United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

May 20, 2003

The Honorable Mark W. Everson
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Commissioner Everson:

I am writing in response to an April 25, 2003 article in the New York Times reporting that the IRS plans to issue new regulations that would require certain individuals seeking to claim the Earned Income Tax Credit (EITC) to provide "the most exhaustive proof of eligibility ever demanded of any class of taxpayers."

The EITC is a tax program geared to the needs of low income working Americans. By enabling working Americans to obtain a tax credit, it helps individuals and families, particularly single working mothers, meet essential needs, from putting food on the table to paying monthly rent to assisting in required educational expenditures. According to the U.S. Census Bureau, in 2001, the EITC helped lift four million people above the poverty line, the most of any federal program. In light of the importance of the EITC, I am concerned about allegations that the IRS intends to impose unprecedented certification obligations on those taxpayers least capable of meeting them and to do so without any meaningful opportunity for public comment or analysis prior to the potentially burdensome requirements going into effect.

Right now, tax fraud is a serious problem in the United States, and many forms of tax noncompliance and abuse are competing for the attention of the IRS. Given the extent of the problem, it is important for the IRS to aim its enforcement efforts at those taxpayers engaged in the most egregious abuses of our tax code. The facts seem to indicate that while tax abuses by low income working American claiming the EITC tax credit pale in comparison with tax abuses by some large corporations and some high income individuals, they may be subjected to disproportionate measures not applied to any other group of taxpayers.

In a report filed with the IRS Oversight Board near the end of 2002, former IRS Commissioner Charles O. Rossotti stated that the IRS is "losing the war" on stopping tax cheats. Citing diminished resources and the complexity of the tax code, Mr. Rossotti concluded that the IRS was "outnumbered" and facing a huge and growing gap "between the number of taxpayers whom the IRS knows are not filing, not reporting or not paying what they owe, and our capacity to require them to comply." The Rossotti report paid special attention to the role being played by some tax professionals to enable some corporations and high income individuals to escape paying their fair share, and the likely consequences for honest taxpayers left footing the tax bill:

> "Recognizing the IRS' diminished capacity, promoters and some tax professionals are selling a wide range of tax schemes and devices designed to improperly reduce taxes to taxpayers based on the simple premise they can get away with it. When this perception becomes increasingly widespread, the essential pillar of our tax system is lost – namely, the belief of honest taxpayers that if someone does not pay what he or she owes, then the IRS will do something about it."

The abusive tax shelter transactions and offshore tax avoidance schemes targeted in the Rossotti report, entered into primarily by corporations and high income individuals, result in tens of billions of dollars in lost U.S. revenues each year, with estimates ranging from $40 to $70 billion annually. In contrast, revenues lost from EITC abuses are estimated to be far less. Moreover, the lost tax revenues for EITC taxpayers who are abusing the system are estimated to be at most in the thousands of dollars per taxpayer, while the lost tax revenues associated with abusive tax shelters and offshore tax schemes generally are estimated to be much higher for each taxpayer involved. In fact, the tax code deems certain arrangements to be tax shelters only after a taxpayer pays a tax promoter at least $100,000 for arranging it. By any estimate, it seems clear that the revenues lost as a result of abusive tax shelter transactions greatly exceed the amount of revenues lost from EITC abuse.

It is that obvious discrepancy which raises a host of questions about the IRS' alleged plans for new EITC certification rules and enforcement efforts. If my understanding is correct, the IRS plans to require EITC claimants to submit detailed documentary evidence, and possibly affidavits, to support their claims, when no equivalent requirements exist for taxpayers claiming millions of dollars in tax benefits involving undocumented domestic and offshore trusts, partnerships and other entities and convoluted and undocumented investment strategies. While EITC abuse should by all means be addressed, it seems both illogical and unfair to place a verification regime on low income taxpayers that would be more onerous than the regime placed on corporations and high income individual taxpayers. Indeed, it seems that the reverse would make more sense: to hold those that improperly avoid the most in taxes to at least the same standard of proof, particularly when those taxpayers typically would be the most capable of responding to a heightened standard.

In addition, I have heard that the proposed EITC regulation may be structured to take immediate effect as an interim final rule, without any meaningful, prior opportunity for public comment or analysis. Given the significance of the proposed change in approach to the EITC; its unprecedented and potentially burdensome character; the unfairness on its face compared to verification requirements for other tax credits; its potentially time-consuming impact on IRS enforcement personnel required to review the documentation; and its potentially devastating impact on working Americans, there is no justification for an abrupt regulatory action. If the target of the new paperwork requirements were corporations or high income individual taxpayers instead, the IRS would at least provide a sufficient opportunity for comment beforehand.

The proposed EITC action also raises questions about whether the IRS is continuing to misplace its limited enforcement resources by focusing more on low income taxpayers than high income taxpayers. Recent statistics compiled by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University indicate that the vast majority of 2002 IRS audits were aimed at low and middle income taxpayers, notwithstanding the fact that those audits resulted in only a small fraction of the total additional taxes recommended by the auditors. According to the TRAC statistics:

- In 2002, 82 percent of the IRS District, Service Center, and International audits ("IRS audits") were conducted on low and middle income individual taxpayers, while only 15 percent were conducted on upper income individual taxpayers. Both sets of audits produced about the same amount of recommendations for additional taxes to be collected.

- In addition, 2002 audits of corporations totaled only 3 percent of total IRS audits, but accounted for over 80 percent of the additional taxes recommended, with most resulting from audits of corporations with assets exceeding $250 million. The TRAC statistics also indicate the IRS is auditing a much smaller percentage of corporations than ten years ago.

This research presents a disturbing analysis of IRS enforcement priorities. On the other hand, the IRS recently announced a recalibration of its enforcement efforts, including a sustained, new focus on stopping abusive tax shelters and offshore tax avoidance schemes by corporations and individuals. That new enforcement effort is a welcome step in the right direction. However, IRS materials indicate that the IRS intends to request an additional $139 million for this new enforcement effort in the upcoming year while, in comparison, it will request for the new EITC enforcement effort an additional $100 million. The requested allocation of enforcement dollars indicates the IRS is not focusing its enforcement efforts on the most egregious tax abuses.

Finally, while it is important that EITC rules be designed in a way that will minimize taxpayer abuse, equally important is the need for fair rules that will not inhibit eligible taxpayers from receiving the tax credits to which they are entitled by law. To obtain a more accurate understanding of the IRS' plans with respect to the EITC, I would appreciate receiving the following information by June 16, 2003.

(1) Please describe the new EITC rule to be proposed by the IRS, including a detailed description of any heightened certification, verification or documentation requirements that would be placed on EITC claimants; identify precedents and equivalent existing requirements for taxpayers claiming similar tax credits; and indicate whether these requirements would apply only apply to EITC claimants or also to other groups of taxpayers claiming federal tax benefits.

(2) Does the IRS plan to ask taxpayers, in some circumstances, to submit an affidavit to support an EITC claim? If so, please identify precedents for requiring taxpayer affidavits in similar circumstances.

(3) Please indicate whether the IRS intends to issue the EITC rule in a form that will require taxpayers immediately to comply with new documentation requirements to obtain the credit, and, if so, why the IRS is failing to solicit or consider any public comment or analysis of the rule prior to these requirements taking effect.

(4) A May 2002 report published by the Brookings Institution concluded that, in 1999, "an estimated $1.75 billion in EITC refunds was diverted toward paying for tax preparation, electronic filing and high-cost refund loans." Please explain how the proposed EITC rule would address the issue of substantial EITC funds being diverted away from low income taxpayers to tax preparation professionals.

(5) One 2003 press report asserted that those applying for the EITC have a one in 47 chance of being audited, while those making more than $100,000 a year have a one in 208 chance of being audited. For the most recently available tax year, please provide IRS statistics showing:

(a) the total number of EITC claimants;
(b) the total number of EITC claimants audited by the IRS;
(c) the total amount of additional revenues resulting from the EITC claimant audits;
(d) the total number of individual taxpayer returns with gross income in excess of $100,000;
(e) the total number of individual taxpayer returns with gross income in excess of $100,000 audited by the IRS; and
(f) the total amount of additional revenues resulting from the audits of individual taxpayer returns with gross income in excess of $100,000.

Thank you for your assistance. Please have your staff direct any questions to Tim Henseler at (202) 224-9123. I look forward to working with you on this important matter.

Sincerely,

Carl Levin, Ranking Member
Permanent Subcommittee on Investigations

CL/tbh