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The IRS Under Siege

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The IRS under Siege

In September 1997, Senator William Roth (R, Delaware) opened Senate hearings on alleged misconduct at the IRS by announcing his outrage at what the Committee had uncovered during its investigation of the agency. “Over the course of the next days,” he said, “we are going to see a picture of a troubled agency, one that is losing the confidence of the American people, and one that all too frequently acts as if it were above the law. This is unacceptable.”

The hearings painted a portrait of a powerful agency run amok. Senators heard from various taxpayers about abuses they claimed to have suffered at the hands of the agency. John Colaprete, owner of The Jewish Mother, a restaurant in Virginia Beach, testified that the IRS had conducted an armed nighttime raid on his home, tearing the door from its hinges, ransacking his house, and impounding his safe, his tax return records, even his dogs. During a simultaneous raid on his business manager’s house, the manager was pulled from the shower at gunpoint and forcibly restrained as he tried to call his lawyer. The manager’s teenage son was knocked to the floor and his fourteen-year-old daughter was forced to undress in full view of several male agents. According to Colaprete, the IRS had instigated the raid, during which it expected to find narcotics, based solely on a tip from his ex-bookkeeper, a convicted embezzler and thief, after an investigation that lasted less than forty-eight hours. “I used to believe that such things could only happen in a communistic bloc country or police state,” Colaprete observed. “I do not believe that any more.”

A year after the hearings took place, it was clear that the most serious charges against the agency were grossly exaggerated and, in many cases, simply false. When the General Accounting Office (GAO) and other agencies subsequently conducted in-depth investigations, they were unable to
substantiate any of the more egregious allegations of IRS abuse. Colaprete brought a $20 million lawsuit against the agents who raided his business, but the case collapsed when several credible witnesses contradicted his account. His own lawyer explained that “over time the more you go over [an unpleasant experience] in your mind, the worse it may have been.” By the time a more balanced appraisal emerged, however, Colaprete’s story and others like it had demonized the agency in the public eye.

The Senate hearings both reflected and contributed to the fact that the IRS was a beleaguered institution in the 1990s. Antitax sentiment had gained powerful legitimacy with Ronald Reagan’s election in 1980. When both Reagan and George H. W. Bush supported tax increases during their presidencies to reduce the federal deficit, proponents of tax cuts were radicalized by a sense of betrayal. They began to focus single-mindedly on pursuing tax cuts regardless of their impact on the federal budget or federal spending programs. Unlike previous conservatives, they were willing to tolerate high federal deficits as the price for reining in government by limiting its revenues.

Remarks by two Republican congressmen reflect the extent to which ardent hostility to taxes had entered the mainstream by the 1990s. During the midterm election campaign of 1994, Representative Bill Archer (R, Texas), who would become chair of the House Ways and Means Committee in 1995, declared, “I personally would like to tear the income tax out by its roots and throw it overboard.” In 1995, John Kasich (R, Ohio), the Budget Committee chair in the House, said in connection with a discussion of the flat tax proposal that “the end game here is to strip the government of the financial means for butting into the lives of Americans, and thus returning power and responsibility to families and localities.” As the agency charged with federal tax collection, the IRS was a natural target of intense criticism and hostility.

The agency was also struggling to modernize its efforts to collect taxes and detect tax evasion. The IRS was and is one of the biggest financial institutions in the world. At the turn of the twentieth century, it was collecting nearly $2 trillion a year from nearly one hundred and thirty million individual and business taxpayers. Financial audits conducted by the General Accounting Office beginning in 1992 revealed that the agency’s accounting and financial control systems were in shambles.
In its first audit, the GAO found that the IRS could not account for $4.3 billion in agency spending. During the following years, accounting failures continued to plague the agency. In 1998, the GAO found “pervasive weaknesses” in the IRS’s financial management systems that prevented it from reliably reporting on how it spent its budget. In a review of IRS collection procedures a year later, the GAO described widespread problems that “resulted in disbursements of fraudulent and other questionable tax refunds, unnecessary burden to taxpayers resulting from taxpayer receipts stolen by IRS employees, and errors or delays in posting payments to taxpayer accounts.” Taxpayers were required to keep careful track of their income, capital gains, deductions, and credits, yet the IRS could not account fully for the nearly $2 trillion it collected every year.

In the 1990s, the IRS labored under the weight of both political hostility and its own inefficiencies and operational failures. Meanwhile, tax professionals at accounting firms, law firms, and financial institutions had started working together to create a set of sophisticated transactions that had the potential to eliminate billions of dollars in taxes owed by wealthy individuals. The IRS, constrained by limited resources and preoccupied with ensuring that it was able to perform its basic function of collecting taxes, would be slow to identify and respond to these shelters.

The Antitax Crusade

Resentment of taxes is not a new phenomenon in American politics. The founding of this nation was the culmination of events that included resistance to taxes. It is only in recent decades, however that taxes have become a central topic in the political conversation. Historian Isaac William Martin observes, “Our national obsession with tax cuts is not a timeless cultural trait. It is a new political development.” It may be hard to believe in the twenty-first century, but in the three decades after World War II politicians rarely fought over taxes, and the public paid little attention to tax policy when casting votes. By the late 1970s, however, taxes became a more salient concern for a larger portion of the electorate.

A significant impetus for this shift in attitudes was a change in how property taxes were assessed at the local government level. A set of informal practices historically had resulted in the assessment of property at a fraction of its value. This buffered citizens, especially homeowners, from
the full financial effect of increases in property value due to inflation and economic growth. In the 1970s, however, state officials took steps to end this system to centralize and standardize property tax assessment, depriving “local assessors of the discretion that they had used to grant informal privileges.”

Assessments based on the full market value of property resulted in significant property tax increases for many homeowners. This prompted a backlash that helped create a political movement focused on reducing taxes. The most prominent early success in this effort was the passage of Proposition 13 in California in 1978, which amended the state constitution to sharply limit increases in property taxes. This measure prompted a host of initiatives across the country that aimed to limit taxes and spending, supported not only by those concerned about tax rates but also by conservatives who hoped to limit the scope of government. The success of these campaigns in turn influenced electoral politics, as many politicians concluded that “big tax cuts were good politics.” The “permanent tax revolt” was born.

The tax revolt gained significant momentum as part of a backlash against the civil rights movement, affirmative action, and their association with the expansion of government benefits for minorities, particularly African Americans. As Tom Edsall and Mary Edsall have shown, the battle over Proposition 13 reflected a deep racial divide. For whites, who supported the referendum by a margin of two to one, property taxes became connected with busing decrees, racial preferences in hiring, and a slew of entitlements, supported by taxes, whose main beneficiaries appeared to be blacks. The tax revolt mapped a division “along lines of taxpayers versus tax recipients” that coincided with racial divisions. African Americans were “disproportionately the recipients of government programs for the poor, disproportionately the beneficiaries of government led efforts to redistribute rights and status, and the black middle and working classes were far more dependent on government programs and jobs than their white counterparts.” The antitax movement provided a compelling logic around which the conservative movement could mobilize white populist sentiment against the liberal agenda that was successfully advanced by the Democratic Party in the 1960s and 1970s.

Among the politicians who seized on reducing taxes was the then governor of California Ronald Reagan. Reagan made tax cuts a central part
of his 1980 presidential campaign, a position that survey data indicated resonated with a large portion of voters. As political scientists Jacob Hacker and Paul Pierson suggest, “[a]lthough it is hazardous to speak of elections producing mandates for specific policy initiatives, it seems appropriate to consider the 1980 election results a mandate for lower taxes.”

Reagan came into office with the desire to cut taxes across the board by 10 percent every year for three years. The Economic Recovery Tax Act of 1981 cut the top marginal rate of the personal income tax from 70 percent to 50 percent, indexed personal income tax rates to protect against tax increases reflecting inflation, and provided deep rate cuts and tax benefits for corporations.

Ultimately, Reagan’s tax-cutting fervor collided with his and other conservatives’ concerns about fiscal prudence and the federal deficit. The 1981 cuts and an economic recession increased the deficit, and the Reagan administration’s desired increases in defense spending threatened to widen it considerably more. In response, Reagan supported 1982 legislation that rolled back corporate tax breaks and imposed new excise taxes. In 1984, the administration again supported tax increases as a response to concerns about a mounting deficit. A comprehensive tax bill, the Tax Reform Act of 1986, reduced tax rates but also eliminated many deductions, resulting in a revenue-neutral impact. As a consequence, while Reagan’s election made tax cutting a mainstream political issue, antitax forces were disappointed overall with his administration’s unwillingness to make tax cuts a priority that trumped other considerations.

That disappointment boiled over into outright revolt when President George H. W. Bush in 1990 reneged on his earlier pledge—captured in his infamous phrase “read my lips”—not to raise taxes. Bush supported tax increases as part of a budget package that was designed to address the growing federal deficit. In response, Representative Newt Gingrich (R, Georgia) and his allies persuaded more than half the Republicans in the House to oppose their party’s ostensible leader. While Bush ultimately obtained passage of a package that included tax increases, the conflict marked the beginning of intensified conservative focus on tax cuts regardless of their fiscal consequences. As Hacker and Pierson observe, “the new-line Republicans reversed the priority between fiscal conservatism and tax cuts. For this generation of politicians, reducing taxes was absolutely central.”
The intensity with which Republicans pursued this mission was reflected in the party’s response to President Clinton’s proposal in 1993 to confront the deficit by passing a budget that included a combination of tax increases and spending cuts. His plan received not a single Republican vote in the House or the Senate, the first time in modern history that a federal budget passed without any support from the minority party. When Republicans regained control of the House in the 1994 elections, they claimed that it was a mandate to implement the policies set forth in the Contract with America, a set of principles that Gingrich had played a prominent role in developing. The Contract pledged to bring about changes that would result in “the end of government that is too big, too intrusive, and too easy with the public’s money.” It promised that Republicans on the first day of the next Congress would “immediately pass” eight major reforms, including the requirement of “a three-fifths majority vote to pass a tax increase.”

The Republicans made no secret of their agenda to eliminate the income tax. In 1996, the House voted to repeal it. Without an alternative method to collect revenue, the measure did not get very far in the Senate. A year later, Congressmen Dick Armey (R, Texas) and Bill Tauzin (R, Louisiana) launched a “Scrap the Code” tour. The two traveled to several cities to speak at anti-income tax rallies, attracting crowds numbering in the thousands.

The single-minded focus on tax cuts was further reflected in the growing prominence of Grover Norquist’s organization, Americans for Tax Reform (ATR). The roots of the organization lay within the Reagan administration, with a White House effort headed by Norquist to generate support for the 1986 tax legislation. The centerpiece of ATR’s strategy was the Taxpayer Pledge that it asked all candidates for Congress to sign. Candidates promised to “oppose any and all efforts to increase the marginal tax rates for individuals and/or businesses,” and to “oppose any net reduction or elimination of deductions and credits, unless matched dollar for dollar by further reducing tax rates.” Over time, signing the pledge became a fundamental requirement for a growing percentage of Republican politicians.

The broader aim of the antitax crusade was to shrink government to a size where, in Norquist’s words, it could be “drowned in a bathtub.” The IRS was a prime target for this campaign. Its difficulties in performing its most basic functions reinforced this resentment toward the agency and fueled the growing belief that the tax system was arbitrary and unjustified.
The IRS under Siege

The Tax Collection Dinosaur

It was not as if operations were running smoothly at the Internal Revenue Service in the 1990s. A big source of the problem was the agency’s inability to upgrade its data collection and analysis systems. Through most of the last decade of the twentieth century, the agency still relied almost exclusively on paper returns to obtain taxpayer information. During tax season, thousands of employees visually scanned more than a hundred million returns, looking for obvious errors. Other employees, hired seasonally by the IRS, typed hurriedly around the clock to input data from forms into the IRS computer system. With so many returns being processed at breakneck speed, mistakes were inevitable. One study showed a 20 percent error rate in the IRS’s data, half of which was attributable to the transcription process. It didn’t help that the agency was using software from the 1960s, storing taxpayer information on magnetic tapes. Data transcription was charged by the line to the IRS unit seeking the information, creating an incentive to capture less rather than more information. Although Congress made piecemeal allocations to various IRS projects to modernize its computers and establish an electronic filing system, the funds were not enough to permit the agency to hire top-flight information technology expertise. The result was several failed efforts to computerize, a total of $4 billion gone to waste, and a huge public embarrassment for the IRS.

So much money was consumed transporting, unloading, transcribing, sorting, filing, and storing paper returns that the IRS had few resources left to analyze the data it did obtain. As a result, the methodology it used to identify suspect returns was simplistic and outdated. To determine which returns to scrutinize more closely, the IRS used a rudimentary statistical method that analyzed the relationships among amounts entered on a return and compared those numbers to returns with similar incomes. This technique was developed based on large-scale comprehensive audits of taxpayers that were intended to identify indicators of inflated deductions, understated income, and other methods of tax evasion. The last time the IRS had conducted such a study was in 1988. When the IRS sought funding to update its data in 1995, Congress refused to allocate the $400 million it requested.

For obvious reasons, the IRS kept the methods it used to identify questionable returns secret, but the technique was so crude that a statistician
figured out which factors functioned as red flags by conducting regression analyses on a sample of returns, comparing those that had been selected for audit with those that had not. The statistician, author of *How to Beat the I.R.S. at Its Own Game*, advised taxpayers claiming large deductions that they could avoid being audited by doing things such as including an explanation of the deductions on the return and writing neatly.\(^3\)\(^5\)

The difficulty of verifying the accuracy of taxpayer filings was especially acute when it came to returns from high-wealth individuals and businesses. Salaried employees in the United States are subject to mandatory withholding of income tax. They also fall under a third-party reporting regime that constrains their ability to evade taxes: employers report earnings to the IRS, banks report interest earned and mortgage payments, and companies report dividends. Taxpayers earning less than a million dollars a year derive three-quarters of their income from wages so opportunities to fudge numbers are limited. In contrast, corporations and wealthier taxpayers—typically business owners, landlords, and partnership investors—have much greater control over how their gains and losses are reported. They generate and oversee the information included in partnership and other business-related forms, which provides them with much more leeway to evade taxes.\(^3\)\(^6\) The IRS plan to update data that Congress declined to fund in 1995 would have focused on these types of taxpayers.\(^3\)\(^7\)

Despite the greater opportunities for evasion enjoyed by wealthy taxpayers and businesses, the IRS could do little with the data it did collect. Congress refused, for instance, to allocate funds to permit the IRS to match partnership filings to individual and corporate tax returns. As a result, there was no simple mechanism to pull up a partnership return, filed under one name and taxpayer identification number, and the corresponding individual or corporate return, filed under another name and identification number.\(^3\)\(^8\) In addition, the design of the original partnership returns did not correlate with specific entries on individual and corporate returns.\(^3\)\(^9\) The agency’s inability to compare the information from these returns was especially significant since partnerships were a favored vehicle for the creation of tax shelters.

The difficulty of catching tax evasion among high-wealth individuals and businesses was compounded by a significant brain drain at the agency during the 1990s. One problem was compensation. The IRS had inadequate resources to offer competitive salaries to the experienced and highly trained tax professionals that it needed to recreate and untangle...
the sophisticated transactions that underlie complex returns. Partnership returns can run into the hundreds of pages; corporate returns into the thousands. IRS salaries were set at 50 percent of salaries in the private sector, which made it difficult to attract people with the expertise to analyze this information effectively. Another issue was the lack of prestige connected with employment at the IRS in the 1990s. In an earlier period, working at the agency was considered an opportunity for career advancement and a source of professional pride. As the IRS’s failures mounted, however, it became increasingly embarrassing to be associated with it.40 Meanwhile large accounting and law firms were aggressively courting top IRS talent to staff their rapidly expanding tax practices.

In the 1990s, the IRS had few resources and even fewer incentives to audit wealthy taxpayers. Under a tracking method imposed by Congress, the agency’s success was measured in great part by how many cases it resolved, not by how much money was brought in by tax collection. As a result, agents tended to be concerned more with moving cases through the pipeline than with spending time deciphering complex filings that might yield more tax revenues. In addition, since 1995, the IRS had been under a specific mandate from Congress to focus on audits of poor working people who may have improperly claimed the earned income tax credit available to taxpayers with income below a certain threshold.41

The agency’s poor performance showed in its audit rates. In the late 1970s the overall individual audit rate was about 2.5 percent. By 1996, it had declined to 1.67 percent, falling below 1 percent in 1999. Partnership returns were audited even less frequently, at a rate of half a percent.42 Corporations with assets over $100 million, which had been audited in 1980 at a rate of 77 percent, were audited in 1997 at a rate of 35 percent.43 The overall audit rate for corporations fell by nearly a third, from 2.9 percent in 1992 to 2.0 percent in 1998.44 In the late 1990s, there was as great a likelihood for a person earning less than $25,000 to be audited as a person earning more than $100,000.45

Although Congress regularly excoriated the IRS for its inadequacies, since the mid-1990s it had denied the agency the resources needed to improve performance. Resentment toward the agency and dissatisfaction with its operation culminated in the Senate hearings in 1997 and 1998. While the hearings revealed shortcomings in the IRS’s operations, they mainly provided a highly visible forum for antitax forces to levy sensational charges about outrageous agency behavior.
The IRS on Trial

Convening the Senate hearings in the fall of 1997, Senator William Roth declared, “There is no other agency in this country that directly touches the lives of more Americans, nor is there any agency which strikes more fear into their hearts. The threat of an audit, the awesome power of the IRS, looms like the Sword of Damocles over the heads of taxpayers. As Chairman of the Senate Finance Committee, I want to know why. I wanted to understand where this fear came from. I wanted to know if it was justified.”

Several IRS agents offered testimony to the Finance Committee that described examples of ineptitude and corruption at the agency. Ominously fearing for their jobs and even their physical safety, they had been given permission to testify anonymously, sitting behind screens and with their voices electronically altered to prevent identification. Jennifer Long, a long-time IRS employee, testified that IRS agents fabricated evidence against taxpayers they had targeted. The agency, she said, wanted to “stick it to people who couldn’t fight back.” Other witnesses described harrowing dealings with the agency that ended in divorce, homelessness, and even suicide.

Congressional leaders decried the IRS’s “SWAT team” raids and “Gestapo-like” tactics. The news media grabbed the story and ran with it. Sound bites from the proceedings were broadcast on the evening news. Hearing witnesses appeared on Sunday morning talk shows to elaborate on their horror stories. Newsweek even ran a cover article coauthored by former IRS Commissioner Fred Goldberg describing how rogue auditors abused taxpayers.

The IRS’s Criminal Investigation Division (CID) was a prominent focus in this avalanche of criticism. A year after the last Finance Committee hearing, however, an independent commission charged by Congress to study the CID concluded that it was “an organization of dedicated, talented, and hardworking individuals who carry out their law enforcement responsibilities in a professional manner.” During the testimony, representatives of the IRS had sat silently by, limited by statutory confidentiality obligations that prohibited the disclosure of taxpayer information and concerned that any response to counter the charges against the agency would only serve to escalate the accusations.
The hearings also revealed useful, but much less publicized, information about the deleterious impact of insufficient resources and counterproductive incentives. IRS employees and outside experts testified that poor taxpayers “were pursued because their cases were more easily brought to a close,” which resulted in better statistics for performance reports, “while those with money to fight back sometimes were allowed to slip away without paying.” In addition, “[p]rocedures were not always followed, sometimes because of corner cutting to meet productivity demands, more often due to lack of training, which was continually cut because Congress did not pay for it.” There were also complaints that “high-level managers took care of friends and made life difficult for those they disliked.”

On May 7, 1998, in a surprising display of bipartisanship, the Senate passed the IRS Restructuring and Reform Act by a vote of 97 to 0. After the bill was reconciled with an earlier House version, President Clinton signed it into law that summer. The legislation provided that the IRS’s mandate was to restructure and revise its procedures and operations to become a more user-friendly agency. The statute also created a new oversight board, imposed new reporting obligations on the IRS, and granted taxpayers enhanced rights and protections against harassment and other misconduct by IRS employees.

The statute, in addition, contained a little-noted section that accounting firms had long favored. Riding the anti-IRS momentum, the organized accounting profession persuaded Congress to include a provision under which communications between taxpayers and tax practitioners, including tax accountants, would receive the same confidentiality protection as traditionally afforded communications between clients and their lawyers. By expanding the universe of material that tax accountants could keep from the IRS, the statutory tax accountant privilege gave accounting firms a boost in competing with law firms for tax advice business.

The 1998 IRS Restructuring and Reform Act’s emphasis on greater solicitude for taxpayers was consistent with the new IRS Commissioner’s agenda. Charles Rossotti, appointed in late 1997, was the founder of a successful computer consulting company. He was the first commissioner without a tax background, but was regarded as someone who could help modernize the agency and improve its relationship with taxpayers. After passage of the 1998 Act, Rossotti revised the agency’s mission statement.
The stated purpose of the IRS had been “to collect the proper amount of tax revenue at the least cost” in a manner “warranting the highest degree of public confidence in our integrity and fairness.” The revised statement emphasized helping Americans “to understand and meet their tax responsibilities.” The IRS, mindful both of the need to modernize its operations and the beating that it had taken in Senate hearings and in the media, was required to put enforcement activities on the back burner, at least for the time being.

From Tax Collection to Customer Service

Under Rossotti’s leadership, the IRS initiated a massive restructuring and modernization. One hundred thousand employees were reassigned to divisions organized according to taxpayer types, retrained on their new job obligations, and educated about the importance of customer satisfaction. Simultaneously, the agency began shifting to new computer systems to strengthen its information tracking capabilities and expand electronic filing mechanisms, an urgent imperative given the technological fiascos earlier in the decade.

There was no question that taxpayer service was a widespread problem. The agency was doing a poor job of educating taxpayers about their filing and payment responsibilities and explaining collection procedures. One telling statistic: In 1995, taxpayers heard 400 million busy signals when they tried to call the IRS. When callers did get through, they often encountered employees who did not have sufficient knowledge—or much inclination—to assist them. Addressing these problems was a priority, but it came at significant cost. Despite its new mandate for the agency, Congress refused to increase funding. According to one source, the IRS’s budget, adjusted for inflation, actually declined 5 percent between 1992 and 1999, while the number of tax returns and the amount of tax collected grew.

The reorganization significantly strained agency resources. To assist in the restructuring, the IRS hired Booz Allen, a management consulting firm, paying it $100 million for its services. A smaller-ticket item was a million-dollar advertising campaign emphasizing the friendlier tone at the agency. Without new funding, enforcement personnel had to be reassigned to address customer service needs. During filing season, for example, many
collection employees were shifted to answering taxpayer queries. Revenue agents also had to devote many hours to participating in the reorganization process. According to Commissioner Rossotti, a year after the IRS Restructuring and Reform Act's passage, the number of staff available for audits and collections was 19 percent lower than in 1997.

Other provisions in the 1998 bill slowed collection efforts. New procedures that provided stronger taxpayer rights with regard to levies and property seizures made these processes more costly and time consuming. Training employees about new procedures took up time and resources. As Rossotti testified a year after the act was passed, taxpayer rights provisions required the equivalent of nearly 3,000 person years of staff time to comply with procedural requirements. Under the statute, the IRS was also curtailed from using lifestyle audits—targeting people who appeared to be living well beyond their means, at least as they reported on their tax returns. These had been a helpful technique to reveal tax evasion among high-wealth individuals.

The 1998 statute’s disabling effects on tax collection were magnified by the inclusion of a provision known colloquially as the “Ten Deadly Sins,” a list of prohibitions that would result in the dismissal of an IRS agent. The list included some clearly serious conduct, such as lying under oath; it also included other misconduct—harassing or retaliating against a taxpayer—that left broad room for interpretation. Under this provision, a taxpayer complaint could entangle an employee in a drawn-out process in which the employee had to justify her actions or risk losing her job. Appointed to be a watchdog over the agency, the new inspector general for tax administration pursued complaints aggressively. The benefit of complaining about revenue agents was not lost on taxpayers, who began to threaten and use complaints to derail the cases against them. A later investigation confirmed the widespread use of complaints as a dilatory tactic, concluding that nearly 90 percent of those brought in 2001 were meritless. One group of tax resisters filed nearly 2,000 false misconduct complaints against revenue agents as part of a fraudulent scheme to avoid paying taxes.

Given the risks of taking a hard line with recalcitrant taxpayers, the best strategy for enforcement agents was to be nice and keep their heads down. “Don’t aggravate taxpayers,” one agent was instructed by his manager. Another was told, “Don’t probe too deeply. Just find three or
four items and close the case.” Talking to a reporter, one collection agent said: “Please don’t call us tax collectors in the newspaper. We don’t collect taxes anymore. We aren’t allowed to.”

The effects showed up in enforcement statistics. In the 1999 fiscal year, property seizures dropped 98 percent from the year before. Bank account levies and wage garnishments were at one quarter of the level they had been two years earlier. In 1999, the overall audit rate for individuals was less than 1 percent. Face-to-face audits declined by 40 percent. At the same time, the IRS continued to focus its audits on poorer Americans. In 1999, for the first time, taxpayers earning less than $25,000 were more likely to be audited than those earning more than $100,000. Since 1988, the audit rate for wealthier Americans had fallen 90 percent, from 11.4 to 1.15 percent.

During the 1980s, the agency had been perceived as doing an adequate job enforcing the tax laws, but by the late 1990s, it was behind the eight ball. Attempting to respond to the difficulties posed by limited resources, obsolete technology, and new legal constraints, it was unable to keep pace with sophisticated new schemes and techniques that might emerge to avoid paying taxes. At the same time, agency officials had little appetite to engage in aggressive enforcement activity that might risk triggering the type of public denunciation that the IRS had received on Capitol Hill and in the media.

In the meantime, wealthy individuals and corporations—with assistance from large financial institutions, state-of-the-art computer systems, and the emerging Internet—were engaging in increasingly complex business transactions. The United States was experiencing an economic boom that lifted the wealth of corporations and large numbers of entrepreneurs to new heights. In the meantime, accounting firms and law firms, under intense competitive pressures, were anxiously seeking to identify new sources of revenue. Tax strategies, sold as products to multiple clients, offered a new avenue to fuel growth and increase profits. The problem was that the profitable strategies were abusive tax shelters—transactions resulting in tax benefits that were not recognized under the law.