

Practice

A Lesson in Accountability and IRS Enforcement

By Charles P. Rettig

The IRS, a branch of the U.S. Department of Treasury, is the nation's tax agency and administers the Internal Revenue Code enacted by Congress, having a Mission: "... to provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." It is unequivocally the absolute best administrative tax agency in the world.

However, the IRS directly interacts with more Americans than any other institution, public or private. The IRS has been delegated the authority to administer and enforce the Internal Revenue laws and has the final administrative authority concerning substantive interpretation of the tax laws as reflected in legislative and regulatory proposals, revenue rulings, letter rulings, and the technical advice memoranda. In FY 2016, the IRS collected more than \$3.3 trillion in gross revenue (over 90% of all federal revenue collected of which approximately \$1.815 trillion related to individual income taxes, \$345 billion related to business taxes and the balance of approximately \$1,172 trillion related to employment, estate and gift, and excise tax forms), processed more than 244 million tax returns and other forms (approximately 134 million form 1040's, including 3,469 with an AGI exceeding \$10 million), issued more than \$426 billion in tax refunds to more than 122.3 million taxpayers, assisted more than 501 million taxpayers who visited *IRS.gov* and an additional 300 million who checked online re the status of their refund.

Overall, in FY2016, the IRS collected a net of almost \$37.4 billion in unpaid assessments on returns filed with additional tax due, assessed close to \$12.5 billion in additional taxes for returns not filed timely and collected almost \$2.3 billion with delinquent returns. The IRS assessed \$27.3 billion in civil penalties of which approximately \$12.1 billion were assessed regarding individual and estate and trust income tax returns.

The IRS enforces the tax law in a number of ways; the more common methods include correspondence (examination by mail) and field (face-to-face audit) examinations. In FY 2016, the IRS examined 1.034 million individual returns, of which 243,722 were face-to-face examinations and 791,233 were less intrusive correspondence examinations (a total examination rate of approximately 0.70% of all individual returns filed in calendar year 2015). Through the enforcement processes, the IRS collected an aggregate of approximately \$54.29 billion (according to the IRS 2015 Data Book, it reportedly costs about 35 cents for each \$100 collected by the IRS). However, enforcement staffing is at a historical low of approximately 15,914 enforcement personnel (approximately 3,525 Revenue



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Officers, 10,159 Revenue Agents, and 2,230 Criminal Special Agents).

Tax Gap and Voluntary Compliance

The estimated federal *gross annual* tax gap (based on information developed from tax years 2008–2010) is estimated to be about \$458 billion. The gross tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. It represents, in dollar terms, the *annual* amount of tax non-compliance.

The net tax gap is the gross tax gap less tax that will be subsequently collected, either paid voluntarily or as the result of IRS administrative and enforcement activities; it is the portion of the gross tax gap that will not be paid. It is estimated that \$52 billion of the \$458 billion gross tax gap will eventually be collected resulting in a net annual tax gap of \$406 billion.

The voluntary compliance rate (VCR) is a ratio measure of relative compliance and is defined as the amount of tax paid voluntarily and timely divided by total true tax, expressed as a percentage. The VCR corresponds to the gross tax gap. The estimated VCR is 81.7 percent. The net compliance rate (NCR) is a ratio measure corresponding to the net tax gap. The NCR is defined as the sum of “tax paid voluntarily and timely” and “enforced and other late payments” divided by “total true tax,” expressed as a percentage. The estimated NCR is 83.7 percent. A high level of voluntary tax compliance remains critical to help ensure taxpayer trust and confidence in our tax system. Those who don’t pay what they owe unfairly shift the tax burden to those who properly meet their tax obligations.

Information Reporting

The tax gap results confirm that the compliance rate is high for income that is subject to third-party information reporting and even higher when there is withholding of estimated future tax obligations. The extent of coverage by information reporting and/or withholding is called “visibility” because incomes that are reported to the IRS are more “visible” to both the IRS and taxpayers. Self-employed individuals and other cash economy participants more easily understate their income because it is not subject to withholding or information reporting. IRS research indicates that taxpayers whose wages are subject to withholding report 99% of their income. Similarly, taxpayers report about 96% of their income that is subject to information reporting. In contrast, taxpayers whose income is not subject to withholding or information reporting,

report about 68% of their income. This percentage drops to about 20% for sole proprietors operating within the national arena such as street vendors, door-to-door sales persons, child care, and others.

Increased information reporting and expedited information exchanges with state and foreign governments can have a significant impact on the federal and state versions of the tax gap. As a result of various electronic matching programs, the government can better identify taxpayers who have underreported or not reported income or have otherwise failed to file returns. Hunting for under-reporters and non-filers has significantly improved as we move further into the electronic age, to some extent lessening the historical need for “in person” audits tax returns.

Reduced IRS Budget

Appropriate resources and the appropriate management of resources received are essential for the IRS to be able to improve compliance and to hopefully reduce the annual tax gap. The IRS continues to be resource-challenged—significant, ongoing reductions to the IRS budget since 2010 have impacted tax enforcement efforts. Together, Congress and the IRS must determine an appropriate level of tax enforcement resources taking into account the balance between taxpayer service and enforcement activities and competing federal priorities. The perception of fairness (or unfairness) and complexity of our current tax system also contribute to the tax gap—fundamental tax simplification is necessary to achieve significant reductions in the overall tax gap.

The IRS must maintain an appropriate presence in each taxpayer and professional neighborhood—not only in the high rent district. Initiatives administered without strong detection and enforcement efforts will not likely succeed. However, perceptions as to detection and enforcement are keys to an effective compliance response. The strategic placement of an empty police car will have a more significant impact than a motorcycle officer hiding in the bushes.

Increased Tax Penalties?

The “kinder, gentler” IRS of years ago led to an unprecedented decline in tax enforcement by the IRS. Various studies have demonstrated that increased civil penalties do not increase overall voluntary compliance. Declining enforcement relies on a strong voluntary compliant constituency. Increased penalties do not increase compliance; increased, visible tax enforcement increases compliance. Increased penalties only increase penalties on a smaller class of taxpayers actually discovered by a resource challenged taxing agency. A low examination rate may only encourage

certain taxpayers to push the compliance envelope since they might perceive a low risk of detection as somehow worthwhile. Further, taxpayers and tax practitioners sometimes have less incentive to fully comply voluntarily if they believe that they can routinely bargain away penalties.

Roadmap to Future Tax Enforcement Efforts

The gross tax gap is composed of three primary components: non-filing, underreporting, and underpayment. The estimated gross tax gaps for these components are \$32 billion, \$387 billion, and \$39 billion, respectively. The gross tax gap estimates can also be grouped by type of tax. The estimated gross tax gap for individual income tax is \$319 billion, for corporation income tax is \$44 billion, for employment tax is \$91 billion, and for estate and excise tax combined is \$4 billion. The estimated net tax gap for individual income tax is \$291 billion, for corporation income tax is \$35 billion, for employment tax is \$79 billion, and for estate and excise tax combined is \$1 billion.

Since the “tax gap” represents unpaid taxes, any estimate is, at best, a WAG (wild guess). However, it represents the best WAG currently available and provides significant guidance in defining the present allocation of limited tax enforcement resources and assists in making future tax policy decisions seeking more cost-effective ways to increase overall voluntary tax compliance.

The bigger tax enforcement targets are, quite obviously, the tax gap components having the most significant compliance problems underreporting (\$382 billion), underpayment (\$39 billion) and non-filing of required returns (\$32 billion). By type of tax, those most concerned should be individuals (\$319 billion), those with employment tax issues (\$91 billion), corporations (\$44 billion) and those facing estate and excise tax issues (a combined \$4 billion).

Accountability

Government and private tax practitioners are each accountable to our system of tax administration and to our profession. The strategic enforcement priorities of the IRS have long focused on enhancing professional responsibilities to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. The complexity found within the Code will long continue to be a significant problem for effective tax administration and even for tax practitioners exercising their best efforts to try to do the right thing. Lawyers, accountants, the government and others frequently disagree about the possible tax

results flowing from a transaction . . . which is why they build federal courtrooms and why our judicial system is comprised of independent federal judges with lifetime appointments.

It is the practitioner’s responsibility to make sure the clients follow the law and observe appropriate standards. The integrity of our system of tax administration depends upon the integrity of the practitioners who must lead the way for their colleagues, clients, and others.

The IRS administers the laws and regulations governing the practice of tax practitioners through the Office of Professional Responsibility (OPR). Practitioners who choose not to comply with established standards of conduct are subject to a broad range of coordinated actions that will effectively address their misconduct, *e.g.*, the assessment of preparer penalties, disciplinary sanctions imposed under the authority of Treasury Circular 230, suspension of electronic filing privileges, and pursuit of injunctive action and, where warranted, criminal prosecution initiated by the Department of Justice.

Practitioners should operate under their own personal “best practices” code and should be proud of their professional accomplishments. From a tax administration standpoint, the IRS would likely prefer to have practitioners adopt “best practices” exceeding the requirements of Circular 230 or the Code, even though not required to do so. Certainly, the vast majority of tax practitioners are professionals who take great pride in their services with a very high degree of personal integrity and credibility.

As tax practitioners, most of us maintain extremely high standards for care and competence. Although we diligently represent the interests of our clients, we do so as professionals cognizant of our role in the system of tax administration. Tax returns are not to be perceived as an offer to negotiate with the government—information set forth on a tax return, signed by a paid return preparer, must be accurate with a reasonable foundation and reasonable support for the characterization of items set forth within the return. Every interaction of every practitioner with each client, government representative, judge, and each other is vitally important to the credibility and integrity of tax profession. You can make a difference with a bit of effort and a lot of care and concern for your representation and the representation of others.

Public Trust and Confidence in the IRS

For years, the IRS has suffered from a damaged public image, which has certainly not served to enhance the overall voluntary compliance with our tax laws. IRS management is tasked with charting the course forward. For years, longevity and career enhancement within the government have

been based on a system of information flow that mirrors the comments and desires of leadership. As stated by Vince Lombardi “Leaders are not born, they are made; and they are made just like anything else, through hard work.” Leadership is an art form that develops over time and with experience. Personal integrity is frequently the cornerstone of success for most leaders who set high standards, create and follow their plan and hopefully accomplish it.

Numerous upper management people (those with career experience, enforcement and otherwise) at the IRS are eligible to retire in the foreseeable future. Something like 45% of senior IRS executives are eligible to retire by 2019 and many are simply waiting to determine the future direction of the IRS. The IRS must balance service to the taxpayer community with an appropriate degree of enforcement of our nation’s tax laws. A freeze of the operational status of the IRS caused by departing executives could significantly reduce taxpayer services and tax enforcement efforts and adversely impact at least the fringe areas of voluntary compliance.

Most employees have remained at the IRS out of a sense of loyalty to the agency—once retirement eligible, they are effectively working for less (retirement benefits basically being a function of current salary) and certainly far less than many would receive if employed in the private sector. It is impossible to train experience without dedicated, experienced trainers. If a significant number of senior executives leave the IRS, the agency will struggle. If it struggles a little, problems will likely occur. If it struggles more than a little, significant problems will occur.

IRS management must continually focus on earning the respect and confidence of U.S. taxpayers and those who represent such taxpayers. Our system of taxation depends upon voluntary compliance with our tax laws. Voluntary compliance is inherently enhanced when the taxpayer and tax professional communities respect the agency enforcing the tax laws of our country. Remember, among its various responsibilities, the IRS is also the “accounts receivable department” for the U.S. government. A proper level of tax enforcement efforts focused on areas of non-compliance can impact voluntary compliance with our tax laws. Public perceptions regarding the fairness of what must be a non-political agency can impact voluntary compliance with our tax laws as much as parking an empty police car at the appropriate intersection.

On the tax enforcement side of the IRS house, many mid-to-lower level employees are generally unaffected by who is or is not the IRS Commissioner. The vast majority of IRS employees have never met an IRS Commissioner. Undoubtedly, adverse public perceptions of the IRS, whether accurate or not, whether isolated or not, adversely impact the IRS workforce—a workforce that includes many extremely fine, hard-working individuals who could have reaped greater personal financial rewards in the private sector. Each IRS employee reports to someone higher up the ladder and that person is generally responsible for assuring that lower-level employees do the job at hand. As in the private sector, some are better managers than others. As in the private sector, some employees are undoubtedly more manageable than others and some do not require much in the way of management. However, the executive ranks of the IRS oversee large numbers of employees and must continually find ways to improve morale and motivate even the most dedicated employees.

Future Tax Enforcement Efforts?

Practitioners roundly support the IRS efforts with respect to responsible enforcement and efficient tax administration. Without question, tax enforcement is vital to the nation. Without question, Congress should be heard by the IRS when legislators raise concerns about the tax gap, and the IRS should be heard by Congress when seeking resources to appropriately address the tax gap. In that mix, however, the rights and interests of taxpayers should never be overlooked. It is also vital to tax enforcement that the issues of each taxpayer be given individual consideration and the rights of each taxpayer are forever safeguarded.

Few other countries can boast of a tax *compliance rate* of over 80%. However, all agree that a *non-compliance rate* approximating 20%—amounting to several hundred billion dollars per year—is clearly unacceptable in our self-assessment tax system. Consider that a one-percent increase in voluntary compliance will increase tax receipts by about \$30 billion in tax receipts. Appropriate funding and appropriately managing limited tax enforcement efforts can significantly impact the tax gap ... ultimately, we are all accountable to ensure the fairness of our system of tax administration.

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