

MINDING THE GAP: A TEN-STEP PROGRAM FOR BETTER TAX COMPLIANCE

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The tax gap, which measures taxpayer noncompliance with the tax laws, has bedeviled tax administrators since tax systems began. When faced with significant noncompliance, a tax administrator's first reaction reasonably might be to ramp up enforcement activity. Noncompliance, however, happens for many different reasons, and an effective compliance strategy encompasses a lot more than mere enforcement. Moreover, achieving high rates of voluntary compliance is the least costly and longest-lasting approach to minimizing the tax gap. Therefore, any effective compliance strategy should have maintaining and increasing voluntary compliance with the tax laws as its primary goal.

In the United States, Congress and the Internal Revenue Service have rightfully focused significant attention on reducing the tax gap.¹ However, saying that we want to "close the tax gap" does not tell us just what, precisely, that entails. It is unlikely that Congress would be willing to fund an IRS of the size necessary to collect virtually every dollar that the IRS thinks is due and owing, nor is it likely that Congress would impose overly burdensome withholding and

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1. See, e.g., *Full Committee Hearing on Closing the Tax Gap Without Creating Burdens for Small Businesses: Hearing Before H. Comm. On Small Business*, 110th Cong. (2007); *IRS and the Tax Gap: Hearing Before H. Budget Comm.*, 110th Cong. (2007); *Deconstructing the Tax Code: Uncollected Taxes and Issues of Transparency: Hearing Before the Subcomm. on Federal Financial Management, Government Information, and Internal Security of the S. Comm. on Homeland Security and Government Affairs*, 109th Cong. (2006); *Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 109th Cong. (2006); *Uncollected Taxes: Can We Reduce the \$300 Billion Tax Gap?: Hearing Before the Subcomm. on Federal Financial Management, Government Information, and Internal Security of the S. Comm. on Homeland Security and Government Affairs*, 109th Cong. (2005); *\$350 Billion Question: How to Solve the Tax Gap: Hearing Before the S. Comm. on Finance*, 108th Cong. (2005); *Bridging the Tax Gap: Hearing Before the S. Comm. on Finance*, 108th Cong. (2004).

reporting requirements.² The most productive approach for tax administration may be to focus on how to increase voluntary compliance in some components of the tax gap while maintaining compliance in most other areas.

This article sets forth a ten-step approach to understanding and minimizing the tax gap. In the course of articulating these ten steps, I examine the IRS's current approach to the tax gap and offer suggestions to improve that approach. These steps can be divided into four categories. First, I explore our current knowledge of the tax gap and how we can increase our understanding of it in steps one through three. In steps four and five, I discuss how the manner in which success at closing the tax gap is measured drives IRS behavior and impacts taxpayers, and I suggest a three-pronged tax gap measure to more closely align IRS performance measures and effective compliance initiatives. In steps six through eight, I identify challenges to the IRS's administration of a humane, effective, and efficient tax system as it implements programs to address the tax gap. Finally, in steps nine and ten, I discuss three aspects of tax administration without which the IRS will not be able to perform well in the twenty-first century—curiosity, resources, and an understanding of its own limits.

The IRS today possesses many of the building blocks necessary to gain a comprehensive understanding of the tax gap. Often, it is the IRS's procedures and performance measures that undermine its ability to effectively act on its understanding and knowledge. By expanding its focus beyond traditional enforcement techniques to include the goal of maintaining and improving long-term compliance, the IRS can minimize the tax gap without imposing unnecessary burden or harm on taxpayers who are trying to comply with complicated tax laws. This approach would demonstrate a balanced approach to the executive branch and Congress, and it would increase the likelihood that the IRS will receive the necessary support and resources.

STEP I: KNOW YOUR GAP, OR WHAT IS THE TAX GAP AND WHY SHOULD WE CARE ABOUT IT?

Stated simply, the tax gap is the difference between what the IRS thinks taxpayers owe and what taxpayers pay voluntarily and timely.³ The IRS esti-

2. For example, Congress is unlikely to require everyone who rides in a taxicab to withhold tax from the cab fare and file an information return with the IRS with respect to the driver. The same is true of homeowners who use an electrician or a plumber. Yet absent withholding and reporting, a portion of the income will be underreported by service providers.

3. The "tax gap" or "gross tax gap" is the gap between the amount of tax imposed by law and the amount voluntarily and timely paid by taxpayers for a given tax year. The "net tax gap" is the portion of the gross tax gap that will remain uncollected after all IRS and taxpayer actions have been completed for a given tax year.

mates that the gross tax gap for the tax year 2001 was \$345 billion.⁴ After accounting for additional revenue collected from late payments and IRS compliance and enforcement actions, the IRS places the tax year 2001 net tax gap at \$290 billion. In effect, the net tax gap constitutes an average “surtax” of \$2,680 on every U.S. household to subsidize noncompliance.⁵

The IRS’s current picture of the tax gap is built on measures of filing, reporting, and payment compliance. The IRS derives estimates of noncompliance in the underreporting component by conducting a series of reviews and audits on a representative sample of taxpayers, known as the National Research Program (NRP).⁶ After extensive case-building using tax return data and additional government databases, the IRS either accepts a return as filed or notifies the taxpayer that the return has been selected for audit. Some audits focus on specific issues, usually through correspondence examinations. The IRS conducts other audits in a face-to-face environment, allowing considerable discretion to the examiner to select which issues should be examined. In addition, to ensure the accuracy of the NRP case-building approach, the IRS conducts a modest number of “calibration audits.” Returns selected for these line-by-line audits are equally drawn from each of the three return “buckets”—accepted as filed, correspondence exam, and face-to-face exam. Since its first NRP effort for tax year 2001, the IRS has committed to an ongoing or “rolling” NRP. That is, the IRS will update its data on a different taxpayer segment periodically and adjust its routine audit selection criteria accordingly.⁷

The tax gap is a helpful construct for tax administrators, in that it attempts

4. INTERNAL REVENUE SERV., TAX YEAR 2001 FEDERAL TAX GAP (2001) [hereinafter IRS TAX GAP MAP], available at http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf. See also I.R.S. News Release IR-2006-28 (Feb. 14, 2006) available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

5. The \$290 billion tax gap for tax year 2001 divided by 108,209,000, the estimated number of households as of March 2001. U.S. CENSUS BUREAU, POPULATION DIV., TABLE AVG1. AVERAGE NUMBER OF PEOPLE PER HOUSEHOLD, BY RACE AND HISPANIC ORIGIN, MARITAL STATUS, AGE, AND EDUCATION OF HOUSEHOLDER MARCH 2001 (2003), <http://www.census.gov/population/socdemo/hh-fam/cps2001/tabavg1.pdf>.

6. See Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1260-61 (2003) for a general description of the National Research Program and its predecessor, the Taxpayer Compliance Measurement Program (TCMP). INTERNAL REVENUE MANUAL § 4.22 (2008), provides detailed instructions for IRS employees in selecting NRP return and conducting NRP examinations.

7. In July 2005, the IRS announced that it would conduct NRP reviews and examinations on Subchapter S corporations. As part of its “rolling” NRP for individual returns (the 1040 series), the IRS began examining Tax Years 2006 and 2007 returns in October 2007 and 2008, respectively. See INTERNAL REVENUE SERV., REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 60-61 (2007) [hereinafter IRS FEDERAL TAX GAP REPORT], available at http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

to quantify the amount and source of tax on legal source income that is due and owing.⁸ These amounts are first categorized by type of noncompliance (nonfiling, underreporting, or underpayment) and within each category of noncompliance, by type of tax (individual income, incorporated and unincorporated business income, and employment tax).⁹ By looking at the tax gap across these categories, tax administrators can identify which noncompliance “buckets” contain the most missing tax dollars. This tax gap analysis is the first step in determining how to allocate tax administration resources in order to ensure that the greatest number of taxpayers pay the correct amount of tax.

There are problems with basing a compliance strategy on a pure tax gap analysis. First, the tax gap map is only as good as the underlying data. The IRS tax gap analysis does not account for income from illegal transactions, and there are entire parts of the map that are estimated based on various formulas. With respect to nonfiling, the IRS does not have any estimates for corporate income, employment, or excise taxes.¹⁰ Second, the numbers in the map reflect the IRS’s own interpretation of what constitutes the correct answer in any given filing situation.¹¹ The IRS may be wrong for various reasons—whether because the IRS’s interpretation of the law is incorrect or in dispute,¹² because it has in-

8. The IRS only estimates the tax gap attributable to income from legal sources, since it is difficult to accurately ascertain the amount of tax attributable to illegal (criminal) activities. *Id.* at 6.

9. The IRS breaks down underreporting further within the “type of tax” subcategories. For example, the tax gap attributable to individual income tax is categorized by non-business income; business income; adjustments, deductions, and exemptions; and credits. See IRS TAX GAP MAP, *supra* note 4.

10. See U.S. GOV’T ACCOUNTABILITY OFFICE, TAX COMPLIANCE: BETTER COMPLIANCE DATA AND LONG-TERM GOALS WOULD SUPPORT A MORE STRATEGIC IRS APPROACH TO REDUCING THE TAX GAP 7 (GAO-05-753, 2005), available at <http://www.gao.gov/new.items/d05753.pdf>, for a discussion of the limitations of the IRS tax gap estimates.

11. The IRS bases its examination positions on guidance issued by the Office of Chief Counsel and the Department of the Treasury. In any given case, auditors apply the available facts to the IRS’s interpretation of the law. Because audits are examinations of the taxpayer’s books and records, it is not until a case reaches the IRS Office of Appeals that the IRS considers the hazards of litigating its positions in its settlement discussions with the taxpayer. Compare INTERNAL REVENUE MANUAL § 4.10.7.5.3.1 (2006) (“Examination personnel have the authority and responsibility to reach a definite conclusion based on a balanced and impartial evaluation of all the evidence This authority does not extend to consideration of the hazards of litigation.”) with INTERNAL REVENUE MANUAL § 1.2.17.1.6 (2006), Policy Statement 8-47 (Approved Apr. 6, 1987) (“Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in the light of the hazards which would exist if the case were litigated.”)

12. See *Regents of the Univ. of Minn. v. United States*, 101 A.F.T.R.2d (RIA) 2008-1532, 2008-1535-38, (D. Minn. 2008) *appeal docketed*, No. 08-2193 (8th Cir. May 28, 2008) for an example of how the IRS’s current position is being disputed. In *Regents*, the court held that a hospital’s medical residents’ stipends were exempt from Federal Insurance

sufficient facts from unresponsive taxpayers, or because IRS procedures themselves drive inaccurate results.¹³

Indeed, given the problems with tax gap analysis, some countries do not measure their tax gap at all, on the ground that such efforts are costly and inconclusive, raising concerns about the timeliness, accuracy, and reliability of the data.¹⁴ The Australian Tax Office (ATO), for example, does not develop tax gap estimates, citing resource and taxpayer burden concerns as well as the belief that trend information gained from such analysis is not useful.¹⁵

Notwithstanding the problems associated with tax gap analysis, it provides a useful framework within which to begin thinking about taxpayer compliance. However, it is only the first step in addressing taxpayer noncompliance. To properly allocate resources, tax administrators should develop a much more detailed matrix of factors influencing tax noncompliance.

STEP II: THE MATRIX: UNDERSTANDING THE TAX GAP REQUIRES MULTI-DIMENSIONAL ANALYSIS

The current IRS tax gap map only shows us one dimension of the tax non-compliance problem—the tax dollars due. This measure is important since the IRS's job is to collect government revenue, without which the government cannot function. But looking only at the amount and type of tax dollars outstanding does not tell us very much about the taxpayers who owe those dollars nor does it tell us how many taxpayers are part of the tax gap problem in each category. And it certainly does not tell us much about how best to go about collecting

Contributions Act (FICA) taxes because the residents were employed by the university (rather than the hospital where they performed services) and otherwise qualified for the student exemption to FICA under IRC § 3121(b)(10). The IRS amended its regulations under this section in 2004 to clearly state that for an institution to be considered a "school, college or university," education must be its "primary purpose." The U.S. District Court for the District of Minnesota in another case held the IRS's regulations were invalid because the plain meaning of "school, college, or university" as set forth in the statute was unambiguous. *See Mayo Found. for Med. Educ. & Research v. United States*, 503 F. Supp. 2d 1164, 1172 (D. Minn. 2007), *appeal docketed*, No. 07-3242 (8th Cir. Sept. 28, 2007).

13. See 2 INTERNAL REVENUE SERV. NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 94-116 (2007) [hereinafter NAT'L TAXPAYER ADVOCATE 2007 REPORT], available at http://www.irs.gov/pub/irs-utl/arc_2007_vol_2.pdf for a discussion of how IRS audit procedures can pose barriers to taxpayers' obtaining the correct outcome of an audit.

14. Jacqui McManus & Neil Warren, *The Case for Measuring the Tax Gap*, 4(1) EJOURNAL OF TAX RES. 61, 70 (2006).

15. *Id.* The United States Congress shared similar concerns about the burdens imposed on compliant taxpayers who must undergo random audits and in 1994 barred the IRS from conducting its Tax Compliance Measurement Program (TCMP) by failing to fund the initiative. The IRS's new research initiative, the National Research Program (NRP), was designed to address these concerns. *See Brown & Mazur, supra* note 6 at 1263-68 (describing the history of the IRS's efforts to quantify the tax gap, including the TCMP).

those outstanding taxes. For example, the IRS estimates that tax attributable to unincorporated business income underreporting was \$109 billion for 2001 and accounted for the largest portion of the tax gap.¹⁶ But we do not know if this figure involves a large number of taxpayers each underreporting a small amount or a small number of taxpayers underreporting large amounts. Knowing whether tax noncompliance is concentrated or widespread has consequences for how the IRS designs compliance initiatives and how it allocates resources.

The IRS does calculate the “Net Misreporting Percentage” (NMP) for underreporting estimates of various types of income and offsets.¹⁷ The NMP is the amount of income or offset misreported divided by the amount that should have been reported. For example, the IRS estimates that the 2001 tax gap attributable to wages, salaries, and tips is \$10 billion, with a NMP of 1%. The tax gap attributable to nonfarm proprietor income is estimated at \$68 billion, with a NMP of 57%.¹⁸ The nonfarm proprietor income tax gap, however, includes a wide range of business activity, from defense consulting to construction to dog walking. Some of these “proprietors” may be misclassified, *i.e.*, they are actually employees. In some businesses, especially those with comprehensive income reporting by third parties, the underreporting may be attributable more to overstated deductions than to underreported gross receipts. The IRS can craft better compliance initiatives if it has data on the type of noncompliance by type of business.

The Department of the Treasury recently acknowledged the need for a more nuanced approach toward the tax gap in a report released in the fall of 2006.¹⁹ Treasury’s report identified several approaches that it believes are effective for closing the tax gap.²⁰ Notably, the report acknowledges that the IRS cannot audit its way out of the tax gap and that there is no single-pronged approach to reducing the tax gap.²¹ Instead, the report notes that customer service

16. See IRS TAX GAP MAP, *supra* note 4. The tax gap map labels this component “individual income tax business income” underreporting. Combining this tax underreporting with the underreported self-employment tax attributable to that income, \$39 billion, increases this component of the tax gap to \$148 billion.

17. To calculate the NMP, the IRS nets (or offsets) both underreporting and overreporting for a given line item. INTERNAL REVENUE SERV., PUBLICATION 1415 (REV 4-96), FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992 3, available at <http://www.irs.gov/pub/irs-soi/p141596.pdf>. Therefore, where there is overreporting due to taxpayer error, the underreporting rate is higher than the net misreporting percentage.

18. See IRS TAX GAP MAP, *supra* note 4.

19. U.S. DEP’T OF THE TREAS. OFFICE OF TAX POLICY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP (2006), available at <http://www.ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf>.

20. The report identifies four key principles and seven components of a “comprehensive, integrated, multi-year strategy” for reducing the tax gap. *Id.* at 2.

21. *Id.* at 9.

and education have significant, albeit difficult to measure, impacts on the tax gap.²² The report emphasizes the importance of third-party reporting of income on taxpayers' compliance behavior.²³ Finally, the report recognizes the indirect, or deterrent, effect of IRS enforcement activities have on taxpayer compliance.²⁴

The Treasury tax gap report is an important document that sets forth the U.S. tax administration's current strategy for addressing the tax gap. However, the IRS's limited understanding of the nature and causes of taxpayer noncompliance undermines effective implementation of the report's recommendations. The next Part explores why it is important for the IRS to understand these aspects of taxpayer noncompliance and how it might go about doing so.

STEP III: CAUSATION MATTERS: AN EFFECTIVE TAX GAP STRATEGY REQUIRES THE IRS TO MATCH TREATMENTS TO CAUSES

One of the fundamental precepts of procedural justice is that punishment shall be proportional to the injury incurred as a result of the proscribed activity. Tax law recognizes that there are degrees of culpability warranting different punishments, often based on issues of intent. For example, the Internal Revenue Code distinguishes between civil and criminal penalties, and in the civil penalty context, generally permits abatement where the taxpayer shows a "reasonable cause" for the proscribed act.²⁵ Thus, although underreporting income and non-filing have an identical result in each and every case—the taxpayer does not inform the government of its taxable income—the IRS should not impose penalties in every case because the causes for that noncompliance are various and often center on intent.²⁶ For example, a taxpayer who does not file because he

22. *Id.* at 14, 16.

23. *Id.* at 7-8.

24. *Id.* at 14. The "indirect" effect of an enforcement action refers to the impact the action will have on future compliance both by the taxpayer audited and by other taxpayers as they hear about audits and decide to be more compliant out of concern that they may be audited.

25. Congress has recognized degrees of culpability by codifying the "reasonable cause" exception for imposition of certain penalties. For example, I.R.C. § 6662(b)(1) authorizes the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax. I.R.C. § 6662(b)(1) (2006). This penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith. I.R.C. § 6664(c)(1) (2006). The determination of reasonable cause takes into account all of the pertinent facts and circumstances, the most important factor being the extent of the taxpayer's effort to determine the proper tax liability. Treas. Reg. § 1.6664-4(b)(1) (as amended in 1995).

26. *See, e.g.*, *Cheek v. United States*, 498 U.S. 192, 201 (1991) ("willfulness" for purposes of two criminal tax statutes requires the government to show that the taxpayer knew he had a duty under the laws, thereby negating the defendant's claim that because of his ignor-

experienced a significant personal tragedy or the onset of dementia should be treated differently from a taxpayer who deliberately seeks to conceal income. An effective tax gap strategy would also use causation analysis to identify cures for noncompliance.

The IRS incorporates some causation analysis into its collection procedures by requiring collection personnel to determine whether the taxpayer fits into a “will pay,” “can’t pay,” or “won’t pay” category when considering an asset seizure.²⁷ In the 2001 NRP study, when IRS auditors conducted approximately 46,000 audits of individual taxpayers, the auditors were asked to describe the reason for noncompliance for each issue they identified. Among issues that resulted in a change in tax liability, the IRS auditors listed 67% as inadvertent mistakes, 27% as computational errors or errors that flowed automatically, and only 3% of errors as intentional.²⁸

While these efforts at classification are commendable, they are really very rudimentary. Some tax commentators, building on the work of Robert Kidder and Craig McEwen, who applied a social science perspective to taxpayer behavior, have proposed a more nuanced typology of tax noncompliance.²⁹ For example, with “brokered” noncompliance, commercial tax preparers contribute to, or “broker,” taxpayer noncompliance.³⁰ Given that about 61% of individual

ance or misunderstanding of the law he had a good faith belief that he was not violating any laws).

27. *Internal Revenue Manual* § 5.10.1.4(1-2) (2004), provides a detailed description of these three categories. Generally, seizures should be limited to those taxpayers who represent true “won’t pay” situations.

28. As I have noted elsewhere, the precisions of these results may be open to question, but even accounting for a significant margin of error, the designation by the IRS’s own auditors of only 3% of identified misreporting issues as intentional raises concerns about whether it is more effective to ramp up enforcement activities, as opposed to increasing education initiatives, for example. See *Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance, 109th Cong. 3* (2006) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://finance.senate.gov/hearings/testimony/2005test/072606no.pdf>.

29. See Robert Kidder & Craig McEwen, *Taxpayer Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE: SOCIAL SCIENCE PERSPECTIVES* 47 (Jeffrey A. Roth & John T. Scholz eds., 1989); See also Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 *U. Kan. L. Rev.* 1145 (Dec. 2003).

30. In addition to “brokered” noncompliance, Leslie Book describes seven other categories. “Procedural” noncompliance occurs when a taxpayer fails to file the appropriate forms within the prescribed timeframes, whereas “lazy” noncompliance arises when the taxpayer fails to keep or provide the required records. “Asocial” noncompliance is classic tax evasion, “unknowing” noncompliance results from the taxpayer’s lack of knowledge about complex or confusing tax laws, and “habitual” noncompliance occurs when the taxpayer’s prior noncompliance sets a pattern for ongoing noncompliance. “Symbolic” and “social” noncompliance derive from the taxpayer’s belief system. In the first instance, the taxpayer fails to comply with the tax laws to signal his objections to their unfair application and in the latter case, the taxpayer is noncompliant because external factors create an environment in

taxpayers now rely on others to prepare their returns for them—and among unincorporated business taxpayers, about 74% use preparers—there is certainly opportunity for significant “brokered” noncompliance.³¹

A more nuanced typology of noncompliance would provide a useful framework for the IRS in analyzing its tax gap data and in training its employees and developing internal procedures. It can help the IRS to better tailor its compliance touches to the appropriate cause of noncompliance and increase its chances of bringing at least some taxpayers into long-term voluntary compliance.

Such an observation does not mean that the tax administrator should make inquiries into each taxpayer’s reason for noncompliance in every case. Just as the tax administrator conducts studies and develops models to refine case selection formulas based on compliance risks, the tax administrator should conduct studies based on representative samples of cases to develop models that reflect the causes of those compliance risks and incorporate the results of those studies into its case selection formulas.³²

Understanding the causes of a particular form of noncompliance may enable the IRS to identify solutions that do not require it to expend enforcement resources. For example, if the cause of noncompliance is tax law complexity (“unknowing” noncompliance), the most effective approach might be legislative reform.³³ Congress did this in 2001, when it amended the “tie-breaker rule”

which cheating is acceptable. Book, *supra* note 30 at 1167-1177.

31. INTERNAL REVENUE SERV., COMPLIANCE DATA WAREHOUSE, INDIVIDUAL RETURNS TRANSACTION FILE (2006) (on file with author). Recent “shopping” visits to unenrolled preparers conducted by the Government Accountability Office, the Treasury Inspector General for Tax Administration, and the New York State Department of Taxation and Revenue all show significant variation in the competence and professional standards of these preparers. See U.S. GOV’T. ACCOUNTABILITY OFFICE, GAO-06-563T, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, CHAIN PREPARERS MADE SERIOUS ERRORS 1, 16 (2006), available at <http://www.gao.gov/new.items/d06563t.pdf> (finding that in 19 “secret shopping” visits to chain preparers conducted by GAO auditors, none of the 19 returns was error-free, and in 10 of the 19 cases preparers did not report all of the taxpayer’s business income, in five cases resulting in unwarranted extra refunds of up to \$2,000); TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2008-40-171, MOST TAX RETURNS PREPARED BY A LIMITED SAMPLE OF UNENROLLED PREPARERS CONTAINED SIGNIFICANT ERRORS (2008), available at <http://www.treas.gov/tigta/auditreports/2008reports/200840171fr.pdf>; Tom Herman, *New York Runs Sting to Nab Crooked Tax Preparers*, Wall St. J., Nov. 26, 2008, at D2. See 2 NAT’L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 44-74; 2 INTERNAL REVENUE SERV. NAT’L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS 74-116 (2008) [hereinafter NAT’L TAXPAYER ADVOCATE 2008 REPORT], available at http://www.irs.gov/pub/irs-utl/08_tas_arc_vol2.pdf, for a detailed exploration of the influence of tax return preparers on taxpayer compliance and noncompliance.

32. See *infra* Step IX for a discussion of one such research effort, the “Tipping Point” study, jointly conducted by the IRS, Taxpayer Advocate Service, and Carnegie Mellon Institute for Software Research.

33. For a detailed analysis of the impact of the I.R.C.’s complexity on taxpayers and the economy, see 1 NAT’L TAXPAYER ADVOCATE 2008 REPORT, *supra* note 31, at 3.

for the Earned Income Tax Credit.³⁴ According to a 1999 Treasury Department study of EITC compliance, 17% of EITC overclaims (\$1.6 billion) were attributable to taxpayers' claiming the EITC with respect to a qualifying child who also was the qualifying child of another taxpayer, *i.e.*, as a result of the tie-breaker rule.³⁵ The Department of the Treasury estimated that legislative clarification of the tiebreaker rule "should have an impact on this component of overclaims by greatly reducing the circumstances in which the Adjusted Gross Income (AGI) tiebreaker rule is applicable."³⁶ Here, Congress reduced the tax gap by amending the law so that taxpayers who were deemed noncompliant under former law were made compliant under current law.

Procedural noncompliance occurs when the tax administrator's procedures create barriers for the taxpayer and set him or her up for failure. A recent Taxpayer Advocate Service (TAS) study showed that over 25% of respondents who received a letter informing them that their returns were under audit for the Earned Income Tax Credit (EITC) did not understand that the IRS was auditing them.³⁷ Almost 40% of the respondents did not understand what aspect of the return that the IRS was questioning.³⁸ Thus, by improving the clarity of its communications with taxpayers, the IRS might improve the quality of the responses and the accuracy of its audit results. Moreover, the IRS might save resources by more clearly communicating with taxpayers, since 72% of respon-

34. Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Pub. L. No. 107-16 §303(f), 115 Stat. 38 (2001) amended I.R.C. § 32(c)(1)(C) (repealed 2004) by limiting the application of the tie-breaker rule to situations where a child is actually claimed by two taxpayers who are, in fact, eligible to claim the child. For example, as amended, if a parent and a grandparent live in the same household with the child and both claim the earned income tax credit (EITC) with respect to that child, the tie-breaker rule deems the child to be the "qualifying child" of the parent. However, if the parent does not claim the child for EITC purposes on his or her return and the grandparent does claim the child on his or her return, the tie-breaker rule will not apply. I.R.C. § 32(c)(1)(C) was later stricken and replaced by I.R.C. § 152 in the Working Families Tax Relief Act, Pub. L. No. 108-311 §§ 201, 205 118 Stat. 1166 (2004). For a discussion of the impact of this law and other EGTRRA changes on EITC compliance, see INTERNAL REVENUE SERV., COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 24-25 (2002), available at <http://www.irs.gov/pub/irs-utl/compesteitc99.pdf>.

35. INTERNAL REVENUE SERV., *supra* note 35, at 13, Table 1.

36. *Id.* at 21.

37. 2 NAT'L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 103. Using a multiple wave process, the Taxpayer Advocate Service (TAS) mailed nearly four thousand surveys to taxpayers who claimed the EITC and were audited. The response rate for the survey was about 24%. Survey percentages have a margin of error of plus or minus 4% at the 95% confidence level. *Id.* at 100.

38. *Id.* at 103. More than 70% of respondents thought the audit notification letter was difficult to understand. Some of the reasons given were: (i) the taxpayer did not understand some words or terms (42.7%); (ii) the letter did not explain what documents to send to the IRS (22%); (iii) the instructions were hard to follow (16.2%); (iv) tone of letter scared the taxpayer (16.4%); and (v) the letter was difficult to read (11.2%). *Id.* at 104.

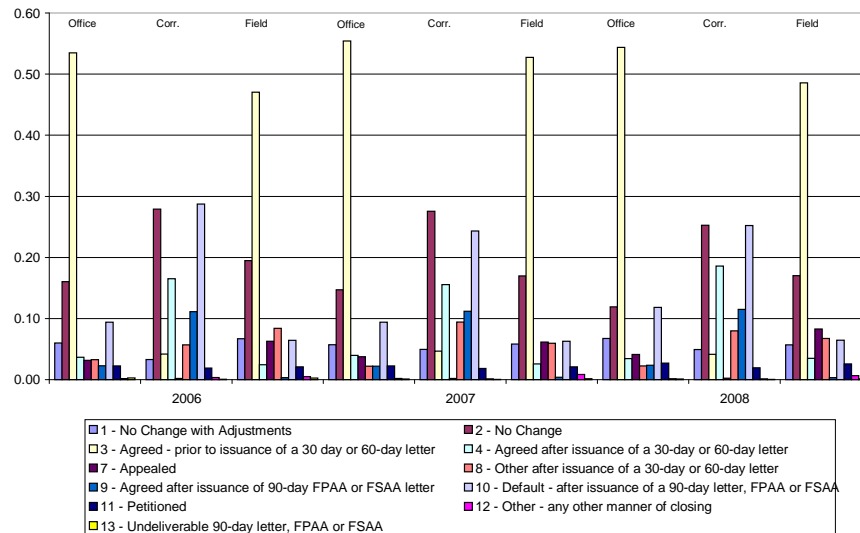
dents said they either called or visited the IRS for help in response to the ter.³⁹

The method by which an audit is conducted also has consequences for taxpayers. The IRS audit program includes three types of examinations: correspondence examinations; examinations conducted in IRS offices; and field examinations, typically held in a taxpayer's home or place of business.⁴⁰ These examinations range from a mailed notice asking for clarification of a single tax return item to a face-to-face interview and complete review of the taxpayer's records. The IRS examined 1,384,563 individual returns in Fiscal Year 2007, of which 83% were conducted as correspondence examinations, while a much smaller number of returns were audited through office or field examinations.⁴¹ Figure 1 shows the discrepancies between agreement, default, and other disposition rates for these three types of exams for Fiscal Years 2006 through 2008. Face-to-face audits produce a higher agreement rate, while correspondence audits have a significantly higher default rate. This degree of disparity should lead the IRS to review its processes and ensure that the audit method itself is not the cause for classifying the taxpayer as noncompliant.

39. *Id.* at 104.

40. *See* Treas. Reg. § 601.105 (as amended in 1987); Treas. Reg. § 301.7605-1 (as amended in 1993); *see also* Statistics of Income (SOI) Tax Stats - IRS Tax Compliance Activities, <http://www.irs.gov/taxstats/compliancestats/article/0,,id=117875,00.html> (last visited Jan. 12, 2009). In addition, the IRS has a compliance program known as Automated Underreporter (AUR) that matches information reporting documents received from payors of income (*e.g.*, Forms W-2 and Forms 1099) with information reported on a taxpayer's return for the purpose of identifying items of unreported income. The AUR function generates notices to taxpayers when underreporting has been identified. However, AUR notices are not considered examinations for purposes of IRS's enforcement statistics.

41. TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, at 8 (Ref. No. 2008-30-095, 2008), *available at* <http://www.treas.gov/tigta/auditreports/2008reports/200830095fr.pdf>.

FIGURE 1: Examination Closures⁴²

An understanding of taxpayer behavior may enable the IRS to utilize its existing resources more efficiently and more effectively. For example, if taxpayers learn that the IRS has discovered their underreporting, they might voluntarily pay the current tax on the underreported income and be more compliant in the future. The IRS recently conducted a test in its Automated Underreporter Program (AUR). The AUR matches income reported on third party information reporting documents such as Form W-2, Wage and Tax Information Statement, and the Form 1099 information return series against income reported on the taxpayer's return. In the "Soft Notice CP 2057 Test," instead of proposing an assessment of tax under its usual procedures, the IRS sent over 2,500 notices to various types of taxpayers for the 2003 and 2004 tax years, informing them that the IRS had identified missing income information on their returns. The notices instructed the taxpayers to either file an amended return (Form 1040X) if they had underreported income in error or ask the payor to correct the information documents reported to the IRS if they were incorrect. Taxpayers who received a soft notice and repeated their behavior would be subject to normal AUR processing in the following year. 25% of the notices resulted in filed amended returns reporting the additional income. Significantly, taxpayers accounting for

42. INTERNAL REVENUE SERV., AUTOMATED INFORMATION MANAGEMENT SYSTEM (AIMS) FROM THE IRS COMPLIANCE DATA WAREHOUSE, FISCAL YEARS 2006-2008 (2008) (on file with author) (excluding audits where the taxpayer did not respond or the notification of audit was undeliverable); see 1 NAT'L TAXPAYER ADVOCATE 2008 REPORT, *supra* note 31, at 227, available at http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf.

78% of the notices sent showed subsequent year behavior correction.⁴³

Once tax administrators develop a more detailed and nuanced understanding of the causes of tax noncompliance, they face the difficult task of incorporating this knowledge into programs and employee education. Employee behavior is driven by the goals and performance measures established by the agency. The next Parts explore some of the specific challenges an agency faces in setting goals and measures that drive an effective tax gap strategy.

STEP IV: WHAT'S THE GOAL: HOW DO YOU DEFINE SUCCESS WITH RESPECT TO THE TAX GAP?

According to the IRS, the voluntary compliance rate “is virtually the same in T[ax] Y[ear] 2001 as it had been in TY 1985.”⁴⁴ Thus, the compliance rate today does not appear to be substantially worse, increases in global transactions, complex financial products, and Internet commerce notwithstanding. Future improvements in tax compliance will occur at the margins.

Today, the IRS’s primary goal with respect to the tax gap must be three-fold: (i) maintain current compliance levels in the face of a changing economic environment; (ii) convert taxpayers who become compliant as a result of an enforcement or compliance action into taxpayers who are voluntarily compliant over the long-term; and (iii) take effective action against those taxpayers who continue to intentionally evade taxes. For reasons discussed below, IRS success in this endeavor is not best measured by a single goal, such as reducing the tax gap by an additional five percentage points. Instead, the definition of success is different for each of the three aspects described above. The IRS will be successful in maintaining current compliance levels if the gross tax gap does not increase overall and within each taxpayer segment. It will be successful in converting noncompliant taxpayers into voluntarily compliant taxpayers if the voluntary compliance rate improves over time.⁴⁵ Success with respect to tax

43. The IRS is currently expanding this initiative in fiscal year 2009. See Internal Revenue Serv., Presentation to the IRS Nationwide 2008 Tax Forum: Addressing Underreporting—The Soft Notice Approach 9 (2008), available at http://www.irs.gov/pub/irs-utl/addressing_underreporting_-_the_soft_notice_approach.pdf.

44. IRS FEDERAL TAX GAP REPORT, *supra* note 7, at 18 (“For example, based on TCMP data from the 1960s through the 1980s, the IRS estimates that the VCR has moved within a range of 2 percentage points and is virtually the same in TY 2001 as it had been in TY 1985.”). The IRS estimates the voluntary compliance rate for TY 2001 to be 83.7%. *Id.* For a discussion of the Voluntary Compliance Rate, see *infra* note 45.

45. The IRS has established overall measures relating to its three major components of the tax gap. It measures payment compliance by the Voluntary Payment Compliance Rate (the proportion of tax liability timely reported that is also timely paid) and the Cumulative Payment Compliance Rate (the proportion of tax liability reported timely that taxpayers pay as of a given date). The IRS measures filing compliance by the Filing Rate (the proportion of

evaders requires specialized measures, for example, the number of successful prosecutions or the identification and publicizing of abusive tax schemes, with imposition and collection of penalties.

By setting goals for separate components of the tax gap, we can measure the effect of different, more targeted programs. Thus, we might set a different compliance goal for the EITC, or for stock basis reporting, or for pass-through entities. We might also set a goal for decreasing the nonfiling rate. Each of these goals can be achieved through a variety of compliance touches, including the following: education, service, communications, gentle touches like soft notices, traditional enforcement tools like liens and levies, and criminal prosecutions in egregious cases. And each of these goals would contribute to maintaining and perhaps improving the voluntary compliance rate. Most importantly, these goals are based on a multi-faceted understanding of the taxpayer population and the compliance challenges involved rather than being an arbitrarily established target. Goals also drive resource allocation and influence both what activities the IRS undertakes and how IRS employees conduct themselves in those activities. To reduce the tax gap for the long term, the IRS should establish performance measures that take into account how effective the IRS is in increasing voluntary compliance as well as in combating tax evasion.

STEP V: YOU GET WHAT YOU MEASURE: HOW IRS PERFORMANCE MEASURES DRIVE ITS BEHAVIOR AND IMPACT ITS EFFICACY

To measure the scope and efficacy of IRS tax gap initiatives, it is tempting to look at easily derived data such as audit rates or the number of liens filed or levies issued. This data is usually cited to demonstrate the IRS's "coverage" of taxpayers, or the extent of the IRS's reach. This narrow definition of coverage excludes the other ways the tax system touches taxpayers, including the following avenues: "soft" notices, availability of walk-in assistance sites, the Taxpayer Advocate Service, media messages, and elementary or secondary school education programs. To accurately measure the IRS's effectiveness in increasing taxpayer compliance with the U.S. tax laws, we need a "coverage" index that is comprehensive and that incorporates the indirect and long-term (longitudinal) effects of tax initiatives. We should be measuring how we are "touching" the entire taxpayer population (including taxpayers-to-be) and how effective those touches are in increasing taxpayers' compliance behavior over the long run.

To date, most of the government solutions for addressing noncompliance

required returns that are timely filed) and the Nonfiling Tax Gap (the dollar amount of unpaid taxes due on returns that are not timely filed). Finally, the IRS measures reporting compliance by the Voluntary Reporting Rate (the proportion of tax liability reported accurately on timely filed returns). Brown & Mazur, *supra* note 6 at 1259-60.

have focused on the traditional tools of tax administration, especially enforcement powers such as examinations, penalties, and seizures. This focus derives in part from the traditional economic model of tax compliance in which compliance depends on the taxpayer's assessment of the risk of detection and degree of punishment.⁴⁶ Moreover, large organizations like the IRS tend to rely on approaches that lend themselves to easily measurable results. This tendency, in turn, leads the IRS to measure performance by counting the tax system's equivalent of widgets. Accordingly, the IRS measures the number of examinations conducted or levies issued and liens filed per year, but it does not attempt to routinely measure the long-term compliance impact of those examinations or collection actions.

Because U.S. tax administrators have not systematically studied the long-term effects of traditional enforcement initiatives on taxpayer compliance, they do not know, for example, the effectiveness of one of the IRS's most powerful enforcement tools, the Notice of Federal Tax Lien.⁴⁷ The IRS measures how many liens it files each fiscal year. However, it does not measure whether the public filing of liens makes a difference in taxpayer compliance behavior over time. Beyond establishing the government's priority over other creditors with respect to a specific tax debt for a specific tax year, the IRS does not know whether filing a lien increases the likelihood that a taxpayer will be compliant in the future without the need for additional government intervention. Moreover, the IRS has not identified what taxpayer or case characteristics would increase the likelihood of long-term compliance when a lien is filed. By gaining a greater understanding of the compliance effect of the Notice of Federal Tax Lien, the IRS can establish performance measures that drive effective rather than automatic lien filing.

A recent Taxpayer Advocate Service study of enforcement activity shows the pitfalls of focusing on widget-counting as evidence of the IRS's effectiveness in increasing compliance. The number of levies issued by the IRS increased by 1,608% (from 220,000 to roughly 3.76 million) from FY 2000 to FY 2007. The increase in total collection yield during this period was only about 45%, or 25% after adjusting for inflation.⁴⁸ An analysis of this relationship on a

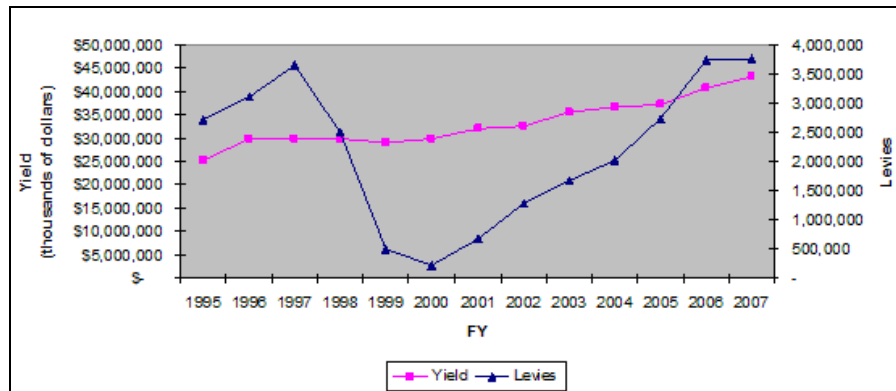
46. Michael G. Allingham & Agna Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 323-38 (1972); see also Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1463 (2003) (comparing enforcement and norm-based theories of taxpayer compliance). In essence, this model assumes that taxpayers loosely compare (i) the monetary benefits they would derive if they cheat on their taxes and get away with it against (ii) the amount they would be required to pay if their cheating is detected multiplied by the percentage likelihood of detection. If the computation under (i) is greater, they will cheat. If the computation under (ii) is greater, they will not cheat.

47. I.R.C. § 6323 (2006).

48. Bureau of Labor Statistics, Dep't of Labor, Consumer Price Index—All Urban

year-to-year basis shows no direct correlation between the volume of levies issued and the corresponding collection yield. As the following chart reveals, from FY 1998 to FY 2000, IRS levies decreased from over 2.5 million to 220,000.⁴⁹ Yet, the collection yield during this period actually increased. From FY 2001 to FY 2002, the use of IRS levies almost doubled (increased by 91%), yet the collection yield increased by only 2%.⁵⁰ One possible explanation is that the IRS is issuing levies inappropriately, that is, in unproductive cases. By measuring and reporting on the number of levies issued and not measuring or reporting on the long-term yield ratio or compliance effect of levies, the IRS overstates its effectiveness and sends a message to its employees that it is the quantity, not the quality, of levies that matters.

FIGURE 2: Total Collection Yield and Levies Issued 1995 - 2007



I am not suggesting here that the IRS should not issue levies or file liens, but I am suggesting that it *judiciously* issue levies or file liens. Rather than *automatically* filing liens, as the IRS currently does under its IRM procedures for most accounts,⁵¹ it should base its lien determinations on research into the im-

Consumers (CPI-U), <http://www.bls.gov/CPI/> (last visited Jan. 12, 2009).

49. INTERNAL REVENUE SERV., 1995-2007 INTERNAL REVENUE SERVICE DATABOOK, at tbl.16 (2007), available at <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>

50. An IRS research study concluded that although traditional enforcement actions declined substantially after the hearings leading up to the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685, "total collection yield was not dramatically impacted by RRA 98," and actually increased in every year but one after RRA 98. INTERNAL REVENUE SERV., SMALL BUSINESS/SELF-EMPLOYED RESEARCH, LIENS, LEVIES, SEIZURES, AND TOTAL YIELD: 10 YEAR FILING TREND (2005) (on file with author).

51. See, e.g., INTERNAL REVENUE MANUAL § 5.12.2.4.1(1) (2005) (requiring Collection Field function employees to file a Notice of Federal Tax Lien (NFTL) where there is an unpaid assessed balance below \$5,000 and the filing will promote compliance; where there is

pact of lien filing on taxpayers' long-term compliance behavior. Such research would attempt to identify the situations in which lien filing enhances taxpayer compliance, and situations in which lien filing impedes long-term compliance. The IRS could create a two-pronged measure of the effectiveness of lien filing: the first prong measuring both the total and average revenue collected attributable to lien filing, and the second measuring the long-term impact of the lien on the taxpayer's compliance behavior. Establishing a measure of long-term compliance will also drive the IRS to design initiatives that enable taxpayers to obtain closure of their tax problems, increasing the likelihood they can become and remain compliant.

STEP VI: ACHIEVING RESOLUTION VS. PUSHING PROBLEMS DOWNSTREAM:
TAXPAYERS NEED CLOSURE

The interaction between the drive to reduce the tax gap and the activities undertaken and measured to accomplish that goal can lead to unexpected results, in part because trying to close the tax gap is a bit like twisting a balloon. That is, if you apply pressure to one part of the tax gap, it will bulge on the other side. For example, the IRS estimates that for 2001, the portion of the tax gap attributable to nonfiling is about \$27 billion, approximately 93% of which is attributed to individuals.⁵² If the IRS addresses the nonfiler problem as it currently does, by measuring the number of tax delinquency investigations,⁵³ and substituted returns it undertakes,⁵⁴ it will surely reduce the dollars attributable to that portion of the tax gap. But merely finding nonfilers and assessing taxes against them will likely increase the portion of the tax gap attributable to nonpayment of taxes, since many nonfilers do not file because they cannot afford to pay their outstanding tax liability. Without a comprehensive strategy to address the nonfiler portion of the tax gap, the IRS will only move tax gap dollars downstream. If the IRS were to measure closure from the taxpayer's perspective, meaning that the taxpayer's issues are in fact resolved, it would view the nonfiling and nonpayment holistically and stand a better chance to convert

an unpaid assessed balance of any amount and the entity is not in compliance with current requirements; where the aggregate unpaid assessed balance is \$5,000 or more; where an installment agreement does not meet certain installment agreement criteria; and where an open account with an aggregate unpaid assessed balance of \$5,000 or more is reported as currently not collectible (where IRS is unable to locate or contact taxpayer, or taxpayer is experiencing an economic hardship)); *see also* INTERNAL REVENUE MANUAL § 5.19.4.5.2(1)-(2) (2006) for lien filing requirements for Automated Collection System employees.

52. *See* IRS FEDERAL TAX GAP REPORT, *supra* note 7.

53. A tax delinquency investigation is created when a nonfiler taxpayer fails to respond to one or two notices concerning the delinquent return.

54. IRC §§ 6651(g), 6020(b) authorize the IRS to prepare a substituted return when it determines that the taxpayer is liable for filing a tax return but has failed to do so after receiving notification from the IRS.

noncompliant taxpayers into voluntarily compliant taxpayers.

To minimize the nonfiler problem, the IRS must not only understand the causes of nonfiling but also develop strategies to address these causes—*i.e.*, create a cure rather than merely passing the problem downstream to other parts of the IRS. If all the tax system does is assess the tax for one year in a nonfiler case, it will have great statistics for that year. But those statistics will not prevent the taxpayer from not filing in the future, nor will they help the nonfiler resolve his or her tax debt. Most taxpayers want resolution. An effective approach to the tax gap must be holistic and address the taxpayer's needs from start to finish. Sometimes a taxpayer will not comply with the tax laws unless he or she faces enforcement action. But enforcement is only one part of an effective compliance strategy.⁵⁵

The IRS underutilizes many of the tools available to it for effecting comprehensive case resolution. Since 1863, for example, the Secretary of the Treasury has had the authority to compromise federal tax debts.⁵⁶ Under the current Offer in Compromise (OIC) program, the IRS can agree to accept as settlement of a tax debt an amount less than the amount legally due on one of three grounds: doubt as to collectibility, doubt as to liability, and “effective tax administration.”⁵⁷ As a condition of accepting a compromise offer, the taxpayer

55. One example of a holistic compliance initiative is an IRS project from the early 1990s designed to address noncompliance by commercial fishermen in Alaska that the IRS believed was the result of confusion about the tax laws as well as community norms and attitudes. Working with local authorities and license databases, the IRS district office identified nonfilers and used a mass summons to obtain information about the recorded value of their catches to generate substitute returns. The IRS, state, and local officials then identified various payments from local fish processors and others that could be subject to levy. Simultaneous with this activity, the IRS launched an extensive outreach and education effort in remote fishing villages and on fishing vessels, preparing returns and training volunteers to assist nonfilers. The IRS also worked with local community organizations, which provided a full-time Yupik-speaking person to help with tax problems. The organizations also provided loans up to \$30,000 to help the nonfilers pay their tax liabilities. This initiative brought in over one thousand previously unfiled returns, approximately \$4.6 million in new assessments, and guilty pleas in nine failure-to-file cases and one tax evasion case. The program also improved long-term voluntary compliance in the target population, reducing nonfiling from 13.1% in tax year 1990 to 9.2% in tax year 1992. Internal Revenue Serv., Memorandum from District Director, Anchorage District, to Chief Compliance Officer, Western Region, Compliance 2000—Prototype Completion (Aug. 23, 1994) (on file with author). For a detailed discussion of the historical and current state of IRS local compliance initiatives, see 1 NAT'L TAXPAYER ADVOCATE 2008 REPORT, *supra* note 31, at 177-178 (2008).

56. In 1863, Congress enacted a predecessor to IRC §7122, the statute providing the IRS's current authority to compromise tax debts, in part so that each case would not have to come before Congress. CONG. GLOBE, 37th Cong., 3rd Sess. (1863), reprinted in J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 1060 (1953) (statements of Representative Fessenden).

57. 26 C.F.R. § 301.7122-1(b). “Effective tax administration” offers have their genesis in language from the RRA 98 Conference Report:

must demonstrate current tax compliance and agree to comply with all federal tax laws for the next five years; failure to do so results in reinstatement of the unpaid tax liability, as Congress stated in the legislative history to the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).

The conferees believe that the ability to compromise tax liability and to make payments of tax liability by installment enhances taxpayer compliance. In addition, the conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and to remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.⁵⁸

Offers in compromise are a win-win situation for taxpayers and the IRS. Under the terms of a “doubt as to collectibility” offer, a taxpayer pays the IRS the amount the IRS deems the taxpayer is able to pay (the “reasonable collection potential”) and agrees to become and remain compliant with the tax laws.⁵⁹ The taxpayer gains closure and a fresh start; the IRS gains a convert to voluntary compliance while retaining protection in the event of lapse (the condition of debt reinstatement). Yet OIC acceptances have declined by over 72% from FY 2001 to FY 2008.⁶⁰ While there are many reasons for this decline, it is possible that IRS uneasiness with the role of OICs in the collection process may play a part. One study noted that in site visits and executive interviews, IRS personnel held widely divergent views of the program’s purpose. These views ranged from the belief that a “fresh start” was a program goal, to the belief that the program simply enabled the agency to collect an appropriate amount from the taxpayer, to the belief that the program was “too generous and should be used as a last resort after trying to collect more tax through other means,” to ques-

[T]he conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (*i.e.*, factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer’s income tax liability would promote effective tax administration.

IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998); *see also* INTERNAL REVENUE MANUAL § 5.8.12.2(1) (2008).

58. H.R. REP. 105-599, at 288-89 (1998) (Conf. Rep.).

59. Reasonable Collection Potential (RCP) equals the net equity of a taxpayer’s assets plus the amount the IRS could generally collect from four or five years of his or her net income (net of reasonable living expenses). Absent special circumstances, the taxpayer must offer at least this amount for an offer to be accepted. INTERNAL REVENUE MANUAL § 5.8.4.4.1 (2008); INTERNAL REVENUE SERV., FORM 656, OFFER IN COMPROMISE 5 (2007), *available at* www.irs.gov/pub/irs-pdf/f656.pdf.

60. INTERNAL REVENUE SERV., SMALL BUSINESS/SELF-EMPLOYED COLLECTION ACTIVITY REPORT, (No. 5000-108, 2008) (on file with author). In FY 2001, the IRS accepted 38,643 offers compared to 10,677 in FY 2008.

tioning whether the program should exist at all.⁶¹

The fear that taxpayers would become noncompliant if the government accepted offers from a few (deserving) taxpayers might be allayed by the facts of the program. In FY 2008, the IRS collected on average 20 cents for every dollar of tax liability owed on accepted OICs.⁶² By contrast, after a tax liability is two years old, the IRS collects virtually nothing through its traditional collection methods.⁶³ Moreover, in 44% of rejected or withdrawn offers from individuals, the IRS later collected less than 50% of the amount offered by the taxpayer (which was less than the amount due).⁶⁴ On the other hand, 80% of taxpayers that accepted offers remained in compliance over the required five-year period.⁶⁵ Thus, rather than being a give-away program, OICs, on average, resulted in more tax collected per dollar owed than traditional IRS enforcement efforts and converted a substantial portion of noncompliant taxpayers into compliant ones.

Initiatives like the Offer in Compromise program, which enable taxpayers to resolve their tax debts, have benefits beyond their direct tax collection effect. Such programs are based on the premise that taxpayers generally want to comply with the tax laws and that if the IRS treats them with courtesy and respect and provides reasonable opportunities to resolve a tax liability if they lapse, overall tax compliance will improve. This approach has its basis in the belief that the traditional economic model of tax compliance does not entirely explain our current high compliance levels and that something else is at work, sometimes called “tax morale.”

STEP VII: TAXPAYER RIGHTS MATTER: FAIRNESS, JUSTICE, AND DUE PROCESS
ARE ESSENTIAL COMPONENTS OF TAX MORALE AND IMPACT TAXPAYER
COMPLIANCE

Tax morale is the somewhat ungainly term used to describe the sum of a taxpayer’s internal motivations that affect his or her behavior, including social

61. INTERNAL REVENUE SERV., SMALL BUSINESS/SELF-EMPLOYED DIVISION, OFFER-IN-COMPROMISE PROGRAM PROCESS IMPROVEMENTS AND INVENTORY REDUCTION RECOMMENDATIONS, at II-2 (2001) (on file with author).

62. *Id.* at Executive Summary.

63. INTERNAL REVENUE SERV., AUTOMATED COLLECTION SYSTEM OPERATING MODEL TEAM, Collectibility Curve (2002) (on file with author).

64. INTERNAL REVENUE SERV. OFFER IN COMPROMISE PROGRAM, ANALYSIS OF VARIOUS ASPECTS OF THE OIC PROGRAM 10 (2004) (report on file with author). In 21% of these cases, the IRS collected nothing at all.

65. *Id.* at 6. When adjusted to exclude taxpayers who received the first collection notice, but no subsequent notices, it appears that approximately 80% of these taxpayers remained in compliance.

and personal norms, cognitive processes, and demographic factors.⁶⁶ A tax administrator concerned about tax morale will necessarily be concerned about how taxpayers feel they are being treated by the tax system. This feeling is influenced by many factors, including the following: government access, openness, availability of information and dispute resolution, courtesy, professionalism, and, most importantly, fairness. Tax morale is one byproduct of the social contract between taxpayers and their government.⁶⁷

This social contract enables the United States tax system to operate relatively well because taxpayers willingly file their tax returns, reporting income that the government would otherwise have to investigate and assess through enforcement measures. Employers willingly pay withheld and matching payroll taxes for their employees, which the government would otherwise have to collect through levies and seizures.⁶⁸ If taxpayers believe that others are not reporting their incomes or paying their fair share of taxes, compliant taxpayers will begin to feel like they have been duped. This feeling is exacerbated if the government treats them badly when they make a mistake or are otherwise unable to pay their own tax bills.

The social contract implies that each party not only has rights but also responsibilities with respect to the other party. If most taxpayers honor their part of the bargain and are compliant, the government will take steps to protect taxpayers' rights and ensure that less compliant taxpayers also pay their taxes or receive punishment. Charters like a "Taxpayer Bill of Rights" explicitly state these provisions.⁶⁹ They serve to reassure the taxpaying public that the gov-

66. See generally Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, in 2 NAT'L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 138. Professor Kornhauser's study reviews the recent literature about compliance, and finds that tax compliance is affected by norms including "procedural justice, trust, belief in the legitimacy of the government, reciprocity, altruism, and identification with the group." *Id.* A taxpayer's compliance behavior can also be affected by external factors, including IRS actions, as well as demographic factors such as age, gender, or education.

67. Lars Feld and Bruno Frey refer to this agreement as the "psychological contract," noting that social psychologists have used this term to distinguish it from a formal contract with sanctions that are negotiated and agreed upon. See Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 L. & POL'Y 102, 106 (2007).

68. In FY 2007, over 88% of all employment tax returns were filed with no balance due. INTERNAL REVENUE SERV., COMPLIANCE DATA WAREHOUSE, BUSINESS RETURN TRANSACTION FILE AND ACCOUNTS RECEIVABLE DOLLAR INVENTORY FOR TAX PERIODS ENDING SEPTEMBER 2006, DECEMBER 2006, MARCH 2007, AND JUNE 2007 (on file with author). (The data does not account for unfiled return investigations.)

69. In 2007, I recommended that Congress enact a Taxpayer Bill of Rights that set forth 10 general rights of taxpayers and 5 corresponding taxpayer obligations. See 1 NAT'L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 478; see also Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation*, in 31 SERIES ON INTERNATIONAL

ernment will protect and honor a taxpayer's rights even as it reminds the taxpayer that rights impose obligations on the taxpayer to comply with the tax laws. A taxpayer bill of rights reinforces (and prevents erosion of) the reason taxpayers most often give to explain why they comply with the tax laws, namely, their perception of themselves as law-abiding and responsible.⁷⁰

Procedural justice is one way taxpayers positively experience fair treatment without necessarily obtaining the result they desire, and limiting procedural justice can negatively impact taxpayer compliance. Unlike a taxpayer bill of rights, which sets forth general principles of fairness, procedural justice is expressed in specific statutory and administrative provisions.⁷¹ For example, tax administrators, legislators, and other commentators occasionally argue that the IRS does not have enough time to assess or collect tax, or that collection is impeded by giving taxpayers a right to challenge IRS collection actions in court. Such arguments fail to acknowledge the role procedural protections play in maintaining taxpayer morale. Because both taxpayers and the tax administrator can make factual and legal mistakes, it is important that taxpayers know there are procedures available for protesting the accuracy and fairness of the tax administrator's actions. Thus, regardless of the outcome, procedures such as audit reconsideration, administrative appeals, and Collection Due Process hearings improve taxpayer morale by demonstrating that the tax administrator is willing to listen to the taxpayer and consider its own actions. Statutory periods of limitation and settlement initiatives bring closure to taxpayers' accounts, which affords them some peace, knowing that in general they will not be haunted all their lives by their missteps. Tax morale suffers if people are not able to obtain some finality and move on.⁷²

TAXPAYER (2008) (discussing comprehensively the role of taxpayer rights in tax administration).

70. INTERNAL REVENUE SERV. OVERSIGHT BOARD, 2007 TAXPAYER ATTITUDE SURVEY 2, 4 (2008), http://www.treas.gov/irsob/reports/2008/2007_Taxpayer-Attitude-Survey.pdf. (84% of taxpayers reported it is not at all acceptable to cheat on your income taxes. When asked "How much influence does each of the following factors have on whether you report and pay your taxes honestly?" the following were the responses for personal integrity: 72% responded a great deal of influence, 15% responded somewhat of an influence, 5% said this had very little influence, and 6% stated that personal integrity was not at all an influence. An additional 2% did not respond or did not know how personal integrity influenced their tax reporting.)

71. *See, e.g.*, IRC § 6330(b) (providing the right to a Collection Due Process hearing before an independent administrative Appeals Officer prior to the IRS issuing its first levy to that taxpayer with respect to a particular tax and tax period).

72. Depending on the circumstances, IRC § 6501 provides that the IRS has between three and six years to assess additions to tax following the filing of a return (in the case of fraud or nonfiling, the assessment window is unlimited). IRC § 6511 provides that the IRS generally has ten years from the date of return filing to collect the tax. The IRS is the single most powerful creditor in the United States. It can levy or seize certain property merely by following certain administrative procedures, without first having to go to court and obtain a judgment as other non-governmental creditors must. An extension of the statutory time-

Taxpayer compliance is also undermined by the government's ongoing failure to show why taxes are different from other payments the taxpayer makes. Although the entire thrust of tax statutes, case law, and tax procedures emphasizes the primary importance of taxes as the "lifeblood of government," the government has failed to compellingly make this case to the U.S. taxpayer. Here, I fault everyone involved in the tax system, both inside and outside the government. It is far too easy to take cheap shots at the IRS or the tax code, pointing out the flaws, ineptitude, or unfairness of the system. No one likes giving up one's money, even if it is for the public good. People need convincing that it is in their own best interests to give up their money. Such convincing is very difficult because it involves reminding taxpayers that there is such a thing as public good and that each of us contributes to it, just as each of us benefits from it. We may disagree with the current distribution of these burdens and benefits—these are important policy discussions in which everyone should participate, at the very least by exercising one's voting rights—but it is counterproductive to talk only about the burdens of taxation and not about the public benefits that tax revenue makes possible.⁷³

The IRS may be doing itself a disservice in this "public good" effort as it strives to become more automated and distances itself from interacting with taxpayers. Do we really want taxpayers to view their transactions with government in the same way they view financial transactions over the Internet? The next Part explores some of the implications for tax compliance of the IRS's increasingly remote interaction with taxpayers.

STEP VIII: REHUMANIZING TAX ADMINISTRATION: PUTTING A HUMAN FACE ON THE IRS AND DESIGNING TAXPAYER-CENTRIC AUTOMATION

Notwithstanding the ubiquity of the computer in our daily lives, taxpayers overwhelmingly prefer to personally interact with the IRS, if they have to interact at all. Although approximately 50% of taxpayers say they are willing to use the IRS website to obtain tax forms and publications or tax law information,⁷⁴ 75% were unwilling to share personal information via the Internet.⁷⁵ More than 25% of taxpayers stated that they are unwilling to use the IRS website for any

frames does not lessen the tax gap but rather increases it—it causes the IRS to continue to focus on historical problems that it has not caught in a timely manner, as opposed to focusing on the current problems of tax compliance, which are far more likely to be actionable and correctible.

73. For a thoughtful analysis of private rights as a public good, and the role taxes play in a democratic society in obtaining and protecting those rights, see STEPHEN HOLMES & CASS R. SUNSTEIN, *THE COST OF RIGHTS, WHY LIBERTY DEPENDS ON TAXES* (1999).

74. *Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services*, in 2 INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE 2006 ANNUAL REPORT TO CONGRESS 7 (2006) [hereinafter NAT'L TAXPAYER ADVOCATE 2006 REPORT].

75. *Id.* at 8.

service activities in the future.⁷⁶ Taxpayers who speak English as a Second Language prefer to speak with an IRS employee about tax issues, particularly in a face-to-face setting.⁷⁷ Taxpayer comfort with the Internet may increase over time, but it is more likely that because of the complex nature of the tax laws and the perceived heavy consequences of doing the wrong thing, taxpayers will continue to want to speak personally to an IRS employee about their account-related matters.⁷⁸

As a general matter, taxpayer preference for personal interaction with the IRS is good news for tax administration because it affords the tax administrator the opportunity to engage and educate the taxpayer, particularly about issues the taxpayer did not know existed. It is also an opportunity to reaffirm the social (or psychological) contract with the taxpayer. For many taxpayers, the emphasis on helpful, personal interaction can allay fears that prove an obstacle to achieving the proper resolution in a tax case.⁷⁹

Of course, the IRS must balance these taxpayer preferences against its resource constraints. Resource concerns partly drive the IRS not only to direct taxpayers to on-line services instead of IRS phone lines, but also to conduct 83% of individual examinations by correspondence instead of face-to-face, and to automate the issuance of levies without an employee reviewing the facts of the case.⁸⁰ These efficiency measures are understandable in light of the vast

76. *Id.* This compares with findings by John B. Horrigan, HOW AMERICANS GET IN TOUCH WITH GOVERNMENT 27 (2004) available at http://www.pewinternet.org/pdfs/PIP_E-Gov_Report_0504.pdf (finding that 36% of adult Americans do not go online).

77. *Id.*

78. Although for some taxpayer segments face-to-face assistance is vital to their ability to comply with the tax laws, most taxpayers prefer telephone assistance. *Id.* at 5.

79. A Taxpayer Advocate Service (TAS) marketing survey found that 25% of the U.S. taxpayer population (and 43% of taxpayers who were eligible for TAS assistance because they had experienced a significant hardship in the last two years) felt intimidated by the IRS. Intimidated taxpayers do not call the IRS for assistance, and therefore the IRS does not have an opportunity to correct the situation by receiving information that only the taxpayer possesses. By changing the tone of initial correspondence or making outgoing calls to taxpayers offering assistance in resolving the tax problem, the IRS might alleviate some of this fear, without impairing its enforcement powers. INTERNAL REVENUE SERV., FINDINGS FROM TASK 149—THE TAXPAYER ADVOCATE SERVICE RESEARCH PROGRAM, WITH A FOCUS ON THE DETAILED STUDY OF THE UNDERSERVED SEGMENT, PHASE II, STUDY #3, at 20-21 (2002) (on file with author).

80. TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, at 8 (Ref. No. 2008-30-095, 2008). In the correspondence examination function, tax examiners generally use an automated batch processing function to manage their case inventories. As cases move through the examination process automatically, each step is programmed for a set time period. Cases automatically move from one step to another without any human intervention unless a taxpayer contacts the IRS, either by telephone or correspondence. See 1 NAT'L TAXPAYER ADVOCATE 2008 REPORT, *supra* note 31, at 248-250 (describing the correspondence exam batch processing system and related problems). The IRS also uses an automated system, the Federal Payment Levy Program (FPLP),

amount of compliance activity the IRS needs to complete each year. However, if these processes are implemented without studying their effects on taxpayers' ability to communicate effectively with the IRS or without screening out taxpayers who may be improperly harmed, automation can impair tax morale and increase noncompliance.⁸¹

Many of the technological improvements the IRS utilizes to make itself more efficient also have the effect of making it feel more remote to taxpayers. The inability to speak to the same employee twice on the phone, the primary use of correspondence in examination and collection cases, the absence of a physical IRS presence in communities throughout the United States, and the corresponding centralization of activities in a few large "campuses" or "call sites" all place a distance between the taxpayer and the IRS.⁸² While some might say this is a positive development—who wants the IRS in one's backyard?—it is unclear what happens to tax morale and taxpayer attitudes toward tax compliance as the tax administrator's human face or voice disappears.

The IRS does not need to contact each and every taxpayer directly in order to maintain a personal connection with taxpayers. Just as the indirect effect of enforcement initiatives can be greater than their direct one-on-one impact, so too with IRS outreach and education. The IRS can create an education function that has a local community presence. It can require its enforcement personnel to make speeches and conduct workshops, and require its executives to conduct town hall meetings with taxpayers, to hear taxpayer concerns directly and not just through intermediaries like preparers or other tax professionals. When considering the centralization of a program or the implementation of an efficiency measure, the IRS should analyze and test its impact on various taxpayer segments. If the program or measure is implemented, the IRS should evaluate its impact to ensure no harm in fact occurred to taxpayers or taxpayer compliance as a result. To put a more human face on the IRS, the IRS needs to enhance its understanding of both compliant and noncompliant taxpayer behavior and the effect of its actions on that behavior, and incorporate that knowledge into its processes that touch taxpayers.

to match IRS records against other federal payments, and automatically issues continuous levies on federal payments for taxpayers who have unpaid federal tax liabilities. *See* IRC § 6331(h).

81. For an example of how the IRS can use automation to relieve taxpayer burden, see 2 NAT'L TAXPAYER ADVOCATE 2008 REPORT, *supra* note 31, at 45 (describing results of an automated filter to identify and screen out taxpayers likely to experience economic hardship as a result of a FPLP levy).

82. *See* Janet Spragens & Nancy Abramowitz, *Low-Income Taxpayers and the Modernized IRS: A View from the Trenches*, 107 TAX NOTES 1407 (2005) (arguing that low income taxpayers in particular are harmed by the IRS's reliance on correspondence and remote contact).

STEP IX: CURIOSITY MATTERS: RESEARCHING WHAT YOU DON'T KNOW AND TESTING WHAT YOU THINK YOU KNOW

In the twenty-first century, tax administrators have more tools available to them to gather and analyze taxpayer information and track taxpayer behavior than they have ever had. For example, the recent enactment of the requirement for financial institutions and on-line payment processors to annually report credit card transactions substantially increases the transparency of commercial revenue, including on-line purchases.⁸³ Taxpayers' awareness that the IRS will learn about previously unreported transactions should have a positive compliance effect.⁸⁴ The IRS can use these third-party information reports in its automated document-matching program. This information will also change the results of the IRS's audit classification and selection models because it adds data about a previously unreported revenue stream.⁸⁵

But enhanced information reporting is only the beginning of the available research tools. Partnering with academics and outside researchers, the IRS can attempt to model taxpayer behavior in response to IRS actions and other external influences. The Taxpayer Advocate Service is sponsoring one such study in partnership with the IRS Office of Program Evaluation and Risk Analysis (OPERA). The "Tipping Point" study is a multi-agent, agent-based model used to simulate the tax-related beliefs, knowledge, decisions, and behaviors of taxpayers in given situations. Once the model achieves a reasonable confidence level of predictability, researchers can alter the scenario's conditions to see how taxpayer behavior changes within the model. This approach might be useful to determine what initiatives are most promising for testing with actual taxpayer segments. It is also taxpayer friendly because it enables the IRS to learn the possible impact of a given initiative on taxpayer compliance without actually impacting taxpayers.⁸⁶

83. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 §3091, 122 Stat. 2654, 2908.

84. Information reporting has a positive effect on taxpayer compliance, presumably because taxpayers are more likely to report income that they believe the IRS has knowledge of.—IRS data show a clear correlation between the degree of information reporting and compliance. Items subject to substantial information reporting such as interest and dividend income have a low misreporting percentage of less than 4%. Items subject to little or no information reporting such as sole proprietor and farm income have misreporting percentages over 50%. IRS, NATIONAL RESEARCH PROGRAM, TAX YEAR 2001. *See also* Brown and Mazur, *supra* note 6, at 1263, noting that approximately five million dependents vanished the year after Congress enacted a requirement that taxpayers report a taxpayer identification number for each dependent claimed.

85. *See A Comprehensive Strategy for Addressing the Cash Economy*, in 2 NAT'L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 14-15 (discussing the need for and uses of a consolidated data warehouse for gross income information from multiple sources).

86. TAS and OPERA contracted with the Center for Computational Analysis of So-

Over the next decade, the IRS needs to reach out to the academic and research communities in fields as diverse as sociology, psychology, behavioral economics, marketing, and decision science to explore how it can most effectively influence taxpayers to become and remain voluntarily compliant and how it can most effectively deter those taxpayers who refuse to become voluntarily compliant. In short, it should sponsor a think tank—a cognitive research lab—staffed with researchers from many disciplines and underwrite research into taxpayer attitudes and behavior.⁸⁷

The IRS also should build incentives for its employees to recommend and develop local compliance initiatives. Even in a global economy, tax compliance is local. It is the actions of individual human beings that add up to an increase or decrease in the tax gap. Curiosity about what makes taxpayers tick, why they do what they do and how we can influence that for the public good is vital for tax administration today.⁸⁸ However, the IRS cannot do this alone. To accomplish this cutting-edge research while going about its core responsibilities, the IRS must be adequately funded.

STEP X: SUSTAINABILITY: THE IRS MUST HAVE THE PROPER RESOURCES,
SUPPORT, OVERSIGHT, AND DIRECTION TO EFFECTIVELY ADDRESS THE TAX
GAP OVER THE LONG TERM

Under federal budget procedures, the IRS is treated as any other spending program, similar to Amtrak or Head Start. Because the budget scoring rules generally treat funds appropriated to the IRS as expenditures but do not take into account the revenue those expenditures generate, the IRS does not receive sufficient funding to maintain the taxpayer service programs and the compliance programs required to maximize revenue collection. The chronic underfunding of the IRS contributes to the tax gap—as well as to the federal budget deficit. For this reason, I have recommended elsewhere that Congress revise its budget rules to fund the IRS as the revenue center that it is.⁸⁹ For example, the

cial and Organizational Systems at Carnegie Mellon University. For a discussion of a simulation of an actual tax-related event, the Tax Year 2004 IRS EITC Certification Study in Hartford County, Connecticut, see *Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analysis: The 2004 Hartford Case Study*, in 2 NAT'L TAXPAYER ADVOCATE 2007 REPORT, *supra* note 13, at 117-136.

87. See Kornhauser, *supra* note 66, at 158-161 for a discussion of how this cognitive research lab might operate.

88. The IRS is beginning to take some steps to formulate a comprehensive research plan. In response to language in the Consolidated Appropriations Act, 2008, Pub. L. No. 110-161, 121 Stat. 1844, 1976 (2007), the IRS, in collaboration with the National Taxpayer Advocate and the IRS Oversight Board, is formulating its first five-year strategic plan for research, to be submitted to the House of Representatives and Senate Appropriations Committees.

89. For a description of how the federal budget process impacts tax administration and a legislative proposal to set the IRS budget without regard to spending caps see *Revising*

IRS annually collects about \$2.7 trillion, about 96% of the federal government's revenue stream.⁹⁰ By asking what resources the IRS needs to collect the federal revenue legally due and owing, and then providing the appropriate funding levels, we increase the chances of IRS successfully achieving its mission.⁹¹

Yet adequate funding alone will not ensure IRS success unless policymakers recognize that the IRS has a core function—raising federal revenue—that is paramount before requiring it to undertake non-core duties, however important. The recent “Economic Stimulus Payment” is a case in point.⁹² I have praised the IRS for its nimbleness with respect to implementing this program that was enacted during a filing season and delivered shortly thereafter.⁹³ Policymakers clearly had compelling reasons for enacting the stimulus program and the IRS was the logical choice to deliver payments. But there were opportunity costs associated with implementing the program. For example, the telephone assistance level of service dropped to 31.9% for the week ending August 23, 2008 and down to 56.3% overall for Fiscal Year 2008 from 80.7% in FY 2007.⁹⁴ Employees who worked on account adjustments, including taxpayer correspondence, amended returns, and certain compliance notices, were shifted to han-

Congressional Budget Procedures to Improve IRS Funding Decisions, in NAT'L TAXPAYER ADVOCATE 2006 REPORT, *supra* note 74, at 442-57.

90. INTERNAL REVENUE SERV., PUBLICATION 55B, DATA BOOK, 2007 3 tbl.1 (2008), available at <http://www.irs.gov/pub/irs-soi/07databk.pdf>.

91. The IRS's mission statement is to “Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.” INTERNAL REVENUE MANUAL § 1.1.1 .1 (1) (2006).

92. Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008). Congress passed the Act in February 2008 to stimulate the economy by placing an estimated \$152 billion into the hands of consumers and businesses. *See, e.g.*, THE WHITE HOUSE, FACT SHEET: BIPARTISAN GROWTH PACKAGE WILL HELP PROTECT OUR NATION'S ECONOMIC HEALTH (2008) available at www.healthstarmedtech.com/downloads/Economic%20Stimulus%20Package.pdf. The legislation provides individual taxpayers with a credit against their 2008 tax liabilities, and taxpayers ordinarily would claim the credit when they filed their 2008 returns during the 2009 filing season. Because Congress wanted to provide economic stimulus more quickly, however, it directed the IRS to make payments as an advance against the credit “as rapidly as possible.” IRC § 6428(g)(3). The IRS began transmitting stimulus payments on Apr. 28, 2008, less than two weeks after the regular filing deadline for 2007 individual income tax returns.

93. *See Hearing on Economic Stimulus Payments: Hearing Before the H. Comm. on Ways & Means, Subcomm. on Oversight*, 110th Cong. (2008) (testimony of Nina E. Olson, National Taxpayer Advocate), available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=7059> [hereinafter NTA ESP Testimony].

94. INTERNAL REVENUE SERV., JOINT OPERATION SNAPSHOT REPORT (2008) (on file with author). (See weeks ending August 23, 2008 and Sept. 30, 2008). The customer service representative (CSR) level of service measures the relative success rate of taxpayers that call for toll-free services seeking assistance from CSRs. Generally speaking, the CSR LOS is calculated by dividing the number of calls answered by CSRs by the total call attempts of callers attempting to reach the CSR queue. *See* NTA ESP Testimony, *supra* note 94, at 7.

ding calls related to the stimulus payment, resulting in backlogs for processing taxpayer correspondence. In early June 2008, the IRS processed one piece of adjustment correspondence for every two pieces it received from individual taxpayers.⁹⁵

Because the IRS holds a wealth of information about taxpayers, it is the logical choice for implementing programs and initiatives in which income is a critical element. But policymakers must be very careful in giving the IRS more programs to run. We must ensure that we do not undermine the IRS's effectiveness in its primary task, collecting federal revenue.

CONCLUSION: A HOLISTIC APPROACH TO IMPROVING TAX COMPLIANCE AND
MINIMIZING THE TAX GAP

So, what is my would-be approach to improving taxpayer compliance? First, the IRS must adopt a three-pronged approach to achieving its goal to increase voluntary compliance and be adequately funded to achieve that goal. Second, in achieving that goal, the IRS should measure the success of any activity—audits, levies, outreach, education, offers in compromise—by whether it enables the taxpayer to become voluntarily compliant and causes the taxpayer to remain compliant over time. Third, the IRS must recognize that, for most taxpayers, the fear of being caught is only one factor that causes them to comply with the tax laws. Thus, enforcement is only one among many valuable compliance tools. Finally, Congress and the executive branch must remind taxpayers about the role taxes play in providing services and infrastructure for every aspect of life in the United States.

Quantifying the various components of the tax gap is very helpful and breaking noncompliance dollars down into nonfiling, underreporting, and underpayment is a good starting point because it provides an idea of where to begin to concentrate our attention. But we cannot stop there. Before deciding to which activities we should channel our resources, we should analyze the various causes of taxpayer noncompliance and the number of taxpayers and type of activities involved within each tax gap “bucket.” Finally, we must supplement the raw dollar tax gap analysis with “downstream consequence” analysis and longitudinal studies of taxpayer behavior. This approach would include an analysis of a given initiative's impact on currently compliant taxpayers, including whether reallocating resources to one initiative from other programs increases taxpayer burden or impairs tax compliance overall.

With an analytical matrix, we can identify both the most fruitful point and the most effective design to address taxpayer noncompliance. This holistic ap-

95. INTERNAL REVENUE SERV. JOINT OPERATIONS CENT., PAPER ADJUSTMENTS INVENTORY FOR INDIVIDUAL MASTER FILE TAXPAYERS (2008) (on file with author).

proach to tax compliance would require the IRS to develop research initiatives that incorporate disciplines as diverse as psychology, sociology, marketing, and behavioral economics. This approach should enhance the effectiveness of the IRS's current enforcement initiatives with respect to long-term compliance because it demonstrates respect for the taxpayer, an awareness of the possibility of inadvertent mistakes, an effort to educate the taxpayer, and a trust that the taxpayer will self-correct. The IRS today has many of the components of this strategy. It just needs to use them appropriately and strategically.