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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON OVERSIGHT *HSE04102*
HOUSE COMMITTEE ON WAYS AND MEANS
ON THE EFFORTS OF IRS' CRIMINAL *AGC0000K*
INVESTIGATION DIVISION TO DETECT *DLG, 63016*
AND DETER UNDERREPORTERS]

Mr. Chairman and Members of the Subcommittee:

Our testimony today deals with what IRS' Criminal Investigation Division needs to do to enhance its ability to detect and deter those persons who underreport their income for tax purposes--a serious national problem. In its August 31, 1979 report on unreported income, IRS estimated that, during tax year 1976, at least \$135 billion in income went unreported and that, as a result, some \$26 billion in potential tax revenues to the Government went uncollected. Those are staggering estimates, yet they probably are understated.

IRS' study focused only on individual taxpayers and certain types of illegal income. Had IRS sought to estimate

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unreported income derived from other sources, both legal and illegal, its overall estimate of the tax gap would have increased substantially. For example, IRS' estimate of \$75 to \$100 billion in unreported income from legal sources did not include that derived by corporations and other businesses.

Similarly, IRS' admittedly "soft" estimate of \$25 to \$35 billion in unreported income from illegal sources included only that derived from heroin trafficking, prostitution, and gambling. Its estimate did not include unreported income derived from other illegal activities such as arson for profit, smuggling of goods other than drugs, bootlegging of cigarettes, protection rackets, embezzlements, and theft. Had IRS been able to estimate the illegal income derived from such activities, there is no doubt that its estimate would have been much higher. For example, in 1974, the U.S. Chamber of Commerce estimated that total losses from white collar crime alone exceeded \$40 billion annually.

Other studies of the subterranean economy have estimated unreported income to be larger than IRS' estimates. The studies' definitions and methodologies vary and are subject to debate. Moreover, their estimates of the problem vary substantially. However, their conclusions are similar-- unreported income and the resulting uncollected taxes constitute a serious national problem.

As we discussed in testimony before this Subcommittee in July 1979 and in testimony before the Subcommittee on

Commerce, Consumer and Monetary Affairs in September, IRS has a range of tools, including criminal investigations, to deal with the unreported income problem. Each of these tools differs in its ability to detect unreported income from legal sources and illegal sources. Thus, to effectively attack and have maximum impact on the unreported income problem, IRS needs to establish an overall compliance strategy which considers all its compliance tools in targeting its resources.

Regardless of what actions IRS takes, it needs a better defined national criminal enforcement strategy to effectively deal with the extensive amount of unreported income from illegal sources. The complex and devious nature of schemes involving illegal activities limit IRS' ability to detect and deter tax evasion which goes hand-in-glove with those activities. Routine audits and collection actions have little chance of detecting such schemes, which often involve no "paper trail." Thus, Criminal investigations are IRS' best means for detecting unreported income from illegal sources.

Each year, over 95 percent of the Criminal Investigation Division's 9,000 detailed investigations are directed at underreporters and nonfilers. Moreover, about 27 percent of the investigations are directed at individuals who do not report all or part of the income they derive from illegal activities. Special agents assigned to the Criminal Investigation Division are specifically trained and authorized to

(1) use sensitive investigative techniques such as surveillances and controlled informants, (2) work with grand juries, strike force attorneys, and Drug Enforcement agents, (3) issue taxpayer and third-party summonses, and (4) otherwise gather and analyze information from sources outside IRS. Properly directed, special agents have the potential to have a substantial impact on the problem of unreported income arising from illegal activities.

However, IRS has not been as effective as it could be in dealing with the tax fraud problem, let alone detecting non-filers and underreporters who derive their income from illegal activities, because it has not developed a well-defined national strategy for dealing with tax fraud. National direction has been inadequate. The Criminal Investigation Division's long-range plan is very general in nature and basically states that the Division will fight tax crime during the next three years. The Division's short-range plan outlines some areas which require national emphasis and does contain several specific, measurable goals. However, it needs to (1) identify more tax evasion areas requiring emphasis and (2) more specifically allocate resources to those areas.

One of the goals included in the current short-range plan requires each of IRS' seven regions to apply from 20 to 35 percent of its investigative time to illegal activities. However, the regions do not specifically allocate this goal

among the 58 district offices. Thus, each district has much latitude in allocating its criminal investigative resources against illegal activities.

The lack of effective national direction and control is particularly distressing from the standpoint of illegal activities because the Criminal Investigation Division has a key investigative technique--information gathering--which enables special agents to get at pockets of noncompliance that might otherwise go untouched and to detect complex and devious tax evasion schemes. However, its value and impact has been limited because IRS makes little effort to coordinate the information gathering activities of the 58 district offices.

Basically, information gathering differs from other IRS activities in that it does not center on analysis of information already in IRS' possession. Rather, it involves obtaining information from other Federal, State, and local agencies; using informants; conducting surveillances; and using other sensitive investigative techniques. It is that type of effort which, in our view, is needed to detect and deter nonfilers and underreporters who derive their income from illegal activities.

Too often, however, some district office criminal investigation divisions try to use this important investigative tool to get at localized pockets of noncompliance, such as artists residing in a particular section of a State,

carnival operators, and individuals who derive income from second trust deeds. Other district information gathering efforts have centered on groups which display no clear tax evasion tendencies, such as taxpayers who purchase large automobiles and owners of expensive homes or private airplanes. Still other efforts are directed at national problems which a district is ill-equipped to handle by itself. Recently, for example, various districts initiated projects whose purposes were to

- identify potential areas of tax abuse in international investments and financing;
- determine the extent of compliance with the tax laws by Government officials, contractors, politicians, and other persons associated with a multitude of governmentally funded programs;
- identify persons and organizations receiving income from any illegal activities; and
- determine the extent of compliance with the tax laws dealing with foreign investments.

All in all, IRS' national office has done little to coordinate information gathering activities, thus reducing the effectiveness of special agents.

In recent years, the Criminal Investigation Division has recognized the inadequacy of the guidance it provides special agents at the district level and has initiated some actions to correct the problem. For example, the Division conducted

a planning model study in fiscal years 1977 and 1978. During fiscal year 1980, the Division plans to test a more rigorous long-range planning process. In addition, it has established a research group which is seeking to develop data top management can use to better direct special agents' activities on a national basis. These actions will not have immediate, measurable effects but the Criminal Investigation Division is moving in the right direction.

While the Division has made improvements to its plans and planning process, it has omitted a key element--input from the Department of Justice. IRS is authorized to recommend prosecution in criminal tax cases but it has no legal authority to prosecute those cases. Instead, IRS depends on the Criminal Section of Justice's Tax Division to review and approve recommended prosecutions and depends on U.S. attorneys to handle the prosecutions. During fiscal years 1976 through 1978, 1,649, or 18 percent, of the Criminal Investigation Division's 9,172 prosecution recommendations were declined for prosecution by Justice's Tax Division or U.S. attorneys. For example:

--In one case, a taxpayer failed to file timely income tax returns for 4 consecutive years. But, in Justice's view, the taxpayer's age, poor health, and low economic status suggested a low probability of conviction. In documenting his reasons for declining the case, the Chief of the Criminal Section of Justice's Tax Division

stated, "This case strikes me as a sure loser." If IRS clearly understood the factors that made this case a "sure loser," it would have applied its resources to another case with better prosecution potential.

--In another case, a narcotics trafficker understated his income by \$127,000 during a 3-year period. Justice declined prosecution on this case because the taxpayer already was serving a 9- to 10-year jail sentence on narcotics charges. This case illustrates that IRS does not fully understand Justice's "dual prosecution" policy. That policy provides that all offenses arising out of a single transaction, such as drug trafficking and evading taxes on the resultant profits, should be tried together.

--In another case, a lawyer understated his income for 2 consecutive years. Justice declined to prosecute the taxpayer, however, because he had made some voluntary disclosures to IRS and paid the taxes due. Justice also cited the nominal amount of the tax deficiency for 1 year as an additional reason for its declination. This case illustrates the need for IRS to better understand, before committing resources to a case, Justice's views on the effects of voluntary disclosures, payments of tax due, and the amount of additional tax that a criminal case ought to involve.

--In another case, a taxpayer failed to report substantial amounts of income for two consecutive years. IRS concurrently pursued various aspects of this case from both a criminal and civil standpoint. Ultimately, Justice declined IRS' recommended criminal prosecution in part because some of the evidence resulted from voluntary disclosures made by the taxpayer to an IRS civil tax examiner. This case demonstrates that IRS needs to better understand Justice's views on the effects of voluntary disclosures on criminal tax cases.

--Finally, in another case, a husband and his wife submitted false documents to IRS in support of their joint tax return. The false documents reduced their tax liability by \$482. IRS recommended criminal prosecution. Justice declined the case in part due to the small dollar amount involved. This case demonstrates that IRS needs to better understand Justice's views on what constitutes too small a dollar amount for criminal tax purposes.

to Dept. of Justice
A lack of coordination between IRS and Justice during the criminal investigation planning process results in unnecessary staff-day expenditures which produce little in the way of prosecutions, let alone convictions. A need exists for better coordination between IRS and Justice. The Attorney General and the Commissioner of Internal Revenue need to jointly develop a system whereby Justice provides

IRS with better guidance for conducting its tax fraud program. Neither agency can handle the tax fraud problem alone. With better coordination, however, each agency's resources would be better applied against tax fraud.

In addition to making better use of its resources through coordination with Justice, IRS needs to determine whether its criminal investigation activities are receiving sufficient resources particularly in comparison to other compliance activities. This is important because unreported income arising from illegal activities may be much higher than IRS indicated in its recent report. Any allocation of investigative resources to the areas of high noncompliance identified in IRS' report should be done as part of a carefully thought out, nationally coordinated criminal enforcement strategy. This means that IRS, in the long term, may have to reallocate discretionary resources from districts not having national priority non-compliance problems to districts having such problems.

This concludes our prepared statement; we would be pleased to respond to questions.