would reduce the amount of red ink. Let's support law enforcement.

My alternative should enjoy strong support in both parties, but especially among Republicans, who even more than Democrats like to tell voters how much they support law enforcement.

My proposal is to significantly increase tax law enforcement. In looking over a pile of IRS data going back to 1992 to see how vigorously our tax laws are being enforced, either of two conclusions struck me as reasonable just based on the numbers.

One conclusion would be that individuals and corporations are more law-abiding now than they were two decades ago. Criminal tax prosecutions in fiscal 2012 were down 44 percent from 1992, according to Justice Department data posted by the Transactional Records Access Clearinghouse. If you control for population growth, the drop in prosecutions is 54 percent. On the corporate side, additional taxes and penalties recommended after audit are down 11 percent in real terms over the same 21 years.

Generally, whatever the enforcement numbers were then, they are smaller now.

A logical inference would be that voluntary compliance is on the rise and that respect for the tax laws is increasing at the same time that chiseling and cheating are withering.

Maybe the data even tell us that the federal government's theory of white-collar law enforcement, known as general deterrence, works. Unlike the local cops, who use specific deterrence to catch every killer, rapist, and burglar they can, the federal government prosecutes a very few in the belief that news of these prosecutions will deter the many. Just maybe, the few, but highly publicized, prosecutions of big turn-of-the-century tax shelter cases were so successful that a lot of would-be tax cheats were scared straight.

Of course, there is an alternate conclusion. It could be that we are enforcing the tax law with less vigor, expecting the tax police to do more and more with less until they have no choice but to let more tax cheating go undetected, uncorrected, and, in the most egregious cases, unprosecuted.

It could be that there is not enough tax law enforcement taking place to deter cheats. Consider the odds of this: Out of an average of a quarter-million or so individual returns reporting million-dollar-plus incomes in recent years, the IRS selects 18 annually for intense global high-net-worth audits. If you are inclined to play the audit lottery, those are very good odds — much less than 1 in 10,000.

After interviewing a few people inside the IRS and reading the national taxpayer advocate's latest report, my money is on the alternative explanation. It's not that companies and people are being more honest with their tax returns; it's that the tax cops simply lack enough people to do the job.

One IRS veteran told me of units that have lost close to half their members, prompting talk by low-level bosses about completely stopping audits of some industries (which I won't identify, for now).

Another complained about being detailed off enforcement to deal with unresolved taxpayer problems. That is part of a vicious circle. Too few IRS auditors, revenue agents, and even clerks to do the work means ever more complaints to the taxpayer advocate, whose inquiries get a high priority in house.

So why aren't President Obama and congressional leaders talking about more law enforcement?

Table 1. Fewer Prosecutions, More Prison Sentences

The number of federal tax crime prosecutions has fallen, and the rate per population has fallen even more, but for those convicted the risk of going to jail has risen significantly.

Year	Prosecutions	Rate Per 100,000 Americans	Share of Prosecutions Ending With Prison Time
1992	2,742	1.07	36%
1993	2,769	1.06	39%
1994	2,456	0.93	39%
1995	2,319	0.87	41%
1996	2,127	0.79	38%
1997	2,332	0.86	38%
1998	1,842	0.67	53%
1999	1,728	0.62	45%
2000	1,418	0.50	55%
2001	1,259	0.44	56%
2002	1,179	0.41	54%
2003	1,230	0.42	53%
2004	1,336	0.46	50%
2005	1,404	0.47	52%
2006	1,377	0.46	54%
2007	1,270	0.42	58%
2008	1,368	0.45	56%
2009	1,280	0.42	61%
2010	1,430	0.46	58%
2011	1,583	0.51	53%
2012	1,539	0.49	57%
Change	-1,203	0.58	21 percentage points
Percentage change	-44%	54%	58%

Source: Transactional Records Access Clearinghouse.

It is not like there is no damage caused by people and companies that pay less than Congress says they must.

“Tax dodging is not a victimless offense,” said Dan Smith, the tax and budget advocate for U.S. PIRG Education Fund. “When corporations skirt taxes, the public is stuck with the tab.”

Small business people like Josh Knauer, president and CEO of Rhiza Labs, a Pittsburgh software company, are fed up with news that their biggest competitors use offshore havens to escape taxes while they pay the full 35 percent rate, or close to it, each year. “In today’s polarized political debate, too many politicians speak of taxes as a cost that businesses should seek to avoid, or worse, as a cost that strangles and threatens the very future of free enterprise,” Knauer wrote last year, noting that his business was made possible by taxpayer investments in education, mathematics, and infrastructure. “My business and businesses generally have gotten a very good return on our tax dollars,” Knauer wrote.

Spending more on tax law enforcement not only would stop rewarding the cheats at the expense of the honest, it is also exceptionally lucrative. National Taxpayer Advocate Nina Olson likes to point

out that an extra dollar spent on tax law enforcement will yield at least \$7.

Think about that when you hear politicians say government should be run like a business. Can you imagine any business that would refuse to spend a dollar that would bring in \$7, for a net profit of \$6? I’d borrow money to buy stock in that business — and so would you.

Economic theory says that just as long as on-the-margin net gains remain positive, extra dollars should be spent this way. Even if a buck for tax law enforcement brings in only \$2 of additional revenue, it would still be a very good deal for taxpayers overall.

And, of course, vigorous enforcement should result in better compliance, which reduces taxpayer costs to administer the law. Talk about a virtuous circle.

But how to get there in a country where the vilest three letters in politics are *tax*?

Let’s change the debate. Let’s start asking our politicians why they are not supporting tax law enforcement (and, closely related, securities law enforcement). Let’s ask why they undermine law enforcement by not funding it adequately. And to

Table 2. Corporate Audits Plummet

The number of corporate tax audits has fallen sharply since 1992 and the amount of additional tax and penalties recommended has also gone down, but on a per-audit basis the examinations look more productive.

Fiscal Year	Number of Audits	Additional Tax and Penalties After Audit	Average Per Audit
1992	75,240	\$28,413,173,163	\$377,633
1993	75,782	\$22,718,688,119	\$299,790
1994	53,147	\$21,841,893,460	\$410,971
1995	49,081	\$25,655,098,748	\$522,709
1996	57,562	\$25,454,353,333	\$442,207
1997	67,650	\$22,277,157,737	\$329,300
1998	52,113	\$18,727,452,414	\$359,362
1999	37,710	\$17,194,134,044	\$455,956
2000	26,510	\$12,728,927,354	\$480,155
2001	21,629	\$17,802,155,070	\$823,068
2002	20,911	\$18,285,537,586	\$874,445
2003	17,271	\$16,475,708,781	\$953,952
2004	15,286	\$19,807,304,725	\$1,295,780
2005	24,293	\$36,937,802,413	\$1,520,512
2006	23,966	\$30,613,427,755	\$1,277,369
2007	27,613	\$27,752,585,344	\$1,005,055
2008	28,062	\$27,242,601,620	\$970,800
2009	27,054	\$31,866,076,059	\$1,177,869
2010	28,192	\$26,619,786,189	\$944,231
2011	29,529	\$25,351,020,670	\$858,512
Change	-45,711	-\$3,062,152,493	\$480,879
Percentage change	-61%	-11%	127%

Source: Transactional Records Access Clearinghouse.

any who retreats into antitax dogma, let's bluntly ask if they are with the honest taxpayers or the crooks.

It is said that the worst thing that can happen to a politician is to be caught in bed with a dead girl or a live boy. Let's change that to taking a donation, or a private jet ride, from a tax scalawag.

Congressional Republicans want to cut the federal workforce by 10 percent, including the IRS, by hiring only one person for every three who leave. Cutting people who bring in money is, well, an amazing budget stance for anyone who purports to represent the party of business and prudent government.

Let's demand studies of who benefits from lax tax law enforcement — studies that can be done by the Congressional Budget Office, the Congressional Research Service, the Joint Committee on Taxation, and the investigative arm of Congress, the Government Accountability Office. And let's support law enforcement by making it easy to get subpoenas for these studies as well as access to actual tax return data.

Let's also stop telling companies in advance what will be examined during audits and setting deadlines too close to the audit. Pet shop owners have surprise inspections. Why shouldn't companies?

And here's one more idea to build popular support for tax law enforcement while ending the subtle aiding and abetting of tax cheating that our politicians in both parties now foster: Let's enact a rule that any individual or company that is subjected to a field audit, but is found to owe nothing or is due money back, gets a check for up to the amount of taxes they paid that year or \$10,000, whichever is less. That should encourage the IRS to select audit targets with greater care. We know that between one-fifth and one-third of individuals and entities audited get a no-change result or a refund.

Now, with that in place, maybe we can stop the aiding and abetting of those who cheat and chisel. As Olson says, we need to stop making honest taxpayers feel like chumps.