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INSTITUTO PARA LA INTEGRACIÓN DE AMÉRICA LATINA Y EL CARIBE**



**SELF-ASSESSMENT, FILING, PAYMENT, AND THE EXAMINATION PROCESS
IN THE UNITED STATES**

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I. Introduction

Making fun about the income tax and complaining about the Internal Revenue Service are sports in the United States. In 1976, while campaigning for office, former-President Jimmy Carter called the tax system a "national disgrace."¹ More recently, during the 1999 presidential campaign, Senator Orrin Hatch, a senior member of the Senate Committee on Finance, declared, "If I had my way I'd get rid of the Internal Revenue Service * * *."² Yet despite these and similar assertions, the U.S. tax system raises in excess of \$2 trillion in annual revenues, nearly 97 percent of all U.S. Government receipts.³

II. The Internal Revenue Service

Organization - The Internal Revenue Service (IRS or Service) is responsible for administering of the federal tax system. The Internal Revenue Service, or the Bureau of Internal Revenue as it was initially known, was created by the Internal Revenue Act of 1862. The IRS is a part of the Treasury Department, and the Commissioner of Internal Revenue, the Service's chief executive, reports to the Secretary of the Treasury. The Service presently employs approximately 100,000 individuals.⁴ With the exception of three individuals, all IRS employees are subject to the rules applicable to the Federal Civil Service and are entitled to the protections afforded federal government employees.

Of the three IRS employees who hold non-Civil Service appointive positions, the President appoints two, the Commissioner of Internal Revenue and the Chief Counsel of the Internal Revenue Service, subject to confirmation of the appointments by the United States Senate. Although occupants of these positions historically have been appointed because of their professional credentials rather than any political activities, because the President appoints them, they are referred to as political appointees. The third appointee is the National Taxpayer Advocate, who is appointed by the Secretary of the Treasury after consulting with the Commissioner and the IRS Oversight Board. Fortunately, and significantly in my view, the number of so-called political appointees working at the IRS is extremely limited.

The Internal Revenue Service has undergone a number of organizational changes over the years. The most significant ones related to the relative importance of the National Office in Washington and the field offices located throughout the country. In the

¹ Summary of 1976 Presidential Debates, Presidential Debate # 1 (September 23, 1976), available at <http://www.cnn.com/ALLPOLITICS/1996/debates/history/1976/index.shtml#index>.

² Transcript of Republican Presidential Forum at New Hampshire Public Television studio, Durham, NH, Oct. 22, 1999, available at <http://www.gwu.edu/~action/primdeb/primdeb1022tr.html>.

³ Administration Fiscal Year 2002 Budget, Table S-11 (Receipts by Source).

⁴ Internal Revenue Service Personnel Summary, by Selected Budget Activity and Type of Personnel, Fiscal Years 2000 and 2001, 2001 IRS Data Book, Publication 55B. (The budget provides for about 100,000 "full-time equivalent" (FTE) employees; the actual number of employees (full and part-time) is larger.) The IRS Data Book is available online at http://www.irs.gov/taxstats/display/0,,i1%3D40%26generic1_d%3D16_907.00.html.

1950's, the Service decentralized in response to problems involving political interference in tax audits by certain Washington and other high-ranking officials. The most recent reorganization, which began several years ago and is in the process of being fully implemented, returns the Service to a more centralized structure, although not all of the senior management officials are located in Washington.

Under its new structure, the Service is organized into so-called "Operating Divisions" that are designed to focus on discreet categories of taxpayers. The Wage & Investment Division serves approximately 116 million individual taxpayers whose only income is comprised of wages or investment income. The Small Business/Self-Employed Division serves approximately 45 million taxpayers who either are self-employed or are small corporate or partnership businesses with assets of \$10 million or less. The Large & Mid-Size Business Division serves 210,000 businesses with assets exceeding \$10 million. The Tax Exempt & Government Entities Division is responsible for employee retirement plans; tax-exempt organizations, such as charities and educational institutions; and sub-national governmental entities. The Small Business/Self-Employed Division is the largest division with approximately 39,000 employees, compared to about 21,000 employees in the Wage & Investment Division, and 9,500 employees in the Large & Mid-size Business Division.

Each Operating Division is headed by a Division Commissioner, who is appointed by the IRS Commissioner. The Division is responsible for all of the functions relating to its assigned category of taxpayers, from tax return filing to tax audits and from educational outreach to the development of substantive and procedural guidance to Service employees and taxpayers. The Service also has a number of centralized units, including a Criminal Investigation Division, an Appeals Division, and the Office of the Chief Counsel.

The income tax contributes the largest percentage of the federal government's total receipts. In fiscal year 2000, individual income taxes totaled approximately \$1 trillion (nearly 50 percent of total receipts); corporate income taxes totaled approximately \$207 billion (slightly over 10 percent of total receipts). Thus, it should not be surprising that most of the Internal Revenue Service's resources are devoted to administration of the income tax.⁵

IRS Employees - The IRS professional workforce is comprised of accountants, actuaries, economists, engineers, information systems specialists, and, of course, lawyers. Their educational backgrounds range from undergraduate college degrees to advanced post-graduate degrees. Unlike Japan's National Tax Agency, the IRS does not have an internal educational organization to provide extensive periods of formal training for its employees. Rather, it relies pre-employment formal education and experience and on on-

⁵ The IRS also is responsible for the annual collection of approximately \$682 billion in employment taxes. Summary of Internal Revenue Collections, by Type of Tax, Fiscal Years 2000 and 2001. 2001 IRS Data Book, *supra* note 4.

the-job training, supplemented by short courses and other *ad hoc* educational experiences. IRS employees, in particular Internal Revenue Agents, often do not receive adequate training to enable them to carry out their tax compliance responsibilities in dealing with the complex tax issues relevant to major business taxpayers. In my opinion, this is a serious failing of U.S. tax administration.

IRS Budget - The Internal Revenue Service is under the budget control of the Secretary of the Treasury and, ultimately, the President. With a current annual budget of approximately \$9.3 billion, budgeting is a full-time process. The IRS prepares its own budget and submits it to the Treasury Department, where it is reviewed and then submitted to the President's Office of Management and Budget. Following Administration approval of the IRS budget, it is submitted to the Congress, where it undergoes several layers of additional review. The budget is analyzed in detail by the House and Senate appropriations committees and more generally by the congressional tax-writing committees (the House Ways and Means Committee and the Senate Finance Committee). Public hearing form a part of the congressional budget process. They enable private-sector individuals and organizations to comment on IRS programs. It is not unusual, for example, for private-sector tax practitioner organizations to testify in support of the IRS budget. In addition, Congress' own watchdog agency, the General Accounting Office, and the IRS Oversight Board, which was created in 1998, independently review the IRS budget and provide comments to the Congress.

The multi-stage consideration of the IRS budget provides opportunities for a careful review of IRS programs and financial management by the Administration and by the Congress. Consideration typically focuses on broad issues of tax administration, such as the effectiveness of the Service's efforts to modernize its information processing systems, the degree to which the Service is providing educational and other support to individual taxpayers; and the overall level of the Service's tax audit activities. Of course, the process also enables the Administration and Members of Congress to reflect their

political views about the tax system and tax compliance. For example, a President or a Member of Congress who is hostile to the tax system might be less supportive of a budget proposal designed to improve the functioning of the IRS. On the whole, however, the IRS budget is relatively free of political influence and, most importantly, it is free of influence by specific taxpayers who might be affected by IRS compliance initiatives.

III. The Assessment System

The U.S. income tax system often is called voluntary, and, indeed, there are voluntary elements. However, the it is more accurately described as a self-assessment system. Every individual taxpayer who earns a specified amount of income (based on filing status) must file a tax return with the IRS by April 15 of the following year. The taxpayer is required to self-access, that is, to compute his or her tax liability and pay any tax that is due without waiting to receive a bill. Taxpayers are subject to both civil

penalties and criminal sanctions if they fail to comply with their reporting and payment obligations. Thus, the U.S. self-assessment system is not voluntary.

In 2001, taxpayers filed approximately 130 million individual income tax returns, 5.5 million corporate income tax returns, and 2.1 million partnership returns.⁶ Approximately 17.5 million (non-farm) sole proprietorship returns were included among the individual income tax returns.⁷ By any measure, these filings by taxpayers represent an impressive level of compliance.

The length and complexity of the tax return that an individual or business taxpayer is required to complete and file vary, depending upon the type of taxpayer (for example, individual, corporation, partnership, or trust) and the complexity of the taxpayer's financial affairs. An individual with a very simple tax profile may file a simplified tax return (Form 1040A or 1040EZ, known as "short forms"). An individual taxpayer with more complicated affairs must file a more detailed return (Form 1040) and often must attach supplemental schedules. Of the approximately 130 million individual income tax returns filed in 2001, 26.3 million (20 percent) were short-form returns.⁸

Increased electronic filing of individual income tax returns has been a major objective of the IRS for more than a decade. In 1998, Congress challenged the IRS to achieve the electronic filing of 80 percent of all tax and information returns by the year

2007.⁹ In 2001, slightly over 40 million individual income tax returns were filed electronically.¹⁰ This figure represents 31 percent of all individual income tax returns.¹¹

Not only does the electronic filing of tax returns simplify and expedite the processing of the returns by the IRS, the returns tend to contain fewer mathematical errors because the returns are computer prepared. Electronic filing eliminates the Service's need to manually convert information received on paper tax returns into electronic data, thereby eliminating data entry errors. The Service asserts that it is able to refund overpayments of tax somewhat more rapidly. And, if these benefits are not

⁶ Summary of Number of Returns, by Type of Return, Fiscal Years 2000 and 2001, 2001 IRS Data Book, *supra* note 4.

⁷ Selected Returns and Forms Filed or To Be Filed by Type During Specified Calendar Years 1975-2002, IRS Statistics of Information (SOI) Bulletin, Fall 2001, available online at <http://www.irs.gov/taxstats/display/0,,i1%3D40%26genericId%3D16909,00.html>.

⁸ Projections of Returns To Be Filed in Calendar Years 2000-2007, SOI Bulletin, Winter 2000-2001, available online at <http://www.irs.ustreas.gov/pub/irs-soi/07rs01pr.pdf>.

⁹ § 2001(a), IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified in various sections of 26 United States Code).

¹⁰ Number of Individual Income Tax Returns Filed Electronically and Accepted, by State, fiscal year 2001, 2001 IRS Data Book, *supra* note 4.

¹¹ Summary of Number of Returns, by Type of Return, Fiscal Years 2000 and 2001, 2001 IRS Data Book, *supra* note 4 (227.9 million returns filed).

enough, the IRS projected a \$114 million savings in processing costs in 2002 if 50 million returns were filed electronically.¹² There is no question that improved tax administration in the United States will rely heavily on the electronic filing of tax and information returns.

All income tax returns, whether filed by individuals or business entities, require disclosure of income subject to tax and specific identification of any deductions from income claimed by the taxpayer. In addition, the taxpayer is required to calculate the tax liability and reduce the tax owed by any available tax credits as well as prior tax payments (by means of withholding or prior estimated tax payments). If the calculation results in a net tax due, the taxpayer is expected to send payment to the IRS along with the tax return. Recently, the IRS instituted an electronic payment procedure utilizing direct bank debit through a government Web site. In addition, certain tax payments may be made by credit card. If the taxpayer is entitled to a refund, the Service will remit the refund rather promptly after receiving the taxpayer's return. A refund to an individual taxpayer usually is remitted within approximately 14 days from the time a return is filed, provided that the taxpayer authorizes the Service to deposit the refund directly in the taxpayer's bank account.¹³

One of the major problems with the U.S. income tax is the complexity of both individual and business tax returns, even for taxpayers with relatively simple financial profiles. This complexity usually is not the result of a failure in the design of the tax returns. Indeed, the Tax Forms and Publications Division, the group within the Service that is responsible for the design of tax forms and instructions, is comprised of individuals experienced in the design of tax forms and is well respected. Rather, the complexity is primarily attributable to the intricacies of the substantive tax law.

Simplification of the tax law in ways that would permit simplification of the tax return preparation process is the perennial subject of much talk but very little legislative action.

Withholding - The vast majority of individual taxpayers do not satisfy their income tax obligations by making payments when they file their income tax returns, but rather, through the mandatory wage withholding system that has been in effect in the United States since 1943.¹⁴ Estimates of voluntary compliance with the tax law vary; recently, it has been estimated that taxpayers voluntarily report 83 percent or more of

¹² "E-Filing Reduces IRS Processing Costs, Other Factors Limit Savings, GAO Finds," Daily Tax Report, p. G-3 (February 12, 2002). Previously, the Service projected 45 million electronic filings in 2002. See Internal Revenue Fact Sheet FS-2002-02 (January 2, 2002), available online at <http://www.irs.gov/pub/irs-news/fs-02-02.pdf>.

¹³ Internal Revenue Fact Sheet FS-2002-02, *supra* note 12.

¹⁴ Certain individual and business taxpayers may be required to make quarterly estimated tax payments. These payments increase cash flow to the government and may increase compliance, since the payments are spread over the year thereby imposing less of a burden on the taxpayer than a single lump-sum payment. Failure to receive a timely estimated tax payment also might provide the IRS with an early warning of a potential collection problem.

income tax due.¹⁵ Assuming this figure is reasonably accurate, I have no doubt that this relatively high rate of compliance is largely attributable to the mandatory wage withholding system.

An interesting consequence of mandatory wage withholding is the fact that approximately 70 percent of all individual taxpayers are entitled to refunds because of excessive withholding ("overwithholding"). In 2000, the Service issued over 92 million refunds to individual taxpayers.¹⁶ Most of these refunds likely were attributable to overwithholding. In spite of a procedure available to taxpayers that enables them to reduce or eliminate any overwithholding, they appear to prefer to receive refunds following the annual filing of their returns, even though the aggregate overwithholding provides a massive interest-free loan to the government.

In 1982, a system of mandatory withholding was instituted for dividend and interest income. The law was controversial, however, and was repealed two years later. At the time of repeal, Congress adopted a modified withholding regime known as "backup withholding." Under the backup withholding system, which has both voluntary and mandatory features, a taxpayer is not subject to withholding on interest and dividend income unless the taxpayer fails to voluntarily report the income on the his or her income tax return. In the event of such a failure, the IRS is authorized to notify the payor of the interest or dividend and require the payor to institute future mandatory withholding. The backup withholding system appears to have worked quite well in increasing the accuracy of dividend and interest reporting.

Information Reporting - The U.S. tax system also contains a number of important third-party information reporting mechanisms. Although it is difficult to access the correlation between information reporting and levels of compliance, information

reporting has become a very important audit tool as the IRS has increased its ability to electronically match third-party information reports to a specific taxpayer's return. Today, for example, the IRS receives most reporting of dividend and interest income in machine readable form, thereby enabling the Service to electronically link the reported information to a taxpayer's return. Thus, for example, if the Service receives a report that a bank paid interest to a particular taxpayer and the taxpayer's return does not disclose receipt of the interest, the IRS will automatically compute the additional tax due by reason of the omitted income, as well as interest and any applicable monetary penalty, and send the taxpayer a bill.

In addition to information reporting on dividends and interest, the IRS receives information on numerous other financial transactions, including broker reports on certain

¹⁵ U.S. General Accounting Office (GAO), "Report to the Joint Committee On Taxation, Reducing the Tax Gap: Results of a GAO-Sponsored Symposium," Report No. T-GGD-95-157 (June 1995) p. 2, available online at <http://www.gao.gov>.

¹⁶ Number of Internal Revenue Refunds Issued, by State, Fiscal Year 2000. 2000 IRS Data Book, Publication 55B. This information is available at <http://www.irs.ustreas.gov/taxstats/display/0,,i1%3D40%26genericId%3D16914,00.html>.

sales of stocks and securities, residential mortgage interest payments which taxpayers may be entitled to claim as deductions, and certain currency transactions.

Information reporting can be a very effective means of improving compliance with a self-assessment system but only if taxpayers think that the information is being used by the tax agency. Recently, the Service announced its intention to begin matching 24 million information returns filed by business partnerships with the tax returns of the partners.¹⁷ I expect that public knowledge of the Service's decision to match information to these returns will result in more accurate reporting of partnership income.

Taxpayer Identification Numbers - Withholding and information reporting systems require some mechanism for matching tax payments and third-party information to taxpayers' returns. The mechanism used in the United States is the taxpayer identification number (TIN), a unique number that distinguishes every taxpayer from all others. The most common TIN is the social security number, which is used by the Social Security Administration to administer the federal retirement (Social Security) and health security (Medicare) programs. For taxpayers who do not have a social security number, including particularly business taxpayers, the IRS assigns a TIN that serves the same tax compliance purpose.

The taxpayer identification number has become an accepted part of U.S. commerce. The number is used in numerous non-tax situations in which an individual must supply an identification number. The acceptance by the American people of a system of taxpayer identification numbers has been an important part of implementing successful wage withholding and information reporting regimes. I realize that the political acceptance of identification numbers may be a controversial issue in some other countries. Thus, a very important step in seeking to implement an identification system is the adoption of procedures that will reasonably assure the confidentiality of a taxpayer's

identification number. IRS rules and regulations contain very specific limitations on the use of this information by the Service, and U.S. law contains rather severe penalties for unauthorized use or disclosure of taxpayer information.

IV. Taxpayer Service

A successful self-assessment system requires effective means to educate taxpayers about the tax law and their compliance responsibilities. The IRS expects to process approximately 214 million tax returns for taxable year 2002.¹⁸ Obviously, it will be impossible for the Service to review all of these returns. Therefore, it must assume that most taxpayers will voluntarily comply with the law, provided that they understand their

¹⁷ David Cay Johnston, "Affluent Avoid Scrutiny on Taxes Even as I.R.S.," New York Times, April 7, 2002. The Service also intends to increase the number of partnership audits. See Allison Bennett, "IRS Launching Intensive Focus on Partnership Audits, Robison Says," Daily Tax Report (Bureau of Nat'l Affairs), Oct. 3, 2001, at G-1.

¹⁸ Projections of Returns To Be Filed in Calendar Years 2000-2008. Article, SOI Bulletin, Winter 2001-2002, available online at <http://www.irs.gov/pub/irs-soi/08rs01pr.pdf>.

obligations. Taxpayers may be aided in understanding their tax compliance obligations in one of two ways: first, through direct educational efforts by the tax administrator and, second, through indirect efforts by the tax administrator in cooperation with the private sector. It is worthwhile for a tax agency to devote resources to improve the effectiveness of both direct and indirect educational efforts.

Direct educational efforts of the tax administrator must be multifaceted. For example, they must include efforts to design user-friendly tax forms and understandable basic explanatory materials; they must make sure that taxpayers are familiar with their procedural rights in the event the tax administrator determines additional tax is due; and they must respond to taxpayers' questions regarding the tax law and administrative procedures.

The IRS undertakes many direct educational efforts. First, taxpayers are able to make face-to-face contact with IRS representatives in local offices. Here they may seek help in preparing and filing a tax return, obtaining a refund, or arranging to pay a delinquent tax. Second, the IRS operates a nationwide telephone answering system designed to assist taxpayers in answering basic substantive tax and procedural questions and assist taxpayers in determining the status of their accounts, for example, whether the taxpayer owes money or is entitled to a refund and, if so, the status of the refund. In 2001, the IRS answered 108 million telephone calls and responded to 19.2 million letters.¹⁹ Third, the Service provides various forms of published guidance to taxpayers, as well as to IRS employees, including formal interpretative regulations and transaction-specific and taxpayer-specific rulings. Much of this guidance is directed to more complex business tax issues; however, a great deal of the guidance deals with common, everyday problems confronting individual taxpayers. Fourth, the Service operates a highly successful Web site at which taxpayers may obtain information on various topics and download tax forms, instructions, and other explanatory publications. During 2001, the

IRS Web site registered more than 2.6 billion hits and over 317 million forms and publications were downloaded.²⁰

I do not mean to suggest that the Service's direct educational efforts are perfect. For example, the quality of responses that taxpayers receive when they contact the IRS by telephone has long been criticized as deficient.²¹ However, the Service appears to recognize the importance of improved services to taxpayers, and the congressional budget committees generally have been supportive of these efforts.

¹⁹ IRS Progress Report, December 2001, 2002 TNT 42-6, available at LEXIS, Tax Analysts File.

²⁰ IRS Progress Report, *supra* note 19.

²¹ "Tax Administration: IRS' 2000 Tax Filing Season," GAO-01-158, December 22, 2000, <http://www.gao.gov>.

The IRS also encourages and supports indirect education in several important ways. For example, it produces print and broadcast announcements, which are disseminated by the media as a public service at no charge. The Service also provides support for over 70,000 private-sector volunteers who assist low-income and elderly individuals to prepare their tax returns (the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly Programs).²² With the financial support of the American Bar Association Section of Taxation, the Service produced an interactive Web site called Tax Interactive ("Taxi") designed to educate young adults about their tax obligations. Representatives of the IRS meet regularly with tax practitioner groups that serve various segments of the taxpaying public, from relatively modest individual taxpayers to the country's largest corporations. These meetings provide opportunities for the IRS to disseminate tax compliance information and provide opportunities for taxpayers and their representatives to inform the IRS of perceived compliance problems.

There are two other topics relating to taxpayer service that I wish to mention. They are the IRS National Taxpayer Advocate and private sector tax return preparers.

National Taxpayer Advocate - The National Taxpayer Advocate occupies a legislatively authorized special position within the Internal Revenue Service. Appointed by the Secretary of the Treasury, in consultation with the Commissioner and the IRS Oversight Board, the Taxpayer Advocate is charged with assisting taxpayers who experience procedural problems with the IRS. The Taxpayer Advocate's office is staffed with Local Taxpayer Advocates stationed throughout the country. If, in connection with the examination of a tax return or the collection of an unpaid tax liability, a taxpayer believes that he or she is not being treated fairly, the taxpayer may solicit the assistance of the Taxpayer Advocate. In certain circumstances, the law authorizes the Taxpayer Advocate to direct the Service to take corrective action. The Taxpayer Advocate also is required to report annually to the Congress on particular substantive law or procedural problems that in the Taxpayer Advocate's opinion affect the ability of taxpayers to easily comply with the tax law.

The Taxpayer Advocate is a politically popular position because it provides individual taxpayers with someone who can "fight the system." There are many instances in which taxpayers receive inaccurate or confusing communications from the Service. In these circumstances, the Taxpayer Advocate may aid in correcting an error or otherwise resolving a procedural problem that the taxpayer has experienced. More controversial are steps that the Taxpayer Advocate may take to override established procedural rules, particularly in connection with the collection of unpaid tax. Because the Taxpayer Advocate's authority was expanded relatively recently, it is not yet clear whether the Taxpayer Advocate will act merely to provide a procedural service to taxpayers or will act in a manner that effectively relieves taxpayers of their legal obligations to comply with the law.

²² Taxpayer Assistance and Education Programs, by Type, Fiscal Year 1998, 1998 IRS Data Book, Publication 55B, available online at <http://www.irs.ustreas.gov/taxstats/display/0..i1%3D40%26genericId%3D16907.00.html>.

Private Sector Return Preparers - Many taxpayers, both individuals and businesses, rely on the services of private tax return preparers. For example, during the period January 2 and May 4, 2001, third-party preparers completed 57 percent of all individual income tax returns.²³ These return preparers are comprised of the Big 4 accounting firms and other large national enterprises such as H&R Block, Inc., a New York Stock Exchange-listed company with \$1.7 billion in fiscal year 2001 U.S. tax return preparation and related revenues, and, as well as small local accounting firms and bookkeeping services and so-called "store front" return preparers. Many return preparers are well-educated and experienced professionals, including individuals trained as accountants. Others, who may not have an accountancy background, receive high quality vocational training, and their work product is subject to peer review. Others have very little training, and unfortunately some are simply dishonest and prey unscrupulously on uneducated low-income taxpayers.

Competent and reputable tax return preparers can serve an important role in improving tax compliance. The return preparer may be a taxpayer's sole human contact with the tax system. Therefore, it is in the tax administrator's interest to provide reasonable support to return preparers in order that they may competently and efficiently perform their duties. However, it also is important that the tax administrator identify and control the activities of unethical preparers. The IRS does a fairly good job in providing support to the tax preparer community through educational outreach efforts, access to preparer information on the IRS Web site, and satisfaction of various tax season needs, such as the bulk delivery of tax returns.

U.S. law contains penalties potentially applicable to a return preparer who fails to properly complete a tax return and authorizes injunctive relief in the event the Service identifies a return preparer that repeatedly acts improperly. However, U.S. law does not require an advance evaluation of a return preparer's qualifications and there is no certification or licensing system. As a result, the Service must play "catch up." Instead of disqualifying incompetent preparers in advance, the Service must wait until it detects a

sufficient number of questionable returns that are attributable to a particular preparer and then seek to locate and discipline the preparer.

V. The Audit Process

The audit process in the United States is comprised of three components. The first, called the Automatic Underreporting Program, involves the review of tax returns by IRS computers. These reviews identify mathematical errors resulting in underpayments or overpayments of tax or, following the match of third-party information returns, detect possible omissions of income. Following the automatic review, a computer triggers a communication to the taxpayer with a request for payment of any amount due or advising

²³ Internal Revenue Service, "Taxpayer Usage Study," (2001), http://www.irs.ustreas.gov/tax_stats.

the taxpayer of a right to a refund. It is apparent that computer examination of individual tax returns has become an increased component of the Service's enforcement strategy. In response to recent criticism about reductions in the number of in-person audits, the IRS has pointed to computer examinations as an illustration of how automation can make the audit process more efficient.

The second form of audit is referred to as the "office audit." These audits involve an in-person review of individual income tax returns by so-called Tax Auditors. These individuals have less training and experience than regular Revenue Agents and tend to deal with returns they are likely to present rather simple audit issues. In 2001, the IRS employed approximately 1,500 Tax Auditors.²⁴ Another form of audit that I include in the "office audit" category actually is conducted by Tax Examiners at the IRS Regional Service Centers and is called a "correspondence audit." Tax Examiners have even less training and experience than Office Auditors. These audits related only to the most basic audit issues, for example, a taxpayer's failure to sign a tax return, and are conducted exclusively through correspondence with the taxpayer.

The third form of audit is the "field audit" and is conducted by more experienced tax examiners called Revenue Agents. In 2001, the IRS employed approximately 11,500 Revenue Agents. Audits of businesses and some individuals are conducted as field audits. Field audits are subcategorized. Audits of small businesses, for example, likely will be conducted by less experienced revenue agents and will be relatively brief in duration. Senior Revenue Agents assigned to examination teams undertake audits of large businesses, particularly large multinational corporations. These agents tend to have experience in the relevant industry and may have particular expertise in a narrow area of the substantive tax law, such as inventory accounting, international tax issues, or transfer pricing.

Examinations of the largest corporations are conducted under the auspices of the Large Case Audit Program (formerly, the Coordinated Examination Program). Taxpayers in the Large Case Audit Program are more or less under continuous audit. A particular audit cycle usually will encompass two or three taxable years, may take one or two years

to complete, and will be followed immediately by the audit of the taxpayer's next two or three taxable years. It is generally thought that about 300 corporations are included in this program, although recent IRS data indicate that considerably fewer Large Case Audits are conducted annually.²⁵ This may be a symptom of the general reduction in IRS audit rates.

Audits serve different purposes depending on the type of taxpayer involved. In the case of individuals and small businesses, audits are intended to send a message to the general taxpaying public that voluntary compliance is prudent because of the risk of

²⁴ IRS, "Taxpayer Usage Study," *supra* note 23.

²⁵ Examination Coverage: Recommended and Average Recommended Additional Tax After Examination by Type and Size of Return, 2001 IRS Data Book, *supra* note 4.

audit. Presently, however, audit coverage in the United States is very low. For example, approximately 789,000 returns filed in 2000 were examined. This number represents only .58 percent of all individual income tax returns filed, and, even this low number is misleading. Revenue Agents or Tax Auditors examined 202,000 returns, representing only .16 percent of all individual income tax returns filed in 2000.²⁶ The other examinations were conducted automatically by computer or constituted correspondence examinations. These low audit levels may convey a different message to the taxpaying public, namely, that aggressive tax reporting may be a successful strategy because of the unlikelihood of getting caught.

Audits of large businesses are intended to send a different message. If a large multinational corporation is audited each year, then it knows that questionable reporting positions likely will be detected and challenged. Thus, an effective large taxpayer audit program encourages large taxpayers to comply. However, the prospect of annual audits will not automatically improve voluntary compliance. The compliance message will be effective only if a business taxpayer's experience demonstrates that the examination team is sufficiently well trained and experienced to identify questionable reporting positions. Presently, there is a perception in the United States that the complexity of the tax returns of large businesses, often comprising of several box loads of forms and attachments, often overwhelms agents who lack sufficient experience and training to understand complex and difficult-to-identify tax issues.

An historically important limitation on examining agents is their lack of authority to compromise tax liabilities with taxpayers. An examining agent may only resolve a matter in the taxpayer's favor upon a showing by the taxpayer that the facts differed from those determined by the agent and favored the taxpayer. Put technically, an agent may not take the hazards of litigation into account in resolving a disputed matter.

If as a result of an audit or information otherwise available, it appears that a taxpayer intentionally failed to comply with the tax law, the IRS Criminal Investigation Division may institute an investigation of the taxpayer. In relative terms, criminal investigations are rare. However, they do occur and when guilt is proven, a taxpayer who willfully intended to evade taxes or failed to file a tax return may be subject to both monetary penalties and imprisonment. Of course, an accused taxpayer is afforded the traditional constitutional and other protections available in the U.S. to persons accused of a crime. The Service and the Department of Justice publicize criminal indictments and successful prosecutions on the theory that such publicity will have a deterrent effect.

VI. Appeals and Collection

²⁶ Examination Coverage: Recommended and Average Recommended Additional Tax After Examination by Type and Size of Return, *supra* note 25. To appreciate this low audit level, compare this .58 percent figure with the 1995 audit rate of 1.57 percent. See General Accounting Office, IRS Audit Rates, Report No. GAO-01-484, April 2001, 2001 TNT 105-31, available at LEXIS, Tax Analysts File.

Appeals - Following completion of an audit, the taxpayer has several procedural choices in the event the examining agent concludes that an underpayment of tax exists. The taxpayer may agree with the agent's determination and pay the amount of tax that is due, together with interest on the underpayment and, on occasion, penalties. Alternatively, the taxpayer may challenge the agent's determination by exercising certain administrative and judicial appeal rights. Administrative appeals are handled by the Office of Appeals, an office within the IRS that is independent of the Operating Divisions and, therefore, of the examining agents.

The purpose of the Appeals Office is seek to resolve disputes between taxpayers and IRS auditors by taking into consideration the risks to both parties if they were to litigate the dispute. The Appeals Office is staffed by Appeals Officers. These individuals are experienced IRS employees typically drawn from the ranks of examining agents. Over the years, the Appeals Office has been successful in resolving the vast majority of disputed matters without the need by taxpayers or the Service to resort to the courts.

A well-managed administrative appeals function is an important part of an efficient tax controversy resolution process because it reduces the need for costly and time-consuming litigation. In order to be effective, however, employees handling appeals must be perceived by taxpayers and IRS agents as knowledgeable, experienced and, perhaps most of all, neutral.

A taxpayer also may challenge an adverse IRS determination in court, although very few cases reach this stage (20,615, as of October 1, 2001).²⁷ At the election of the taxpayer, several alternative forums are available, including the United States District Court and the United States Court of Federal Claims. However, most judicial controversies are handled by the United States Tax Court, a national court comprised of 19 presidentially-appointed judges. Unlike other courts, a taxpayer may contest a tax deficiency in the Tax Court without first paying the tax liability that the Service asserts is due. The court is headquartered in Washington, but the judges conduct trials throughout the United States.

The Tax Court serves as a successful forum for resolving tax cases for several reasons. First, the taxpayer is not required to prepay the asserted tax liability. Second, most of the Tax Court judges have a tax background and, therefore, bring a higher level of subject-matter expertise to the controversy than would a generalist judge with little or no familiarity with the tax law. Third, the Tax Court judges and other members of the Tax Court staff make extra efforts to assist individual taxpayers who are unfamiliar with the tax law and procedures in understanding the law and in complying with the rules of the court. As a result, most of the cases filed in the Tax Court do not require a trial. For example, of the 837 cases on which the Tax Court acted in 2000, only 148 or 18 percent of the cases were litigated and decided. Almost 50 percent (405) of the cases were settled

²⁷ Chief Counsel Workload: Tax Litigation, by Type of Case, 2001 IRS Data Book, *supra* note 4.

by agreement between the taxpayer and the Service.²⁸ The court dismissed the remainder of the cases, likely because of the taxpayers' failure to comply with various procedural rules.

Decisions of the Tax Court may be appealed by the taxpayer or the Government to a Circuit Court of Appeals and, ultimately, to the United States Supreme Court. However the courts of appeals consider relatively few tax cases, and Supreme Court consideration is ever more limited.

Collection - Of the approximately \$2 trillion of tax revenues received by the federal government in 2001, 98.5 percent of this amount was voluntarily remitted by taxpayers; only 1.5 percent was collected through IRS enforcement activities.²⁹ Nevertheless, collection of delinquent tax liabilities is a very important but also a very delicate process.

The need to be forceful in collecting unpaid taxes must be balanced against the need to treat taxpayers with dignity; carry out collection actions in a courteous manner whenever possible; and attempt to accommodate situations in which taxpayers are facing significant non-tax problems, such as illness, marital problems, unemployment, a weak business environment, or potential insolvency. Over the years, occasional complaints of abuses of the collection process by IRS Collection Officers has led to both statutory and administrative constraints on collection activities.

VII. Relations with State Tax Administrators

The Internal Revenue Service has a long history of cooperation with state tax administrators. By federal statute, the IRS is authorized to enter into information exchange agreements with state tax agencies, and it has done so with many states. In addition, the Service consults with state agencies that are seeking to improve their tax

administration systems. The Service also cooperates with some states in providing educational programs for tax return preparers and tax practitioners. More recently, the IRS and the states have been cooperating on electronic filing initiatives. Presently, taxpayers in 37 states and the District of Columbia may electronically file their federal and state income tax returns in a single transaction with the IRS. The IRS then forwards the state data to the appropriate state tax agency.³⁰

Cooperative arrangements between the IRS and the states probably benefit the states more than they benefit the federal government. However, under the U.S. system of

²⁸ Chief Counsel Workload: Tax Litigation, by Type of Case, *supra* note 27.

²⁹ Charles O. Rossotti, Commissioner of Internal Revenue, "Audit and Collection Activity for Fiscal 2001" (Collection Yield Table), February 28, 2002, 2002 TNT 41-10, available at LEXIS, Tax Analysts File; Summary of Internal Revenue Collections, by Type of Tax, Fiscal Years 2000 and 2001, 2001 IRS Data Book, *supra* note 4.

³⁰ Internal Revenue Fact Sheet FS-2002-02, *supra* note 12.

government, in which states and the federal government exercise overlapping tax jurisdiction and generally function best when they cooperate, these interactive efforts improve the overall efficiency of the federal and sub-national tax systems.

VIII. International Tax Compliance

In the modern world, the activities of a country's tax authority in assuring tax compliance are much more challenging as a result of the globalization of economic activity. The IRS undertakes numerous initiatives to improve U.S. tax compliance with respect to international transactions, cooperates with many other countries in attempting to improve global tax compliance, and works with other countries in attempts to improve their national tax administrations. This is a very interesting and important topic, but, in the interest of time, I consider it beyond the scope of these comments.

IX. Conclusion

U.S. tax administration faces serious challenges. The IRS computers are alarmingly out of date, and, in spite of the expenditure of billions of dollars over the past decade, improvements in information technology have fallen short of expectations. Additionally, lack of training hampers the effectiveness of IRS examining agents and certain other front-line employees. Unfortunately, government service is not held in the same high esteem in the United States as it is in some other countries. Thus, experienced IRS employees with the highest skill levels regularly leave the Service's employ to enter the private sector as a result of offers of compensation that the IRS is unable to match. Moreover, harsh criticism of the IRS by some politicians and members of the press over the past decade have had an adverse effect on the morale of IRS employees, thereby making it more difficult for the Service to recruit promising new candidates.

Notwithstanding the challenges facing tax administration in the United States and the criticisms that have been lodged against the Internal Revenue Service, the agency generally performs its obligations in an exemplary manner. The relatively high rate of tax compliance in the United States is primarily attributable to three factors: first, the success of wage withholding and information reporting; second, the existence of responsible and active members of the private sector who recognize the importance of the tax system; and third, the fact that the Service is a reputable and honest agent of government that generally draws an appropriate balance between enforcement of the law and taxpayer service.

I suppose that it is inevitable that tax administrators, wherever located, will be subject of humor and criticism. After all, no one likes to pay taxes. However, it generally is by means of the tax system that a government obtains the revenues it needs to provide for its citizens. Thus, there is no more important responsibility than contributing to the development and maintenance of effective tax compliance. In my opinion, no greater opportunity for government service exists than in the service of a country's tax agency.