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The Key to Closing the Tax Gap: Understanding

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THE KEY TO CLOSING THE TAX GAP: UNDERSTANDING

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I. INTRODUCTION

The tax gap, the difference between the amount of taxes owed and the amount that is actually paid on time, is an annual \$290 billion problem. Providing greater guidance to taxpayers and tax professionals through increased Internal Revenue Service (IRS) resources can begin to close this gap.¹

¹ This Note examines the tax gap as it concerns income taxes and will not examine any sort of tax gap as it relates to gift and estate taxes. Gift and estate taxes only account for approximately 2% of annual revenue. See REGIS W. CAMPFIELD, MARTIN B. DICKERSON & WILLIAM J. TURNIER, *TAXATION OF ESTATES, GIFTS, & TRUSTS* 17 (23d ed. 2006) (computation of data from 2004). Furthermore, while the introduction deals with Kentucky, this Note is focused on federal income taxation, not state taxation.

In June of 2008, I received a letter from the Kentucky Department of Revenue informing me that I had been noncompliant on my 2006 tax return and owed more money to the Kentucky Department of Treasury. After several phone calls with an extremely helpful agent, we determined what had happened. Between filing two part-year resident returns in West Virginia and Kentucky; filing a federal individual income tax return; determining how to report short-term capital gains, long-term capital gains, and qualified dividends on all three returns; and determining how to report three different W-2's from two different states, we concluded that I simply made a mistake. In fact, I had even tried to pay more taxes in order to avoid being noncompliant by reporting all of the capital gains and dividends on the Kentucky return, even though I had only earned one-fourth while living in Kentucky. After obtaining copies of my statements and filing an amended return, the problem was resolved and I received a refund.

Even though I had made a mistake, I was still considered noncompliant and was part of the cause of Kentucky's tax gap before the situation was rectified. Due to the complexity of the code and forms, I simply did not understand the proper way to report my income. If I had received better guidance initially, I never would have been a part of Kentucky's tax gap.

Once January 1st rolls around and until April 15th of each year, tax return preparation haunts most individuals. The tax gap is the realization of these fears. Whether the taxpayer intentionally or unintentionally erred on his or her tax return, he or she becomes the target of the Internal Revenue Service (IRS). Several variables could have prevented this result: a simplified tax code or increasing the taxpayer's understanding of the code.

Tax professionals are not immune to this situation either. Regardless of how much training or education the preparer has had in tax law, it is still very apparent that he or she makes errors as well. Yet again, a simplified tax code or increased understanding would remedy these errors.

In order for anything to be accomplished in the reduction of the tax gap, the IRS's resources must be increased. At this point, the IRS is barely able to keep up with its current obligations, let alone take on any new initiatives in providing guidance to taxpayers and tax professionals. Thus, a delicate balance must be struck between providing guidance and using resources.

Part II of this Note will explain the tax gap and its effects. Part III of this Note will explain the several causes behind the tax gap. Part IV of this Note will detail specific strategies designed to reduce the tax gap and which strategies are most in line with providing guidance and being effective. Finally, Part V will discuss President Obama's policies and their potential impact on the tax gap.

II. THE TAX GAP

A. *The Mathematics of the Tax Gap*

The tax gap is an ever-increasing problem that most taxpayers completely ignore. The gross tax gap is the difference between the amount of taxes

owed and the amount that is actually paid on time.² The IRS created the National Research Program (NRP) to conduct a survey of 46,000 tax returns to determine the tax gap in 2001.³ The survey is the first attempt to measure the tax gap since 1988.⁴ The tax gap analysis shows that in the year 2001, the gross tax gap was \$345 billion.⁵ After audits and enforcement, the IRS was able to recover about \$55 billion of the taxes owed, resulting in a net tax gap of \$290 billion.⁶ Thus, the net compliance rate for 2001 is 86.3 percent.⁷

Some individuals claim that an 86.3 percent compliance rate is quite large in comparison to compliance rates of other laws, like the seat belt law at 81 percent.⁸ While the compliance rate is greater than other laws, the effects of the tax gap are much more extreme than a seat belt law. Seat belt laws, when violated, affect only the individual that has violated the law. However, when the Internal Revenue Code has been violated, it affects all taxpayers, not just the violator, by increasing taxes for compliant taxpayers and reducing the government's ability to provide beneficial services to the public.

Furthermore, some individuals attempt to downplay the significance of the tax gap by stating that it "does not seem to have increased over the years."⁹ However, this is somewhat of a misstatement. An annual tax gap of \$290 billion adds up quickly and increases the public debt exponentially. The problem is not just the tax gap for one year; the problem is the tax gap that occurs *every* year. There are several reasons why taxpayers and the government must not ignore the importance of the tax gap and, ultimately, reducing it.

B. *The Effects of the Tax Gap*

The tax gap has several effects on the public. First, the tax gap affects the public by (1) reducing what government services taxpayers have at the mo-

² U.S. DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (2006) [hereinafter U.S. DEP'T OF THE TREASURY].

³ CENTER ON BUDGET AND POLICY PRIORITIES, CLOSING THE TAX GAP 1 (2006) [hereinafter CENTER ON BUDGET AND POL'Y PRIORITIES].

⁴ *Id.*

⁵ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 5.

⁶ CENTER ON BUDGET AND POL'Y PRIORITIES, *supra* note 3, at 1.

⁷ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 5.

⁸ *IRS and the Tax Gap: Hearing Before the House Budget Committee*, 110th Cong. 109–11 (2007) (statement of Chris Edwards, Director of Tax Pol'y Studies, CATO Institute).

⁹ *Id.* As one author has noted, "The tax gap is not a primary problem — it is a side effect of our grossly complex tax law and high tax rates." Chris Edwards, *Obama's Treasure Hunt*, in TAX ANALYSTS, TOWARD TAX REFORM: RECOMMENDATIONS FOR PRESIDENT OBAMA'S TASK FORCE 36 (2009), available at <http://www.taxanalysts.com> [hereinafter TAX ANALYSTS, TOWARD TAX REFORM]. While this is a valid and accurate statement, the tax gap is the only measure to show how grossly complex tax law is and how high tax rates truly are. Further, to focus on the tax gap is the only way to get politicians and taxpayers to take note of the problems with the tax system and attempt to fix them.

ment, and (2) reducing what services the public could have if the tax gap were nonexistent.¹⁰ Tax collection is the government's revenue to provide services to the public.¹¹ Thus, by failing to collect billions of dollars annually, the government must either (1) decrease spending or (2) increase the national debt in order to support its efforts.¹² Based on recent events, including both the Iraq War and the Emergency Economic Stabilization Act of 2008, it does not appear that government spending will decrease by any means.¹³ If government spending continues to increase and less revenue is received, the national debt must then increase. The total national debt as of April 1, 2010 is already \$12.76 trillion.¹⁴ This recent increase in spending only highlights the importance of closing the tax gap before it increases the national debt beyond manageability.

By increasing the public debt, the tax burden is shifted to compliant taxpayers.¹⁵ The IRS National Taxpayer Advocate stated that if all compliant taxpayers were to bear an equal portion of the tax gap, each taxpayer would have to pay an extra \$2,200 annually on top of his or her own taxes owed.¹⁶ Viewed in another light, compliant taxpayers ultimately pay approximately twenty percent more due to the tax gap.¹⁷ Furthermore, the lack of revenue from taxes owed prevents the government from making payments to reduce the national debt.¹⁸ The government could take the additional revenue held by the tax gap, invest it, and begin to reduce the annual deficit.¹⁹ Consequently, not only does the tax gap increase the national debt, it prevents the possible decrease of it.

Even though government spending does not appear to be decreasing, it is uncertain what services taxpayers are missing out on due to the tax gap. If the government was receiving an extra \$300 billion annually, it could be supporting new initiatives that target public concerns — whether it be the enforcement of alternative fuel usage or health care reform, \$300 billion could create a vast difference for the future of these initiatives. On the other hand, the extra revenue could be used to improve current programs for the public. Regardless of

¹⁰ OMB WATCH, BRIDGING THE TAX GAP: THE CASE FOR INCREASING THE IRS BUDGET 4 (2008).

¹¹ *Id.*

¹² *Id.*

¹³ See *infra* Part V for a closer examination of recent events and their probable effect on the tax gap.

¹⁴ Treasury Direct, The Debt to the Penny and Who Holds It, Apr. 1, 2010, <http://www.treasurydirect.gov/NP/BPDLLogin?application=np>.

¹⁵ *Id.*

¹⁶ OMB WATCH, *supra* note 10, at 4.

¹⁷ Robert Longley, *What is the Tax Gap and Why Does It Cost You Money?: Annual Shortfall Raises Taxes for All*, About.com, <http://usgovinfo.about.com/od/smallbusiness/a/taxgap.htm?p=1> (last visited Mar. 1, 2010).

¹⁸ OMB WATCH, *supra* note 10, at 4.

¹⁹ *Id.*

how the revenue could be used, it would still be beneficial and, until the tax gap is reduced, we will not see any of its possible benefits — without increasing our national debt.

Second, the tax gap further impacts national debt by requiring the government to borrow assets from other countries. This leads to a multitude of other issues. The major foreign holders of treasury securities as of January 2010 are as follows: (1) China holds approximately \$889 billion; (2) Japan holds approximately \$765 billion; (3) oil exporters, including but not limited to Iran, Iraq, and Saudi Arabia, hold approximately \$218 billion; (4) the United Kingdom holds approximately \$206 billion; and (5) Brazil holds approximately \$169 billion.²⁰ Of the \$12.76 trillion national debt, foreign holders own approximately \$3.7 trillion of the United States' debt.²¹

The United States is put at both political and financial risks because of foreign held debt. There may be certain situations in which the United States may want to take action that is in opposition to the foreign holders of our debt but will hesitate due to the fiscal power these nations now hold as its creditors.²² “[I]n a crisis, the United States’ position as a big net borrower could prove an Achilles’ heel that considerably amplifies the magnitude and duration of a crisis.”²³ Moreover, the United States’ reliance on these countries to continue financing it makes it incredibly dependent.²⁴ If these foreign debt holders stop buying United States debt, the United States would be unable to operate.²⁵ Some possible effects would be the rise of interest rates, the drop in dollar value, and, ultimately, a market slowdown in growth.²⁶ Particularly disturbing is the amount of debt that Iran, Iraq, and other oil exporters hold considering the current state of the United States’ foreign relations with these countries. Thus, it is important to increase revenue on our own.

Third, the tax gap is “economically inefficient” because it encourages tax avoidance.²⁷ As the tax gap increases and people realize the enormous

²⁰ U.S. Department of the Treasury, Major Foreign Holders of Treasury Securities (Jan. 2010), <http://www.treas.gov/tic/mfh.txt>.

²¹ *Id.*

²² Posting of Eric Ames to InvestorCentric Blog, <http://www.nuwireinvestor.com/blogs/investorcentric/2008/09/americas-huge-debt-to-foreign-countries.html> (Sept. 10, 2008, 13:02 EST).

²³ *Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?: Hearing Before the Comm. on the Budget, H.R.*, 110th Cong. 60–62 (2007) [hereinafter *Foreign Holdings of U.S. Debt*: statement of Rogoff] (statement of Dr. Kenneth Rogoff, Thomas D. Cabot Professor of Public Pol’y and Professor of Economics, Harvard University, and Visiting Fellow, Brookings Institution).

²⁴ Posting of Eric Ames, *supra* note 22.

²⁵ *Foreign Holdings of U.S. Debt*: statement of Rogoff, *supra* note 23, at 60–62.

²⁶ *Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?: Hearing Before the Comm. on the Budget, H.R.*, 110th Cong. 45–49 (2007) (statement of Dr. Robert D. Hormats, Vice Chairman, Goldman Sachs (Int’l)).

²⁷ CENTER ON BUDGET AND POL’Y PRIORITIES, *supra* note 3, at 1.

amount of taxes that remain uncollected, these people will believe, on the fairness principle, that they should not have to pay taxes as well.²⁸ The tax gap, then, will continue to increase. This also ultimately leads to a downward spiral in public policy, where taxpayers will object to tax increases, again, due to unfairness, and new government services and expansions financed by the possible tax increases will not receive support — regardless of how important the services may be.²⁹

Effectively, the tax gap is much more than just the difference between the amount of taxes owed and the amount paid on time. It has resounding effects, which only make the importance of closing the tax gap that much more apparent. Whether we focus our attention on the tax gap's effect on taxpayer services, an increased national debt, or foreign held debt ramifications, the “parade of horrors” makes the tax gap more than just a \$290 billion annual problem.

III. THE CAUSES OF THE TAX GAP

A. *Sources of the Tax Gap*

The NRP survey results indicate that the main source of the tax gap is due to individual income tax account errors, which represent about two-thirds of the gap.³⁰ As shown by **Chart 1** on the following page, there are three main sources of the tax gap in individual income tax account errors: (1) underreporting, (2) non-filing, and (3) underpayment.³¹ Of these three sources, underreporting is the greatest problem. Underreporting of tax includes either underreporting of income or overstating deductions or credits.³² It accounts for about eighty-three percent of the tax gap.³³ More specifically, about forty-one percent of the gross tax gap is due to underreporting of net business income by individuals.³⁴

The remaining seventeen percent of the tax gap is due to non-filing of tax returns and underpayments of taxes.³⁵ Underpayment of taxes accounts for ten percent of the remainder of the tax gap.³⁶ These underpayments are largely due to the failure of employers to send withheld income and employment taxes

²⁸ *Id.*

²⁹ OMB WATCH, *supra* note 10, at 4.

³⁰ INTERNAL REVENUE SERVICE, TAX-GAP FACTS & FIGURES (2005), http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf.

³¹ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 6.

³² *Id.*

³³ *Id.* at 7.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 6.

to the IRS, rather than individuals failing to completely pay taxes owed.³⁷ The final source of the tax gap, about seven percent, is the failure of individuals to file tax returns.³⁸

Based on the NRP's findings, noncompliance rates are higher for income that is not subject to mandatory withholding by the payer or third-party reporting requirements.³⁹ In comparison, only approximately one percent of the taxes due on wage income that is subject to mandatory withholding and third party reporting was not reported to the IRS by taxpayers in tax year 2001.⁴⁰ However, it is uncertain how many of these errors can be attributed to intentional evasion.⁴¹ Regardless, providing guidance to taxpayers and simplifying the code would help eliminate evasion and unintentional errors alike.

Percentage of Tax Gap



Chart 1. Sources of the Tax Gap

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.* at 7–8.

⁴⁰ *Id.* at 7.

⁴¹ *Id.* at 8.

B. *Tax Professional Errors*

Tax professionals — whether a Certified Public Accountant (CPA), tax attorney, or someone who has had some other tax training — are supposed to be able to guide their clients in tax return preparation. However, based on recent studies, even tax professionals are having difficulty with the complexity of the Internal Revenue Code. This only makes it more apparent that lack of understanding is the culprit behind the tax gap.

The United States Government Accountability Office (GAO) conducted a limited study on chain paid preparers and their rates of errors.⁴² Paid preparers include those individuals that are enrolled agents, who must pass an examination on tax matters or prove previous IRS employment, and unenrolled agents, which include self-employed individuals and individuals that work for tax preparation chains.⁴³ According to the study, fifty-six percent of all individual tax returns filed for tax year 2002 used a paid preparer.⁴⁴ Most of the individuals that used a paid preparer were those taxpayers that had more complicated returns.⁴⁵

The GAO conducted its study by visiting nineteen outlets of several tax preparation chains with two different scenarios.⁴⁶ The study indicated that the paid preparers prepared significantly incorrect returns including the following errors: (1) extra refunds of up to almost \$2,000 in five cases; (2) extra payments costing taxpayers over \$1,500 in two cases; (3) not reporting business income in ten of the nineteen cases; (4) claiming ineligible children for the earned income credit in half of the cases; (5) failure to take the most beneficial postsecondary education tax credits in thirty-three percent of the cases; and (6) failure to itemize deductions or take all the applicable deductions in seven out of nine cases.⁴⁷ Ultimately, all nineteen of the GAO's visits to tax preparation chains resulted in some sort of error.⁴⁸

As stated previously, underreporting of net business income results in the largest portion of the tax gap.⁴⁹ Thus, the fact that the GAO's study reported huge errors concerning business income is quite alarming. Each of the nineteen cases included self-employment income; however, two out of nine returns of the first scenario and eight out of ten returns of the second scenario did not report

⁴² See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, CHAIN PREPARERS MADE SERIOUS MISTAKES (2006) [hereinafter U.S. GOV'T ACCOUNTABILITY OFF.].

⁴³ See *id.*

⁴⁴ *Id.* at 6.

⁴⁵ See *id.* at 6–8.

⁴⁶ *Id.* at 3.

⁴⁷ *Id.* at 5.

⁴⁸ *Id.* at 14.

⁴⁹ See *supra* Part III.A.

the income.⁵⁰ Even in the minimal cases where the income was reported, the paid preparers gave incorrect information by advising the GAO taxpayer that reporting the income was *optional* because the IRS would not have knowledge of it otherwise or that the income did not need to be reported unless it was over \$3,200.⁵¹ The scenarios that the GAO presented were similar to those in which taxpayers underreported business income for tax year 2001.⁵² Thus, it is clear that regardless of whether a taxpayer prepares his or her own return or relies on a paid preparer that has been trained, errors occur.

Several other studies also evidence the need to reduce the complexity of tax preparation for taxpayers and tax professionals. The NRP study determined that fifty-six percent of returns prepared by a paid preparer had errors in comparison to only forty-seven percent prepared by the taxpayer.⁵³ The IRS further conducted a study based on tax year 1994 that evaluated 2046 tax returns claiming the earned income tax credit.⁵⁴ The study revealed that of the \$17.2 billion in earned income tax credit benefits claimed, \$4.4 billion or twenty-six percent was over-claimed.⁵⁵ The following list includes error rates among the sub-categories of paid preparers:

- Attorneys, CPAs, and enrolled agents prepared nine percent of the evaluated returns and had an error rate of 14.8 percent;
- Tax preparation chains prepared 15.6 percent of the returns and had an error rate of 23.1 percent;
- The “other” category of paid preparers prepared thirty percent of the returns and had an error rate of 30.6 percent.⁵⁶

These error rates are particularly disturbing considering that almost half of the returns were self-prepared and had an error rate of twenty-six percent, and the error rate of nationally recognized chains was only slightly below at 23.1 percent.⁵⁷ Although the actual magnitude of the error is not expressed in percentages, it appears that it is almost more advantageous for a taxpayer to keep the

⁵⁰ U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 42, at 19.

⁵¹ *Id.* (emphasis added). The definitions of “gross income” and “net earnings from self-employment” do not in any way suggest that the reporting is optional. I.R.C. § 61 (2006); I.R.C. § 1402 (2006).

⁵² U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 42, at 20.

⁵³ *Id.* at 27.

⁵⁴ Michael A. O'Connor, *Tax Preparation Services for Lower-Income Filers: A Glass Half Full, or Half Empty?*, TAX NOTES, Jan. 8, 2001, at 238.

⁵⁵ *Id.* at 239.

⁵⁶ *Id.*

⁵⁷ *Id.*

money spent on a paid preparer since the taxpayer, in essence, does the same amount of damage on his or her own.

These studies illustrate how easy it is for tax professionals to make errors, but the greatest, most recent example of lack of understanding within the field is that of Timothy Geithner. Geithner, now United States Secretary of the Treasury, failed to pay \$34,000 of self-employment taxes over a span of several years.⁵⁸ Notably, Geithner had enlisted an accountant to aid with his returns.⁵⁹ Thus, as the studies above suggest, tax professionals have the same issues understanding the tax code as taxpayers without any sort of training, which makes it that much easier for mistakes — intentional or innocent — to occur. Although the error was dismissed as an “honest mistake,”⁶⁰ for the several years that Geithner failed to pay the taxes, he contributed to the tax gap. Beyond the fact that Geithner’s accountant made errors, it is important to recognize Geithner’s position as the head of the Department of the Treasury. The Department of the Treasury manages government revenue through tax collection as well as through issuing regulations relating to Internal Revenue Code sections.⁶¹ There is an apparent problem when even the official charged with enforcing the tax code makes honest mistakes in completing his own taxes.

From these studies as well as the real-life example of Timothy Geithner, it is important to recognize that individual taxpayers are not the only preparers that face difficulties and make mistakes. Most of these paid preparers have at least had some sort of basic training and exposure to tax return preparation.⁶² Yet, still, their mistakes increase the tax gap.

⁵⁸ Op-Ed., *A Geithner Tax Amnesty*, WALL ST. J., Jan. 15, 2009, at A10 [hereinafter *A Geithner Tax Amnesty*]. The IRS audited Geithner in 2006 for the years 2003 and 2004. However, even after this audit, Geithner only paid back taxes for the years audited and failed to amend his tax returns for 2001 and 2002 until after the issue was brought to light during the Treasury Secretary selection process. *Id.*

⁵⁹ Op-Ed., *Geithner’s Tax Code*, WALL ST. J., Jan. 22, 2009, at A16.

⁶⁰ *A Geithner Tax Amnesty*, *supra* note 58.

⁶¹ See United States Department of the Treasury, Duties & Functions of the Department of the Treasury, <http://treas.gov/education/duties> (last visited Mar. 1, 2010).

⁶² See O’Connor, *supra* note 54, at 243–44. Attorneys typically complete four years of undergraduate college, three years of law school, and pass a multi-day bar exam. CPAs typically complete four years of undergraduate college and pass a multi-day exam. Enrolled agents are admitted to practice before the IRS under Circular 230, regulations issued by the Secretary of the Treasury. Chain paid preparers operate training programs that are open to the public. One example of a course takes on average about 56 hours to complete and a written exam. The “other” category includes both highly experienced individuals and self-taught individuals. *Id.*

C. *Internal Revenue Service Resources*

Although the three major sources of the tax gap have been determined, they have not been remedied. The greatest problem behind the tax gap, then, lies within the IRS's resources or, rather, lack thereof. The IRS budget has failed to increase in a decade, after adjusting for inflation, regardless of the mounting demands it faces in providing public services as well as tax enforcement.⁶³ Even within the last few years, the IRS's budget has increased by only a nominal amount. As **Chart 2** shows, in fiscal year (FY) 2006, the enacted total appropriation was \$10.8 billion.⁶⁴ In FY 2007, the budget increased by only 1.4 percent.⁶⁵ For FY 2008, the budget increased by 4.1 percent.⁶⁶ Although this increase was greater than the year before, it is still not enough to make up for the total lack of resources that has plagued the IRS in relationship to the amount of services it must provide.

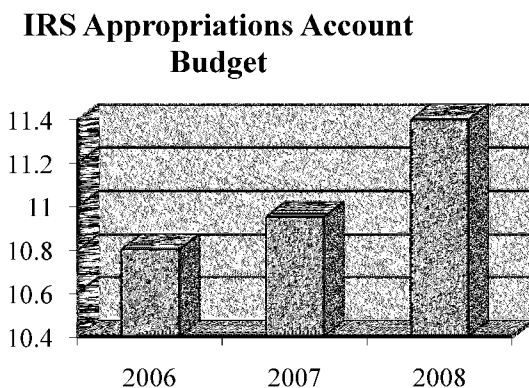


Chart 2. IRS Appropriations Account Budget

⁶³ OMB WATCH, *supra* note 10, at 5. Based on the inflation calculator provided on the Bureau of Labor Statistics's website, \$1 in 2006 had the same buying power as \$1.07 in 2008, deducing an inflation rate of seven percent. See Bureau of Labor Statistics, Overview of BLS Statistics on Inflation and Prices, <http://www.bls.gov/bls/inflation.htm> (2008) (click on the "CPI inflation calculator" link, enter \$1 in the first box, select 2006 from the first drop-down menu, select 2008 from the second drop-down menu, and click "Calculate").

⁶⁴ U.S. Department of the Treasury, Internal Revenue Service Budget in Brief FY 2008 (2007), available at <http://www.irs.gov/pub/newsroom/budget-in-brief-2008.pdf> [hereinafter U.S. Dep't of the Treasury, I.R.S. Budget in Brief].

⁶⁵ See *id.*

⁶⁶ See *id.*

To illustrate the actual increases in the budget, it is important to adjust the amounts for inflation. Thus, the \$10.96 billion budget in 2007 has the same buying power as only \$10.66 billion in 2006.⁶⁷ The \$11.4 billion budget in 2008 has the same buying power as only \$10.67 billion in 2006 and \$10.98 billion in 2007.⁶⁸ Hence, the actual budget changes can be seen in **Chart 3** below.

Budget Adjusted for Inflation

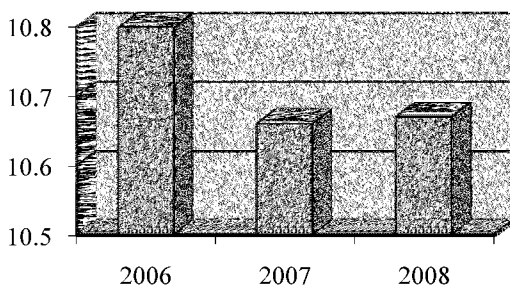


Chart 3. IRS Appropriations Account Budget Adjusted for Inflation

The area of the IRS's budget that has felt the impact most is the enforcement account.⁶⁹ The enforcement account includes support for "tax return examinations, tax collections, and document matching services that compare financial records."⁷⁰ The enforcement account budgets, between FY 1995 and FY 2006, increased by less than five percent.⁷¹ During this period,

- Inflation eroded the value of this funding by 36 percent;
- The size of the economy grew 42 percent;
- The number of tax returns the IRS processed increased by 11 percent, from 205 million to 228 million; and

⁶⁷ Bureau of Labor Statistics, *supra* note 63. Follow the same steps as indicated in footnote 63, but change the dollar amounts and years as necessary.

⁶⁸ *Id.*

⁶⁹ OMB WATCH, *supra* note 10, at 5.

⁷⁰ *Id.*

⁷¹ *Id.*

- Hundreds of changes to the IRS's authority and tax laws gave the agency more work.⁷²

This staggering growth in combination with lack of funding significantly handicaps the IRS's power in extinguishing the tax gap.

These funding problems directly impact other IRS resources, such as employment.⁷³ Total employment has actually decreased over the past ten years, from 114,000 to 92,000.⁷⁴ The greatest area, again, that has felt the most impact of lack of resources is within enforcement, including IRS employees who perform the audits.⁷⁵ The number of revenue agents has fallen by forty percent, and the number of officers has fallen by thirty percent.⁷⁶ Without the manpower to audit tax returns, it is extremely difficult to determine all errors contributing to the tax gap.

With the lack of funding and manpower to enforce tax policy, the quality and quantity of audits has significantly decreased. Audits are the first step and an integral aspect to closing the tax gap.⁷⁷ **Chart 4** shows that with funding levels and staffing, audit rates have decreased over the past ten years.⁷⁸ The audit rate in FY 1996 was 1.67 percent for individual income tax returns.⁷⁹ This rate dropped to 0.5 percent in FY 2000 and has increased to 1.0 percent in FY 2006.⁸⁰ However, this increase from FY 2000 to FY 2006 is still insufficient considering the increase in size of the economy, the number of returns filed, and the abundant changes in tax law.

⁷² *Id.*

⁷³ *Id.* at 6.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* at 7.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

Audit Rates of Individual Returns

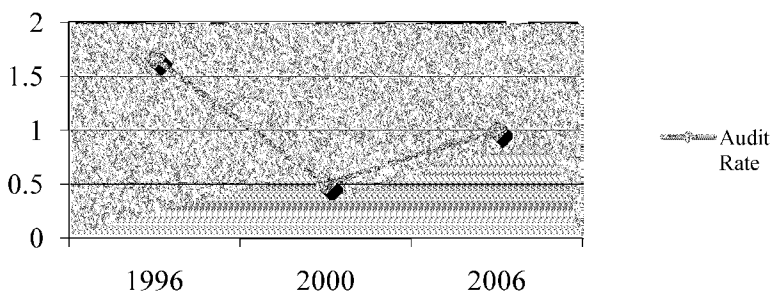


Chart 4. Audit Rates of Individual Income Tax Returns

The severity of this problem is increased by examining the decrease of audits according to taxpayer income levels. Taxpayers with incomes over \$100,000 and business income tax returns have all been insufficiently audited in comparison with prior year levels.⁸¹ For taxpayers with an income over \$100,000, audit rates were 5.28 percent in FY 1992, 2.85 percent in FY 1996, and 1.3 percent in FY 2006.⁸² Business income has been audited at a fairly steady rate since FY 1995.⁸³ However, because business income has been identified as the leading source behind the tax gap, more audits are necessary to investigate and enforce tax laws.⁸⁴

Individual income tax returns audits are not the only audits that are being neglected. Corporate audit rates have also decreased from 2.4 percent in FY 1996 to 1.2 percent in FY 2006.⁸⁵ Furthermore, audit rates have decreased most significantly among the largest corporations in the last ten years, from a seventy percent decline in corporations with assets between \$5 and \$10 million and a thirty-five percent decline in corporations with assets between \$50 and \$100 million.⁸⁶ Because corporations are able to take advantage of loopholes and special interest provisions, audit rates must increase.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 7–8.

Moreover, the types of audits have decreased resulting in less of an opportunity to close the tax gap. Face-to-face audits are the most meticulous and exhaustive investigations the IRS conducts.⁸⁷ This type of audit generally produces considerably more revenue than its alternative, a correspondence audit.⁸⁸ Correspondence audits normally consist of an IRS letter being sent to the taxpayer containing a few questions about the taxpayer's return.⁸⁹ Face-to-face audits of taxpayers earning over \$100,000 produced, on average, \$54,934 in FY 2006.⁹⁰ Correspondence audits, on the other hand, only produced \$31,912.⁹¹ Audits of large corporations showed an even greater need for more face-to-face audits. Face-to-face audits of large corporations produced an average of \$2.6 million, while correspondence audits of similar corporations only produced \$285,000.⁹² Even though face-to-face audits produce a significant portion of the tax gap, seventy-seven percent of all audits in FY 2006 were correspondence audits.⁹³

The IRS has a difficult job to undertake in closing the tax gap. However, by determining the major players in the tax gap, the IRS can focus its attention to these areas. With increased funding, the IRS can then provide greater guidance to taxpayers and tax professionals alike.

IV. THE SOLUTIONS TO THE TAX GAP

It is important to recognize that

the tax code is a major instrument of U.S. policy. No one argues that expenditure policy should be left alone. As an evolving society develops new needs and new information sources, institutions must change, and government must spend its money differently. The same holds true for collecting taxes. Certainly, some aspects of the tax code should be changed only gradually, especially those that involve complex accounting matters. But an equal claim for a modest pace of reform can be made for many expenditures Other expenditure provisions, such as the size of the armed forces, must evolve more rapidly. Thus, the tax

⁸⁷ *Id.* at 8.

⁸⁸ *Id.* at 10.

⁸⁹ *Id.*

⁹⁰ *Id.* at 11.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

code will evolve not just because politicians can't keep their hands off of it, but also because they should not.⁹⁴

This statement applies not just to the tax code but our tax system as a whole. If Capitol Hill is serious about closing the tax gap, change must ensue.

There are two basic methods for reducing the tax gap: (1) providing guidance to taxpayers and tax professionals, and (2) increasing the IRS's resources. The IRS and other governmental entities have been strategizing for some time on the appropriate solutions to eliminate the tax gap.⁹⁵ All of these strategies can be boiled down to the basic theme of increasing the taxpayer's and tax professional's understanding of tax law. Moreover, it is important to be aware of the lack of uniformity within the tax adjudication system and how this amplifies the tax gap problem. However, in order to provide guidance and understanding, the IRS must be granted more funding and manpower to implement these strategies. Thus, Part IV.A. focuses on the IRS's strategy for reducing the tax gap, while Part IV.B. explains the current state of tax adjudication. Both Parts IV.A and IV.B. highlight the proposed changes in their respective topics and how the changes relate to the key to closing the tax gap: understanding. Part IV.C. emphasizes the need for increased IRS funding so that guidance may be supplied.

A. *The IRS's Strategy for Reducing the Tax Gap*

The IRS, Treasury, and the Office of Management and Budget (OMB) joined together to develop a strategy for reducing the tax gap.⁹⁶ They identified four key principles, which will guide the development of their plan:

- First, unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Second, sources of noncompliance should be targeted with specificity.

⁹⁴ C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 7 (2d ed. 2008).

⁹⁵ Many experts and scholars believe that reducing the tax gap is a moot point. For example, Michael Graetz, a Yale University professor and former Treasury official, echoes these sentiments by stating, "We're shooting ourselves in the foot economically by relying as heavily as we do on income taxes when the rest of the world relies on consumption taxes I think you can tinker with the existing system, but anybody who believes they are going to get enough revenue simply by improving collection of taxes owed is fooling themselves." John D. McKinnon, *U.S. News: White House Leans Toward Tighter Enforcement of Taxes*, WALL ST. J., Mar. 26, 2009, at A4. While Graetz and others believe that a complete overhaul is necessary and *could* happen, the probabilities are against such a change. Thus, this Note focuses on the current system and how it can be improved — rather than waiting on some miraculous transformation of the tax system.

⁹⁶ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 2.

- Third, enforcement activities should be combined with a commitment to taxpayer service.
- Fourth, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.⁹⁷

The plan implements seven components, which — it is believed — should reduce the tax gap. While some of the components are good ideas, they are not necessarily practical and do not go to the core of the tax gap, which is taxpayers' and tax professionals' lack of understanding of the tax code. Below, this Note will explain these components briefly in subparts IV.A.1. and 2. On the other hand, several of the components precisely address the core issue. This Note will address these components in greater detail in subparts IV.A.3. through 5.

1. Reduce Opportunities for Evasion and Improve Compliance Activities

Two important steps the IRS must take to impact the tax gap are to reduce opportunities for taxpayers to evade paying their taxes and improve compliance activities, which essentially go hand-in-hand. The IRS's comprehensive strategy concerning reduction of opportunities for evasion involves several methods, also intersecting with the goal of improved compliance. These methods include (1) strengthening reporting requirements for third-parties; (2) expanding IRS access to reliable data from third-parties; (3) enhancing examination and collections authority; (4) enabling the IRS to detect and prevent taxpayer non-compliance year after year; and (5) setting penalties at more appropriate levels to change taxpayer behavior but reasonable enough to enforce.⁹⁸

It is believed that the key to reducing evasion and improving compliance is to improve the receipt of reliable third-party information.⁹⁹ Third-party information refers to information returns provided by employers, financial institutions, and state and federal governments.¹⁰⁰ The IRS currently receives more than 1.5 billion information returns from these third parties.¹⁰¹ Regardless, the IRS still does not receive enough reliable information to close the tax gap.¹⁰² Most significantly, the IRS lacks reliable information concerning business in-

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at 9.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

come, specifically self-employment information, which is the leading source of the tax gap.¹⁰³

Thus, the first method of reducing opportunities for evasion is strengthening reporting requirements, which is “essential to improving tax compliance” and reducing the tax gap.¹⁰⁴ Much of the underreporting that occurs in business income — the primary source of the tax gap — occurs in cash transactions, where a person is not required to report the transaction.¹⁰⁵ One way to eliminate this problem includes expanding the scope of information reporting, thereby strengthening reporting requirements.¹⁰⁶ Access to more information sources and third-party information, such as credit and debit card transactions reporting by financial institutions, would allow the IRS to better target its audits and enforcement.¹⁰⁷ This would also lead to greater voluntary compliance because taxpayers would fear making errors, being audited, and suffering penalties. “[V]isibility [of the taxpayer and his or her information] is a key factor in tax compliance.”¹⁰⁸

One such example of the increase in access, which has been proposed in Congress, is the increased reporting requirement for financial institutions that process business credit and debit card transactions to report the business’s annual expenditures.¹⁰⁹ The Bush administration re-proposed the idea in February 2007, after Congress ignored it in 2006, with an estimate of raising \$10.3 billion of revenue over ten years.¹¹⁰ However, the reporting requirement has been criticized for several reasons. First, it could result in high compliance costs for small businesses.¹¹¹ Second, it is uncertain how the IRS will be able to use the data.¹¹² Credit card companies will most likely report only credit data, while businesses will report both credit and cash transactions combined.¹¹³ Thus, it will be difficult for the IRS to reconcile this information, as it will be difficult to

¹⁰³ *Id.*

¹⁰⁴ Congress Invites My Ideas for Improving Tax Compliance and of Course I Respond, Letter from Prof. James Edward Maule, Mauled Again, http://mauledagain.blogspot.com/2007_03_01_archive.html#5764735760967873213 (March 23, 2007, 9:04 EST) [hereinafter Letter from Prof. James Edward Maule].

¹⁰⁵ *Id.*

¹⁰⁶ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 13.

¹⁰⁷ *Id.*; see *supra* Part IV.A.1.

¹⁰⁸ Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 AM. U. L. REV. 1163, 1179 (2007) (citation omitted).

¹⁰⁹ Martin A. Sullivan, *Treasury Expects Billions From Credit Card Reporting Proposal*, TAX ANALYSTS, June 4, 2007, at 890, available at <http://www.taxanalysts.com/www/features.nsf/Articles/7CD60C28151D8003852572F800542887?OpenDocument>.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 891.

¹¹² *Id.*

¹¹³ *Id.*

separate and follow the two types of transactions.¹¹⁴ Finally, unnecessary audits of honest businesses could result due to the IRS's inability to effectively reconcile the financial institution's data, resulting in a waste of the IRS's time and resources.¹¹⁵

Another method, which is consistent with the idea behind this Note, for reducing opportunities for evasion is by providing guidance to taxpayers. As the Treasury explained, "[g]uidance clarifies ambiguous areas of the law, increasing voluntary compliance. Guidance also targets specific areas of non-compliance [sic] and prevents abusive behavior, such as tax shelters."¹¹⁶ By providing regulations and administrative guidance to taxpayers, there will be less confusion for taxpayers to make unintentional errors and, ultimately, decrease the tax gap. Several examples of guidance that have already been implemented are the regulations following the American Jobs Creation Act of 2004, which executed additional reportable transaction disclosures and penalties, and new publications of forms and instructions.¹¹⁷ Such regulations and administrative guidance not only prevent costly errors, but they increase the efficiency in tax administration.¹¹⁸

While the idea of strengthening reporting requirements appears to be a large leap in the reduction of the tax gap, it will most likely be difficult to implement. Just like the example of the increased reporting of credit card transactions, requiring greater third-party information could be costly for the taxpayer and the third-party. Unless the IRS can make such reporting inexpensive and less time-consuming, it is unlikely that this approach will be effective. The requirements will likely be ignored, which will lead to the third-party being penalized. This completely misses the mark. The third-party should not be penalized for what the taxpayer should have reported in the first place. If the IRS would like to increase reporting requirements, it must ensure that the third party is not burdened more than the taxpayer.

Additional reporting requirements should be limited to those institutions that have the capabilities to track the pertinent information and limited to those transactions that are capable of being effectively tracked. One such example is tax basis reporting for investments by mutual funds and brokerage firms.¹¹⁹

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 892.

¹¹⁶ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 9.

¹¹⁷ *Id.* at 10.

¹¹⁸ *Id.*

¹¹⁹ Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371, 379 (2007). The tax basis can be considered the cost basis, i.e., the amount paid for the stock on the date of the sale. Tax basis problem is explained as follows:

Under current law, the Code provides that the net amount realized less adjusted basis determines a taxpayer's gain or loss. The amount realized is a current "fact" and presents no major conceptual or administrative problems. But the same cannot be said about tax basis identification. For reasons relat-

These firms are in the perfect situation to track the tax basis for their clients; most of them have some sort of data tracking system in existence that already records this type of information.¹²⁰ Therefore, in order to reduce opportunities for evasion, the IRS must balance the third-party's interests as well and determine which entities are in the best positions to supply more information. Ultimately, while this approach may provide transparency to the IRS, it does little to increase a taxpayer's understanding of the tax code and the proper way to report income.

As noted above, providing additional guidance and *clearer* guidance is an important step to reducing the tax gap by reducing tax evasion and improving compliance. If it is clear what the IRS and/or tax form are asking of the taxpayer, it will make it extremely difficult for an individual to avoid providing the information or claiming an extra deduction.

2. Make a Multi-Year Commitment to Research

Research, such as the National Research Program (NRP), aids the IRS in closing the tax gap by determining which areas are most noncompliant, improving voluntary compliance, and allocating funding and staffing resources more effectively.¹²¹ The NRP has already taken vast strides in the initial phase of reducing the tax gap. After the IRS reviewed approximately 46,000 tax returns from tax year 2001, the NRP was able to identify the greatest sources of the tax gap.¹²² Such an examination can "provide[] a critical benchmark for determining the sources of noncompliance and for measuring changes in compliance rates over time."¹²³ These benchmarks have already provided guidance to target changes in the areas of business income and increased audits.

Based on the success of the NRP, it is clear that more research could be beneficial to make waves in tax gap reduction. Although the NRP most recently measured the tax gap as of tax year 2001, the IRS is relying on research conducted over twenty years ago to determine compliance in areas other than those studied in the NRP.¹²⁴ Furthermore, without current analysis of the tax gap in

ing to complexity, the absence of a substantiation requirement, and the lack of compliance incentives, tax basis identifications have historically proven extraordinarily difficult for taxpayers to make. When confronted with these difficulties, taxpayers must often make estimates; and when they do, they unintentionally or deliberately err in their own favor, costing the government billions of dollars annually.

Id. at 377–79.

¹²⁰ *Id.* at 379.

¹²¹ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 11.

¹²² *See supra* Part III.B.

¹²³ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 11.

¹²⁴ *Id.*

all areas, the IRS cannot respond quickly enough to eliminate any “emerging vulnerabilities” in the tax code and administration.¹²⁵

The IRS has already begun considering research in several new areas. First, the NRP reporting compliance studies, such as that of tax year 2001, must be updated repeatedly so the IRS may address any new compliance problems that emerge.¹²⁶ Second, the NRP reporting compliance studies must be expanded to other areas and sources of noncompliance such as partnerships, non-profit organizations, and government entities.¹²⁷ Third, smaller and targeted studies should be conducted to gain more information about certain sources of noncompliance and determine whether the new compliance strategies are working or futile.¹²⁸ Fourth, studies should be expanded to determine the relationship between taxpayer services and compliance.¹²⁹ This relates to the idea of guidance being the key to reducing opportunities for evasion.¹³⁰ By determining which taxpayer services aid compliance most effectively, the IRS can develop more programs to relieve taxpayer burdens, improve compliance, and reduce the tax gap.¹³¹ Fifth, research can aid the IRS in developing tools to determine “similarities in abusive tax reduction strategies.”¹³² If the IRS is able to determine such patterns, it can recognize and audit the noncompliance more immediately.¹³³ Finally, research can aid the IRS in determining which sources of noncompliance need more attention and resources and which areas need less.¹³⁴

Thus, a multi-year commitment to research could significantly help the IRS to reduce the tax gap. This is really just the starting point for reducing the tax gap, however. It will take more than just informational studies to change the current tax situation. One problem that the IRS faces in implementing this strategy is its lack of resources. Conducting these studies requires both money and people. If the IRS is capable of obtaining more funding for these research projects, the studies can help the IRS to target sources of noncompliance. However, the IRS cannot just conduct studies and fail to take action based on its findings.¹³⁵ This would be a waste of resources that could have been used to

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at 12.

¹³⁰ *See supra* Part IV.A.1.

¹³¹ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 12.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ “What is and has been lacking is not ideas, but political will.” H. David Rosenbloom, *Political Will Can Shore Up Tax Administration, Enact Reform*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 73. As will be discussed in greater detail in Part V, President Obama has initiated his own study of the tax system. The goals and areas of the study are essentially the same

audit noncompliant taxpayers instead and actually receive revenue. Although current studies are twenty years old and each year new provisions are added to the Internal Revenue Code, the code has not changed so dramatically that the studies are irrelevant today. If research is continuously conducted, it should focus on different, specific aspects of the tax system rather than focusing on general problems that have already been studied. The IRS must continue to use the information from the studies to create strategies and direct guidance to increase compliance, which will slowly but surely reduce the tax gap.

3. Continue Improvements in Information Technology

As computers and Internet have exploded over the past two decades, it is important for businesses and even governmental entities to remain up-to-date with their information technology. Tax administration is no exception. “[T]axpayers consider, for good reason, computers to be central to the tax return preparation and filing process”¹³⁶ — whether to use tax preparation programs, file returns electronically, or search for answers on the IRS’s website (irs.gov).

The IRS has determined several areas in which its information technology is lagging and has dedicated itself to improving these areas.¹³⁷ First, the IRS has adopted a new data system, the Customer Account Data Engine (CADE), which will allow it to manage accounts more efficiently and effectively.¹³⁸ CADE may also enable the IRS’s research goals by providing the data, again more efficiently and effectively, for the studies.¹³⁹ CADE has already proven to be successful. With each new release that is rolled out, the number of returns processed increases significantly.¹⁴⁰ For example, in 2007, CADE was able to process 11.2 million returns for the year; in 2008, CADE was able to process 15.1 million returns through March 7, 2008.¹⁴¹

Second, information technology will be improved to deliver better guidance and customer service for taxpayers.¹⁴² Several examples of this improved information technology are an updated E-File system and other web services at reduced costs.¹⁴³ Finally, the IRS will invest in infrastructure that will aid in

as those already completed; thus, the only real benefit of the new study is that President Obama may actually take action based on the findings.

¹³⁶ Soled, *supra* note 119, at 374–75.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 12.

¹⁴⁰ Internal Revenue Service, *IRS CADE Processing System Tops 15 Million Tax Returns*, March 12, 2008, <http://www.irs.gov/newsroom/article/0,,id=180038,00.html>.

¹⁴¹ *Id.*

¹⁴² U.S. DEP’T OF THE TREASURY, *supra* note 2, at 12.

¹⁴³ *Id.*

performing operations more efficiently so that previously used resources can be used in other areas such as enforcement.¹⁴⁴

By improving information technology, the IRS can pursue several areas that have affected and contributed to the tax gap. Information technology is one area in which the IRS is not utilizing its opportunity to improve taxpayer guidance to its full potential. The IRS's website could be greatly improved to provide relevant answers more quickly to taxpayers. Most individual taxpayers are not educated in tax lingo and may not know the exact terminology to use when searching for an answer. The search function, then, provides hundreds of results for a simple query; however, it typically takes several attempts before the relevant result appears. If the individual is unsuccessful in obtaining the result he or she needs, he or she will likely be discouraged and fill out the return incorrectly. Thus, the search function needs to be improved.

Furthermore, a short video tutorial could be a useful tool for individuals, businesses, and tax-exempt entities. The tutorial could cover basic concepts such as describing the necessary forms and what different terms mean. More advanced tutorials could cover the areas that have been identified as the most troubling for taxpayers — including the earned income tax credit. Just a short video narrated by a person could greatly aid many taxpayers by not only being available immediately (instead of waiting on someone to answer a phone call) but also by providing a breath of fresh air from the monotonous form instructions. Any information provided from the videos would then be built upon by the instructions or from any other information given by another source.

By improving the web site and customer service, the IRS will be able to provide better guidance, reduce opportunities for evasion, and ensure more compliance. Furthermore, with a more efficient data system and infrastructure, the IRS will be able to determine sources of noncompliance without as much of a delay, enhance its research goals, and shift its resources to other departments — *e.g.*, to help promote the increase in taxpayers' and tax professionals' understanding.

¹⁴⁴ *Id.*

4. Enhance Taxpayer Service and Coordinate with Partners and Stakeholders

Enhancing taxpayer services is one of the keys to reducing the tax gap. By providing guidance through taxpayer services, the IRS can help to diminish some of the confusion associated with the tax code and reduce the number of unintentional errors on returns.¹⁴⁵ With fewer errors, there will be greater compliance and a smaller tax gap. Furthermore, enforcement activities will also be decreased because there will be no need for notices or audits after the error-free returns have been filed.¹⁴⁶

The IRS has been providing taxpayer services in several manners. First, several programs are provided for face-to-face interaction including outreach and education programs, taxpayer assistance centers, volunteer income tax assistance, and tax counseling for the elderly sites.¹⁴⁷ Second, forms and publications also provide directions and guidance while the taxpayer is preparing his or her return.¹⁴⁸ Third, reading rulings and regulations may aid in clarifying an ambiguous term or determining how to calculate a figure.¹⁴⁹ Fourth, the IRS also provides toll-free call centers for any questions that need to be answered more immediately.¹⁵⁰ Finally, probably one of the most valuable and most accessible resources for taxpayers is the Internet.¹⁵¹ As explained previously, the IRS is attempting to expand its information technology sector.¹⁵² This will likely help many taxpayers who prefer receiving an immediate response without having to be put on hold when calling for assistance or having to drive to a tax center.

Many of these programs have already proven to be successful in increasing taxpayer service. The E-File option allowed fifty-six percent of individual taxpayers to successfully file their returns online.¹⁵³ This percentage was more than twice the number of taxpayers that filed electronically in 1999.¹⁵⁴ For low-income taxpayers involved in Federal tax litigation, Low-Income Taxpayer Clinics have provided either free or nominal charge representation.¹⁵⁵ These clinics have also offered tax education for those taxpayers whose second lan-

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *See id.*

¹⁴⁹ *See id.* at 14.

¹⁵⁰ *See id.*

¹⁵¹ *See id.*

¹⁵² *See supra* Part IV.A.3.

¹⁵³ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 14.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

guage is English.¹⁵⁶ The Compliance Assurance Process (CAP) has provided assistance to large corporations, allowing them to work with the IRS to ensure that their returns are accurate before filing.¹⁵⁷ This pilot program is a great asset to large corporations because it provides them further certainty at an earlier date about their tax liabilities.¹⁵⁸

The IRS's Internet ventures regarding taxpayer services have also already proven to be successful. Beyond just the E-File function, the number of hits on the IRS's website was over 135 million in FY 2006.¹⁵⁹ The website permits taxpayers to obtain and print forms, track their refunds, and get immediate answers to their questions.¹⁶⁰ Furthermore, third parties can gain access to information that will help prepare their information returns including matching of taxpayer identification numbers.¹⁶¹ All of these online resources provide guidance for taxpayers to avoid errors and increase efficiency.

Another suggestion for providing services and guidance to the public, which is unfortunately not a part of the IRS's strategy, is to provide tax education in high school.¹⁶² Due to the complexity of the tax code, many taxpayers make unintentional errors simply because they do not understand what they are doing. It takes at least four years of higher education for an accountant to be qualified to fully understand the nature of taxes and calculate them correctly. If someone does not have any education in the tax system, it can be completely overwhelming and result in many errors. By requiring tax education in high school, taxpayers can feel more comfortable in tax preparation. Furthermore, they will be able to recognize what would result in noncompliance and avoid it.¹⁶³ "Educating citizens before or as they enter the taxpaying world is much more efficient and effective than trying to remove their misperceptions after the fact during tax audits and tax litigation."¹⁶⁴ Ultimately, by providing this type of guidance, noncompliance will decrease in accordance with the tax gap.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² Letter from Prof. James Edward Maule, *supra* note 104.

¹⁶³ *See id.*

¹⁶⁴ *Id.*

The legislature has also been involved in improving taxpayer services. In 2005, The Senate Committee on Appropriations requested a five-year plan to enhance taxpayer services, the Taxpayer Assistance Blueprint.¹⁶⁵ This plan includes

a process for assessing taxpayer needs and preferences, develop[ing] a decision model to prioritize service initiatives and funding, recommend[ing] service improvement initiatives, creat[ing] customer-centric performance and outcome measures, and outlin[ing] a multi-year research plan.¹⁶⁶

The plan was divided into two phases.¹⁶⁷ The first phase was geared toward stakeholder and employee engagement and included research to determine taxpayer needs, preferences, and behaviors.¹⁶⁸ The second phase built on the analysis of TAB Phase 1 and included additional extensive research on taxpayer preferences, behaviors, and needs.¹⁶⁹ Based on the results of these two phases, the TAB Strategic Plan was developed to improve taxpayer services.¹⁷⁰ One of the guiding principles and recognitions of the TAB is that taxpayers require enhancing services, i.e., guidance, to improve compliance.¹⁷¹

As with the other areas of the IRS's comprehensive strategy to reducing the tax gap, it is important to provide guidance and increase efficiency with partners and stakeholders. The IRS and Treasury attempt to coordinate with all parties that deal in some way with tax administration including state and foreign governments, taxpayer representatives, and practitioners.¹⁷² These efforts gen-

¹⁶⁵ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 14.

¹⁶⁶ *Id.*

¹⁶⁷ Internal Revenue Service, *Taxpayer Assistance Blueprint (TAB)* (2008), <http://www.irs.gov/individuals/article/0,,id=156394,00.html>.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ INTERNAL REVENUE SERVICE, REPORT TO CONGRESS: PROGRESS ON THE IMPLEMENTATION OF THE TAXPAYER ASSISTANCE BLUEPRINT 3 (2008), *available at* <http://www.irs.gov/pub/irs-pdf/p4701.pdf>.

¹⁷¹ *Id.* at 9.

¹⁷² U.S. DEP'T OF THE TREASURY, *supra* note 2, at 15. The IRS has already been involved in several coordination activities and will continue to enhance these efforts to close the tax gap. First, in order to eliminate tax shelters, the United States has entered into tax treaties and information exchange agreements. *Id.* at 16. These agreements enable the United States to gain information from foreign tax authorities to enforce the Internal Revenue Code. *Id.* Other agreements, such as the Joint International Tax Shelter Information Centre (JITSIC), also allow the United States and other foreign authorities to share information to prevent abusive tax evasion. *Id.* Many tax experts believe that the greatest tax reform needed, that will ultimately reduce the tax gap, is the reform of international taxation. *See, e.g.,* Reuven S. Avi-Yonah, *Closing the International Tax Gap Via Cooperation, Not Competition*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9; Rocco V. Femia, *Consider International Trends and Norms in Reforming*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9; Alan W. Granwell, *Be Careful in Designing International*

erally result in increased compliance by taxpayers, greater efficiency, and enhanced taxpayer services, which may lead to a reduction in the tax gap.¹⁷³

First, the IRS and state governments have joined together to analyze and tackle patterns in noncompliance.¹⁷⁴ By combining federal and state employment tax reporting and allowing taxpayers to pay their federal and state taxes online through the Electronic Federal Tax Payment System, the IRS will be able to monitor returns and determine noncompliance.¹⁷⁵ Furthermore, it aids in providing efficiency to taxpayers and to the tax system as a whole.

Second, one of the most important partnerships the IRS can develop is that with practitioners. As explained earlier in this Note, tax professionals and paid preparers make a large number of errors, specifically in the area with the highest noncompliance rate.¹⁷⁶ Thus far, the IRS has developed relationships with numerous national practitioner groups, business representatives, and industry organizations.¹⁷⁷ However, as noted in Part III.B., the fact that tax professionals have such a high error rate in tax return preparation means these relationships are not solid enough.¹⁷⁸

By cultivating these partnerships, the IRS can begin to close the tax gap in several ways. First, the IRS can gain information about problems in tax return preparation or any incidents that may require change in tax administration.¹⁷⁹ The practitioners are able to view and practice the tax code from an entirely different position than the IRS. This perspective can aid the IRS in what it needs to do next to improve the system and, consequently, reduce the tax gap. Second, the partnership ensures that the practitioners are supplying sound tax advice.¹⁸⁰ This guidance, again, leads to less unintentional and intentional errors and more efficiency, which closes the tax gap. Several areas in which the IRS wants to enhance outreach efforts with these partnerships are (1) correct

Tax Reform, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9; Paul N. Singer, *Individual Nonfilers & the International Tax Gap*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9. The problem is boiled down to the ability of foreign residents to earn investment income from United States sources and U.S. residents living and earning income abroad — without any sort of real regulations or transparency concerning the transaction. Because the premise of this Note is the increase of taxpayers' and tax preparers' understanding of the tax code, I find it important to note the various tax experts' focus on reform of international taxation to reduce the tax gap, however unnecessary to go into great detail on the possible solutions.

¹⁷³ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 15.

¹⁷⁴ *Id.* at 16.

¹⁷⁵ *See id.* In 2007, the IRS also planned to initiate several other federal-state partnership programs within a year and a half. *Id.* Basically, these programs allow the IRS to use state or other federal agency information in accordance with its own information and target the noncompliant taxpayers more promptly. *See id.*

¹⁷⁶ *See supra* Part III.B.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *See* U.S. DEP'T OF THE TREASURY, *supra* note 2, at 16.

¹⁸⁰ *Id.*

reporting of gross receipts, (2) correct computation of business deductions, and (3) third-party information reporting.¹⁸¹ Notably, these areas are those that were determined by the NRP as the major sources behind the tax gap — underreporting or overstating deductions of business income.¹⁸²

Finally, the Treasury and IRS have formed a partnership with taxpayer representatives.¹⁸³ This partnership enables the IRS to learn about taxpayer concerns.¹⁸⁴ By determining taxpayer concerns, the IRS can either provide more guidance in these areas or reform these areas to ensure greater compliance. Some examples of the IRS's work with taxpayer representatives include concerns from low-income taxpayers and small businesses.¹⁸⁵ The IRS has improved Earned Income Tax Credit (EITC) procedures due to comments from the taxpayer representatives.¹⁸⁶ It has also taken into consideration the balance between taxpayer burdens and the increased need for compliance with small businesses.¹⁸⁷

Enhancing taxpayer services is a positive step towards closing the tax gap. Most of these programs like the taxpayer assistance centers and CAP have proven to be effective. Forms and publications are an important tool for taxpayers in that they provide instructions and explanations. However, rulings and regulations are not always readily available for the average taxpayer nor are they any easier to understand than the form instructions or Internal Revenue Code. The IRS must determine a way in which this information would be easily obtainable. One such way would be through its website, if the website were updated to provide information in a more effective manner.

Providing tax education in high schools is an opportunity our whole nation is missing out on. While students are required to take physical education, music, and art classes in order to graduate, it would be much more practical for students to take an introductory tax course.¹⁸⁸ Most individuals, when even mentioning taxes, roll their eyes, shrug their shoulders, and sigh in disdain. While much of this disdain is a result of the requirement of having to pay taxes, most of the frustration results from failing to have a clue on what the taxpayer

¹⁸¹ *Id.* at 17.

¹⁸² *See supra* Part III.A.

¹⁸³ U.S. DEP'T OF THE TREASURY, *supra* note 2, at 17.

¹⁸⁴ *Id.*

¹⁸⁵ *See id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ While it is true that even tax professionals make errors, making the efficacy of a high school tax course appear minute, it is still a positive step towards providing greater guidance to future taxpayers. The course would certainly not make taxpayers experts by any means, but the advantages could be *at least* two-fold: (1) the taxpayers will have a basic understanding so that tax return preparation is not as daunting and seeking greater guidance from other sources is also not as frustrating for the individual; and (2) the taxpayer, if using a tax professional, would be able to have a greater voice in the preparation and notice if, and when, the return includes errors.

must do — even if he or she receives a refund. Tax return preparation is the dreaded evil, but an introductory course and basic level of knowledge could greatly alleviate this frustration. The cost of such a course would be nominal in comparison to the amount of revenue the government would collect from the decreasing tax gap.

Considering fifty-six percent of taxpayers used paid preparers in tax year 2002,¹⁸⁹ the training and guidance these preparers receive is invaluable. Furthermore, the error rates of these groups of preparers evidence the need for more coordination with these groups. This is a very viable option in that regulations may be passed requiring increased annual training and increased penalties for those preparers who fail to have the requisite training. With this increased coordination with tax professionals as well as state and foreign governments, the IRS can truly take advantage of an opportunity to reduce the tax gap.

The need to increase taxpayer services is apparent — whether through tax education, assistance centers, or coordination with tax professionals. Not only will taxpayers receive guidance on how to prepare their returns but also this will help to avoid errors before the taxpayer is deemed noncompliant and hounded by the IRS. Furthermore, it enhances the efficiency of the IRS because enforcement agents will not have to target taxpayers and perform as many audits; instead, their job functions can expand to other areas of tax administration.

5. Reform and Simplify the Tax Law

At already 17,000 pages, the tax code continues to be increasingly complex and perplexing.¹⁹⁰ Each year, more and more regulations are added to the code, which either overlap with existing regulations, override existing regulations, or add a whole new facet to the code.¹⁹¹ With this high complexity comes a high taxpayer burden in attempting to figure out the code.¹⁹² Unfortunately, this leads to either unintentional errors by taxpayers who lack understanding or allows for the exploitation of the tax system.¹⁹³ Furthermore, the high complexity hinders the IRS's ability to administer the tax code effectively.¹⁹⁴

¹⁸⁹ See *supra* Part III.B.

¹⁹⁰ Alison Acosta Fraser & William Packer, *Closing the Tax Gap Means Taxpayers Beware!*, THE HERITAGE FOUND. 4, April 13, 2007, <http://www.heritage.org/Research/Taxes/wm1424.cfm>.

¹⁹¹ See *id.* With each year that passes and more provisions are either added, deleted, or substituted from the Internal Revenue Code, “tax lawyers (and students) must be prepared, often with little notice, to discard old concepts and master new ones.” STEPHEN A. LIND ET. AL, FUNDAMENTALS OF CORPORATE TAXATION: CASES AND MATERIALS 10 (7th ed., 2008). As noted in Part III.B., tax professionals make errors in return preparation; with these constant modifications, a tax professional certainly cannot be expected to fully understand and master the code.

¹⁹² Fraser & Packer, *supra* note 190.

¹⁹³ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 15.

¹⁹⁴ *Id.*

If the tax code was analyzed and simplified, a great leap would be taken toward closing the tax gap. First, taxpayers would not have such a difficult time understanding the code. This would lead to fewer unintentional errors as well as less opportunities for intentional evasion.¹⁹⁵ The direct correlation between complexity and noncompliance evidences that year after year, as the complexity of tax law increases, taxpayers are less able to comply.¹⁹⁶ If tax law were simplified, greater compliance would result, which would produce a smaller tax gap. Second, a simplified tax code would be easier for the IRS to administer and enforce.¹⁹⁷ Much of the complexity of the code results from new tax provisions that were enacted with social policy goals in mind.¹⁹⁸ In fact, “tax breaks rather than direct expenditures account for one-fourth to one-third of the benefits and subsidies granted to the public.”¹⁹⁹ As a result, the IRS spends more time attempting to administer these regulations rather than dealing with basic compliance.²⁰⁰ With less hours and resources spent dealing with the complexity of the code, more hours and resources could be shifted to providing public service and enforcing compliance.

As noted already, much of the complexity of the tax code is a result of legislators using the tax code to promote a social policy. This is a reverse view of the use of the tax system. The tax system is a means of receiving revenue to fund governmental programs *if the revenue exists*. Instead, politicians are using the tax system as a means of funding governmental programs without looking at whether the funding will exist.²⁰¹ As one expert has stated, “Lasting improvement [to the tax system] will require a commitment to stop enacting changes

¹⁹⁵ *Id.*

¹⁹⁶ Letter from Prof. James Edward Maule, *supra* note 104.

¹⁹⁷ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 15.

¹⁹⁸ *Id.* While many tax provisions have been implemented with social policy goals in mind, the real problem lies with those provisions that have been implemented with social policy goals in mind but have been completely ineffective in dealing with the social policy. As one expert suggests, “For far too long Congress has financed social programs through the tax system and continued them whether they work or not. At the very least, we need to sunset every tax subsidy at least once every five years.” Martin Lobel, *Simplifying the Tax System Will Help Our Economy*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 67.

¹⁹⁹ STEUERLE, *supra* note 94, at 2.

²⁰⁰ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 15.

²⁰¹ In order to reduce the tax gap, simplicity is an important tool to improving understanding. However, this can only be accomplished by banishing the current “piecemeal approach that results in the enactment of proposals designed to hit a revenue target.” Annette Nellen, *Strive for a Sound and Respected Tax System*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 71. A classic and current example of this reverse use of the tax system is health care reform and, specifically, the Patient Protection and Affordable Care Act, H.R. 3590, 111th Cong. (2009). Again, rather than looking to see if funding will exist from the tax system to support the new program, new tax provisions will be implemented to further the social policy goal without the existence of the revenue. In other words, our current tax system is a “budget-driven tax legislative process.” LIND, *supra* note 191, at 5.

that violate principles of good tax policy or that use the tax law to solve problems that would be better addressed another way.”²⁰²

The tax code will never be “easy” or “simple.” However, it can be simplified for the benefit of taxpayers and the IRS alike. “[T]he United States needs — now more than ever — a much cleaner and simpler tax system. A flat tax . . . would likely prove far fairer and more efficient in practice than the current labyrinth of taxes.”²⁰³ Even without implementing a flat tax, the increasing number of loopholes, deductions, and special interest provisions should be cut down to foster a more welcoming and less overwhelming environment.

Simplification should not just be limited to the Internal Revenue Code but should address all areas of our tax system. Simplification can be achieved by allowing certain individuals to waive the requirement of filing a return at all. This may be achieved by limiting the waiver to a group of individuals who earn under a designated amount²⁰⁴ or through the use of a tax agency reconciliation system.²⁰⁵ Regardless of the method, by reducing the number of complicated returns required to be filed, compliance rates can be improved. First, tax evasion will be nearly impossible. Second, the IRS will not have to dedicate as many of its resources to enforcement for these individuals. Third, taxpayer and tax professional errors are less likely to occur depending on which system is implemented.

Although the job of reforming the tax code appears to be a hefty one, its efforts would likely be one of the most effective steps toward reducing the tax gap. However, lawmakers must be able to put their special interests aside, which is the hindering step in simplifying the Internal Revenue Code. With these changes — whether by simplification of the code or reduction of the return requirement, there will be less unintentional and intentional errors and the IRS will be able to determine these errors more effectively. Consequently, the tax gap will be reduced.

²⁰² Nellen, *supra* note 201, at 68. Nellen goes on to explain that “[f]or too long, our federal tax system has been viewed not only as a revenue source, but as a method for solving almost any problem,” which has ultimately led to the current complexity. *Id.*

²⁰³ *Foreign Holdings of U.S. Debt*: statement of Rogoff, *supra* note 23, at 60–62.

²⁰⁴ See, e.g., *infra* Part V (noting President Obama’s desire to eliminate income taxes for seniors earning less than \$50,000).

²⁰⁵ William G. Gale, *Remove the Return*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 41. Tax agency reconciliation systems are those in which the IRS sends a provisional tax return to households and allows for the taxpayer to either confirm or change the information as necessary. *Id.* This type of system is beneficial for at least two reasons: (1) the IRS has already done most of the work so the taxpayer has less to be concerned with; and (2) the IRS can be more greatly ensured that it will receive taxes owed because it will be more difficult for the taxpayer to evade taxes and it will be impossible for the taxpayer to not file.

B. *Court Guidance*

A long-standing debate has been that of the courts — federal and tax — and their roles in providing uniformity to enforcement of the Internal Revenue Code. Some argue for a national appellate tax court, while others argue that the federal circuit courts of appeal should deferentially review tax court decisions.²⁰⁶ Another issue that should be considered is the Supreme Court's reluctance to provide any new guidance in some areas of taxation.²⁰⁷ Regardless of which measure is taken to increase the courts' uniformity on tax issues, such an attempt will not only clarify the immediate tax issue for the taxpayer affected, but it will provide guidance to taxpayers in similar situations. This guidance will ultimately positively impact the tax gap as well.

The problem of the lax in court guidance is best summarized as follows:

Two of the most astute observers of the federal tax system . . . said over half a century ago that the federal tax controversy system had too much litigation and too many sources of authority ([one observer] counted 13). Those characteristics produce maximum flexibility in all directions for taxpayers. Taxpayer pressure for such flexibility explains why Congress overruled the [*Dobson*] rule in 1948 and why the many proposals to create a court of tax appeals have gone nowhere: Taxpayers don't want their flexibility constrained. If the Tax Court is unlikely to rule in a taxpayer's favor, an individual can consider his local district court and its related court of appeals. If that venue is not conducive to victory, he can consider the claims court and its related court of appeals.²⁰⁸

While this great "flexibility" appears to be advantageous to the taxpayer participating in the litigation, it is disadvantageous to, essentially, everyone else. While the litigating taxpayer is solely considering his or her financial stake at the moment, it is the ultimate financial stake for everyone that must be considered — the tax gap. For guidance to be effective it must be consistent; and consistency is the antithesis to flexibility.

²⁰⁶ See Andre L. Smith, *Deferential Review of Tax Court Decisions of Law: Promoting Expertise, Uniformity, and Impartiality*, 58 TAX LAW. 361, 361 (2005).

²⁰⁷ See, e.g., Jerome B. Libin, *Should the Internal Revenue Code Include a GAAR?*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 62–63 (explaining that the Supreme Court's last attempt to clarify the business purpose and economic substance doctrines was over thirty years ago in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)).

²⁰⁸ Jasper L. Cummings, Jr., *Creation of National Appellate Tax Court Will Improve Tax Law*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 30 (citations omitted).

1. The Struggle of Authority Between the Tax Court and the Federal Courts

Section 7482 of the Internal Revenue Code provides that

[t]he United States Courts of Appeals . . . shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as the decisions of the district courts in civil actions tried without a jury; and the judgment of such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari²⁰⁹

The venue of appellate court is generally determined by the legal residence of the taxpayer; however, the venue may be stipulated by the parties.²¹⁰ While these provisions appear straight forward, they have created quite a bit of conflict between the Tax Court and the circuit courts of appeal. The Tax Court and appellate courts are in a power struggle; there is an overarching concern of uniformity; and, since uniformity is lacking, taxpayers may essentially forum shop for a desirable result, as noted above.

The Tax Court is a court of national jurisdiction. Because of this fact, appeals from the Tax Court can be brought in any of the federal courts of appeal.²¹¹ This results in two dilemmas for the Tax Court when the same issue is before it that has been decided differently at the circuit court level: (1) if two circuits have decided the issue differently, the Tax Court must decide which decision to follow, if either; and (2) if the Tax Court's decision has been reversed on appeal, it must decide whether "it should alter its result and accede to the appellate position in the first case, or continue to follow its original position in the present case."²¹² These two dilemmas result not only in a struggle between the Tax Court and the federal court system, but also result in a lack of uniformity in the application of tax law.

Initially, the Tax Court deferentially disregarded appellate opinions with which it had previously differed in result, essentially reasoning that uniformity takes precedence over blindly applying the appellate court's decision.²¹³ As can

²⁰⁹ I.R.C. § 7482(a)(1) (1997).

²¹⁰ *Id.* § 7482(b)(1)–(2).

²¹¹ Donald B. Tobin, *The Tax Court Revisits the Golden Rule: Lardas v. Commissioner*, 47 TAX LAW. 559, 560 (1994).

²¹² *Id.*

²¹³ *See id.*

[The Tax Court] must thoroughly reconsider the problem in light of the reasoning of the reversing appellate court and, if convinced thereby, the obvious procedure is to follow the higher court. But if still of the opinion that its orig-

be expected, the appellate courts were none too pleased with this result.²¹⁴ Then, in 1970, the Tax Court overruled its prior decision to deferentially disregard appellate opinions by reasoning:

“[I]t is our best judgment that better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone . . . [W]e think that where the Court of Appeals to which appeal lies has already passed upon the issue before us, efficient and harmonious judicial administration calls for us to follow the decision of that court.”²¹⁵

It must be noted, however, that the Tax Court does not feel that it lacks the authority to disregard the appellate courts’ decisions; rather, “it would be futile and wasteful to do so where [the Tax Court] would surely be reversed”²¹⁶ and it is “only in the interest of ‘harmonious judicial administration’” that it accede to the appellate court.²¹⁷

However, in 1992, the Tax Court again changed its tune on whether and in what situations it would apply appellate court decisions. In *Lardas v. Commissioner*, the Tax Court determined that it would focus on whether “it would be ‘futile to decide this case as [it thinks] right.’”²¹⁸ In effect, the Tax Court will only follow the appellate court’s decision if the case involves the exact same issue on identical facts.²¹⁹ With this result, the struggle continues and nothing is clearly resolved. If a case is never appealed from the circuit court level and never heard by the Supreme Court, the circuits could always provide conflicting views of the interpretation of the applicable code section. Furthermore, if a case has been decided at the circuit court level and another with the Tax Court (with no appeal) with differing results, again taxpayers are left with no idea of the “correct” interpretation of the code.

inal result was right, a court of national jurisdiction to avoid confusion should follow its own honest beliefs . . .

Id. (quoting *Lawrence v. Comm’r*, 27 T.C. 713, 716 (1957), rev’d 258 F.2d 562 (9th Cir. 1958)).

²¹⁴ *Id.*

²¹⁵ *Id.* at 561 (quoting *Golsen v. Comm’r*, 54 T.C. 742, 757 (1970), aff’d 445 F.2d 985 (10th Cir.), cert. denied 404 U.S. 940 (1971)).

²¹⁶ *Id.* at n.17 (quoting *Lardas v. Comm’r*, 99 T.C. 490, 495 (1992)).

²¹⁷ *Id.* at 561.

²¹⁸ *Id.* at 563 (quoting *Lardas*, 99 T.C. at 498).

²¹⁹ *Id.*

2. The Possibilities for Resolution of the Struggle and Providing Uniformity

Regardless of the ego and authority struggle between the Tax Court and appellate courts, some sort of action must be taken to increase the uniformity of the interpretation of the Internal Revenue Code, thereby increasing taxpayers' understanding of the code. Either Congress or the Supreme Court must take action to rectify this issue.

When Congress implemented the current system of review of tax issues, it desired uniformity in the application of tax law as well as the need to provide deference to the circuit courts.²²⁰ However, as evidenced by the prior subsection, the Tax Court and circuit courts have failed at reconciling these concerns, and Congress has not intervened to resolve the issue.²²¹ One such way to resolve the issue is to reform the Tax Court. The Federal Courts Study Commission issued a report, which "recommended changing the Tax Court by creating an Article III appellate division of the Tax Court with exclusive jurisdiction over tax issues"²²² Alternatively, the Commission recommended the creation of a national appellate court to solely oversee the Tax Court.²²³ While there has been much debate and criticism of a national appellate tax court,²²⁴ in the context of providing guidance to taxpayers to decrease the tax gap, a national appellate tax court is a strong solution. Circuit splits are profuse in the interpretation of tax law as the circuits are not bound to follow one another's interpretations; with a national appellate tax court, this would not occur.²²⁵ Also, when dealing with the *federal* tax code, which is applied to all taxpayers in all jurisdictions, it is nonsensical to have differing interpretations based on one's residence. Within this context, a national appellate tax court would "virtually perfect national tax uniformity, and increase the certainty and predictability of tax law application."²²⁶

If Congress will not intervene to resolve the issue between the Tax Court and appellate courts, the Supreme Court must step up to the challenge. In

²²⁰ *Id.* at 566.

²²¹ *Id.* at 567.

²²² *Id.* (citing JUDICIAL CONFERENCE OF THE UNITED STATES, REPORT OF THE FEDERAL COURTS STUDY COMM. 69–71 (1990)). Article III of the United States Constitution states: "The judicial power of the United States, shall be vested in one Supreme court, and in such inferior courts as the Congress may from time to time ordain and establish." U.S. CONST. art. III., § 1.

²²³ Tobin, *supra* note 211, at 567.

²²⁴ See generally Smith, *supra* note 206.

²²⁵ "The meaning and scope of . . . common law tax jurisprudence has beduflled (and yet challenged) tax advisors for decades. . . . [L]iteral compliance with the Code may not be enough for a transaction to pass muster." LIND, *supra* note 191, at 14.

²²⁶ Tobin, *supra* note 211, at 390–91 (citing Steve R. Johnson, *The Phoenix and the Perils of the Second Best: Why Heightened Appellate Deference to Tax Court Decisions is Undesirable*, 77 OR. L. REV. 235, 244 (1998)).

Freytag v. Commissioner,²²⁷ the Supreme Court held that the Tax Court was an Article I court, rejecting the idea that the Tax Court was merely “a department under the executive branch.”²²⁸ This result still sparks the debate between the Tax Court and circuit courts of appeal. Initially, the result lends to the idea that the Tax Court “is a court of national jurisdiction with unique responsibilities” and, therefore, does not need to defer to appellate court decisions.²²⁹ However, as an Article I court, the Tax Court could be viewed as similar to a district court, meaning it must defer to the appellate courts.²³⁰ Ultimately, the Supreme Court must define the Tax Court’s scope more clearly rather than add fuel to the fire for both sides of the debate.

Although litigating taxpayers seemingly desire flexibility, in the context of the tax gap, flexibility is a detriment to the tax system. Even for a litigating taxpayer, uniformity is far more desirable; in fact, if the issue at hand had already been resolved without any possibility of a conflicting result in the Tax Court or federal court system, the taxpayer may not even be in the throes of litigation. Rather, the taxpayer would have known of the uniform interpretation of the law at the outset and would have applied it.²³¹ Furthermore, any increase in uniform guidance that the courts can give on the interpretation of tax law is beneficial to the decrease of the tax gap. With guidance comes taxpayer and tax professional understanding; and with taxpayer and tax professional understanding comes less errors and less of an ability to intentionally evade the law based on lack of clarity.

C. *Increase IRS Resources*

No matter how innovative the IRS’s comprehensive strategy to reducing the tax gap may be and no matter how many taxation cases the courts interpret consistently, the IRS must still have ample resources to implement and enforce the strategy and interpretations of the code. As explained earlier, the IRS’s resources are far below what is necessary to effectively implement tax administration and enforcement.²³² In tax year 2006, the IRS received 140 million individual, partnership, and corporate returns and 1.5 billion information returns from third parties.²³³ With a budget of \$10.5 billion, it had to process these returns, provide service to taxpayers and tax return preparers, enforce compliance, and collect more than \$2 trillion in taxes owed.²³⁴ The lack of IRS funding and

²²⁷ 111 S.Ct. 2631, 2645 (1991).

²²⁸ *Id.* at 2645–46; Tobin, *supra* note 211, at 567.

²²⁹ Tobin, *supra* note 211, at 567.

²³⁰ *Id.* at 567–68.

²³¹ This proposition is assuming that the taxpayer did not intentionally err to evade taxes.

²³² See *supra* Part III.B.

²³³ U.S. DEP’T OF THE TREASURY, *supra* note 2, at 12–13.

²³⁴ *Id.* at 13.

manpower not only makes it difficult to reduce the tax gap but makes it a primary source of the tax gap.²³⁵

In order to reduce the tax gap, IRS funding must be increased to improve tax administration and enforcement activities. Tax administration that will improve compliance includes guidance activities such as improving information technology, expanding taxpayer services, and increasing reporting requirements.²³⁶ All of these improvements and expansions come at a price however. IRS funding must be reevaluated and increased according to the demands on the IRS and its needs. These demands and needs include the evaluation of the increasing size of the economy, the increasing number of tax returns filed annually, and the abundant changes in tax law annually.²³⁷

Tax enforcement funding must also be increased. Audits, especially face-to-face audits, are essential to effectively reduce the current tax gap and to prevent noncompliance in the future. With an average yield of \$54,934 for income over \$100,000 or \$2.6 million for large corporations, face-to-face audits quickly close the tax gap.²³⁸ Furthermore, with an increase in audits and IRS presence, taxpayers will be less likely to intentionally evade tax laws out of fear of being caught.

Furthermore, both tax administration and tax enforcement branches of the IRS need appropriate levels of staffing. Without enough employees to take care of the tasks at hand, the IRS is unable to perform its functions without overwhelming all of its current employees. An increase in manpower would increase the IRS's ability to effectively administer and enforce tax law, thereby reducing the tax gap.

The tax gap initiative would be greatly helped by an increase in resources. Although an increased budget may not seem feasible due to the government's recent increased spending, it should be seriously considered as any money furnished to the IRS is not a waste. The IRS is "an agency in which every dollar invested generates multiples of dollars in return."²³⁹ In fact, for tax year 2006, the IRS's budget was \$10.8 billion,²⁴⁰ while its gross collections were \$2.518 trillion.²⁴¹ Thus, for every \$1 expended in revenue collection, \$233 was collected.

²³⁵ See *supra* Part III.B.

²³⁶ See *supra* Part IV.A.

²³⁷ See *id.*

²³⁸ See *supra* Part III.B.

²³⁹ Letter from Prof. James Edward Maule, *supra* note 104.

²⁴⁰ U.S. DEP'T OF THE TREASURY, I.R.S. BUDGET IN BRIEF, *supra* note 64.

²⁴¹ INTERNAL REVENUE SERVICE, INTERNAL REVENUE COLLECTIONS AND REFUNDS, BY TYPE OF TAX, FISCAL YEARS 2005 AND 2006, TABLE 1, available at http://www.irs.gov/pub/irs-soi/table_1_2006_dp.xls.

V. THE PRESIDENT'S POLICIES AND THE TAX GAP

Even with a potentially effective strategy to reduce the tax gap and IRS resources to implement the strategy, all parties, including the new Obama administration, must be on the same page as far as tax policy. Barack Obama promised change during the 2008 presidential election. His comprehensive tax plan and recent actions promise the same. However, it is uncertain just yet whether these changes will help or hurt the tax gap.

On March 25, 2009, President Obama announced his creation of the tax force on tax reform, headed by Paul Volcker.²⁴² The tax force's duty is to review the deficiencies of our current tax system and provide a report and recommendations.²⁴³ Specifically, the tax force's goals are to (1) reduce the tax gap, (2) simplify compliance for taxpayers, and (3) decrease the number of loopholes that benefit corporations.²⁴⁴ The tax force's initial deadline to present the report and recommendations was December 4, 2009.²⁴⁵ However, as of April 4, 2010, no such report nor recommendations have been released and will not be released indefinitely.²⁴⁶

Initially, during President Obama's presidential campaign, he published his comprehensive tax plan, which this Note will discuss briefly. Several of President Obama's tax changes in the comprehensive tax plan are very much in line with the IRS's comprehensive strategy for reducing the tax gap. First, and certainly most importantly, the tax plan calls for a simplified tax system.²⁴⁷ President Obama's tax plan strives to allow forty million Americans to do their taxes in less than five minutes with a less complex tax system.²⁴⁸ As explained earlier, a simplified tax system would be a great leap in the reduction of the tax gap.²⁴⁹ Because these forty million taxpayers would be able to understand their tax return preparation, errors would decrease, compliance would increase, and the tax gap would decrease.

²⁴² John D. McKinnon, Greg Hitt & Naftali Bendavid, *U.S. News: White House to Hunt for New Tax Revenues — Task Force to Weigh Ending Loopholes, Bolstering Enforcement as Lawmakers Take Aim at Budget*, WALL ST. J., Mar. 25, 2009, at A4.

²⁴³ McKinnon, *supra* note 95.

²⁴⁴ Robert Goulder, *Foreword: The Volcker Task Force on Tax Reform*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 10.

²⁴⁵ McKinnon, *supra* note 95.

²⁴⁶ A statement released by Volcker stated that he "want[s] the task force] to review as many suggestions as possible and to have sufficient time to fully consider the hundreds of suggestions that have come in already." Press Release, Chairman Paul Volcker, President's Economic Recovery Advisory Board, Tax Task Force, Posting by Austan Goolsbee to The White House Blog, <http://www.whitehouse.gov/blog/2009/11> (Nov. 27, 2009, 16:07 EST).

²⁴⁷ BARACK OBAMA'S COMPREHENSIVE TAX PLAN 2 (2008), *available at* http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf.

²⁴⁸ *Id.*

²⁴⁹ *See supra* Part IV.A.5.

Another positive tax change would be the elimination of income taxes for seniors making less than \$50,000.²⁵⁰ This tax change is, again, in line with the idea of tax simplification. Under President Obama's plan, twenty-seven million seniors will not need to file an income tax return.²⁵¹ Without having to file an income tax return, there will not be any errors unless the senior did not qualify for the exemption. Thus, there should generally not be any noncompliance.

The most positive tax change would be the elimination of special interest provisions.²⁵² There are three ways in which this can reduce the tax gap. First, it will simplify the tax system to avoid errors caused by misunderstanding the provisions. Second, it will avoid intentional misstatements that businesses will make in order to meet the special interest provisions. Finally, the system will appear to be fairer, which will boost all taxpayers' faith in the system and promote compliance.

On the other hand, several of President Obama's initial tax proposals would hinder the reduction of the tax gap. While President Obama intends to simplify the tax system for forty million taxpayers, he still intends to add tax cut provisions for small businesses and entrepreneurs — the largest source behind the tax gap — which could muddy the waters.²⁵³ The elimination of capital gains taxes for entrepreneurs could lead to intentional underreporting in order for the entrepreneur or small business to fall within the category receiving the exemption.²⁵⁴ Other provisions that could add to the complexity of the system for individuals include the retirement savings incentive and expanding the Earned Income Tax Credit (EITC) for families that meet certain requirements.²⁵⁵ Thus, overall, President Obama's initial proposals could have both positive and negative effects on the tax gap.

Although President Obama set out with these tax changes in mind, his actions in the past year have weighed against any hope of reducing the tax gap. Not only has President Obama signed a \$787 billion economic stimulus and prepared two excessive annual budgets, but he has also signed legislation to complete overhauling our health care system — the impact of which we do not

²⁵⁰ BARACK OBAMA'S COMPREHENSIVE TAX PLAN, *supra* note 247, at 2.

²⁵¹ *See id.*

²⁵² *Id.* at 4. This goal is unlikely in that more special tax breaks may be added in various areas including that of alternative energy.

²⁵³ *See id.* at 3–4.

²⁵⁴ *See id.* at 3. However, as of December 9, 2009, President Obama's plan of eliminating capital gains taxes on small business investment for one year was destroyed by the House more than doubling the tax rate from 15% to 35% by reclassifying capital gains as ordinary income. Op-Ed., *Zero to Thirty-Five in Twenty-Four Hours*, WALL ST. J., Dec. 10, 2009, at A24.

²⁵⁵ BARACK OBAMA'S COMPREHENSIVE TAX PLAN, *supra* note 247, at 2. As noted in Part III.B., the earned income tax credit results in large errors.

actually know yet.²⁵⁶ As noted in Part II.A., the amount of debt the United States already holds is excessive.²⁵⁷ President Obama's actions do not stop at these measures, however. Four major themes were effective for the Tax Reform Act of 1986:²⁵⁸ "marginal rate cuts, tax base reform to increase neutrality and horizontal equality, distributional neutrality, and revenue neutrality."²⁵⁹ However, President Obama's actions have opposed these four major themes:

Rather than cutting marginal tax rates, Obama plans to increase effective marginal rates at the top end in a variety of ways. Rather than reforming the tax base, Obama has proposed creating numerous special breaks, such as a new tax credit for college expenses.

Regarding the distribution of tax payments, Obama is raising taxes on households at the top while providing refundable giveaways to households at the bottom, such as the Making Work Pay tax credit and expansions in the child and earned income tax credits. But the top fifth of households already pay an effective federal tax rate of 26 percent, while the bottom fifth pay just 4 percent, on average. The tax code is already far too graduated, and Obama is exacerbating this inequity.

The fourth theme of 1986, revenue neutrality, is of no interest to the Obama administration. When announcing the new task force, the administration reiterated its promise not to raise taxes on families with income less than \$250,000. But the president already broke that promise with a cigarette tax increase in February [2009], and his cap-and-trade energy plan is effectively a large tax increase on all families. Healthcare reform might also include a significant tax increase on average families. Thus, it

²⁵⁶ Op-Ed., *The Deficit Commission Trap: Why Not Appointees Like Phil Gramm?*, WALL ST. J., Dec. 29, 2009, at A20.

²⁵⁷ With an increase in spending, President Obama's only legitimate avenue for financing his projects is by increasing taxes. But increasing taxes will only reduce the need to cut his future spending. The trend continues and the "parade of horrors" in Part II.A. continues as well. Not to mention that any raise in taxes does not in any way reduce the tax gap: "[b]efore we consider raising taxes on anyone, we need to focus on collecting taxes already owed under current law" Sen. Kent Conrad (D., N.D.), Letter to the Editor, *Left and Right Need to Balance Taxes and Spending*, WALL ST. J., Jan. 8, 2010, at A16.

²⁵⁸ The Tax Reform Act of 1986 eliminated loopholes, dramatically cut tax rates, and was overall one of the most successful tax reforms the United States has seen to its tax system. Chris Edwards, *Obama's Treasure Hunt*, in TAX ANALYSTS, TOWARD TAX REFORM, *supra* note 9, at 33.

²⁵⁹ *Id.* at 33; see STEUERLE, *supra* note 94, at 9–15 for an explanation of the principles of horizontal equity, vertical equity, distribution neutrality, and revenue neutrality.

wouldn't be surprising if the Obama tax task force also morphed into a drive to raise taxes on the middle class.²⁶⁰

The fact that President Obama has taken initiative in forming a task force may appear to be a step in the direction of tax reform, but it is unlikely that the tax force's report and recommendations will have any effect — as no other recent studies and recommendations have generated tax reform amongst legislators. Furthermore, “tax policy has always been a handmaiden to budget policy.”²⁶¹ President Obama's initiatives since taking office, including his spending budget, do not exactly provide a sign of hope for closing the tax gap.

VI. CONCLUSION

The tax gap is a serious problem that should not be ignored. Although it may appear to be a minimal problem at only 2.3% of the \$12.76 trillion public debt,²⁶² its impact resonates much louder. Each year, the public debt increases by approximately another \$290 billion due to the tax gap. After four years, the tax gap has increased the public debt by another \$1 trillion.

The “parade of horrors” that ensues due to the tax gap stresses the importance of reducing it.²⁶³ The public is paying for the tax gap in more than just monetary ways. Without the revenue the government would receive otherwise, the public is losing beneficial government services.²⁶⁴ Furthermore, without revenue to pay for recent spending, the government must resort to borrowing money from foreign nations, including China, Japan, Iraq, and Iran.²⁶⁵ By placing about thirty percent of the United States' debt in the hands of these foreign countries, the government is placing the United States at risk both financially and politically.²⁶⁶

In order to reduce the tax gap, it is important to recognize the major players in the tax gap game, ranging from taxpayer underreporting, tax professional errors, and lack of IRS resources. With these players in mind, the IRS and Treasury must implement plans that enforce the ideas of guidance and understanding. With the complexity and unfairness of the tax system, unintentional as well as intentional errors are bound to occur. If the IRS were able to provide more guidance to taxpayers and tax professionals, fewer errors would occur because the tax code would be more understandable. Several areas that must be

²⁶⁰ Edwards, *supra* note 258, at 33–34 (footnotes omitted).

²⁶¹ STEUERLE, *supra* note 94, at 7.

²⁶² This percentage is based on the \$290 billion tax gap divided by the \$12.76 trillion total national debt.

²⁶³ See *supra* Part II.

²⁶⁴ See *supra* Part II.A.

²⁶⁵ See *id.*

²⁶⁶ See *id.*

focused on include information technology, taxpayer services, simplifying the tax code, and coordinating with practitioners.²⁶⁷

Another method that would certainly help increase taxpayer and tax professional understanding is a push toward uniformity in tax law adjudication. As of now, the Tax Court and appellate courts are at odds on who should get the final word on interpretation, which provides nothing but confusion. Congress or the Supreme Court intervening to clarify the courts' roles would aid the problem, at the very least. However, a national appellate court could greatly diminish the problem — if not eliminate it.

The IRS must also be provided more resources in order to effectively reduce the tax gap. Without these resources, the IRS is unable to administer the tax code successfully or enforce the tax code through audits or other means.²⁶⁸ In order to provide guidance and understanding to taxpayers and tax professionals, the IRS must be given sufficient funding and manpower. A delicate balance, however, must be achieved between providing taxpayer and tax professional services and using increased funding.

The new Obama administration will play a vital role in the reduction of the tax gap. Although President Obama began his presidency with a tax plan that could improve the tax gap, his recent actions have weighed against this result.²⁶⁹ Even with the new task force on tax reform, the tax gap cannot be closed without some sort of initiative — beyond just theory and numbers. If the administration can focus on the importance of closing the tax gap and working with the IRS on tackling this feat, the government and taxpayers alike could benefit significantly. President Obama promised change in America; although unlikely, hopefully, this change will also involve the tax gap.

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²⁶⁷ See *supra* Part IV.A.

²⁶⁸ See *supra* Part IV.B.

²⁶⁹ See *supra* Part V.

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