

is described as a 23 percent rate, not as a 30 percent rate. If the public is to compare the cost of a sales tax to the cost of an income tax that it would replace, it needs to have rates determined in a comparable manner. If a taxpayer earns \$130, pays \$30 in income taxes, and spends the remaining \$100 to purchase an item, his tax rate is referred to as 23 percent. If the income tax were replaced by a sales tax, and if the taxpayer purchased the same item for \$100 and paid \$30 in sales tax, his tax rate should be considered the same as it was under the income tax regime. If you tell the taxpayer that if a sales tax is adopted, his tax rate will change from 23 percent to 30 percent, you would mislead him into thinking that his tax liability would be greater under the sales tax.

The fact is that either method of determining the tax rate has the potential to mislead when the listener does not understand the difference in methods of determination. The method chosen by the proponents of the tax actually seems better to me in that it provides a more accurate figure for comparison. If a taxpayer knows that he is paying income tax at an average rate of 25 percent, the 23 percent rate gives him a better figure for comparison than does the 30 percent rate that a tax-exclusive determination would provide. I could not criticize anyone for using either the 23 percent or 30 percent rate, because each has its merits and its disadvantages. I certainly cannot see how the use of either rate could qualify for an award for dishonesty.

The choice of the 23 percent rate likely was motivated, at least partly, by advocacy considerations. The use of language for advocacy purposes is a common occurrence and is by no means used exclusively by politicians. For example, lawyers — and even law professors — have been known to indulge in that practice. The preference for using a 30 percent rate could be seen as driven by political or advocacy considerations to make unfavorable the comparison of the sales tax to the income tax.

10 Suggestions for Closing the Tax Gap

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One thing is clear about the tax gap: There are so many reports on it by the IRS, the Government Accountability Office, Congress, and others that it is time to simply do something about it. No more reports are needed. The following is a list of 10 items that would be a good starting point in closing the tax gap. Some of these suggestions can be implemented by the IRS, while others would need congressional help. The tax gap will never be eliminated, but it can and should be reduced.

Congressional Help May Be Needed

10. Require third-party middlemen such as auctioneers to report gross sales by anyone selling more than \$1,000 in total value and more than 100 items per year. It is well documented that many “vendors” on online auctions do not report their sales to the IRS. It is also well documented that when third parties report income to the IRS, taxpayers also report the income.¹ There is no reason for online vendors to be “tax exempt” while their brick-and-mortar counterparts pay taxes because they are easier to identify.

9. Require wholesalers to report gross purchases by their business customers (including C corporations). This is an easy way at least to identify nonfilers and underreporting by business, which is a major source of the tax gap.² Anyone using a resale number to avoid sales taxes has demonstrated that he is in business; so as long as the seller is already tracking those sales, a simple note to the IRS doesn’t entail that much work and may identify a

¹See Department of the Treasury, “A Comprehensive Strategy for Reducing the Tax Gap,” Office of Tax Policy, Sept. 26, 2006, p. 6: “Noncompliance is highest among taxpayers whose income is not subject to third-party reporting or withholding requirements.”

²See, for example, the written statement of Nina E. Olson, national taxpayer advocate, before the Subcommittee on Federal Financial Management, Government Information, and International Security on Oct. 26, 2005, the “IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001) (indicating that self-employed taxpayers are responsible for about 67 percent of the tax gap). This estimate includes underreporting, non-filing, and non-payment of income and employment taxes by self-employed taxpayers.” Available at <http://www.irs.gov/pub/irs-utl/ntatetestimonytaxgap102605.pdf>, p. 3, n.13 (last visited Aug. 22, 2007).

whole lot of businesses that the IRS is unaware of. Similarly, as a means of identifying businesses (and maybe even unreported income the business is already reporting), credit card companies should be required to report all payments to vendors.³

8. Require reporting by businesses of the names and addresses of those who use cash to purchase items totaling \$1,000 or more. Who uses that much cash to make purchases? Usually, people who have unreported income. Again, it is a starting point for the IRS to find those who have income (generally from businesses) that is not reported to the IRS or “independent contractors” who are paid under the table. Although one can quibble about the amount — maybe it should be less, maybe more (current reporting is required for transactions exceeding \$10,000) — cash is a problem.⁴ Reporting those who use cash to purchase big-ticket items would seem to be a good source of information about potential owners of cash-basis businesses and independent contractors.⁵

7. Make it much easier for those who haven’t filed or who owe tax to get up to date by reducing penalties and interest when appropriate. Unlike the above suggestions, this one would require both Congress and the IRS to make the offer in compromise program more efficient and fairer.⁶

This suggestion is not based on any research or any reference to articles on the subject. But it just seems logical that once someone falls behind in paying or, worse, drops out of the system entirely, he is not likely to voluntarily reenter it, because he probably believes the IRS will try to collect all back taxes, penalties, and interest. One “friend”⁷ of mine just received a notice from

³This could cause duplicate reporting when the buyer of goods and the credit card company both report the transaction to the IRS. But it’s better for some companies to have to reconcile their sales and cost of goods sold than for others to get away with not reporting at all.

⁴One recent viewpoint advocated eliminating cash. Jay A. Soled, “To Close the Tax Gap, Eliminate Cash,” *Tax Notes*, Apr. 23, 2007, p. 379, *Doc 2007-9223*, 2007 TNT 79-41. In that same issue, there was another tax gap article by Dustin Stamper, “GAO Identifies Areas in Tax Gap Data Needing More Research,” *Tax Notes*, Apr. 23, 2007, p. 291, *Doc 2007-10012*, 2007 TNT 77-4. Narrowing the tax gap clearly is a hot topic for writers, for research, and, apparently, for delay by the IRS and Congress in implementation.

⁵What about the “honest” taxpayer who wins \$4,000 at a friendly poker game and now can’t use that money to buy a new 50-inch plasma/LCD TV without being reported to the IRS? No problem. All he has to do is deposit the cash in the bank and then write a check or use a credit or debit card for the purchase. Technically, of course, the gambling winnings, even from a friendly game at home, are taxable, but that is a subject for another article.

Although it might be an interesting approach to reduce the threshold for bank reporting from \$10,000 in cash deposits, that would probably cause many false leads. Lowering the \$10,000 to \$5,000 might be a good idea. But that topic is far too complex for this list of 10 items.

⁶How to do that is far too complex to tackle here.

⁷Actually, not a friend, but an ex-bartender I knew, who remembered that I was a part-time CPA. That was all it took for him to ask, “Does it make sense to you that I could owe double

(Footnote continued in next column.)

the IRS saying that he had not filed for four years and that, based on the IRS’s calculations, he owes about \$10,000 in tax and about the same amount in additional penalties and interest. No sympathy here, but he cannot pay the \$20,000. Something has to be done to get these people to file their returns for the current year. It would be even better for him to have believed that he could have come forward earlier and worked it out.

No Congressional Help Needed

6. Create a new schedule for the Form 1040 and call it Schedule 1099. Individual taxpayers not engaged in business transactions could use the new schedule to report amounts they pay to independent contractors, such as CPAs, home builders, plumbers, electricians, lawyers, doctors, housekeepers, or nannies. Those who remodel their kitchen for \$35,000 may be a good source of information for the IRS. If it makes sense for a business to report more than \$600 paid to anyone (except a corporation⁸), then it makes sense for the rest of us to have the ability (even if is not required) to do the same. A survey of taxpayers indicated that 30 percent agreed it was their personal responsibility to report cheating.⁹ So why not make it easy to do that?

5. The IRS must make it clear to taxpayers that it is using innovative methods to find taxpayers who are underreporting their income. One thing the IRS could do is write to taxpayers asking for clarification if it appears that their income is not enough to support their itemized deductions (mortgage interest deductions, charitable contributions, and so on). The letter might ask for a simple cash flow statement or an explanation as to how they could deduct \$40,000 while reporting only \$50,000 in income. In many cases there will be valid reasons,¹⁰ but unless there is a perception that the IRS will ask about what on its face looks like a questionable return, there is little incentive for taxpayers to file honest returns.

4. Similar to the above, an easy way to find potential underreporting of business income is to compare the amount of sales to the cost of goods sold. That is because many businesses that underreport income still deduct

the taxes for the years I didn’t file because I was moving around so much?” The good news was that he is currently reporting, but maybe only because he has a job for which he receives a Form W-2.

⁸Also, Congress or the IRS should eliminate the Form 1099 exception for corporations. Even if you buy from a corporation, businesses otherwise required to file informational returns should be required to report payments to corporations. They already are required to report those payments, but only to doctors and lawyers. It is time to require those payments to be reported if they are to accountants, plumbers, electricians, and so on.

⁹IRS Oversight Board, 2005 Taxpayer Attitude Survey, available at <http://www.treas.gov/irsob/releases/2006/02212006.pdf> (last visited Aug. 22, 2007). The percentage remained the same in 2006. IRS Oversight Board, 2006 Taxpayer Attitude Survey, available at http://www.treas.gov/irsob/reports/2006_taxpayer_attitude_survey.pdf (last visited Aug. 22, 2007).

¹⁰There may be reasons such as having been laid off or paying a great deal of state income tax for a prior year that included a windfall.

100 percent of their inventory cost. Thus, if in a typical industry the inventory markup is 100 percent, a business that bought \$30,000 of inventory should report sales of \$60,000. Accordingly, a tax return that reports sales of \$60,000 and inventory costs of \$40,000 at least warrants a letter, if not a full-blown audit. When it comes to collecting sales tax, most states are pretty good at using this method to find underreported sales taxes. It's time the IRS used a similar method.

3. Compare 100 percent of Schedules K-1 to individual returns related to S corporations, partnerships, trusts, and estates. It is also time for the IRS to do a much better job of auditing the income tax returns of estates and trusts (Form 1041), which are almost never audited. Because everyone knows about that low audit rate, it defies logic to believe that some taxpayers aren't using that knowledge to their advantage.¹¹

2. Our country is made up of citizens who generally believe in the tax system, or at least participate in it and pay their taxes. Why not enlist them as potential bounty hunters? The system already exists for reporting nonfilers or underreporters to the IRS and for the IRS to pay a reward of up to 15 percent for that information. If the current system were successful, evidence of that success would probably be that the average citizen was aware of the potential rewards. Does anyone believe the average citizen is either aware of the potential reward or that, even if he was, he would know how to contact the IRS with information necessary to turn in a nonpayer? Can anyone name the form that is required to report a nonpayer?¹² No! That is probably a good indication that no one is thinking about submitting one.

If the IRS really wants to close the tax gap, it should also want assistance from those who pay their fair share, and it should make the process of turning in nonfilers or underreporting taxpayers more user-friendly. A new form should be included as part of the Form 1040 package. Why not a Form 1040 — IGOTU. Make it a one-page form that is easy to file with as much information about a prospective tax cheat as is known. Of course, this form could be abused, but if the IRS simply uses it as

a lead for names and addresses of nonfilers, what's the harm? The IRS could send a letter to an alleged cheat asking if the person operates a business and if so, why he didn't report that business on his tax return.

Use of Criminal Cases for Better Compliance

1. Higher penalties and more audits discourage cheating.¹³ One of those penalties is criminal sanctions. Most people know that the odds of a criminal case being filed for tax evasion is probably less than the odds of being hit by lightning. If one knows that the only consequence of being caught for tax evasion is having to pay the tax owed plus interest and penalties (and also knows the chance of even being caught is low when only about 1 percent of tax returns are being audited), some people will play the audit lottery game.

What would happen if the wayward taxpayer believed there was a real chance he would be charged with a crime if he intentionally failed to file his tax return or intentionally underreported his income? That might increase reporting, especially if he thought the chances of getting caught were more than 1 percent.

A message needs to be sent. Cases should be referred to the criminal division for misdemeanor¹⁴ prosecution if some amounts are underreported or deductions overstated. If the magnitude of the offense is very high, felonies should be charged. Just the fact that one's name will be part of the public record if charged may deter some. Prison should probably be the exception, but heavy criminal fines, plus hours of public service, should be mandatory, and criminals should be required to pay all IRS and court costs. Finally, once convicted, tax cheats should be audited every three years for at least nine years, and fines should be increased for repeat offenders.

At first blush, it may seem harsh to use the criminal process as a major weapon in the tax arena. But if someone who is caught forging a check for \$1,000 is routinely charged with a crime, why should someone who is intentionally cheating the tax system out of the same amount get a civil penalty and no criminal record? It's time to both call and treat these people as the criminals that they are. Maybe then they will pay their taxes like the vast majority of their fellow citizens do.¹⁵

¹¹If the IRS is currently comparing K-1s or auditing trusts, I apologize. But I couldn't find any evidence of the latter in the SOIs and as for the former, it is often hard for us as accountants to figure out what to do with K-1s. I suspect that those who aren't trained tax preparers have a hard time when they get a K-1 from a partnership, S corporation, trust, or estate.

¹²It appears that the current system uses Form 211 and that the maximum is 15 percent on up to \$10 million. With a potential for up to \$1.5 million, do you think compliance might increase if small-business owners knew that any employee they fired might turn around and complete the form included with their Form 1040 package (or with their TurboTax program) because they probably know the boss was pocketing all of the cash receipts? For more information on the current system, see <http://www.irs.gov/foia/article/0,,id=132336,00.html> (last visited Aug. 22, 2007).

¹³Michael Allingham and Sandmo Agnar, "Income Tax Evasion: A Theoretical Analysis," 1 *J. Public Econ.*, 323-328 (1972).

¹⁴According to former acting IRS Commissioner Kevin Brown, "Frankly, you cannot interest U.S. attorneys in prosecuting misdemeanors. Perhaps in the drug area, but not in the tax area." See Dustin Stamper, "Brown Following Everson's Lead," *Tax Notes*, May 14, 2007, p. 606, Doc 2007-11449, 2007 TNT 91-3.

¹⁵This new policy should be prospective. Also, it is important to point out that the term "intentional" makes it clear that criminal charges should not be brought against those who simply make a mistake interpreting the tax laws or who fail to report minimal amounts of income because they do not keep perfectly accurate books and records.