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Tax Law Enforcement: Progress and Opportunities

At the federal level the non payment of taxes has been estimated to cost the government $250 billion to $300 billion a year,[1] requiring those costs to be shifted onto other taxpayers or made up by cuts in basic government services. There are two types of activities that can shift costs from some taxpayers to the rest of the taxpayers: tax evasion (when a taxpayer fails to pay taxes that are legally owed) and tax avoidance (when taxpayers exploit legal tax loopholes to reduce their tax liability). While this line can be blurred when individuals or corporations use tax shelters of questionable legality, it is important to recognize that there is generally a distinction between tax evasion and tax avoidance. This paper will focus primarily on tax evasion.

There are not comprehensive estimates of the amount of state taxes lost each year due to tax cheating. But leading authorities in Massachusetts have made projections of the revenue that could be recovered if the Commonwealth were to increase the resources available to catch those who seek to evade paying taxes they owe. The Inspector General has estimated that for every dollar invested in tax enforcement ten dollars of revenue could be generated.[2] The Department of Revenue has made similar projections, indicating that each additional auditor hired would ultimately generate $1.0 million to $1.5 million of revenue annually.[3]

This paper will examine the recent history of funding for tax enforcement in Massachusetts, provide an example of the ways large taxpayers can avoid paying taxes they appear to owe, discuss the revenue that could be protected by enhanced enforcement, and explain how this revenue could help to address the state's fiscal crisis.

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[1] Charles Rossotti, IRS Commissioner Interviewed on Frontline: Tax Me If You Can, February 19, 2004. Transcript available at http://www.pbs.org/wgbh/pages/frontline/shows/tax/interviews/rossotti.html. (Rossotti explained that this estimate is the total cost for "a whole spectrum of things, where people [are] just flatly hiding the income, people not filing returns at all, to corporate shelters and so forth. So that $250 billion to $300 billion -- that's everything.")

[2] Letter from Inspector General Sullivan to Governor Romney, Senate President Travaglini and Speaker Finneran, January 24, 2003, p.2.

[3] Testimony of Department of Revenue Commissioner Alan LeBovidge to the Joint Committee on Taxation, reported in State House News March 11, 2003.

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Are Tax Avoidance and Tax Evasion Problems?

Obviously it is impossible to know about all of the tax avoidance and tax evasion activities that the state does not have the resources to discover. But sometimes examples become public.

For example, in the course of the bankruptcy proceedings for the company WorldCom, the Bankruptcy Examiner came across an elaborate scheme that appears to have allowed the company to avoid paying hundreds of millions of dollars in state taxes. Writing in *State Tax Notes*, David Brunori described the technique as follows:

> WorldCom formed a … holding company…the holding company licensed [World Com's] "management foresight" to its subsidiaries in return for $20 billion. Because the subsidiaries got to deduct the royalty payments to the holding company, they avoided some $350 million in corporate taxes.[4]

After this scheme was uncovered in the bankruptcy proceedings, Massachusetts and thirteen other states filed legal claims against WorldCom (which has merged with MCI) for lost tax revenue. The *Wall Street Journal* reported,

> Massachusetts has filed claims seeking to collect $89.9 million in back taxes, penalties and interest from MCI. All told, the 14 states will be filing claims to collect more than $500 million from MCI over the tax-avoidance strategy, according to people familiar with the states' efforts.[5]

It has not been proven that this scheme is illegal. A change made to Massachusetts tax laws last year would likely have made this scheme more difficult. In addition, there are further changes that could be made to Massachusetts tax laws that would make this type of scheme ineffective. Many states use a system of taxing corporations known as "combined reporting." In these states, companies are required to report the income of all subsidiaries that are part of a unitary business. In all of the combined reporting states in which WorldCom was operating, this scheme does not appear to have reduced its tax burden. Laws that require combined reporting make it harder for corporations to avoid paying taxes by shifting income between subsidiaries.

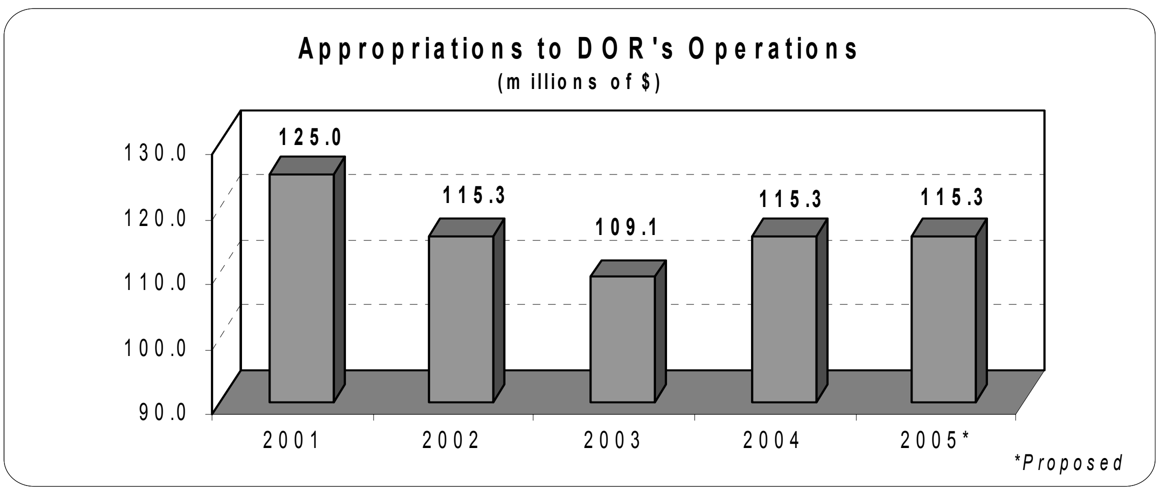
[4] Brunori, David. "Foresight for Sale," State Tax Notes, February 4, 2004.

[5] Weil, Jonathan and Young, Shawn. "States Seek to Bar KPMG as Auditor For WorldCom," The Wall Street Journal, March 18, 2004; Page A3.

Massachusetts appears to have taken the position that under existing law it is owed $89.9 million because taxes that were legally owed were not paid. This problem was discovered because the company went into bankruptcy and its books were examined in detail. It is unknown whether WroldCom's activities would eventually have been caught by an audit. There is also no way to estimate definitively how many similar schemes are being implemented each year. It is clear that the amounts of money potentially at stake are significant.

Wide scale tax avoidance and evasion have been described in detail by the Pulitzer Prize-Winning New York *Times* reporter David Cay Johnston in the 2003 book *Perfectly Legal*[6] and also in a recent Frontline report *Tax Me if You Can*, which can be viewed at http://www.pbs.org/wgbh/pages/frontline/shows/tax/. While these sources pay more attention to the federal level, similar issues arise at the state level.

Does Massachusetts Fully Fund Tax Enforcement?



The Massachusetts Department of Revenue's administrative budget was $125.0 million in FY 2001. As the fiscal crisis began in FY 2002, the Department of Revenue was subjected to cuts similar to those being implemented across the state. The budget was reduced to $115.3 million in FY 2002 and $109.1 million in FY 2003.[7] Had funding for the Massachusetts Department of Revenue's operations simply kept pace with inflation it would have been $130.0 million – or $20.9 million higher – in FY 2003.

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[6] *Perfectly Legal*, by David Cay Johnston (New York: Penguin Group, 2003).

[7] The Department also received "Retained Revenue" funding in FY2003 and FY2004. The FY2003 funding came from and was used to enhance the implementation of a tax amnesty and enforcement program and other initiatives. The FY2004 revenue was used to hire additional auditors and collectors as will be discussed below.

Spending cuts often have long term costs. When preventive healthcare programs are cut, patients often end up receiving more expensive emergency room care. Investments in early childhood education can sometimes reduce the need for expensive special education services for children who might otherwise need them later in life. But perhaps nowhere is the cost of a cut felt as immediately as when the state reduces the number of people enforcing the tax laws.

Such cuts are likely both to reduce immediately the amount recovered through audits and to lead to long term reductions in revenue if public awareness of the lack of enforcement encourages greater utilization of complex tax evasion schemes.

Real Progress in 2004

In the fiscal year 2004 budget, the Legislature began to make meaningful progress in restoring funding for the Department of Revenue. During the budget process, the House and Senate added $5.2 million to the Department of Revenue's operating budget. In addition, the legislature established a "retained revenue" account to finance the hiring of new auditors. A retained revenue account is an account that allows a department within state government to retain some of the revenue that it generates. In this case, the Department of Revenue was authorized to hire additional auditors and use some of the money they would generate to cover their expenses.

The state budget authorized $2.64 million in retained revenue for this purpose.[8] Pursuant to this authorization, the Department of Revenue has hired 39 additional auditors (19 multi-state auditors and 20 in-state) and 10 new collectors. With these resources, the department has already generated over $10 million in gross revenue and anticipates generating $15 million by the end of FY04. Because in the first year of this project it took time to hire the auditors, begin the audits, and generate the revenue, the department expects significantly greater revenue to be generated in fiscal year 2005. It is expected that the full-year costs of these personnel will be $3.2 million and they will generate $63.4 million for a net benefit of $60.2 million for the Commonwealth.[9]

Of all of the reforms enacted in the past year, this may have been one of the most effective. It is hard to imagine a more egregious example of waste than allowing millions of dollars to be lost to tax evaders because of inadequate resources to enforce the tax laws. Furthermore, saving nearly twenty dollars for every dollar invested makes enforcing the tax laws an extremely cost-effective reform.

[8] Budget item 1201-0130
[9] Response of DOR Spokesman to Request for Information on 3/26/04

Are There Reasons Not To Increase Enforcement of Tax Laws?

The tax collector is never the most politically popular government official. Taxpayers are often concerned that innocent mistakes or overly aggressive auditors will force them to pay additional taxes or penalties.

In 1997 and 1998, the United States Senate held hearings about alleged abuses by the Internal Revenue Service.

> The story: unnamed IRS agents falsely making unnamed people pay taxes they did not owe; dozens of criminal investigation agents, brandishing guns, entering peaceful offices and homes as if they expected armed drug dealers; agents issuing subpoenas for no purpose except to embarrass people.[10]

These hearings created a public perception of dangerous and inappropriate activities by the IRS and contributed to changes that made enforcement at the national level more difficult. Eventually the General Accounting Office produced a report based on investigations of the charges made. That report stated, "Generally we found no corroborating evidence that the criminal investigations described at the hearing were retaliatory against the specific taxpayer." It also found "that decisions to initiate the investigations were reasonably based on the information available to IRS at the time and ….we found no evidence that IRS employees had acted improperly in obtaining and executing the search warrants."[11]

Thus, while many individuals may fear overly zealous tax auditors, it is likely that these fears are based largely on a deceptive image that has been painted of tax agencies. Furthermore, as will be described in the revenue estimates section below, increased auditing of large multi-state companies would appear to be the most cost-effective investment in tax enforcement. Adding resources in this aspect of enforcement would not impose any new burdens on most taxpayers.

How Much Additional Revenue could be Generated?

At some point, adding resources to tax enforcement would reach a point of diminishing returns. It is hard to estimate where that point would be. This paper therefore will not seek to project revenues that could be generated by increasing enforcement resources beyond where they were in 2001, adjusted for inflation.

[10] *Perfectly Legal*, Page 146.
[11] GAO report quoted in *Perfectly Legal*, page 156.

Massachusetts could, however, simply restore the DOR funding level to what it had been in 2001. That would require an approximately $16 million increase in the DOR appropriation. That is the difference between the inflation-adjusted FY01 funding level (about $134 million) and the sum of the FY2004 funding level of $115.3 million and retained revenue of $2.64 million.

Based on data from four nearby states, the Office of the Inspector General determined that in those states the audit processes produce $10 in revenue for every dollar that is spent. Applying this ratio, increasing the budget of the Department of Revenue by $16 million would eventually increase revenues by $160 million.

The Department of Revenue has proposed a different methodology, but produces to very similar results. The DOR estimates that each in-state auditor generates approximately $1 million in additional revenue. The department also estimates that each multi-state auditor (those auditing companies based in other states) generates $1.5 million each year.[12]

Even if the total cost of hiring each auditor, appropriate support staff, and associated collectors is $100,000 a year (and it is likely less)[13], $16 million of new revenue would allow for the hiring of 160 auditors and could generate from $160 to $240 million (depending on whether they are in-state or multi-state auditors). While it is possible that the per-auditor payoff would decrease if 160 new auditors were to be hired, there does not appear to be any evidence that there would be a significantly reduced payoff at these levels. In addition, it may be possible to add more than 160 new auditors with $16 million.

These estimates would, however, have to be discounted in the first year that funds were appropriated. It takes time for auditors to be hired and trained and to begin initiating and completing audits. While it appears clear that there would still be a significant net gain in the first year, it would likely be much less than the payback that would be received in future years. As was explained above, the first year return in fiscal year 2004 is estimated to be about five to one.

These numbers may also significantly underestimate the effects of increased enforcement. The Department of Revenue estimates describe actual revenue generated by each auditor. They do not include the deterrent affects that increased enforcement would likely have.

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[12] Response of DOR Spokesman to Request for Information on 3/26/04.
[13] DOR has estimated that forty new auditors and ten new collectors will cost a total of $3.2 million in FY05.

Will Increased Enforcement Solve the State's Budget Problems?

In the past three years, Massachusetts has imposed about $3 billion in budget cuts, affecting core services ranging from healthcare to education, to basic safety net protections. The state continues to face a severe budget shortfall.[14]

Two hundred million dollars or so in revenue will not solve these problems. But that revenue could provide an opportunity to restore funding for specific programs. It has been estimated that it would cost less than $7 million to restore healthcare for the 10,000 children now on the waiting list to receive health insurance through the Children's Medical Security Plan.[15] It would cost $18 million to restore the state program that funded grants to local school districts to reduce class sizes. It would cost $35 million to fund the state's anti-smoking program at the levels recommended by the federal Centers for Disease Control and Prevention.[16]

[14] Massachusetts Budget and Policy Center, Budget Monitor, February 6, 2004 (available at http://www.massbudget.org/05House1BudgetMonitor.pdf).
[15] Health Care For All, *Impact of the Governor's FY05 Budget on Children's Health*, February 12, 2004.
[16] Tobacco Free Massachusetts, viewed on March 29, 2003 at: http://www.tobaccofreemass.org/triagebudget05.php.