

Statement of

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Before the

United States
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Impact of Sentencing Guidelines
On Tax Compliance

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UNITED STATES SENTENCING COMMISSION
TESTIMONY OF
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Mr. Chairman and Members of the Commission, I am Michael P. Dolan, Acting Commissioner of the Internal Revenue Service. With me today is Acting IRS Chief Counsel David Jordan and Associate Chief Counsel (Enforcement Litigation), Patrick J. Dowling.

Before presenting my testimony today, I want to express my appreciation to the United States Sentencing Commission for the opportunity to appear at this hearing to discuss a major issue of concern to the Internal Revenue Service - the November 1992 amendments to the Sentencing Guidelines will adversely affect tax administration.

The Internal Revenue Service views this as an extremely vital issue as we address serious compliance problems that challenge the health of our voluntary tax system. The seriousness of the compliance problems facing the tax system and the impact that the 1992 amendments would have on

our compliance efforts resulted in correspondence to Senators Biden and Thurmond, the Chairman and Ranking Minority Member, of the Judiciary Committee. Our concerns were upheld by Senators Biden and Thurmond in letters to Judge Wilkins on September 18, 1992.

Our mission is, and will continue to be, to foster voluntary compliance. Yet, as we looked at events that were occurring in the tax system, we realized that change is needed in order to preserve the fairness and effectiveness of our voluntary assessment system.

The Sentencing Commission has historically supported the Service in addressing these concerns. In 1987, when the original Sentencing Guidelines were promulgated, the Commission noted in the Background Commentary to Section 2T1.1 the tax compliance need for increasing the number of prison sentences in criminal tax cases and highlighted this need by pointing out that "[c]urrent estimates are that income taxes are underpaid by approximately \$90 billion annually." Today, the underpayment of income taxes is estimated to range from \$110 billion to \$127 billion. The largest part of this income tax gap, and the most troublesome part in terms of our ability to collect it, is the reporting gap--the amount of tax liability not

voluntarily reported on returns. This accounts for \$113.7 billion or 89.5 percent of the \$127 billion estimate.

A tax gap also exists in areas besides income tax -- the Treasury is being denied billions of dollars in uncollected excise taxes, payroll taxes and estate and gift taxes.

Coupled with the growing tax gap is the fact that our enforcement activities have not kept pace with the growth in the number of returns filed and the increase in the complexity of those returns. In today's world, there are too many returns, too many complex laws and too few enforcement resources to permit us to continue "business as usual."

In an effort to respond to these problems, the Service spent a number of years formulating a new approach to tax administration. The Service has begun to implement its new approach which we call "Compliance 2000".

Compliance 2000 recognizes that a good part of what we call noncompliance with the tax laws is caused by taxpayers' lack of understanding of what is required in the first place. For these taxpayers, it makes good business sense to increase our efforts to help them comply

through outreach, education and burden reduction rather than using enforcement means. An example of this is our nationwide effort encouraging nonfilers to contact the IRS and receive assistance in returning to the taxpaying rolls.

Compliance 2000 also recognizes that, despite our most aggressive assistance and outreach efforts, some segments of the population will not voluntarily respond. In those cases, we will direct our enforcement resources and employ our traditional enforcement arsenal -- the examination of returns, the imposition of civil penalties, the filing of suits seeking injunctions, the collection of delinquent taxes using liens and levies and in particularly egregious cases, criminal investigations and prosecutions -- to obtain compliance. The success of our Compliance 2000 efforts will depend, in part, on the effectiveness of our tax enforcement efforts. By effectively identifying and dealing with intentional noncompliance we will be sending a message to every American -- that there are serious consequences to failing to voluntarily comply with the tax laws.

For example, one of the most serious challenges to voluntary compliance today are those taxpayers who do not file returns. To assure the continued well-being of the tax system, it is imperative that we bring the six

to nine million nonfilers into the system and keep them in the system. As part of Compliance 2000, we are educating nonfilers on the need to contact IRS and receive assistance in returning to the taxpaying rolls. But educating and assisting nonfilers is not enough. We expect to rely heavily on our tax enforcement efforts to bring in the nonfilers who will not return to the system voluntarily. In chronic and particularly flagrant cases we will need to resort to criminal prosecution, and in these cases the Sentencing Guidelines will have a significant impact on our ability to succeed in returning nonfilers to the system. Sadly, after the 1992 amendments, the Guidelines may actually impede our efforts.

Several statistics illustrate the focused role that criminal prosecutions and, more specifically, the Guidelines play in the overall tax enforcement effort. Last year, we processed 204 million returns; assisted more than 74 million taxpayers; and examined 1.3 million tax returns. Our Criminal Investigation function initiated roughly 5,500 investigations and in concert with the Justice Department obtained tax-related convictions in 2,651 cases, representing one conviction for every 76,900 returns filed and less than 4 criminal investigations for every 1,000 returns examined.

Criminal tax enforcement has always been small in comparison to our civil enforcement; but it is an important part of the our overall tax compliance efforts. Criminal investigation and prosecution are reserved for only the most serious tax violations we uncover. We define the seriousness of a tax offense not simply in terms of the amount of taxes lost in a particular case, but rather in terms of the nature of the offense and the threat it poses to the integrity of the Federal tax system.

Those 2,651 criminal convictions are selected and brought to send a dual message. To the vast majority of Americans who voluntarily comply with the tax laws and pay their fair share, the message is one of fairness and equality -- that their Government will ensure that those who intentionally do not comply with the tax laws will be brought to Justice. To those who have committed tax crimes or who are contemplating doing so, the message is one of warning -- there will be severe consequences for their actions. To ensure that this message strikes home to virtually every individual and business in the country, our Criminal Investigation Program takes great care in ensuring that their investigations cover a wide spectrum of occupations, businesses, income brackets, regions of the country and types of violations.

What message is conveyed to taxpayers -- when, after we take care selecting a case and expending scarce enforcement resources, the violation is deemed minor enough to warrant a virtual certainty of probation for the offender? What does this tell honest taxpayers about the government's commitment to maintain the integrity of the tax system? What does it tell potential violators about whether it is worth risking prosecution to violate the revenue laws? The message conveyed can hardly be clear enough to serve a deterrent purpose.

Given their limited number, our criminal cases ought generally to hold out a high likelihood of incarceration, if only for a short period of time, in order to vindicate the honesty of most taxpayers and deter potential tax offenders. This Commission, indeed, once recognized as much, stating that "[u]nder pre-guidelines sentencing practice, courts sentenced to probation an inappropriately high percentage of offenders guilty of certain economic crimes, such as...tax evasion, that in the Commission's view are 'serious'". Yet, by contrast, the revised Sentencing Guidelines virtually eliminate the prospect of jail time for all but offenses involving the largest amounts of unreported tax.

As you know, under these guidelines, the recommended prison term is tied to the amount of the tax loss, i.e., the amount of tax that was intended to be evaded. Under the Sentencing Table amendments to the Guidelines which took effect in November 1992, the maximum amount of tax loss that could, with an acceptance of responsibility, result in a sentence of straight probation in an evasion case was increased from \$10,000 to \$40,000. This makes it unlikely that taxpayers with up to \$142,000 in unreported income will be incarcerated under the guidelines for tax evasion. But fewer than 8 percent of all individual taxpayers receive that much income in one year (and only 20 percent receive that much in three years), much less evade reporting it.

The result is even worse in a failure to file case. In failure to file prosecutions, the maximum tax loss that could, with an acceptance of responsibility, result in a sentence of probation was increased from \$20,000 to \$70,000. As a result, taxpayers who willfully fail to file tax returns and receive up to \$250,000 in income over a three-year period are unlikely under the guidelines to be incarcerated for their crimes. But only 6% of all taxpayers earn that much in three years and far fewer are able to earn that much in a single year. In sum, only a very small percentage of all taxpayers

who commit tax crimes face a certainty of some incarceration under the current guidelines -- no matter how short the period of confinement.

Another of many examples of challenges to the tax system involves the Service's electronic filing program, which has increasingly been the target of false filings and fraudulent claims for refund involving use of the earned income credit. These cases normally fall in the \$2,000 to \$3,000 range and, although considered small when measured under the "tax loss" standard of the guidelines, they are difficult to investigate and must often preempt other investigative work, because they involve direct losses to the Treasury.

The electronic filing program reduces the burden of filing for millions of taxpayers; helps honest taxpayers get their refunds promptly; and saves the Service the costs of storing and handling paper returns. But in spite of its value to the government and the taxpaying public, perpetrators of these crimes need only glance at the sentencing guidelines to know that if they commit an electronic filing offense and are caught, they will draw sentences in the 0 to 6 month range and are unlikely to face any period of confinement. For them, the risks may not outweigh the possible rewards of flagrant crime. Likewise, the investigators charged with protecting the

system are aware that when they select one of these cases for investigation their efforts are likely to do little more than publicize the low sentences produced by the Guidelines and that pursuing such investigation may actually have the unintended result of encouraging similar violations.

Nonfiling and electronic filing fraud are not isolated problems. We are faced with similar enforcement challenges involving employment and withholding taxes, fraudulent nonpayment of assessed taxes, and excise tax related violations, to name a few. Although many of these crimes may involve small tax losses, the tax system cannot withstand widespread abuses of this kind.

Our criminal investigation program plays an important role in Compliance 2000, our comprehensive strategy for reducing the tax gap and improving voluntary compliance over the long-run. We have spent a great deal of time structuring our criminal program to send a message to the American public that the tax system is fair and that tax crimes will not be tolerated. The current Guidelines send a very different message -- that tax crimes are not serious. This message is sent by a sentencing system which holds out the possibility of a purely probationary sentence, rather than certain incarceration, for almost all tax violators.

Deterrence has been and remains the primary reason we commence criminal tax investigations. The high likelihood of obtaining probationary sentences may actually deter criminal investigations and prosecutions and create a class of significant tax violations where the threat of criminal investigation and prosecution is practically nonexistent. As a result, a purely statistical analysis of historical sentencing patterns will not show the impact of predictably low sentences on the behavior of the broad range of potential tax violators whose crimes are likely to be sentenced in the 0 to 6 month range and who may, therefore, never be investigated or prosecuted.

We are cognizant that last year's change in the Sentencing Table was not prompted by a need to produce lower sentences for tax offenses but was actually motivated by concerns wholly apart from the sentencing of these cases. There was, in fact, no evidence prior to the 1992 amendments that guideline ranges in tax cases were too severe or otherwise in need of downward modification. But last year's Sentencing Table modifications, together with the contemporaneous implementation of Compliance 2000, prompted us to consider how the sentencing of tax crimes ought ideally to fit within our compliance efforts. As a result, rather than simply seek to recoup the two sentencing levels lost as a result of last year's amendment,

we proposed Amendment 41, which was published along with the Proposed Guideline Amendments for public comment.

Amendment 41 is designed to facilitate the primary goal of Compliance 2000 - to enhance voluntary compliance with the tax laws. It provides for certain confinement (without regard to possible adjustments and departures) of most tax violators whose crimes produce tax losses exceeding \$10,000. But the key feature of the proposal is the affirmative use of acceptance of responsibility to encourage those who generate tax losses of \$10,000 or less to reenter the tax system as a precondition to a sentence of probation.

For most tax offenses, Amendment 41 established a base offense level of 10, which applies to offenses generating a tax loss of \$10,000 or less. A violator at this level who receives a 2 level downward adjustment for acceptance of responsibility will fall into level 8 and be sentenced in the 0 to 6 month range. Thus, eligibility for straight probation would be contingent on the offender's willingness to accept responsibility. In tax cases, we contemplate that the courts would grant the downward adjustment for acceptance of responsibility both before and after a trial only when the offender acknowledges the violation and takes steps to reenter the tax system by filing correct amended returns and attempting to pay back taxes

or by disclosing all pertinent tax information to the Service and providing truthful financial information sufficient to establish the existence of a current inability to pay the taxes.

We recognize that this is a novel approach which differs from that used in sentencing under the Fraud and Theft Tables. But, tax fraud is different from other forms of fraud and theft directed against the Government. Virtually every individual, family, business, and organization in the United States and many foreigners come in contact with the internal revenue laws in one form or another. Consequently, every taxpayer, every year has the opportunity to either voluntarily comply with the law or to cheat the Government out of tax revenues. Deterrence is , therefore, crucial in tax cases, and when incarceration is inappropriate, it is essential that the sentencing system at least encourage the tax offender's honest reentry into the system.

We recognize that proposed Amendment 5 is also under consideration by the Commission and recognize that its adoption would alleviate most of the damage caused by last year's change in the Sentencing Table. It provides for an incarceration rate roughly in the range of Amendment 41 and is, in fact preferable to 41 in at least one respect, because it provides for

higher sentences in the very high tax loss ranges. Although we agree that this change should be made, we favor the concept behind Amendment 41, because it would eliminate the possibility that a tax offender could be sentenced to probation for committing the more serious tax crimes without having accepted responsibility or otherwise made an honest attempt to return to the tax paying rolls. By contrast, Amendment 5 admits to the possibility that some tax evaders -- potentially a very large class of them -- could, and in all likelihood would, be sentenced to probation without imposing upon them the need to make an effort to return to the tax system.

In addition, Amendment 5 eliminates the 2 level upward adjustment for sophisticated means. We do not favor this change, because it would eliminate the ability to distinguish defendants whose crimes are highly sophisticated or who go to greater lengths to conceal their wrongdoing. On balance, although we like some aspects of Amendment 5, we prefer Amendment 41 because it more closely supports the compliance philosophy behind Compliance 2000.

Members of my staff and the Office of Chief Counsel have had a number of promising discussions with the Commission's Staff concerning these issues, and I want to thank the Commission for the many courtesies

that have been extended to us. It is my sincere hope that our collective efforts can achieve sentencing guidelines for tax cases that reflect the breadth of the Service's investigative responsibility; the importance of deterring tax crimes; and the potential for using criminal sentencing to return tax offenders to the taxpaying rolls. Only through successful achievement of these goals will the health and well-being of our voluntary tax system be preserved.

Mr. Chairman, this concludes my testimony. I, or members of my staff, would be pleased to answer any questions you, or members of the Commission, may have at this time. Again, thank you for the opportunity to address the Commission this morning.