SYMPOSIUM
CLOSING THE TAX GAP

INTRODUCTION
THE TAX COMPLIANCE CONUNDRUM

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The annual tax gap—the difference between tax due and tax paid—is estimated at well over $300 billion.[2] The fact that some taxpayers pay all the tax they owe, and others only a fraction of that, is commonly (and rightly) said to raise problems of tax equity. It also raises efficiency issues, primarily because underpayment is centered in certain sectors. There, the failure to collect tax serves as a non-legislated subsidy, distorting capital and labor flows. The inefficiency caused by the failure to collect taxes due might be as great as any single inefficiency of the entire tax system.[3] What the tax gap is, and is not, and how we should and should not go about closing that gap, is the subject of the articles in this symposium.

Nina Olson is the first Taxpayer Advocate; she has attracted a cadre of capable employees and has used that office as a bully pulpit to protect taxpayer interests. Her work in that office has given her a unique perspective into the compliance problem. In *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, Olson takes issue with the enforcement-oriented traditional model of tax compliance, which sees taxpayers as Holmesian bad actors, cheating whenever the risk adjusted payoff is positive. Olson points out that underpayment may have other causes: taxpayers may find the law that is too confusing to understand, or use preparers who are incompetent or overly aggressive. In any event, our highest priority ought to be to inculcate values that lead to truly voluntary compliance—that is, compliance that is not generated under the threat of any potential punishment. Among Olson's more interesting proposals

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2. The IRS estimates that the gross tax gap was $345 billion in 2001. Internal Revenue Serv., *IRS Updates Tax Gap Estimates* (IR-2006-28 Feb. 14, 2006), *available at* http://www.irs.gov/newsroom/article/0,,id=154496,00.html.

3. Joseph Bankman, *Can We Legislate Our Way out of the Tax Gap?*, 117 TAX NOTES 506 (2007).

is that we increase, rather than decrease, the old-fashioned, in-person (or at least personal) responses taxpayers receive from IRS service centers and district offices. The computerized system we have moved to is cheap and efficient but does not connect to taxpayers in a way that optimizes voluntary compliance.

In this Article, Olson argues that (selective) application of a kinder, gentler compliance model is justified by its long-term effect on compliance. It's easy to see other justifications for Olson's approach. Tax filing is an expensive and harrowing process that imposes substantial welfare costs. All else equal, a punitive compliance system increases these costs. It also imposes substantial costs on the IRS. From a welfarist perspective, it will never make sense to spend $1.00 (or even $.70) to collect a $1.00 in tax. The reason for this is the costs of collection are true social costs that improve welfare not one whit. We'd be better off if we left the dollar in the hands of its (wrongful) owner, where it could circulate throughout society! Of course, paying attention to how compliance initiatives are perceived by taxpayers is also consistent with less economistic notions of political justice. Olson's proposals, at their broadest reach, might be supported because they treat the satisfaction of 140 million citizen-taxpayers as an end in itself, rather than treating the taxpayers merely as a source of welfare or revenue. Olson's Article (and the underlying suggestions and arguments in that Article) is likely to play a significant role in the upcoming debate over efforts to close the tax gap.

In *Cash Businesses and Tax Evasion*, Susan Morse, Stuart Karlinsky and I look at the cash business sector, where the norm underreporting rate is (depending on how one defines that sector) greater than fifty percent. The hoped-for advance in this piece is a detailed qualitative picture of how, and why, cash business owners underpay tax. Our findings contrast sharply with the story Olson tells of EITC underrereporting. In EITC filings, errors can be traced to taxpayer confusion and/or ill-prepared or rapacious preparers. In the cash sector, taxpayers generally know they are underpaying tax and have the most obvious reasons for doing so. As one of our interviewees stated "Why do taxpayers [underpay]? Because they'd rather have $10 in their pocket instead of $5." One common thread between our Article and Olson's Article is the attention given to the preparer's role in the tax gap.

In *Tax Defiers and the Tax Gap: Stopping "Frivolous Squared" Before It Spreads*, former Assistant Attorney General Nathan Hochman addresses the compliance problems posed by the tax protestor movement. Hochman outlines the near-absurd arguments upon which the movement relies: the income tax is unconstitutional because it violates the First Amendment (violates free exercise of religion) and the Thirteenth Amendment (constitutes slavery), because the Sixteenth Amendment was not properly ratified, and so on. These arguments have been soundly rejected by the courts. Taxpayers who rely on these arguments, however, have historically faced low penalties and prosecution has been haphazard. The result is a small but hardy protestor movement, whose leaders boast of their own non-compliance and urge others to follow their lead. The movement does not appear (thus far) to constitute a significant portion of the tax gap. Any such non-compliance, of course, is to be regretted (and fought) and allowing the movement to burn bright leaves open the possibility that it will someday catch fire with a broader section of the public.

The occasion for Hochman's article is the government's adoption of the Tax Defier Initiative. The Initiative is designed to ensure a more coordinated response to the protestor movement from the many U.S. Attorneys Offices, the IRS and the Justice Department. Enhanced penalties for willful non-filing, proposed but not yet enacted, are seen as a part of, or at least consistent with, the Initiative. Those unfamiliar with this part of government might cynically pass off the Initiative as more public relations than substance. However, in recent years, Justice and the IRS worked together in a similar coordinated fashion to fight corporate tax shelters. That effort has been spectacularly successful. The IRS field agents have gotten good centralized support and have found many shelters on audit, and Justice has done a terrific job litigating cases that have not settled. As a result, tax shelter activity has declined substantially. Early indications are that this initiative might be similarly successful.

The remaining three articles address a different question: the extent to which the behavior described contributes to the tax gap. In *Refund Anticipation Loans and the Tax Gap*, Leslie Book looks at the argument that the ability to tie tax preparation services to refund anticipation loans leads to overaggressive tax preparation. A refund anticipation loan (RAL) is a short-term loan initiated by the preparer (though outsourced in part or whole to a lender) and secured by the tax refund. The annual implied interest rate on RALs ranges from high to sky-high. For that reason, RALs are generally opposed by consumer advocates; industry responds that the short time period for RALs makes the annual percentage meaningless and that taxpayers willingly pay a convenience fee for a service they find useful. Book explores the argument that the ability to garner fees on the refund loans might make lead preparers to be more aggressive in helping taxpayers fill out returns. Though the individual relationship between the size of the refund and the preparer fee varies, the bigger the refund, the bigger the potential RAL, and the greater preparer fee generated by the RAL. Book finds fault in the arguments used by critics to attack RALs and industry used to defend RALs. He concludes that RALs might well contribute to non-compliance, but the evidence is too inconclusive at this point to ban them for this reason.

Toward the end of his Article, Book shifts focus somewhat and proposes that the IRS attempt to gain insight into the casual role of preparers in the tax gap by finding those preparers whose clients have large underpayments. The IRS might then adopt a nuanced "responsive regulation" approach to those preparers, suggesting internal controls to limit client underpayments, and imposing burdensome reporting requirements on those preparers who do not adopt such controls. It's an intriguing idea that fits with the attention given to the role of preparers in parts of Olson's Article, and in the article by Morse, Karlinsky and myself. One would suspect that a primary result of this approach would be to identify preparers who serve cash basis business, in which underpayment is rife. Such preparers might be required to ask more questions and demand more documentation. (A similar set of rules, statutory in nature, now apply to EITC preparers.) This, in turn, might limit non-compliance. The social payoff would not depend on the fact that preparers now actively foment non-compliance. It might be the taxpayers who are cheating, and the preparers are following good (if not best) practices. But one way to change taxpayer behavior is to change preparer best practices, and to insist that preparers with high-risk taxpayers follow those practices. An interesting question is how Book's proposal would apply to e-filing programs, such as Intuit's Turbo Tax.

In *Targeting the Tax Gap: The Case of the RAL and the Advanced Notice of Proposed Rulemaking*, Danshera Cords voices the freedom of contract arguments in favor of the loan program: taxpayers, as consumers, want or need the refund sooner than the IRS can provide it. Rather than ban the program, Cords argues, we ought to better control unscrupulous preparers, or work to provide faster refunds. The key question, of course, is whether and to what extent that can be done. Cords' essay is written as a response to Book's contribution. In fact, though, her bottom-line recommendation is the same as Book's: there is not evidence sufficient to ban RALs. The difference between the two essays is mostly one of emphasis. Book finds strong (and weak) arguments on both sides. In this essay, at least, Cords finds the weak arguments on the side of those who would ban RALs.

Employment taxes have always been estimated to comprise a sizeable portion of the tax gap. In *The Gap in the Employment Tax Gap*, Richard Winchester argues that the compliance rate on these taxes is even lower than estimates suggest. The reason for this is that owner employees of corporations and partnerships can realize their return either through salary or return on capital. To avoid payroll tax, they have an incentive to pay themselves low salaries and reap their return in the form of dividends or, in the case of partnerships, profit distributions. Undercollection of payroll tax not only deprives the government of revenue, it raises a question of horizontal equity. The technique of paying oneself a low salary is not available to sole proprietors. They are stuck, with some exceptions, paying payroll tax on their entire net income.

One can quibble with Winchester's decision to put the missing income here in the category of the tax gap. It is often difficult to analytically separate the return of an owner-employee into capital and labor components. A taxpayer who makes a determination in her favor is not necessarily avoiding tax due, since under current law the amount of tax due is not easy to determine. That is one of the reasons why the government rarely challenges taxpayers here. (The other reason is that the individual cases do not involve a lot of money). That said, Winchester is surely right that the different effective rates of payroll tax on sole proprietorships and other forms of business enterprise make no sense and clarification of the law along the lines supported by Winchester would raise billions of dollars annually.

In *The Estate Tax Non-Gap: Why Repeal a "Voluntary" Tax?*, Paul Caron and James Repetti take an opposite tack with their subject than Richard Winchester takes with his. Winchester argues that employment tax gap is underestimated; Caron and Repetti argue that the estate tax gap is overestimated. Three decades ago, George Cooper wrote an influential article describing the estate tax as so easily avoided as to make it nearly voluntary.[4] That conclusion became one of the arguments that was and is used by modern-day estate tax opponents such as Grover Norquist. The estate tax, it is said, is not only unfair and inefficient, it is easily avoided, at least by some taxpayers. Caron and Repetti examine this argument and find it wanting. They point out that common "avoidance" techniques such as family limited partnerships or charitable lead trusts impose significant transaction costs or risks and at best somewhat reduce the effective rate of the tax. What does reduce the effective tax rate to the relatively low figure cited by opponents is the charitable deduction. However, giving money to charity so as to receive the charitable deduction is not the kind of avoidance behavior that is properly seen comprising part of the tax gap. It is behavior that is intended by Congress. Indeed, the fact that the estate tax leads taxpayers to leave more money to charity may be seen as a desirable effect of the tax.

The IRS estimates the non-compliance rate for the estate tax at about twenty-three percent—a bit greater than for the individual or corporate income tax. However, the IRS admits to a high level of uncertainty in its estimate. Others have estimated the non-compliance rate as low as ten percent. The relatively high audit rate for estates, together with the legal penalties placed upon executors, who generally do not benefit from evasion, lead Caron and Repetti to believe that the actual non-compliance rate may be closer to the latter figure.

These articles were delivered at the Closing the Tax Gap Symposium held at Stanford Law School and sponsored by the *Stanford Law & Policy Review*, on November 8, 2008. This was the first foray into compliance-related scholarship for a few contributors; others have a long history of scholarship or policy in this area. Compliance is a perennially central subject to tax. It will be interesting to see how the contributors' opinions or policy prescriptions change as conditions and scholarship in this area develops.

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4. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).