Practice

By Charles P. Rettig and Kathryn Keneally

The Increasingly Risky Business of Tax Gap Evasion and Voluntary Disclosure

Charles P. Rettig is a Partner with the firm of Hochman, Salkin, Rettig, Toscher & Perez, P.C., in Beverly Hills, California.

Kathryn Keneally is a Partner at Fulbright & Jaworski, LLP, in New York, New York. Ms. Keneally is the immediate past chair of the ABA Section of Taxation Civil and Criminal Tax Penalties Committee and is a member of the U.S. Sentencing Commission Practitioner's Advisory Group.

The IRS is aggressively attempting to increase its enforcement activities in an effort to reduce the "tax gap," partially as a result of strong, ongoing Congressional interest. The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is actually paid voluntarily and timely. It represents, in dollar terms, the *annual* amount of noncompliance with our tax laws. Since the tax gap represents unpaid taxes any estimate is, at best, an estimate. The current federal net tax gap is estimated at $298 billion per year (based on IRS tax gap data for tax year 2001, IRS enforcement activities, coupled with other late payments, recover about $55 billion of the gross tax gap) representing a noncompliance rate of 15 percent to 16 percent. Few other countries can boast of a tax compliance rate of approximately 84 percent! However, all agree that a noncompliance rate of 15 percent to 16 percent amounting to several hundred billion dollars is unacceptable in our self-assessment tax system.

Tax Gap Oversight

Pope Benedict XVI is reportedly working on a doctrinal pronouncement that will condemn tax evasion as "socially unjust." In his second encyclical—the most authoritative statement a Pope can issue—the pontiff will denounce the use of "tax havens" and offshore bank accounts by wealthy individuals, since this reduces tax revenues for the benefit of society as a whole. The encyclical will focus on humanity's social and economic problems in an era of globalization.

The Senate Finance Committee recently held hearings entitled *A Closer Look at the Size and Sources of the Tax Gap.*[1] At the same time, the Governmental Accountability Office (GAO) issued its Tax Compliance Report[2] stating that the tax gap may be reduced through:

(1) tax code simplification and fundamental tax reform noting that for tax year 2001 errors in claimed tax credits and deductions contributed $32 billion to the tax gap;

(2) providing IRS with more enforcement tools, noting that:
   (a) increased withholding and information reporting would help uncover the largest contributor to the tax gap (underreported) income, and
   (b) increased IRS enforcement resources would enable it to contact millions of potentially noncompliant taxpayers it has identified but currently cannot contact given various resource constraints; and

(3) utilizing multiple approaches, setting tax gap reduction goals and measuring progress against these goals, leveraging technology to enhance IRS's efficiency, periodically measuring noncompliance and its causes, optimal allocation of resources, and evaluating the results of any initiatives designed to reduce the tax gap.

Within the past year, the Treasury released both *A Comprehensive Strategy for Reducing the Tax Gap*[3] and *A Report on Voluntary Compliance.*[4] The Treasury is focused on reducing the tax gap through (1) an overall reduction of the opportunities for evasion; (2) making a multi-year commitment to research measuring the effectiveness of IRS activities and initiatives; (3) ongoing technology improvements designed to improve compliance through early detection, better case selection, and better case management; (4) improved compliance activities (document matching, examination and collection activities, *etc.* designed to improve compliance among those directly contacted by IRS as well as others who would be deterred from noncompliant behavior as a consequence of more visible IRS enforcement presence); (5) enhanced taxpayer services to reduce unintentional taxpayer errors; (6) proposals to simplify the tax law; (7) enhanced coordination with state and foreign governments and providing information to practitioner organizations. In his FY2008 budget, President Bush proposed 16 legislative changes in order to improve tax compliance. As of June 6, 2007, nine bills relevant to the tax gap have been introduced in the 110th Congress: S. 335, H.R. 695, S. 396, H.R. 878, S. 601, S. 681, H.R. 1667, S. 1219 and H.R. 2136.

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TCMP and NRP Studies

The IRS has replaced the Taxpayer Compliance Measurement Program (TCMP) (a systematic approach for estimating the tax gap) with the National Research Program (NRP). The last TCMP was for tax year 1988. Although IRS attempted to conduct a new TCMP on several occasions in the 1990s, some members of Congress objected because of the high cost to the IRS and the compliance burden placed on taxpayers who were selected in the TCMP sample. In response, IRS developed the NRP to collect data that it hopes will more accurately measure payment, filing and reporting compliance and to deliver the data to the IRS Business Operation Divisions providing support for the development of strategic plans and improvements in targeting areas of noncompliance. The NRP approach was applied to about 46,000 randomly selected returns for tax year 2001.

Currently, the IRS is examining S corporations as part of the NRP. The IRS estimates that a large portion of the tax gap is attributable to small businesses including Subchapter S corporations. The random sample consists of approximately 5,000 returns covering two tax years, 2003 and 2004. The case building and classification phases of the study are completed. The examination phase of the study began in October 2005 with the results scheduled to be available in December 2008.

Tax Enforcement Limitations

Many have emphasized increased tax enforcement in an effort to reduce the tax gap. However, much of the gross tax gap for individual income tax filers is due to types of unreported income that is difficult to detect. Some of the detected tax liability cannot be easily collected, particularly from taxpayers who are clearly unable to pay. Finally, many detected tax liabilities are so small relative to enforcement costs that it is not cost-effective to pursue collection.

The gross tax gap mostly comprises under-reporting of income, underpayment of reported taxes and the nonfiling of returns. It is believed that 82 percent of the estimated gross tax gap of $345 billion consists of underreporting on filed returns ($285 billion); eight percent is associated with nonfiling ($27 billion); and 10 percent is associated with the nonpayment of tax ($33 billion). The majority of the tax gap appears to relate to individual income tax ($197 billion or approximately 57 percent—principally nonbusiness income and business income) and employment tax ($39 billion or approximately 11 percent—principally self-employment tax). The balance relates to corporate tax, estate tax and excise taxes. Taxes on illegal activities are excluded from these estimates. Having identified the primary sources of the tax gap, it should not be overly difficult to anticipate future IRS enforcement actions.

Sources of significant noncompliance should be publicly announced and targeted with specificity.

The percentage of underreported individual income varies significantly depending on the degree of information reporting and whether or not withholding is required. For example, IRS tax gap data suggest that only 1.2 percent of the wages, salaries and tips were underreported in 2001, but 57.1 percent of non–farm proprietor income was underreported. These data suggest that increased information reporting and withholding would reduce the tax gap. Any increased revenue would have to be weighed against higher administrative costs of the IRS and higher compliance costs of individuals.

Increased tax enforcement actions alone may have a limited effect on the tax gap. Between fiscal years 2001 and 2006, the IRS increased its enforcement efforts, and the enforcement revenue collected rose from $33.8 billion to $48.7 billion. Although $14.9 billion represents a 44-percent increase, it is only 4.3 percent of the estimated $345 billion gross tax gap in 2001. During the period FY2001–FY2006, staffing for key enforcement occupations rose from 20,203 to 21,185 (4.8 percent); examinations of individual tax returns increased from 731,756 (or 0.58 percent of returns) to 1,293,681 (or 0.98 percent of returns); examinations of business returns rose from 7,384,600 (or 0.55 percent of returns) to 8,722,410 (or 0.60 percent of returns); and examinations of tax-exempt-organization returns increased from 5,342 to 7,079 (preliminary estimate).

The perception of increased enforcement coupled with public announcements could be important. Sources of significant noncompliance should be publicly announced and targeted with specificity. For example, the IRS has indicated that it will focus particular attention on large taxpayers' international activities. Sometimes, a highly visible but empty police car is a better deterrent than increasing the fine for the relatively few violators actually caught speeding. Although some are calling for increased penalties for noncompliance, penalties only penalize those who are actually identified. If the parents aren't home, the children will turn up the volume and slide down the banister without much thought about the consequences of their unwise decisions.

Enhanced Taxpayer Service and Tax Law Simplification

Taxpayer service is important to help taxpayers avoid unintentional errors, which inadvertently increase the tax gap. Given the increasing complexity of the tax code, providing taxpayers with assistance and clear and accurate information before they file their tax returns reduces unnecessary contacts afterwards, allowing the IRS to focus enforcement resources on taxpayers who may be intentionally evading their tax obligations.

The Treasury Inspector General for Tax Administration (TIGTA) recently reported that more than 24 million individuals unnecessarily filed income tax returns from tax year 2003 through tax year 2005.[5] Collectively, taxpayers spent an average of $390 million and 75 million hours per year preparing and filing these unnecessary returns, and the IRS spent an average of $11 million annually to process the returns. TIGTA defined an unnecessary tax return as a return filed either to obtain a refund of taxes already paid or because taxpayers did not understand the tax law even though their income did not meet the filing threshold. According to the report, 15 percent of the unnecessary tax returns did not generate a refund while 85 percent of these returns were filed to obtain a full refund of withheld taxes. More than half of the refund filers were under age 21, and 76 percent of those under 21 could be claimed as dependents on other taxpayers' returns. TIGTA noted that more than 60 percent of the returns were filed on paper. Simplifying the tax law would reduce unintentional errors caused by a lack of understanding. Simplification would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws.

Voluntary Disclosures in a Tax Gap–Driven Environment

Practitioners often struggle with the issue of whether a taxpayer can avoid a criminal tax investigation by making a disclosure of prior tax crimes to the IRS. A "voluntary disclosure" is generally the process of voluntarily reporting previously undisclosed income (or false deductions) through an amended return or the filing of a delinquent return. A taxpayer's timely, voluntary disclosure of a significant unreported tax liability is an important factor to the IRS in considering whether the matter should be referred to the Department of Justice for criminal prosecution. A voluntary disclosure is also a factor the Department of Justice will consider in deciding whether to prosecute a taxpayer.[6] Properly resolving this issue can mean the difference between a taxpayer being criminally excused of a tax crime or being convicted on the basis of admissions derived from the voluntary disclosure itself.

The IRS voluntary disclosure policy creates no substantive or procedural rights for taxpayers, but is a matter of internal IRS practice, provided solely for internal guidance to IRS personnel.[7] Most courts agree, although one District Court found the policy created rights in the taxpayer.[8] Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution. A timely voluntary disclosure will not automatically guarantee immunity from criminal prosecution, but a true voluntary disclosure will normally result in the IRS not even recommending a criminal prosecution to the Department of Justice.

In practice, a true voluntary disclosure is a strong deterrent for the IRS from initiating a criminal investigation. In effect, from a tax administration point of view, those who voluntarily disclose often lacked sufficient jury appeal and there were more culpable taxpayers to investigate. A voluntary disclosure must be truthful, timely and complete, and the taxpayer must demonstrate a willingness to cooperate (and must in fact cooperate) with the IRS in determining the correct tax liability.[9] The taxpayer must make good-faith arrangements with the IRS to pay in full, the tax, interest and any penalties determined by the IRS to be applicable.[10] Additionally, the policy only applies to income earned through a legal business—so-called legal source income. Al Capone could not take advantage of the policy.

The *timeliness* requirement of the policy is critically important. To be *timely*, the disclosure must be received before the IRS has:

- initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
- received information from a third party (*e.g.*, informant, other governmental agency, or the media) alerting the IRS to the *specific* taxpayer's noncompliance;
- initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
- acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (*e.g.*, search warrant, grand jury subpoena).[11]

Any taxpayer who contacts the IRS in person or through a representative regarding voluntary disclosure will be directed to IRS Criminal Investigation for an evaluation of the disclosure. IRS Criminal Investigation Special Agents are encouraged to consult IRS Area Counsel on issues relating to a voluntary disclosure.[12] Examples of timely voluntary disclosures include the following:

- A letter from an attorney that encloses amended returns from a client that are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest and any penalties determined by the IRS to be applicable in full and which meets the timeliness standard set forth above
- A disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information that might lead to an examination of the taxpayer; however, the IRS has not yet commenced an examination or investigation of the

taxpayer or notified the taxpayer of its intent to do so. This is a voluntary disclosure because the civil compliance project involving the scheme does not yet directly relate to the specific liability of the taxpayer.

- A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so.[13]

Examples of what will *not* be considered a voluntary disclosure include the following:

- A letter from an attorney stating his or her client, who wishes to remain anonymous, wants to resolve his or her tax liability. This is not a voluntary disclosure until the identity of the taxpayer is disclosed and all other required elements are satisfied.
- A disclosure made by a taxpayer who is under grand jury investigation. This is not a voluntary disclosure because the taxpayer is already under criminal investigation. The conclusion would be the same whether or not the taxpayer knew of the grand jury investigation.
- A disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted gross receipts from a partnership, but whose partner is already under investigation for omitted income skimmed from the partnership. This is not a voluntary disclosure because the IRS has already initiated an investigation, which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing investigation.
- A disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted constructive dividends received from a corporation which is currently under examination. This is not a voluntary disclosure because the IRS has already initiated an examination, which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing examination.
- A disclosure made by a taxpayer after an employee has contacted the IRS regarding the taxpayer's double set of books. This is not a voluntary disclosure even if no examination or investigation has yet commenced because the IRS has already been informed by the third party of the specific taxpayer's noncompliance. The conclusion would be the same whether or not the taxpayer knew of the informant's contact with the IRS.[14]

To determine whether a disclosure is truly voluntary, the IRS will review the actual status of any prior interest in the taxpayer, the taxpayer's potential knowledge of such interest, and the taxpayer's fear of some potential trigger that could have alerted the IRS. A voluntary disclosure cannot be made anonymously. Any plan by a taxpayer, or his representative, to resolve a tax liability, file a correct return or offer payment of taxes for an anonymous client will not be considered a voluntary disclosure.[15]

A voluntary disclosure does not technically occur until the IRS has actually been contacted. As such, it is imperative that the disclosure to the IRS occurs as quickly as possible. The IRS will rarely recommend prosecution if there has been a timely voluntary disclosure. Since returns filed pursuant to a timely voluntary disclosure have significant audit potential, they should be "bulletproof" in correctly reflecting the taxpayer's income and expense items. Because of various federal-state information sharing agreements, any applicable state returns should be contemporaneously filed or amended with the federal returns. Returns for related entities should also be contemporaneously filed or amended. Questions or doubts should likely be resolved in favor of the government. If a return filed pursuant to a voluntary disclosure is less than accurate, the taxpayer is compounding—not helping—the problem.

How Many Returns Must Be Filed or Amended?

While there is certainly no well-established rule as to how many returns must be filed in making a voluntary disclosure, the general consensus is probably six tax years since the applicable statute of limitations for most tax-related crimes is six years.[16] The disclosure should eliminate any IRS concern that there might be any potential issues with respect to a particular tax year for which the applicable statute of limitations for criminal prosecutions has not already expired. Additional returns could be in order since the statute of limitations for a criminal prosecution is tolled for the period of time a taxpayer is outside of the United States or is a fugitive from justice.[17]

Counsel must determine whether to contact the IRS before submitting a voluntary disclosure and actually filing the delinquent or amended tax returns. Some practitioners prefer to submit a Freedom of Information Act request seeking income information already in the possession of the IRS before filing the returns.[18] Some simply choose to file the delinquent or amended returns, with payment, with the appropriate IRS Service Center by certified mail, requesting a return receipt. Filings are often sent in separately for each tax year spaced out over a brief time period. Such filings often occur during the typical tax return filing season (around April 15 and October 15 for individual returns) on the belief that there is safety in numbers.

Some prefer making the voluntary disclosure in a meeting with the Special Agent in Charge of the local IRS Criminal Investigation where the investigation would be conducted. At this meeting, the potential voluntary disclosure would initially be discussed in a hypothetical format. Counsel would generally outline the facts in hypothetical form (probably in writing) and would request whether IRS CI would consider the return filing to be a voluntary disclosure in order to avoid recommendation of a criminal prosecution. Counsel may also attempt to secure an IRS waiver of all applicable penalties before revealing the taxpayer's identity. In the event that CI responds affirmatively, counsel would then disclose the client's identity and taxpayer identification number. Under the voluntary disclosure policy, the disclosure does not occur until the taxpayer's identity is revealed.

The IRS voluntary disclosure policy provides a greater level of certainty to taxpayers wishing to appropriately respond to their potential tax problems. Although a voluntary disclosure may seem appropriate, it could become a prescription for disaster. The representative must thoroughly review all potentially relevant information before determining whether and when a voluntary disclosure should occur.

We live in a country founded by smugglers and those resisting the exercise of government powers in England. Increasing penalties or sending violators to prison will not provide a meaningful improvement to tax compliance. The complexity found within the Internal Revenue Code will long continue to be a significant problem for effective tax administration. However, the IRS receives volumes of electronic information from outside sources and other taxing authorities. Many civil examinations and criminal investigations are in the administrative pipeline. Notwithstanding the strong, wide-ranging focus on the tax gap and an increasingly significant possibility of detection and potential punishment, many taxpayers continue to believe they will escape detection. Certainly, the whale only gets harpooned when it surfaces for air. However, at some point it must surface to survive.

Endnotes

1 July 26, 2006.
2 *Id.*
3 September 26, 2006.
4 August 2, 2007.
5 *Evaluation of the Characteristics of Unnecessarily Filed Individual Income Tax Returns*, Report 2007-40-130; August 17, 2007
6 Internal Revenue Manual (9.5).3.3.1.2.1 (12/11/02).
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.*
11 Code Sec. 6531.