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Departing Chief Says I.R.S. Is Losing War on Tax Cheats

By DAVID CAY JOHNSTON

Preparing to step down tomorrow after five years, the Commissioner of the Internal Revenue Service, Charles O. Rossotti, says the agency is steadily losing the war with tax cheats, especially the wealthiest and most sophisticated among them.

The Bush administration, which has yet to name a replacement for Mr. Rossotti, recognizes that tax cheating is widespread but says the I.R.S. is getting the right amount of money in its budget. And the administration stopped Mr. Rossotti from speaking his mind to Congress, according to three senior I.R.S. officials.

Advertisement The officials said the oversight subcommittee of the House Ways and Means Committee was to have held its first hearing on sophisticated tax cheats on Oct. 1. But the hearing was called off at the request of Mr. Rossotti, who the officials said had been ordered by the Bush administration not to testify about his views that the I.R.S. cannot adequately enforce the law without annual budget increases that keep pace with the growing number of tax returns and the increasing sophistication of tax cheats.

Asked whether he had been muzzled, Mr. Rossotti, who had won wide praise in tax circles for bringing a culture of candor to the I.R.S., refused to comment. Asked why, he said, "I am still a member of this administration."

But Mr. Rossotti expressed his concerns in an interview. "The tax system continues to grow in complexity, while the resource base of the I.R.S. is not growing and in real terms is shrinking," he said. "Basically, demands and resources are going in the opposite direction."

"This is systematically undermining one of the most important foundations of the American economy," he said.

In a report to a civilian oversight board created by Congress in 1998, Mr. Rossotti made his point with numbers that became public the day before the hearing was canceled.

The great majority of major tax cheats, in some categories four of five, will be allowed to get away without paying their full share because the I.R.S. lacks the money to enforce the law, Mr. Rossotti wrote.

Over all, the I.R.S. gets a budget of 41 cents per tax return, 10 percent less, after adjusting for inflation, than in 1997. Yet during those five years many sophisticated new techniques to evade taxes have come onto the market, sold by

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Charles O. Rossotti said "the resource base of the I.R.S." is shrinking in real terms.

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the nation's largest accounting firms and others. And Congress has enacted 293 changes in the tax law, imposed complex rules protecting taxpayer rights and demanded the diversion of many law enforcement resources to functions like answering telephone calls from taxpayers.

David Hariton, a corporate tax lawyer at Sullivan & Cromwell, said tax avoidance has become so sophisticated that "the government needs to devote 10 times as many resources as it does now if it wants to tax capital effectively."

He said the additional spending would bring in many tens of dollars of tax for each dollar spent on law enforcement.

Because most I.R.S. resources are devoted to routine work like processing tax returns, the 10 percent reduction has meant a 28 percent decline in money for audits, investigations and collections, Mr. Rossotti wrote to the board.

"The I.R.S. is simply outnumbered," he wrote.

He said the I.R.S. needs to work 13.3 million cases in which documents, primarily from partnerships and similar entities that are used mostly by wealthy investors, do not match up with reports on individual tax returns. But the agency has the resources to pursue only a fifth of these cases.

In his report to the oversight board, Mr. Rossotti put the tax loss from that area alone at \$7 billion annually. But in earlier reports to Congress the I.R.S. has used figures that could put the tax loss as high as \$64 billion. Mr. Rossotti has said that every fifth dollar of partnership income is not showing up on tax returns.

He said the I.R.S. had also identified 82,100 taxpayers who used offshore accounts to evade taxes, but could pursue only 17,000 of them. He estimated the annual tax loss at \$447 million, or less than \$7,000 for each taxpayer, a modest figure when compared with his previous estimates of multibillion dollar losses. Jack Blum, an I.R.S. consultant, has estimated that offshore evasion alone costs the government \$70 billion annually.

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To close the law enforcement gap this year, Mr. Rossotti said, the I.R.S. needs \$1.9 billion — an increase of 51 percent for its enforcement budget — and authority to hire 29,306 more people, on top of the 48,000 it already has in compliance and enforcement.

In addition, he wrote, at a bare minimum the agency needs a 2 percent increase, above inflation, each year just to keep pace with growth in the tax system.

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News reports about what Mr. Rossotti wrote to the oversight board infuriated officials in the Office of Management and Budget, who insisted he make no other public comments contrary to the administration's view that the I.R.S. budget is adequate and that he say nothing about future budgets, according to senior I.R.S. officials.

The I.R.S. is getting a 4.8 percent increase in its law enforcement budget, to \$3.7 billion, this year, Mitchell B. Daniels Jr., director of the Office of Management and Budget, wrote last month to Senator Max Baucus, the Montana Democrat who is chairman of the Senate Finance Committee. Senator Baucus had written Mr. Daniels in September asking whether the I.R.S. had enough money to enforce the law.

Mr. Daniels wrote: "I am confident that these resources," together with tax simplification and other reforms being studied by the Treasury Department, "will allow the I.R.S. to effectively attack the serious noncompliance problems Treasury has identified."

Former commissioners, retired I.R.S. executives and others who work closely with the agency say it needs a large infusion of money for law enforcement to reverse the wave of tax cheating, which, they warn, will only grow, especially among corporations and high-income individuals, so long as law enforcement is weak.

One recently retired I.R.S. senior executive, who said his new employer would not allow him to be identified in an article, said "the I.R.S. does not need

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another \$100 million, it needs 2 or 3 billion more."

Dennis Crawford, who retired this fall as acting chief of criminal investigation, agreed that the agency was letting too many tax cheats get away for lack of resources to pursue them, but said a sudden and huge budget increase would be wasted.

"The I.R.S. doesn't have the capacity to handle a \$2 billion budget increase," he said. Rather, he said, it needs steady and significant increases to build its capacity until it is sufficient to deter tax cheats.

Five current and recently retired criminal investigators, in interviews this year, described solid cases against major tax cheats that were not being pursued for lack of money.

One of these agents, describing a citizen who uses offshore accounts to cheat the government out of more than a million dollars, said he was appalled that not only was no criminal charge being brought, but the citizen was not even being pursued civilly just to pay the taxes.

Mr. Rossotti, 61, left a successful career as chief executive of a technology and management company in 1997 to try to fix the I.R.S.

When he arrived he was widely expected to focus on the agency's antiquated computers, some of which were bought during the Kennedy administration.

But Mr. Rossotti said that in the six months that he had to study the agency before taking charge he came to realize that its management structure was even more troubled than its antiquated technology.

Two former commissioners praised Mr. Rossotti for addressing management problems effectively, but faulted him for being slow to recognize the collapse of law enforcement.

"He's done well under difficult circumstances," said Donald C. Alexander, the Nixon administration tax commissioner. "I just wish he had spent more money on revenue agents and less on consultants."

Mr. Rossotti spent more than \$200 million on advice from the Booz Allen Hamilton consulting firm to reorganize the I.R.S. around four types of taxpayers — large and medium-size corporations, small businesses and the self employed, wage-earning individuals and tax-exempt entities. This eliminated the old system, which was based on geography.

Mr. Rossotti also improved a variety of management reports and refocused his dwindling audit staff on new kinds of cheating that were proliferating.

Sheldon Cohen, the Johnson administration commissioner, said he was delighted that Mr. Rossotti had begun to address the collapse of tax law enforcement, however belatedly.

Mr. Alexander said that "Rossotti has this survey showing everyone loves the I.R.S. now and everyone hated it five years ago."

"The reason the I.R.S. was hated in 1997 and 1998 was that the Senate held those hearings to blast the I.R.S. and most of the media went right along with it," Mr.

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Alexander said. "Rossotti placated Congress very well when they were in that idiot mood in 1997 and 1998, but he should have shifted much more quickly into addressing cheating, which he started on 18 months later than he should have."

As for Mr. Rossotti's replacement, Claire Buchan, a White House spokeswoman, said, "When there is a decision by the president as to who he wishes to nominate there will be an announcement."

In the meantime, Mr. Rossotti's deputy, Bob Wenzel, will be acting commissioner.

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