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"Wither the Tax Gap?"

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SCHEDULE FOR 2016 NYU TAX POLICY COLLOQUIUM
(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 19 – Eric Talley, Columbia Law School. “Corporate Inversions and the unbundling of Regulatory Competition.”

2. January 26 – Michael Simkovic, Seton Hall Law School. “The Knowledge Tax.”

3. February 2 – Lucy Martin, University of North Carolina at Chapel Hill, Department of Political Science. “The Structure of American Income Tax Policy Preferences.”

4. February 9 – Donald Marron, Urban Institute. “Should Governments Tax Unhealthy Foods and Drinks?"

5. February 23 – Reuven S. Avi-Yonah, University of Michigan Law School. “Evaluating BEPS”

6. March 1 – Kevin Markle, University of Iowa Business School. “The Effect of Financial Constraints on Income Shifting by U.S. Multinationals.”

7. March 8 – Theodore P. Seto, Loyola Law School, Los Angeles. “Preference-Shifting and the Non-Falsifiability of Optimal Tax Theory.”

8. March 22 – James Kwak, University of Connecticut School of Law. “Reducing Inequality With a Retrospective Tax on Capital.”

9. March 29 – Miranda Stewart, The Australian National University. “Transnational Tax Law: Fiction or Reality, Future or Now?”

10. April 5 – Richard Prisinzano, U.S. Treasury Department, and Danny Yagan, University of California at Berkeley Economics Department, et al. “Business In The United States: Who Owns It And How Much Tax Do They Pay?”

11. April 12 – Lily Kahng, Seattle University School of Law. “Who Owns Human Capital?”

12. **April 19 – James Alm, Tulane Economics Department, and Jay Soled, Rutgers Business School. “Whither the Tax Gap?”**

13. April 26 – Jane Gravelle, Congressional Research Service. “Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?”

14. May 3 – Monica Prasad, Northwestern University Department of Sociology. “The Popular Origins of Neoliberalism in the Reagan Tax Cut of 1981.”

WHITHER THE TAX GAP?

James Alm & Jay A. Soled*

For decades, policy makers and politicians have railed against the "tax gap," or the difference between what taxpayers are legally obligated to pay in taxes and what they actually pay in taxes. To close the gap, Congress has instituted numerous reforms, with varying degrees of success. Notwithstanding these efforts, the tax gap has largely remained intact, and, if anything, its size has gradually grown over the last several decades.

However, the tax gap may well begin to whither away, if not immediately then over time. Three developments will help narrow the tax gap's size. First, the ubiquity of credit cards, debit cards, and smartphone payment apps has purged cash—the erstwhile driving engine of the tax gap—from its use in many economic transactions. Second, the availability of third-party sources of information, combined with the universal use of computerization to store, access, and analyze information, has made the use of tax information returns much more feasible in a variety of contexts, often eliminating a taxpayer's ability to hide income here in the United States or overseas. Third, broad economic trends such as concentration and globalization have generated a workforce dynamic in which taxpayers generally are employed by large business enterprises (where individual tax compliance is fairly high) rather than traditional mom-and-pop businesses (where individual tax compliance is typically low).

The implications associated with a lower tax gap are vast. Even beyond the usual considerations associated with greater tax compliance (e.g., increased revenues, reduced noncompliance-induced inefficiencies, and improved horizontal and vertical equity of tax burdens), taxpayers will experience a shift in the labor market and an adjustment in the prices paid for consumer goods and services. Also, rather than conducting audits and deterring noncompliance, the Internal Revenue Service (IRS) would be able to dedicate a greater share of its limited resources to other pressing agenda items, such as assisting taxpayers in their compliance endeavors.

There are, of course, other economic trends that may counter the forces that will act to reduce the tax gap. Also, for a whole host of reasons, especially reductions in IRS funding, the tax gap will not be closed anytime soon. Nevertheless, the tide against tax noncompliance may finally be turning.

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I. INTRODUCTION

There is much discussion in the popular media and academic presses regarding the severity of the "tax gap,"[1] defined as the difference between what taxpayers actually pay in taxes in a timely manner and what they should pay if they fully complied with the tax laws.[2] The tax gap was most recently estimated by the Internal Revenue Service (IRS) for the year 2006 to be

[1] Tax gap articles and reports abound. For a smattering of such literature, see Heather Bennett, *IRS Must Get Grip on Tax Gap, Taxpayer Advocate Says*, 106 TAX NOTES 531 (2005); *Dustin Stumper, Everson Pledges to Narrow Growing Tax Gap*, 110 TAX NOTES 807 (2006); George K. Yin, *JCT Chief Discusses the Tax Gap*, 107 TAX NOTES 1449 (2005); JAMES M. BICKLEY, CONG. RESEARCH SERV., R42739, TAX GAP, TAX COMPLIANCE, AND PROPOSED LEGISLATION IN THE 112TH CONG. (2012), *available at* https://www.fas.org/sgp/crs/misc/R42739.pdf; JAMES M. BICKLEY, CONG. RESEARCH SERV., RL338882, TAX GAP AND TAX ENFORCEMENT (2007), *available at* http://assets.opencrs.com/rpts/RL33882_20070216.pdf; INTERNAL REVENUE SERV. & DEP'T OF THE TREASURY, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE (2007) [hereinafter 2007 TAX GAP STUDY], *available at* http://www.irs.gov/pub/irs-news/tax_ gap_report_final_080207_linked.pdf; OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP (2006), *available at* http://www.irs.gov/pub/irs-news/comprehensive_strategy.pdf.

[2] *See* Eric Toder, *What Is the Tax Gap?*, 117 TAX NOTES 367 (2007); Mark J. Mazur & Alan H. Plumley, *Understanding the Tax Gap*, 60 NAT'L TAX J. 569 (2007); Robert E. Brown & Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement*, 56 NAT'L TAX J. 689 (2003); Nina E. Olson, *Closing the Tax Gap: Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 STAN. L. & POL'Y REV. 7 (2009).

$450 billion annually.[3] This is a stunning dollar amount. Indeed, were the IRS to completely close this gap, the agency would come close to eliminating the nation's annual federal government budget deficit.[4]

Over time and in absolute dollar amounts, the tax gap's size has progressively grown. The first IRS estimates of the tax gap were for 1973 and indicated a gross individual and corporate income tax gap of $28 billion to $32 billion.[5] Subsequent estimates throughout the 1970s and 1980s indicated a steady growth in the tax gap.[6] By the time the IRS released updated estimates for 1992 for the individual income tax, the gross tax gap had increased to over $93 billion.[7] Since then, the tax gap has continued to grow to where it is today (i.e., $450 billion).[8] The general sentiment among most observers is that this trend will likely continue and perhaps even worsen.[9]

However, the predictions of a persistent and steadily growing tax gap are in all likelihood wrong. Instead, it seems far more probable that the tax gap will diminish in size in the future. This prediction is based upon the following three significant trends. First, the use of credit cards, debit cards, and smartphone payment apps has become much more prevalent in economic commerce. This manner of conducting economic transactions creates an electronic (and traceable) trail of commerce and simultaneously subverts the driving engine behind many tax evasion activities, namely, the use of cash.[10] Second, governments around the world, including the United States, have added new third-party compliance measures that take advantage of computer advances to monitor taxpayer economic activities so that the opportunity for taxpayers to pay less than they owe by mistake or by subterfuge has been and will continue to be

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[3] *See* Press Release, Internal Revenue Service, IRS Releases New Tax Gap Estimates: Compliance Rates Remain Statistically Unchanged from Previous Study (Jan. 6, 2012) (IR-2012-4), *available at* http://www.irs.gov/pub/irs-news/ir-12-004.pdf.

[4] *See* CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK, 2016–2026 (2016), *available at* https://www.cbo.gov/publication/51129 (indicating that the 2015 FY deficit for the federal government was $439 billion and rose to $544 billion in FY 2016 and projecting that the deficit will increase over the next decade).

[5] *See* INTERNAL REVENUE SERV., PUBLICATION 7285: INCOME TAX COMPLIANCE RESEARCH: GROSS TAX GAP ESTIMATES AND PROJECTIONS FOR 1973–1992 (1988).

[6] *See* INTERNAL REVENUE SERV., PUBLICATION 1415: FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992, at 5 (rev. Apr. 1996), *available at* https://www.irs.gov/pub/irs-soi/p141596.pdf; Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 NAT'L TAX J. 345, 345 (1985) (estimating a $90 billion tax gap for 1981).

[7] *See* INTERNAL REVENUE SERV., *supra* note 6, at v.

[8] *See* CONG. BUDGET OFFICE, *supra* note 4. The IRS plans to release an updated tax gap study in spring 2016.

[9] *See, e.g.*, Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 574 (2006) ("This shortfall—the so-called tax gap—is not only large, but has more than tripled over the past two decades and continues to grow.").

[10] *See supra* Part III.A.

dramatically reduced.[11] Third, as business enterprises have grown in magnitude—in many instances eradicating small businesses—there is more direct and indirect tax compliance oversight. [12]

This analysis proceeds as follows. Section II provides an overview of the tax gap. Section III details each of the trends that, together, should cause the tax gap to narrow. Section IV discusses the possible implications associated with a narrower tax gap. Section V concludes, acknowledging that while there exist some countervailing tendencies toward tax noncompliance, the stronger trends are those acting to reduce the tax gap.

II. AN OVERVIEW OF THE TAX GAP

At the outset, it is important to differentiate tax avoidance from tax evasion. Taxpayers may participate in legal "tax avoidance" activities, such as income splitting, postponement of taxes, and tax arbitrage across income that faces different tax treatment, all of which minimizes one's tax liability.[13] In contrast, the term "tax evasion" refers to illegal and intentional actions taken by taxpayers to circumvent their legally due tax obligations,[14] by underreporting incomes, overstating deductions, exemptions, or credits, failing to file appropriate tax returns, and even engaging in barter. Most often these actions are viewed through the lens of the individual income tax, but these types of action can clearly be taken to mitigate other forms of taxation.[15] It is the existence of tax evasion, not tax avoidance, that creates what is termed the "tax gap."[16]

The tax gap is defined by the IRS as the amount of tax liability legally incurred by taxpayers that is not paid in a timely manner; more precisely, the tax gap is the difference between tax revenues actually collected in any given year and the amount that should be

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[11] *See supra* Part III.B.

[12] *See supra* Part III.C.

[13] BLACK'S LAW DICTIONARY 1500 (8th ed. 2004).

[14] *Id.* at 1501.

[15] For example, regarding the corporate income tax, firms can underreport income, overstate deductions, or fail to file tax returns, just as individuals do in the realm of the individual income tax. Similarly, sales taxes present numerous opportunities for evasion. Individuals can attempt to evade a jurisdiction's sales taxes on specific commodities by purchasing them in other neighboring areas and then consuming them in the relevant jurisdiction without paying the required use tax, and individuals can simply evade taxes on intangible services. *See* Richard Thompson Ainsworth, *Zappers: Technology-Assisted Tax Fraud, SSUTA, and the Encryption Solutions*, 61 TAX LAW. 1075 (2008). A broad-based retail sales tax is certain to include significant exemptions (e.g., food, health, education, and services), thereby creating individual and firm incentives for evasion. For a value-added tax, firms can present fraudulent invoices that allow them to understate their tax liabilities, or they can simply fail to register (especially if their value-added tax is high, as is the case with service providers); individuals may even seek to register as firms to disguise their own personal consumption of purchased inputs. Michael Keen & Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 109 NAT'L TAX J. 861 (2006).

[16] *See supra* notes 1, 2.

collected if taxpayers fully complied with the tax laws.[17] In the most recent 2006 estimates from the IRS, the tax gap consists of three separate components: (1) the "nonfiling gap" (i.e., taxes not paid by taxpayers who do not file a return at all or, alternatively, who file after the due date), (2) the "underreporting gap" (i.e., taxes not paid by taxpayers who file a return but misreport their true tax liability), and (3) the "underpayment gap" (i.e., taxes reported on filed tax returns that are not timely paid by taxpayers).[18]

As a compendium of these three components, the IRS has published what it refers to as the Tax Gap Map (see attached appendix),[19] which graphically highlights the extent to which each of the components contributed to the overall tax gap in 2006. Furthermore, the map breaks down each component by type of tax (i.e., individual income tax, corporate income tax, employment tax, estate tax, and excise tax) to illustrate the specific types of taxes that are nonfiled, underreported, or underpaid.[20]

The map shows that, by far, the largest component of the 2006 tax gap was the underreporting gap (equal to $376 billion), which comprised approximately 83.5 percent of the entire tax gap. The largest contributor to the underreporting gap was underreporting of the individual income tax (equal to $235 billion). Due to the severity of the underreporting gap, the map breaks down that component even further, exposing the fact that the largest contributor to underreported individual income tax was unreported business income (equal to $122 billion).[21]

While all tax gap estimates appear to be "precise," the true "accuracy" of these dollar estimates, needless to say, is subject to much uncertainty.[22] Consider the particular challenges associated with estimating the underreporting gap: tax evasion is illegal, and taxpayers have strong incentives to conceal their cheating, particularly given financial and other penalties that are imposed on those who are found purposefully shortchanging their taxes. The approach that the IRS historically has used to compute its estimate of the underreporting gap was based largely upon what is termed the "direct" measurement of evasion via actual audits of individual

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[17] *See supra* notes 1, 2.

[18] *See* George K. Yin, *Principles and Practices to Enhance Compliance and Enforcement of the Personal Income Tax*, 31 VA. TAX REV. 381 (2012); Rosemary D. Marcuss, *Understanding Compliance: What's the Tax Gap Got to Do with It?*, 133 TAX NOTES 887, 892 (2011).

[19] *See* Tax Gap Map, *available at* http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf.

[20] *See* Yin, *supra* note 18, at 385 ("The three largest elements of the underreporting gap were underreporting of the [personal income tax] ($235 billion, or 62.5% of the underreporting gap), employment taxes ($72 billion, or 19.1% of the underreporting gap), and the [corporate income tax] ($67 billion, or 17.8% of the underreporting gap).").

[21] Over time, these statistics have generally remained the same. *See supra* notes 5–6.

[22] *See, e.g.,* Toder, *supra* note 2, at 372 ("Nonetheless, a large amount of uncertainty must be assigned to the current tax gap estimate."); *see generally* TREASURY INSPECTOR GEN. FOR TAX ADMIN., SOME CONCERNS REMAIN ABOUT THE OVERALL CONFIDENCE THAT CAN BE PLACED IN INTERNAL REVENUE SERVICE TAX GAP PROJECTIONS (2006) (2006-50-077), *available at* https://www.treasury.gov/tigta/auditreports/2006reports/200650077fr.html.

returns.[23] For example, from 1965 to 1988 the IRS conducted detailed line-by-line audits of a stratified random sample of roughly 50,000 individual tax returns on a three-year cycle via its Taxpayer Compliance Measurement Program (TCMP).[24] These audits yielded an IRS estimate of the taxpayer's "true" income, which the agency could then compare to "actual" reported items. The TCMP has now been replaced by the National Research Program (NRP),[25] which examines roughly 46,000 randomly selected individual returns for selected years (which, to date, include 2001 and 2006), only some of which were subject to line-by-line audits. It is these NRP data that have been used for the more recent IRS estimates of the tax gap.[26]

With respect to the remaining two components of the tax gap, namely, the underpayment gap and the nonfiling gap, the difficulty of measurement varies. It is relatively easy to compute the underpayment gap, which is simply the difference between how much tax is reported by taxpayers and how much they actually pay on time.[27] It is far more challenging to estimate the nonfiling gap, which results from comparing the overall tax-filing population with those who actually file and estimating the tax that nonfilers would owe less the tax that they may have paid via source withholding.[28]

For decades, the tax gap has plagued the nation's finances. Its presence has a variety of harmful economic effects. The most obvious impact is that it contributes to larger federal government budget deficits, forcing either spending cuts or tax increases. The reduction in tax collections affects the taxes that compliant taxpayers face and the public services that they receive. The tax gap also has more subtle effects beyond these revenue losses. For example, when taxpayers alter their behavior to cheat on their taxes, such as in their choices of hours to work, occupations to enter, and investments to undertake, they create misallocations in resource use that affect the economy.[29] Furthermore, the tax gap alters the distribution of income in

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[23] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-753, TAX COMPLIANCE: BETTER COMPLIANCE DATA AND LONG-TERM GOALS WOULD SUPPORT A MORE STRATEGIC IRS APPROACH TO REDUCING THE TAX GAP (2005), *available at* http://www.gao.gov/assets/250/247137.html.

[24] *Id.* ("TCMP started with tax year 1963 and examined individual returns most frequently—generally every 3 years—through tax year 1988. IRS contacted all taxpayers selected for TCMP studies.").

[25] Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255 (2003).

[26] *Id.*

[27] The IRS estimates the underpayment gap using internal IRS tabulations. *See* INTERNAL REVENUE SERV., *supra* note 5.

[28] The IRS estimates the nonfiling gap using its own data and that supplied by the Census Bureau. *See* 2007 TAX GAP STUDY, *supra* note 1.

[29] For attempts to estimate these efficiency effects, see James Alm, *The Welfare Cost of the Underground Economy*, 23 ECON. INQUIRY 243 (1985); Jonathan R. Kesselman, *Income Tax Evasion: An Intersectoral Analysis*, 38 J. PUB. ECON. 137 (1989). For a more recent effort to estimate these efficiency effects, see James Alm, *Analyzing and Reforming Tunisia's Tax System*, *in* COMPARATIVE ECONOMIC PERSPECTIVES ON EUROPE AND THE MENA REGION (M. Mustafa Erdogdu ed., 2016). Also, for an analysis of the efficiency effects of information

arbitrary, unpredictable, and unfair ways since some taxpayers are better able to exploit the tax system than others.[30] The tax gap may also contribute to feelings of unjust treatment and disrespect for the law,[31] requiring the government to expend resources to detect noncompliance, to measure its magnitude, and to penalize its perpetrators. It even affects the accuracy of macroeconomic statistics since the presence of large amounts of tax evasion means that official measures of output likely omit much economic activity.[32] More broadly, it is not possible to understand the true impact of taxation without recognizing the existence and the effects of the tax gap.

To date, the U.S. tax gap has proven largely resistant to efforts to reduce its size, and the experience of other countries around the world is similar.[33] Even so, we argue that there are emerging forces that seem likely to reduce the tax gap in future years. In the next section, we discuss these trends.

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exchange, see Luca Marchiori & Olivier Pierrard, *Unlocking the Gates of Paradise: General Equilibrium Effects of Information Exchange* (Central Bank of Luxembourg, Working Paper, 2016).

[30] For a recent attempt to estimate these distributional effects, see Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 NAT'L TAX J. 397 (2010).

[31] In the analysis of tax evasion behavior, there are many approaches that attempt to explain behavior by incorporating various related notions of unjust treatment and disrespect for the law, most of which have their origins in the psychology of taxation. For example, some theorists suggest that taxpayer "trust" in government affects compliance behavior. James Alm & Benno Torgler, *Do Ethics Matter? Tax Compliance and Morality*, 101 J. BUS. ETHICS 635 (2011). Others adopt a slightly different terminology and explore the interaction between enforcement effort ("power") and facilitation ("trust") on the part of the tax authority. Erich Kirchler, Erik Hoelzl & Ingrid Wahl, *Enforced Versus Voluntary Tax Compliance: The "Slippery Slope" Framework*, 29 J. ECON. PSYCHOL. 210 (2008). Still others suggest that people may choose to comply willingly ("committed compliance") or unwillingly ("capitulative compliance"), they may take full advantage of the law in minimizing their taxes ("creative compliance"), or they may choose noncompliance; depending upon these choices, appropriate enforcement policies vary. DOREEN MCBARNET, CRIME, COMPLIANCE, AND CONTROL (2004). Finally, others argue that individuals are motivated either by "deference" or "defiance" motives and that enforcement actions should be tailored to reflect these different motivations. VALERIE BRAITHWAITE, DEFIANCE IN TAXATION AND GOVERNANCE—RESISTING AND DISMISSING AUTHORITY IN A DEMOCRACY (2009).

[32] *See* Friedrich Schneider & Dominik H. Enste, *Shadow Economies: Size, Causes, and Consequences*, 38 J. ECON. LITERATURE 77 (2000).

[33] *See* Richard Murphy, *Closing the European Tax Gap* (2012) *available at* http://www.socialistsanddemocrats.eu/sites/default/files/120229_richard_murphy_eu_tax_gap_en.pdf (explaining the severity of the European tax gap and why it is so challenging to close).

III. TRENDS THAT WILL NARROW THE TAX GAP

There are many commentators and politicians who contend that taxpayer noncompliance is so embedded in the nation's fabric that it is virtually impossible to reverse.[34] In other words, it is said, given the economic incentives for cheating, those taxpayers who purposefully shortchange the government are not apt to undergo a metamorphosis anytime soon and start paying their legally due taxes. Furthermore, the IRS lacks the resources not only to detect noncompliance in a comprehensive fashion but also to prosecute the agency's claims to the full extent of the law; even if the IRS were inclined and able to do so, the political backlash would be massive and negative. As a result, many believe that the tax gap will persist and even grow over time.[35] Those taxpayers who act unscrupulously and whose actions are met with impunity are likely to continue in their behavior, and other taxpayers who learn of these derelictions may start to behave in a similarly noncompliant way.[36]

However, notwithstanding these points, there are three external forces that should cause the tax gap to narrow over time: (A) the rise of electronic commerce, (B) information availability via computerization, and (C) a shifting labor force.

A. The Rise of Electronic Commerce

The use of physical currency to transact commerce has a long history, dating back at least four millennia.[37] Its use constitutes a tremendous advancement from the economic system of barter that predated it.[38] Notwithstanding the virtues of physical currency to facilitate business transactions, currency use suffers from a fundamental flaw from a tax compliance perspective: it is virtually impossible to trace. As such, currency has been one of the underground economy's

[34] *See Closing the Tax Gap Without Creating Burdens for Small Businesses*: *Hearing Before the H. Comm. on Small Business*, 110th Cong. (2007); *Deconstructing the Tax Code: Uncollected Taxes and Issues of Transparency: Hearing Before the Subcomm. on Federal Financial Management, Government Information, and Internal Security of the S. Comm. on Homeland Security and Government Affairs*, 109th Cong. (2006).

[35] *See* Raskolnikov, *supra* note 9.

[36] *See* Benno Torgler, *Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments*, 16 J. ECON. SURV. 657, 663–66 (2002) (describing how group dynamics may contribute to tax noncompliance); Ernst Fehr & Urs Fischbacher, *The Economics of Strong Reciprocity*, *in* MORAL SENTIMENTS & MATERIAL INTERESTS: THE FOUNDATIONS OF COOPERATION IN ECONOMIC LIFE 167 (2005) ("[I]f people believe that cheating on taxes, corruption, or abuses of the welfare state are widespread, they themselves are more likely to cheat on taxes, take bribes, or abuse welfare state institutions.").

[37] *See Money*, *in* INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL SCIENCES 249–53 (William A. Darity Jr. ed., 2nd ed. vol. 5 2008).

[38] *See* Claire Priest, *Currency Policies and Legal Development in Colonial New England*, 110 YALE L.J. 1303, 1318 (2001) ("Pure barter creates essentially two impediments to economic activity that have been emphasized in the economic literature: the need for a 'double coincidence of wants,' and information problems associated with an economy without money prices.").

cornerstones.[39] Indeed, the magnitude of its use is one of the main metrics by which the size of the underground economy is often estimated.[40]

However, over the course of the last several decades, the use of electronic currency in commerce has experienced a meteoric rise, supplanting physical currency use. Electronic commerce comes in essentially three forms: credit cards, debit cards, and smartphone payment applications. These three commerce modes are of very recent vintage. In the mid-twentieth century, credit cards were introduced,[41] followed soon thereafter by the introduction of debit cards[42] and, just in the last decade, by smartphone payment applications.[43]

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[39] *See* Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 38 (2009) ("Underpayment of tax on business income is commonly attributed to the receipt of cash."); Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 506 (2007) (describing how those who participate in the cash economy (e.g., "comprised of non-franchise retail or restaurants, service providers, general contractors and similar businesses throughout the economy") generally do not pay tax or pay very little tax).

[40] *See, e.g.*, FRIEDRICH SCHNEIDER & DOMINIK H. ENSTE, THE SHADOW ECONOMY—AN INTERNATIONAL SURVEY (2002). More recently, see James Alm & Abel Embaye, *Using Panel Methods to Estimate Shadow Economies Around the World, 1984–1986*, 41 PUB. FIN. REV. 510 (2013). There are, in fact, various definitions of the "underground economy," also referred to as the "shadow economy," the "informal economy," and the "black economy," among other monikers. One definition is that the underground economy includes all economic activities that contribute to the officially calculated gross national (or domestic) product but that are not included in these accounts. Relatedly, the underground economy could be defined as all market-based but unreported income from the production of legal goods and services, either from monetary or barter transactions, that would normally be taxable if they were reported to the tax authorities. Perhaps the most widely accepted definition is that the shadow economy includes all market-based goods and services (legal or illegal) that escape inclusion in official accounts.

[41] *See* Mary Bellis, *Who Invented Credit Cards?*, ABOUT.COM (Mar. 17, 2015), http://inventors.about.com/od/cstartinventions/a/credit_cards.htm ("The inventor of the first bank issued credit card was John Biggins of the Flatbush National Bank of Brooklyn in New York. In 1946, Biggins invented the 'Charge-It' program between bank customers and local merchants. Merchants could deposit sales slips into the bank and the bank billed the customer who used the card.").

[42] *See* Eric Tilden, *A Detailed History of Debit Cards*, EHOW.COM (2016), http://www.ehow.com/about_5462528_detailed-history-debit-cards.html ("The First National Bank of Seattle issued the first debit card to business executives with large savings accounts in 1978. These cards acted like a check signature or a guarantee card, where the bank promised the funds would cover the transaction without the customer needing a check to complete the transaction.").

[43] *See* Associated Press, *A Cash Call*, ECONOMIST, Feb. 15, 2007, *available at* http://www.economist.com/node/8697424 ("Mobile phones are becoming an increasingly popular way to make all sorts of payments."). In some countries, such as Kenya, electronic commerce is essentially replacing cash. *See, e.g.*, Tom Standage, *Why Does Kenya Lead the*

The emergence of electronic currency as a means of payment strongly supports the proposition that the widespread use of cash to finance transactions may be coming to an end.[44] In the area of consumer purchases, comprehensive reports prepared by the Federal Reserve Bank of Boston utilize the annual Survey of Consumer Payment Choice for its findings.[45] In its 2012 report (the most recent year for which data are available), there are two stunning statistics. First, credit and charge card payments constituted 21.6 percent of all purchases, the highest level ever recorded.[46] Second, "the average stock of cash carried by an individual for transactions fell more than 30 percent in real terms since the mid-1980s (from $112 to $79) and the typical amount of a

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World in Mobile Money?, ECONOMIST, May 27, 2013, *available at* http://www.economist.com/blogs/economist-explains/2013/05/economist-explains-18:

> Launched in 2007 by Safaricom, the country's largest mobile-network operator, it is now used by over 17 [million] Kenyans, equivalent to more than two-thirds of the adult population; around 25% of the country's gross national product flows through it. M-PESA lets people transfer cash using their phones, and is by far the most successful scheme of its type on earth.

[44] *See* Catherine New, *Cash Dying as Credit Card Payments Predicted to Grow in Volume*, HUFFINGTON POST (June 7, 2012), http://www.huffingtonpost.com/ 2012/06/07/credit-card-payments-growth_n_1575417.html:

> What was once the most secure way to pay for things—hard cash—is increasingly becoming currency non grata in wallets and checkouts across the country. Airlines won't take it for in-flight snacks and a growing number of stores and restaurants like Standard Market, a new neighborhood market in Chicago, won't accept it. It's plastic or bust for consumers who want to do a transaction in these card-only places.
>
> Meanwhile, plastic cards purchases comprised 66 percent of all in-person sales, with nearly half of them, or 31 percent, made with debit cards, according to [Javelin Strategy & Research, a marketing research firm]. Last year shoppers used credit cards for 29 percent of point-of-sale purchases; Javelin expects that number to rise to 33 percent by 2017. Shoppers deployed gift cards and prepaid cards for 6 percent of purchases made with plastic last year. A mere 7 percent of transactions involved use of a paper check, with such transactions projected to drop further in the next few years.

See generally John Heggestaen, *Cash Is Fading and Checks are Dying as Smartphones and Tablets Change the Way We Pay*, BUS. INSIDER (Aug. 4, 2014), http://www.businessinsider.com/cash-is-fading-and-checks-are-dying-as-smartphones-and-tablets-change-the-way-we-pay-2014-8.

[45] *See* SCOTT SCHUH & JOANNA STAVINS, FED. RESERVE BANK OF BOSTON, THE 2011 AND 2012 SURVEYS OF CONSUMER PAYMENT CHOICES (Sept. 29, 2014) (Research Data Report No. 14-1), *available at* https://www.bostonfed.org/economic/rdr/2014/rdr1401.pdf.

[46] *Id.* at 5.

cash withdrawn by an individual from banks fell nearly 50 percent (from $261 to $132)."[47]

The implications for the underground economy of this decline in cash use are vast.[48] The use of electronic means of payment will almost certainly reduce the extent of the underground economy because individuals who once routinely hid their transactions via cash will now be stripped of this luxury. Every electronic payment leaves an indelible mark. These "marks" enable IRS auditors to accurately access income flows. To minimize their taxable income (e.g., the underreporting gap), taxpayers may continue to overstate their deductions and expenses (for which auditors can demand substantiation), but their income can no longer be readily hidden or camouflaged.

From a tax compliance perspective, academics have often called for the elimination or curtailment of the use of physical currency.[49] To date, politicians have yet to heed these calls for reform. For the foreseeable future, cash will thus remain a pillar of the nation's economy. Even so, its importance will almost certainly continue to diminish. And although there are differences between the underground economy and the tax gap, there are also clear overlaps. Thus, as the importance of cash diminishes, the tax gap should correspondingly narrow in size.

B. Information Availability via Computerization

Computers have opened the doors to information storage and utilization the likes of which are historically unparalleled; they can readily save large stocks of information and can comb through them at lightning speed.[50] This has resulted in a second trend, namely an unparalleled access to information.

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[47] *See* Tamás Briglevics & Scott Schuh, *U.S. Consumer Demand for Cash in the Era of Low Interest Rates and Electronic Payments* 1 (Fed. Reserve Bank of Boston, Working Paper 13-23, 2013), *available at* http://www.bostonfed.org/economic/wp/wp2013/wp1323.pdf.

[48] Even at the local coffee store, consumers are forgoing the use of cash. *See, e.g.*, Jeff Sommer, *Cheap Coffee and the Starbucks Premium*, N.Y. TIMES, Aug. 16, 2015, at B6 (Starbucks's chief executive reports that "mobile payments now represent 20 percent of all in-store transactions in our U.S. stores, more than double the figure from only two years ago.").

[49] *See, e.g.*, Jeffrey H. Kahn & Gregg Polsky, *The End of Cash, the Income Tax, and the Next 100 Years*, 41 FLA. ST. U. L. REV. 159 (2013).

[50] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-548, DATA MINING: FEDERAL EFFORTS COVER A WIDE RANGE OF USES 3 (2004), *available at* http://www.gao.gov/products/GAO-04-548 ("The use of [data mining] has been driven by the exponential growth in the volumes and availability of information collected by the public and private sectors, as well as by advances in computing and data storage capabilities."); Paul Schwartz, *Data Processing and Government Administration: The Failure of the American Legal Response to the Computer*, 43 HASTINGS L.J. 1321, 1335 (1992) ("The computer's remarkable ability to process and store vast quantities of information results from combining binary math with extraordinary advances in the design of circuits, software, and magnetic storage devices.").

Over the last several decades, Congress has put technology to use, requiring third-party tax information reporting throughout the economy.[51] Employers must issue Form W-2, in which wage income is reported to the IRS, to all employees.[52] Banks and brokerage firms must issue Forms 1099-INT and 1099-DIV to investors, reporting interest and dividend income.[53] Businesses must issue Form 1099-MISC to independent contractors, reporting payments for services rendered.[54] The failure to prepare and timely submit these tax information returns is subject to penalties that have become increasingly onerous.[55]

Consider a recent example of how Congress has capitalized upon technological advancements. For decades, upon the sale or disposition of taxpayers' investment assets, taxpayers often failed to accurately report their assets' tax bases in computing their gains and losses.[56] Sometimes this was due to a lack of good record keeping, other times this was due to ignorance of how the law applied (e.g., the effect of a stock split on the tax basis of a capital stock investment), and yet other times it was done intentionally to minimize a tax burden.[57] In 2008 Congress decided that taxpayers' tax basis misreporting was contributing too greatly to the tax gap. Because the vast majority of taxpayers held their marketable security investments with sophisticated third-party brokers who had the resources to track the tax basis that their clients had in their investment assets and who also understood how to apply intricate tax basis adjustments, Congress took action. Notwithstanding cries from the financial and banking industries that they faced a mountain of technical issues that could not be overcome, Congress passed legislation mandating that third-party brokers track the tax bases that their clients had in their investments and report these dollar figures on tax information returns.[58] This law has been in effect for several years, earning accolades from both the press and general public regarding its

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[51] *See* INTERNAL REVENUE SERV., *supra* note 5 ("Overall, compliance is highest where there is third-party information reporting and/or withholding. For example, most wages and salaries are reported by employers to the IRS on Forms W-2 and are subject to withholding. As a result, a net of only 1 percent of wage and salary income was misreported. But amounts subject to little or no information reporting had a 56 percent net misreporting rate in 2006."); Karen Setze, *Taxpayers Honest When Someone's Checking, Say IRS Officials*, 111 TAX NOTES 1216, 1216 (2006) ("[R]esults from the recently completed individual reporting compliance study for 2001 . . . showed that only 1.2 percent of wage income was underreported, 57 percent of nonfarm proprietor income was misreported . . . and 72 percent of farm income was misreported.").

[52] I.R.C. § 6051(a).

[53] *Id.* §§ 6049(a), 6042(a).

[54] *Id.* § 6041(a).

[55] *See id.* §§ 6721, 6722 (in the Trade Preferences Extension Act of 2015, Pub. L. No. 114-27, § 8(b) (2015), Congress recently increased the penalties for inaccurate information returns from $100 to $250).

[56] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-603, CAPITAL GAINS TAX GAP: REQUIRING BROKERS TO REPORT SECURITIES COST BASIS WOULD IMPROVE COMPLIANCE IF RELATED CHALLENGES ARE ADDRESSED (2006), *available at* http://www.gao.gov/new.items/d06603.pdf.

[57] *Id.*

[58] The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854–55 (requiring tax basis reporting beginning in the 2011 tax year).

administrative efficiencies.[59] It is also likely that there have been significant revenue gains from the law as basis misreporting has undoubtedly declined.

In light of technological advancements, the expansion of third-party tax information reporting shows no signs of abating. Congress has a powerful device at hand to monitor taxpayers' income far more accurately than when, for example, the ancient Egyptians had to use the Nile's height to gauge the amount of taxes that farmers were responsible for paying.[60] Due to its benefits, Congress has expanded[61] and will no doubt continue to expand third-party tax information reporting.[62]

As discussed in more detail below, the IRS has gained from these technological advancements and innovations in terms of (1) efficiency improvements and (2) overseas account reporting.

1. Efficiency Improvements

By capitalizing upon technological advancements, the tax administration process has made remarkable strides in efficiency. These improvements are essentially twofold in nature: ease of processing and increase in accuracy.

Consider first the ease of processing. In earlier, pre-computer times, the IRS would receive handwritten and typed tax returns; once received, the information populating these tax returns would be manually keypunched into computers, a truly labor-intensive task that was prone to transcription errors. In the technological era, this antiquated system of processing has been virtually eliminated. Now it only takes milliseconds for IRS computers to match third-party information returns with self-reported taxpayer declarations. Electronic filing enables millions of tax information returns prepared by third parties, with billions of individual entries, to be received, processed, and matched with the electronically received tax return counterparts submitted by taxpayers. In 2015 (for the 2014 filing season), close to 90 percent of individual income tax returns were filed electronically,[63] a percentage threshold that is anticipated to grow[64]

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[59] *See* Tara Siegel Bernard, *New Laws Take Guesswork Out of Investment Tax Liability*, N.Y. TIMES, Mar. 15, 2013, *available at* http://www.nytimes.com/2013/03/16/your-money/new-tax-laws-cover-cost-basis-of-investments.html?_r=0.

[60] Aristide Theodorides, *The Concept of Law in Ancient Egypt*, *in* THE LEGACY OF EGYPT 291, 292 (J. R. Harris ed., 2d ed. 1971).

[61] *See, e.g.*, I.R.C. § 6050W (requiring information reporting for certain credit and debit card transactions). *See generally* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010).

[62] *See, e.g.*, James Alm & Jay A. Soled, *Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance*, 40 OHIO N. L. REV. 693 (2014) (beyond marketable securities, Congress might consider extending third-party tax basis reporting to pass-through entity investments such as partnerships and S corporations).

[63] *See* INTERNAL REVENUE SERV., PUB. 3415: ELECTRONIC TAX DOCUMENT ADMINISTRATION ADVISORY COMMITTEE REPORT TO CONGRESS (rev. June 2015), *available at* http://www.irs.gov/pub/irs-pdf/p3415.pdf.

and will improve even further the ability of the IRS to more quickly gather information, more rapidly process this information, and more efficiently target its enforcement efforts.

From a tax compliance perspective, third-party tax information reporting expansion has not been for naught. Empirical evidence strongly supports the virtues of third-party tax information reporting: when third-party tax information return reporting is present (particularly when coupled with withholding), tax compliance is high.[65] The converse is also true: in the absence of third-party tax information return reporting, tax compliance plummets.[66]

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[64] *Id.*

[65] Through its audits, the IRS has established the Net Misreporting Percentage (NMP) for different sources of income, which measure the unreported (or "misreported") income as a fraction of the estimated "true" income. (To illustrate, suppose that unreported income equals $20 and reported income equals $80. Then the NMP equals ($20/[$20+$80]), or 20 percent.) As indicated in Table 1 below (for 2001), the IRS estimated that the NMPs are lowest for income types that are matched with third-party information sources and highest for nonmatched income types. *See* INTERNAL REVENUE SERV., TAX YEAR 2001 FEDERAL TAX GAP (EXTENDED VERSION) (IRS Office of Research, Analysis, and Statistics 2006), *available at* http://www.irs.gov/pub/irs-soi/01rastg07map.pdf. For example, the NMP for wages and salaries (which, aside from information return matching, e.g., Form W-2, is also subject to employer withholding), is virtually zero, at 1.2 percent.

TABLE 1

IRS Estimates of Net Misreporting Percentages, 2001 Tax Gap Estimates

Source of Income	**Net Misreporting Percentage (%)**
Wages and Salaries	1.2
Interest and Dividends	3.7
Pensions and IRA Income	4.1
Unemployment Income	11.1
S Corps, Partnerships, and Trusts	17.8
Capital Gains	11.8
Alimony Income	7.2
Nonfarm Business Income	57.1
Farm Income	72.0
Other Gains	64.4
Rent and Royalties	51.3
Other Income	63.5

Updated IRS estimates for the 2006 tax gap depict a largely similar pattern, although the updated estimates report the NMP only for broader income categories. *See* INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE TAX YEAR 2006 TAX GAP ESTIMATION (IRS Office of Research, Analysis, and Statistics 2012) [hereinafter 2006 TAX GAP ESTIMATION], *available at* http://www.irs.gov/pub/irs-soi/06rastg12overvw.pdf. Similar results apply for other years as well. *See, e.g.*, INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992 (IRS Office of Research, Analysis, and Statistics 1996), *available at* https://www.irs.gov/pub/irs-soi/p141596.pdf.

Consider next the heightened level of accuracy that is part and parcel of the electronic filing process. In the past, taxpayers had to rely on pencil and paper, abacuses, and calculators to compute their income, deductions, and credits—and ultimately their tax due. These modes of making numeric calculations had varying degrees of accuracy. In contrast, numeric calculations made by tax return preparation software are apt to be pluperfect.[67] This perfection largely eliminates the portion of the tax gap that was previously attributable to taxpayers' mathematical mistakes.

In the 21st century, the transformative nature of electronic filing is often taken for granted. However, one should not be blasé about it. Electronic filing enables millions of tax information returns prepared by third parties, with billions of individual entries, to be received, processed, and matched with their electronically received counterparts of the tax returns submitted by taxpayers. The manner and speed in which this matching is handled is unprecedented in the history of tax collection. Indeed this constitutes one of the pivotal reasons why the tax gap is likely to be narrowed in future years.

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[66] As indicated by Table 2 below, the NMPs for income that is not subject to third-party matching (e.g., nonfarm business income, farm income, other gains, and rent and royalties) exceed 50 percent. *See* 2006 TAX GAP ESTIMATION, *supra* note 65.

TABLE 2

IRS Estimates of Net Misreporting Percentages, 2006 Tax Gap Estimates

Type of Income	**Net Misreporting Percentage (%)**	**Percentage of Tax Gap (%)**
Subject to substantial information reporting and withholding (wages and salaries)	1	5.3
Subject to substantial information reporting (pensions and annuities, unemployment compensation, dividends, interest, Social Security benefits)	8	5.8
Subject to some information reporting (deductions, exemptions, partnerships and S corporation income, capital gains, alimony income)	11	30.9
Subject to little or no information reporting (nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income, adjustments)	56	58.0

[67] *E.g.*, *compare* INTERNAL REVENUE SERV., INTERNAL REVENUE SERVICE DATA BOOK 2014, at tbl.15 (2015), *available at* http://www.irs.gov/pub/irs-soi/14databk.pdf (reporting that the number of mathematical errors found on individual income tax returns for the 2013 filing season was 2,266,024), *with* INTERNAL REVENUE SERV., INTERNAL REVENUE SERVICE DATA BOOK 2008, at tbl.15 (2009), *available at* https://www.irs.gov/pub/irs-soi/08databkrevised.pdf (reporting that the number of mathematical errors found on individual income tax returns for the 2007 filing season was 3,670,071).

2. Overseas Account Reporting

It was not long ago that many taxpayers would park their investments overseas and then "forget" to report the income earned on these investments on their U.S. income tax returns.[68] Overseas investment venues that were especially popular included Switzerland and various Caribbean islands.[69] For decades, this practice generated massive tax revenue losses, augmenting the tax gap's size.[70] In theory, taxpayers who engaged in such subterfuge risked detection and punishment, including criminal prosecution.[71] However, the chances of detection were infinitesimally small, particularly in light of Swiss bank secrecy laws that made taxpayers' bank accounts seemingly inaccessible to the outside world.[72] Several developments, though, have largely removed the advantage that taxpayers once had in being able to hide their overseas income, developments related to information storage and information transmission.

Information Storage. By way of background, vast volumes of information can now be stored on hard drives, disks, thumb drives, and in the cloud. Computer users can prevent access to this sensitive information through the use of appropriate passwords, so-called firewalls, and other prophylactic measures. These efforts to safeguard information are sometimes successful; other times, they are not.

When it comes to income, overseas banks have historically retained this information electronically. The IRS has recently been able to gain access to this electronic information through two channels: from "rogue insiders," who are motivated by whistle-blower reward money or revenge[73] and from "rogue outsiders" (aka "hackers"), whose motivations are often

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[68] For a comprehensive overview of the problem, see JANE G. GRAVELLE, CONG. RESEARCH SERVICE, R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION (2015), *available at* https://www.fas.org/sgp/crs/misc/R40623.pdf.

[69] *See* PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. & GOV'T AFFAIRS, TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY, 109th Cong., at 9 (2006) ("This Report presents several case histories of persons who hid assets or shifted income to offshore jurisdictions, including Belize, the British Virgin Islands, the Cayman Islands, the Isle of Man, Nevis, and Panama.").

[70] *See* Susan C. Morse, *Tax Compliance Norm Formation Under High-Penalty Regimes*, 44 CONN. L. REV. 675 (2012); Joe Guttentag & Reuven Avi-Yonah, *Closing the International Tax Gap*, *in* BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION (Max B. Sawicky ed., 2006); David Cay Johnston, *Tax Cheats Called Out of Control*, N.Y. TIMES, Aug. 1, 2006, at B2; Martin A. Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956 (2004).

[71] I.R.C. § 7201.

[72] *See* Jeff Seff, *Cracking Down on Tax Evaders—Swiss Banking: Secrets, Lies, and Deceptions*, 38 S.U. L. Rev. 150, 173–75 (presenting an overview of the history of Swiss bank secrecy laws); Carolyn B. Lovejoy, *UBS Strikes a Deal: The Recent Impact of Wakened Bank Secrecy on Swiss Banking*, 14 N.C. BANKING INST. 435, 442–46 (2010) (same).

[73] *See* David Kocieniewski, *Get Out of Jail Free? No, It's Better*, N.Y. TIMES, Sept. 12, 2012, at A1 (describing how Bradley Birkenfeld disclosed the identity of many U.S. taxpayers who had hid assets in Swiss bank accounts and, as a result, was subsequently awarded a whistle-

elusive but who are determined to get this sensitive information into the public domain.[74] Whatever the case, the IRS is the benefactor of these rogue insiders and outsiders, obtaining unprecedented access to what was once veiled and secretive information.

In the aftermath of security information breaches at several financial institutions,[75] retail stores,[76] and even the IRS,[77] the general public has quickly learned that electronic information is not impermeable to leaks, wherever and however it is stored and safeguarded. Due to the vulnerabilities of detection, the risk of potential blackmail, and the threat of possible criminal prosecution, the allure of parking assets overseas has been greatly diminished. The massive number of taxpayers participating in the IRS's Voluntary Disclosure Program attests to the fact that this mode of hiding income has come to a virtual halt.[78]

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blower amount of $104 million); Laura Saunders & Robin Sidel, *Whistleblower Gets $104 Million*, WALL ST. J., Sept. 12, 2012, at C1 (same). As a direct result of the information Birkenfeld provided, UBS paid the U.S. government $780 million to avoid criminal prosectuion, and the bank agreed to turn over account information for over 4,500 U.S. taxpayers. Deferred Prosecution Agreement, United States v. UBS AG, No. 09-60033-CR-COHN (Fla. Dist. Ct. S.D. 2009), *available at* http://www.justice.gov/sites/default/files/tax/legacy/2009/02/19/UBS_Signed_Deferred_Prosecution_Agreement.pdf.

[74] *See, e.g.*, Michael S. Schmidt & Steven Lee Myers, *Panama Law Firm's Leaked Files Detail Offshore Accounts Tied to World Leaders*, NY TIMES at D2 (April 3, 2016), available at http://www.nytimes.com/2016/04/04/us/politics/leaked-documents-offshore-accounts-putin.html?_r=0.

[75] *See* Danny Yadron, Emily Glazer, & Devlin Barrett, *J.P. Morgan Hackers Attempted to Infiltrate Other Financial Institutions*, WALL ST. J., Oct. 6, 2014, *available at* http://www.wsj.com/articles/j-p-morgan-hackers-attempted-to-infiltrate-other-financial-institutions-1412637570.

[76] *See* Bill Hardekopf, *The Big Security Breaches of 2014*, FORBES, May 26, 2015, *available at* http://www.forbes.com/sites/moneybuilder/2015/01/13/the-big-data-breaches-of-2014/.

[77] *See* Elizabeth Weise, *IRS Hacked: 100,000 Accounts Breached*, U.S.A. TODAY, Oct. 6, 2014, *available at* http://www.usatoday.com/story/tech/2015/05/26/irs-breach-100000-accounts-get-transcript/27980049/.

[78] *See* Press Release, Internal Revenue Serv., IRS Says Offshore Effort Tops $5 Billion, Announces New Details on the Voluntary Disclosure Program and Closing of Offshore Loophole (June 26, 2012) (IR-2012-64), *available at* www.irs.gov/uac/IRS-Says-Offshore-Effort-Tops-$5-Billion,-Announces-New-Details-on-the-Voluntary-Disclosure-Program-and-Closing-of-Offshore-Loophole; Lovejoy, *supra* note 72, at 436 ("The recent changes in the interpretation of Swiss bank secrecy laws, as evidenced by the Deferred Prosecution Agreement with UBS, will likely cause: (1) irreparable harm to Swiss banking industry; (2) virtual elimination of tax avoidance techniques previously available to American depositors in Swiss banks; and (3) greater tax revenues for the U.S. government."). *See generally* Edward A. Morse, *Whistleblowers and Tax Enforcement: Using Insider Information to Close the "Tax Gap,"* 24 AKRON TAX J. 1 (2009).

Information Transmission. Congress did not want to leave to chance whether the IRS was able to detect evasion or whether rogue insiders or outsiders were sufficiently motivated to take disclosure action.[79] The legislative branch therefore recently took steps to help ensure compliance, steps that even a decade earlier were probably not technologically feasible.

The problem Congress sought to address was fairly simple. Unscrupulous taxpayers would park funds overseas and then, as disguised foreign investors, reinvest these funds in the United States.[80] By engaging in this transformation process, almost akin to money laundering, U.S. taxpayers could skirt their tax obligations and do so with virtual impunity.[81] In addressing these tax concerns, bilateral tax treaties, tax information exchange agreements, and Conventions in Mutual Administrative Assistance on Tax Matters with other countries had proven wholly inadequate.[82]

The congressional solution is embodied in the Foreign Account Tax Compliance Act (FATCA).[83] The salient features of FATCA are twofold. The first feature is a requirement that foreign financial institutions[84] provide detailed information to the IRS regarding their account

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[79] Aside from congressional legislative actions, the IRS has taken its own measures to use technology to detect noncompliance. *See* Richard Satran, *I.R.S. High-Tech Tools Track Your Digital Footprints*, U.S. NEWS & WORLD REP., Apr. 4, 2013, *available at* http://money.usnews.com/money/personal-finance/mutual-funds/articles/2013/04/04/irs-high-tech-tools-track-your-digital-footprints ("The Internal Revenue Service is collecting a lot more than taxes this year—it's also acquiring a huge volume of personal information on taxpayers' digital activities, from eBay auctions to Facebook posts and, for the first time ever, credit card and e-payment transaction records, as it expands its search for tax cheats to places it's never gone before."); ERIC TODER, URBAN INST. & URBAN-BROOKINGS TAX POL'Y CTR., REDUCING THE TAX GAP: THE ILLUSION OF PAIN-FREE DEFICIT REDUCTION 9 (July 3, 2007), *available at* http://www.taxpolicycenter.org/uploadedpdf/411496_reducing_tax_gap.pdf ("IRS has recently funded development of advanced computational and data mining techniques to detect patterns of flows between entities that suggest the possibility of abuse.").

[80] *See* Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, 34 BROOK. J. INT'L L. 783, 793 (2009).

[81] *See* STAFF OF JOINT COMM. ON TAXATION, TAX COMPLIANCE AND ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES, JCX-23-09, 111 th Cong., at 18 (2009), *available at* https://www.jct.gov/publications.html?func=startdown&id=3520.

[82] *Id.* at 50–58.

[83] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501–62, 124 Stat. 71, 97–118 (2010).

[84] I.R.C. § 1471(d)(5) defines "foreign financial institution" as any entity that

> (A) accepts deposits in the ordinary course of a banking or similar business
>
> (B) as a substantial portion of its business, holds financial assets for the account of others, or
>
> (C) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in section 475(c)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in section 475(e)(2)), or any interest (including a

holders. This information includes (i) whether the investor is a U.S. person (on the basis of due diligence procedures detailed in Treasury regulations);[85] and (ii) reporting annually (a) the name, address, and TIN of each U.S. account holder; (b) the account number; (c) the amount balance or value held in such account; and (d) the gross receipts and gross withdrawals or payments from the account during the year.[86] The second feature of FATCA is its extensive penalty withholding system. In broad terms, the Code now imposes a 30 percent withholding tax regime upon payments made to nonparticipating foreign financial institutions[87] and so-called recalcitrant account holders (i.e., those investors who choose not to disclose their national identity).[88] The scope of payments upon which withholding extends is extraordinarily broad and includes any U.S.-based payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.[89] Furthermore, the scope extends to "any gross proceeds from the sale or disposition of any property . . . which can produce interest or dividends from sources within the United States." [90]

The effects of FATCA are just beginning to emerge. While many foreign financial institutions and others have bemoaned FATCA's administrative burdens and the concomitant expenses,[91] from a tax compliance perspective, it brings incredibly important tax compliance information to light. No longer can foreign financial institutions blind themselves to the nationality of their investors; if they do, they risk having all of their investors subject to an onerous withholding tax regime related to their U.S. investments.

Overseas tax reform measures did not stop there. In the face of the financial crises and urged on by the Organisation for Economic Co-operation and Development (OECD), G20 countries convened a summit in early 2009. During the course of this summit, participating nations, under the threat of economic sanctions, urged many tax havens to sign bilateral tax

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> futures or forward contract or option) in such securities, partnership interests, or commodities.

[85] *Id.* § 1471(b)(1)(A).

[86] *Id.* § 1471(c)(1)(A)–(D).

[87] *Id.* § 1471(a).

[88] *Id.* § 1471(d)(6).

[89] *Id.* § 1473(1)(A)(i).

[90] *Id.* § 1473(1)(A)(ii).

[91] *See, e.g.*, Tracy A. Kaye, *Innovations in the War Against Tax Evasion*, 2014 B.Y.U. L. REV. 363, 363 (2014) ("FATCA garnered worldwide attention. The European Union expressed its concerns to the U.S. Treasury about the compliance burden on the financial industry and the conflict with EU Member States' laws on privacy and data protection."); *see also* Alison Bennett, *Tax Legislation: Dozens of Stakeholders from Around Globe Raise Concerns on FATCA Regime*, 29 TAX MGM'T WKLY. REP. (BNA) 1535 (2010); Dean Marsan, *FATCA: The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures—Managing This Risk (Part III),* 88 TAXES 27 (2011).

treaties that required the exchange of bank information.[92] By the end of 2009, erstwhile tax havens had signed more than 300 treaties, widely seen as one of the most significant actions against tax evasion via tax havens that had ever been undertaken.[93]

As a practical matter, then, taxpayers are finding it increasingly difficult to hide their income from tax authorities around the world.[94] In a nutshell, technological advancements have enabled Congress to pass laws that usher in a new era of tax transparency, eschewing past opaqueness.

C. A Shifting Labor Force

A third trend is that national economies are experiencing seismic labor force shifts. Individuals are increasingly gravitating toward work in ever-larger business enterprises. Compelling evidence for this proposition is found in reports from the U.S. Census Bureau.[95] The most recent report indicates that only 17.6 percent of the labor force now works for "very small enterprises" (defined as having fewer than twenty employees);[96] the rest of the labor force works for small, medium, and large enterprises.[97] Indeed, over half of the nation's labor force now works for "large enterprises" (defined as having 500 or more employees).[98] This trend began decades ago, and it has continued in recent years.

Some notion of the economic effects of this shifting labor force can be found in a simple illustration. Many supermarket chains are now trying to offer one-stop shopping. A case in point is a Shoprite Supermarket that recently opened in one of the authors' neighborhoods. Aside from

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[92] *See* ORG. FOR ECON. CO-OPERATION & DEV., THE ERA OF BANK SECRECY IS OVER: THE G20/OECD PROCESS IS DELIVERING RESULTS (2011), *available at* http://www.oecd.org/dataoecd/54/60/48996146.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 11-730, IRS'S INFORMATION EXCHANGES WITH OTHER COUNTRIES COULD BE IMPROVED THROUGH BETTER PERFORMANCE INFORMATION (2011), *available at* http://www.gao.gov/assets/590/585299.pdf.

[93] *See* Niels Johannesen & Gabriel Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, 6 AM. ECON. J.: ECON. POL'Y 65 (2014). These enforcement efforts have continued since then, albeit the exact effects of these treaties remain uncertain. *Id.*

[94] *See* Peter Eavis, *Finding the Good News in Widespread Tax Cheating*, N.Y. TIMES (April 5, 2016), *available at* http://www.nytimes.com/2016/04/06/upshot/finding-the-good-news-in-widespread-tax-cheating.html?_r=0 ("[S]ince 2011, around 20 governments have collected some $50 billion in additional taxes as a result of the anti-evasion efforts. Even the documents reported to be from [the Panama law firm charged with abetting tax fraud] showed a decline in the number of offshore companies set up by the firm. Ten years ago, the number was around 13,200; in 2015 it was just over 4,300."); *see generally* Susan C. Morse, *Ask for Help, Uncle Sam: The Future of Global Tax Reporting*, 57 VILL. L. REV. 529 (2012).

[95] *See* ANTHONY CARUSO, STATISTICS OF U.S. BUSINESSES EMPLOYMENT AND PAYROLL SUMMARY: 2012 (2015) (U.S. Census Report G12-SUSB), *available at* http://www.census.gov/content/dam/Census/library/publications/2015/econ/g12-susb.pdf.

[96] *Id.* at 1.

[97] *Id.*

[98] *Id.*

a cornucopia of food offerings commonplace in most national supermarket chains, this Shoprite Supermarket has several "sub-stores" under its roof: a fresh vegetable stand (including a farmers' market on Sundays), an enormous bakery, a deli that makes every variety of sandwich, wrap, and Panini, a complete oyster bar, a health food juicing stand, a salad bar that stretches several aisles, a gourmet coffee department staffed with knowledgeable baristas, a pizzeria that makes every variety of pizza, Stromboli, and calzone, a florist that has a broad array of floral offerings, and a sushi stand. This Shoprite Supermarket is open seven days a week from 7 a.m. until 11 p.m. and is open every day of the year, including Thanksgiving, Christmas, and New Year's Day.

The opening of this Shoprite Supermarket has had reverberations for many surrounding small businesses. For every dollar spent at this Shoprite Supermarket, there is correspondingly one less dollar spent at the local township's farmers' market, bakery, kosher deli, fish market, health food market, florist, and restaurants. Anecdotal evidence from these surrounding small business enterprises indicates that the economic stresses arising from the Shoprite Supermarket opening has put many of them at risk of closing.

This scenario is emblematic of a widespread global phenomenon in which mammoth-sized business enterprises such as Wal-Mart, Costco, and Home Depot have become commonplace fixtures dotting the urban, suburban, and rural landscapes throughout the country. These enterprises often have a crushing effect on the surrounding small business enterprises.[99] Study after study affirms this proposition, referred to, at least in the context of Wal-Mart, as the "Wal-Mart Effect."[100]

It is not our intention to evaluate the broader positive and negative economic effects of the rise of mammoth-sized business enterprises (e.g., consumers may pay less for their purchases,[101] jobs are created in the larger business enterprises but lost in the smaller ones, and/or employees' benefits may be meager[102]). However, from a tax perspective, this labor

[99] *See* Tatiana Schlossberg, *Manhattan's Corner Stores, A Neighborhood Staple, Struggling to Survive*, N.Y. TIMES, Aug. 4, 2015, at A18 ("Bodegas look for ways to stay open as rents rise and chain stores grow."); David Neumark, Junfu Zhang & Stephen Ciccarella, *The Effects of Wal-Mart on Local Labor Markets*, 63 J. URBAN ECON. 405, 428 (2008) ("On average, Wal-Mart store openings reduce retail employment by about 2.7 percent, implying that each Wal-Mart employee replaces about 1.4 employees in the rest of the retail sector.").

[100] *See* Emek Basker, *The Causes and Consequences of Wal-Mart's Growth*, 21 J. ECON. PERSP. 177, 178 (2007) ("Between 1963—one year after the first Wal-Mart store opened in Rogers, Arkansas—and 2002, the number of single-store retailers in the United States declined by 55 percent while the number of chain stores nearly doubled. The number of stores belonging to chains with 100 or more stores more than tripled over this period (U.S. Census Bureau, 1963, 2002).").

[101] *See* Emek Basker, *Selling A Cheaper Mousetrap: Wal-Mart's Effects on Retail Prices*, 58 J. URBAN ECON. 203 (2005).

[102] *See* Steve Greenhouse & Michael Barbaro, *Wal-Mart Memo Suggests Ways to Cut Employee Benefit Costs*, N.Y. TIMES (Oct. 26, 2005), *available at* http://www.nytimes.com/2005/10/26/business/walmart-memo-suggests-ways-to-cut-employee-benefit-costs.html?_r=0 ("A draft memo to Wal-Mart's board was obtained from Wal-Mart

market trend is clearly one that will lead to enhanced tax compliance. The reasons are threefold.

First, large businesses offer considerably fewer tax-evasion opportunities than small businesses. Because of the ease with which small business owners may collude to evade taxes,[103] they are notoriously tax noncompliant.[104] Indeed, the classic case of collusion is the sole proprietor who needs only to look in the mirror to decide (with his reflection) whether, for tax purposes, he should report, say, the $800 he received in cash proceeds from his business that day. With two owners, the need for collusion obviously makes evasion more challenging, but not insurmountable, particularly in those cases when the co-owners are married or siblings, with common economic interests. In contrast, because evasion opportunities are virtually nonexistent for employees of large-scale business enterprises, they are generally tax compliant.[105] Consider the fact that large business enterprises often are structured in a pyramid fashion, with each layer of the pyramid overseeing the one immediately below. This oversight greatly reduces the risk of collusion because, at every pyramid level, all employees know that employees at the oversight layer immediately above (i.e., their superiors) will require a full accounting for every dollar coming in and leaving the layer below.

Second, large business enterprises are predominantly publicly owned.[106] In such cases, the elected board of directors is held accountable to the shareholders and must demonstrate the profitability of the business enterprise. Because bonuses and pay raises are often tied to earnings, management generally will do everything within its power to show robust profits. Hiding income may contribute to profits, but evasion exposes management to condemnation (or worse) if discovered.

Third, and most importantly, large business enterprises have special reporting obligations

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Watch, a nonprofit group, allied with labor unions, that asserts that Wal-Mart's pay and benefits are too low.").

[103] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1014, TAX GAP: A STRATEGY FOR REDUCING THE GAP SHOULD INCLUDE OPTIONS FOR ADDRESSING SOLE PROPRIETOR NONCOMPLIANCE 10 (2007), *available at* http://www.gao.gov/assets/270/265399.pdf ("[A]n estimated 70 percent of Schedule C filers in 2001 (about 12.9 million) made an error when reporting net business income (that is, net profit or loss on line 31 of Schedule C). Most of the misreporting was underreporting. . . . [A]n estimated 61 percent of Schedule C filers underreported their net income and 9 percent overreported.").

[104] *See, e.g.*, Kathleen Delaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Compliance*, 67 TAX L. REV. 111, 113 (2013) ("When combined with under-reported self-employment tax ($57 billion), individual small business noncompliance accounts for approximately $179 billion, or 40% of the total tax gap.").

[105] *See* INTERNAL REVENUE SERV., TAX GAP FOR TAX YEAR 2006, OVERVIEW 3, chart 1 (2012), *available at* http:// www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf (wages and salaries have a "net misreporting percentage" (defined as the ratio of net misreported income to true income) of 1 percent).

[106] *See* America's 500 Biggest Companies, TIME MAG., Oct. 30, 2014, *available at* http://time.com/3550055/fortune-500-2014/ (listing the nation's five hundred largest companies, the vast majority of which are publicly traded).

that dissuade tax noncompliance. These reporting obligations are reflected by two schedules that corporate taxpayers must complete as part of Form 1120 (U.S. Corporate Tax Return): Schedule M-1 (Reconciliation of Income (Loss) per Books with Income per Return)[107] and Schedule UTP (Uncertain Tax Position Statement). Schedule M-1 reflects differences between income reporting under generally accepted accounting principles and income reporting under the Internal Revenue Code; the larger the difference between these two dollar amounts, the more likely that the IRS will conduct an audit.[108] The heightened chance for an IRS audit presumably dissuades many taxpayers from taking aggressive tax positions. Schedule UTP functions in a similar manner. If, for federal income tax purposes, a "large" corporate taxpayer (defined as having $10 million of assets on its audited financial statements)[109] has audited financial statements in which it or a related party has recorded a reserve for an "uncertain" tax position (i.e., a position that it anticipates the IRS may challenge), the taxpayer must submit a Schedule UTP.[110] This reporting mandate assists the IRS in the detection process of aggressive tax return positions; and, like the Schedule M-1, it creates incentives for large-business-enterprise taxpayers to exercise caution.[111]

To date, there is little empirical information that directly supports the proposition that these three trends—the rise of electronic transactions, information availability via computerization, and a shifting labor force—are closing the tax gap. Nevertheless, there are compelling reasons to strongly suggest that this should soon be the case. On the whole, then, the tax gap may thus be finally meeting its match, not so much from IRS enforcement efforts per se but from these technological and economic trends.

IV. PUBLIC POLICY IMPLICATIONS

If the aforementioned trends do in fact work over time to reduce the tax gap, the public policy implications would be vast, with significant and far-reaching economic, political, and administrative dimensions. Consider each.

A. Economic Dimensions

Recall the range of economic effects associated with the tax gap's existence, starting with a loss in tax revenues and extending to inefficiencies in resource allocation and inequities in the

[107] Those corporations that report on Schedule L of Form 1120 total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year equaling or exceeding $10 million must file an even more detailed schedule, known as Schedule M-3 (Net Income (Loss) Reconciliations for Corporations with Total Assets of $10 Million or More).

[108] *See* Treasury Dep't, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, 1999 TAX NOTES TODAY 127-12 (1999); Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting of Income*, 55 TAX L. REV. 175 (2002).

[109] I.R.S. Ann. 2010-75, 2010-41, I.R.B. 428 (2010).

[110] INTERNAL REVENUE SERV., INSTRUCTIONS TO FORM 1120, SCHEDULE UTP 1 (2012).

[111] *See generally* Ilya A. Lipin, *Uncertain Tax Positions and the New Tax Policy of Disclosure Through the Schedule UTP*, 30 VA. TAX REV. 663 (2011).

tax burden.[112] A declining tax gap would clearly tend to reverse these effects. Put differently, if the existence of the tax gap affects revenue adequacy, resource allocation efficiency, and distributional equity of taxation, then a declining tax gap would have similar—but opposite—effects on these economic aspects.

Revenue Adequacy. The effects on tax collections are clear-cut. The existence of the tax gap generates substantial revenue losses;[113] if there is a declining tax gap, then this will generate additional revenues, which will allow a combination of increases in spending and decreases in other taxes.

Resource Allocation Efficiency. The effects on efficiency are more complicated. The existence of sectors to which resources may move to evade taxes means that taxes create incentives for such movement. This movement generates inefficiencies, commonly referred to as the "excess burden of taxation" and defined as welfare losses in excess of tax revenues actually collected. Put differently, the excess burden of a tax is a measure of the lost output due to the distorting effects of the tax.[114]

In the presence of taxation, labor, capital, and other factors of production have often migrated into the untaxed, or underground, economy to evade taxation, a migration that affects the production (as well as prices) of goods and services in the untaxed and taxed sectors. This movement of resources generates economic inefficiencies as there is an increase in the production of goods and services that are untaxed and there is a decline in goods and services that are taxed appropriately.

However, a decline in the tax gap means that the possibility of evading taxes via mobility into untaxed sectors is reduced. As a result, the resource misallocation described in the prior paragraph will be reversed, and there will be corresponding efficiency gains. While identifying these resource allocation efficiency effects requires a detailed computable general equilibrium

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112 *See supra* Part II.

113 *Id.*

114 The nature of the inefficiency of taxation can be illustrated by way of a simple example. Suppose that the advertised price for a new watch is $40 and suppose further that one person is willing to pay $55 for the watch and that another person is willing to pay $45. By paying the advertised price of $40, both individuals benefit, the first by $15 and the second by $5, for a total benefit of $20, which is called the *consumer surplus*. Now, consider what happens if an excise tax of $10 per watch is imposed. The watch will now cost $50. The person who was willing to pay $55 will still purchase the watch and pay a tax of $10, enjoying only a $5 benefit. The person who was willing to pay $45 will no longer purchase the watch because its cost ($50) is now greater than the amount he was willing to pay ($45). The tax has generated revenues of $10, but the tax has also made both individuals worse off: the consumer surplus has fallen by $15, from $20 to only $5. Because the $15 decline in consumer surplus is greater than the tax revenues of $10, there is an excess burden that equals the difference, or $5. Almost all taxes generate excess burden because most taxes cause taxpayers (and employers) to change their behavior. The overall losses to everyone in society constitute an estimate of the total excess burden, or the total efficiency loss, of taxes.

model of the economy, existing studies suggest that the efficiency gains from a reduction in the tax gap would be quite significant, potentially as large as 10 percent to 30 percent of taxes and between 3 percent and 7 percent of output.[115]

Closely related to these efficiency effects are their sectoral, occupational, and employment effects. As a general rule, resources migrate to those economic sectors that yield the highest returns, bearing in mind that taxes on sectors reverse the migration process as taxes dampen returns.[116] In the presence of the tax gap, this means that workers have an incentive to choose employment in those sectors where cash use predominates and taxes go unpaid. Assuming labor is mobile, labor will respond to taxes in the taxed sector by moving between the taxed and untaxed sectors until the net-of-tax return across the various sectors is equalized.[117] This movement affects the wages of labor in the different sectors, raising gross-of-tax wages in the taxed sector as labor flows away from this sector while simultaneously reducing wages in untaxed sectors as labor migrates into these sectors.[118] However, if the possibility of evading taxes is reduced as the tax gap declines, then mobility effects will be reversed.

Fully identifying these impacts once again requires a detailed general equilibrium model of the economy. A study conducted in another country, Colombia, demonstrates the mobility effects associated with tax evasion.[119] Using a general equilibrium model that divided the Columbian economy into four sectors (farming, urban/informal, urban/unskilled, and urban/skilled), the study found that high rates of labor taxation led to an overall increase in the number of unemployed workers and also increased employment in the informal sector. A decline in the tax gap would reverse the incentives for labor to migrate to the untaxed sector via its effects on the relative returns in the untaxed and taxed sectors.[120]

Distributional Equity. The existence of the tax gap also has major effects on the distribution of income, although these effects are generally misunderstood. The standard assumption underlying the incidence of tax evasion is that the successful evader retains the evaded income in its entirety so that the beneficiaries of evasion are its perpetrators.[121] However, this assumption is likely to be incorrect, or at least incomplete. Those who benefit from tax evasion are not necessarily the individuals actually engaging in evasion. Indeed, these participants may not financially benefit at all. In many situations, tax evasion can be viewed as a

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[115] James Alm & Edward B. Sennoga, *Mobility, Competition, and the Distributional Effects of Tax Evasion*, 63 NAT'L TAX J. 1055 (2010).

[116] *Id.*

[117] *Id.*

[118] There will also be an impact on the returns to other factors of production, product prices, and the overall unemployment rate. *Id.*

[119] *See* James Alm & Hugo Lopez-Castano, *Payroll Taxes in Colombia*, *in* FISCAL REFORM IN COLOMBIA—PROBLEMS AND PROSPECTS 191 (Richard Bird, James Poterba & Joel Slemrod eds., 2005).

[120] In another case study for Tunisia, similar sectoral effects were found. *See* Alm, *supra* note 29.

[121] The first and still classic analysis is by Michael Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972).

"tax advantage" generated by the tax laws; yet, if there is any advantage at all, then replication and competition via the mobility of factors and products will work toward the elimination of this advantage. Put differently, a general equilibrium process of adjustment should occur through changes in the relative prices of both commodities and factors of production as resources move into and out of the relevant activities, and these changes should tend to eliminate, or at least to reduce, the initial financial advantage associated with tax evasion.[122] These types of general equilibrium effects are not typically considered in the standard approach to tax evasion.

A simple case that demonstrates these effects is tax evasion by domestic help, such as housecleaners, babysitters, and yard-care workers. Tax evasion here may actually benefit the higher-income households hiring these services because the former can pay lower prices for the services of the latter. Two examples illustrate this point—one in which there is equal negotiating power between the parties and the other in which one of the two parties holds the upper hand.

First, suppose that a "service seeker" and a "service provider" are on equal footing in terms of negotiating power. Suppose further that a painter (the service provider) is willing to paint the home of an individual (the service seeker) for $10,000. If the painter were to report this income, assuming a 40 percent tax rate, then she would net $6,000 after taxes. The painter and the home owner could negotiate a cash price in which the painter will instead accept $8,000, which is untaxed due to the nature of the cash transaction. This arrangement leaves both the painter and the homeowner $2,000 richer. It is, of course, the government that loses $4,000 of revenue.

Second, suppose that the service seeker (e.g., a restaurant owner) has the upper hand in negotiating with the service provider (e.g., waiters) due to an excess supply of labor in the service market. Suppose that waiters who are "on the books" earn $15 per hour and pay 40 percent tax on their earnings (netting $9 per hour). Suppose also that a restaurant owner can hire waiters "off the books" by paying them $9 per hour. In this situation, the waiter who receives cash does not benefit from being paid off the books. Rather, it is only the restaurant owner who benefits, pocketing the $6 difference between the "on the books" $15 per hour rate and the "off the books" $9 per hour rate.

These two examples demonstrate how wages and prices are determined when the underground economy flourishes. More generally, these examples suggest how wages and prices are affected when the existence of tax evasion leads to a tax gap. If cash were no longer used in the transactions or if tax evasion were no longer a viable option, then there would be major impacts on product and factor prices, and thus on income distribution.

A complete analysis of these distributional effects requires a detailed computational general equilibrium model of an economy, and the precise distributional effects will, of course, depend on the specific circumstances. Still, existing work suggests that the ultimate distributional effects may differ significantly from the effects that assume no general equilibrium adjustments;

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[122] *See* Martinez-Vazquez, Jorge, *Who Benefits from Tax Evasion? The Incidence of Tax Evasion*, 1 PUB. ECON. REV. 105 (1996); James Alm & Keith Finlay, *Who Benefits from Tax Evasion?*, 43 ECON. ANALYSIS & POL'Y 139 (2013).

indeed, these studies indicate that taxpayers who successfully evade their tax liabilities often have a post-evasion welfare that is only marginally higher than their post-tax welfare if they had fully complied with the tax.[123] Further, those taxpayers who evade their taxes retain only about three-fourths of their initial increase in welfare, while one-fourth of their initial gains disappear as a result of mobility that reflects competition and entry into the informal sector.[124] Consequently, and consistent with the erosion of the initial benefits of tax evasion via general equilibrium adjustments, the evading taxpayers only marginally benefit from successful tax evasion; furthermore, this advantage diminishes with mobility via competition/entry in the informal sector, and at least some of the benefits of tax evasion are shifted to consumers and to other factors.

In a broad sense, general equilibrium calculations demonstrate that the gains from evasion are shifted at least in part from the evaders to the consumers of their output via lower prices as general equilibrium mobility effects work through relative price and productivity changes to eliminate the incentive for workers to enter the untaxed sector. As more workers enter the untaxed sector, their production pushes down the relative price of the informal sector output and consequently the hourly returns; the movement of workers between the sectors also changes the relative productivity of workers in each sector as capital also moves between the sectors. In equilibrium, therefore, the marginal entrant to the untaxed sector has the gains from evading taxes offset by the relative price and productivity effects. If the existence of the tax gap generates these effects, then a declining tax gap will reverse them.

B. Political Dimensions

In recent decades, a common political refrain has been the claim that there is no need to raise taxes or to cut spending.[125] Instead, politicians have often asserted that the nation may collect additional revenues simply through enhanced tax compliance.[126] If the tax gap is truly

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[123] *See supra* note 115.

[124] *Id.*

[125] In the most famous of these declarations, in 1988 then presidential hopeful George H. W. Bush declared: "Read my lips: no new taxes." Benjamin C. Ayers, C. Bryan Cloyd & John R. Robinson, *Read My Lips . . .: Does the Tax Rhetoric of Presidential Candidates Affect Security Prices?*, 48 J.L. & ECON. 125 (2005).

[126] *See, e.g.*, PRESIDENT'S ECON. RECOVERY ADVISORY BD., REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAX 53–64 (2010) (outlining compliance recommendations that would yield more tax revenue). To achieve this objective, some have said that the IRS must offer better taxpayer service. *See* 2007 TAX GAP STUDY, *supra* note 1, at 4 ("Service is especially important to help taxpayers avoid unintentional errors. 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 post-filing contacts, allowing the IRS to focus enforcement resources on taxpayers who intentionally evade their tax obligations."). Others have contended that a better-funded IRS armed with stronger enforcement tools will galvanize more robust tax compliance. *See* TODER, *supra* note 79, at 1 ("For example, in the 1988 presidential campaign, Democratic candidate Michael Dukakis called for more tax enforcement as a means of reducing the budget deficit and cited his success in improving tax

closing, then this would have a monumental impact on political discourse of this nature.

On a superficial level, the nature of political discourse itself would have to adjust. Politicians who have routinely signed "no new tax" pledges[127] yet promised vast public infrastructure improvements funded with additional tax revenue would have to rethink their financing strategies. Put differently, the reliance in political debate upon what many politicians commonly believe to be, or at least describe as, "low hanging fruit" (e.g., closing the tax gap) would disappear.

On a more substantive level, politicians would have to consider the need to raise additional revenue, enact budget cuts, or let the federal budget deficit grow. The existence of a large tax gap has always served a political convenience. The standard mantra has been something like this: "We do not need to raise taxes to finance expenditures—we simply need to enforce the tax laws that are already on the books." However, if the decline in the tax gap eliminated this option, then politicians would have to confront difficult political choices. Would they raise marginal tax rates? Would they cut their favorite spending program? Would they recommend more borrowing, including the associated higher debt limit? Politicians would now have to confront more realistic means of dealing with these and similar questions.

Over the past several decades, the existence of the tax gap has served the needs of politicians on both sides of the political aisle: politicians on the left or on the right could advocate more spending financed by the "costless" method of eliminating the tax gap without incurring the wrath of groups like Americans for Tax Reform, which regard higher tax rates as a broken pledge. However, as the tax gap narrows, the political dynamics will change. If politicians want to extract additional revenue without the "free lunch" of the tax gap, they will have to rethink their approach, including changes in various administrative policies of the IRS, as discussed in the next section.[128]

C. Administrative Dimensions

For the past several decades, the IRS has endured constant scrutiny regarding its ability

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compliance in Massachusetts as a model of what might be accomplished at the federal level."); Eric Katz, *After Years of Cutting Funding, Republicans Seek to Privatize Part of the IRS*, GOV'T EXECUTIVE, July 22, 2015, *available at* http://www.govexec.com/management/2015/07/after-years-cutting-funding-republicans-seek-privatize-part-irs/118365/ ("'The real scandal around the IRS is that they have been so poorly funded that they cannot go after these folks who are deliberately avoiding tax payments,' Obama said in an appearance on *The Daily Show with Jon Stewart* Tuesday evening.").

[127] *See* Dominic Tierney, *Grover Norquist and the Unbreakable Vow*, ATLANTIC, Dec. 12, 2012, *available at* http://www.theatlantic.com/politics/archive/2012/12/grover-norquist-and-the-unbreakable-vow/266513/.

[128] *See* Toder, *supra* note 79, at 20 ("Costs of closing the tax gap include IRS budgetary costs and compliance burdens on taxpayers and third parties. Decisions about increasing IRS enforcement and imposing additional requirements must balance expected improvements in compliance against these additional costs.").

to monitor taxpayer compliance and to provide meaningful deterrence. This scrutiny has traditionally been measured by a simple metric: the percentage of audits that the agency was able to conduct.[129] Based upon this metric, the IRS does not seem too adept. At least in the general public's eyes, the agency has appeared to be faltering as audit levels have plummeted, hovering at historic lows.[130]

It is hardly surprising that over the past decade the IRS has conducted fewer audits. The agency's budget has either shrunk or stagnated, causing the number of IRS staff to dwindle.[131] Simultaneously, the number of individual income (and other) tax returns keeps growing.[132] In addition, the agency has been charged with a plethora of added responsibilities, including the task of implementing and overseeing the Affordable Care Act.[133]

In theory, the nation appears poised to be beset with rampant taxpayer noncompliance as the IRS has been financially crippled and its duties greatly expanded. However, to date this has not happened. At least as evidenced by the prior tax gap studies, the percentage of noncompliant

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[129] *See* Suzanne Woolley, *2015 Is the Best Year Yet to Date to Cheat on Your Taxes*, BLOOMBERG BUSINESS (Jan. 15, 2015), http://www.bloomberg.com/news/articles/2015-01-15/2015-is-the-best-year-yet-to-cheat-on-your-taxes ("For some filers or their tax preparers [because the anticipated 2015 audit rate is projected to be so low], this all might seem like license to experiment with a more aggressive strategy.").

[130] *See* INTERNAL REVENUE SERV., FISCAL YEAR 2014 ENFORCEMENT AND SERVICE RESULTS (May 2015), *available at* http://www.irs.gov/PUP/newsroom/FY-2014%20Enforcement%20and%20Service%20Results%20--%20web%20version.pdf (depicting a decline in the audit rate with an anemic 0.86 percent audit rate for 2014, its lowest rate in ten years).

[131] Howard Gleckman, *The War on the IRS: Congress Cuts Its Funding to the Lowest Level Since 1998*, FORBES, Dec. 16, 2014, *available at* http://www.forbes.com/sites/beltway/2014/12/16/the-war-on-the-irs/ ("The massive 2015 spending bill that President Obama is likely to sign this week continues an ongoing effort to trash the Internal Revenue Service. It is a cynical recipe for a self-fulfilling disaster: Give the agency more and more work. Cut its budget. Blame it for failing to do its job. Repeat."); GOV'T ACCOUNTABILITY OFFICE, GAO-13-151, TAX GAP: IRS COULD SIGNIFICANTLY INCREASE REVENUES BY BETTER TARGETING ENFORCEMENT RESOURCES 1 (2012), *available at* http://www.gao.gov/assets/660/650521.pdf.

[132] *See* INTERNAL REVENUE SERV., *supra* note 130 (in eight of the last ten years, the number of individual income tax returns submitted has increased).

[133] *See* Nat'l Taxpayer Advocate, *The IRS's Administration of the Affordable Care Act Has Gone Well Overall, but Some Glitches Have Arisen*, *in* FISCAL YEAR 2016 OBJECTIVES REPORT TO CONGRESS 38, 38 (vol. 1) (2015), *available at* http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2016-JRC/Area_of_Focus_3_IRS_Administration_of_ACA.pdf ("Overall, the IRS has done a commendable job of implementing the first stages of the Patient Protection and Affordable Care Act of 2009 (ACA), including developing or updating information technology systems, issuing guidance, and collaborating with other federal agencies.").

taxpayers has remained fairly constant.[134] These findings are not surprising. Indeed, as evidenced by Part III of this analysis, the trend will likely be toward greater tax compliance as opportunities for noncompliance become fewer and farther between.

Assuming that the tax gap is narrowing, the implications for the IRS are vast. Consider the fact that conducting audits is resource intensive in nature. With less need to conduct audits, the agency's resources would be liberated to achieve other objectives. In particular, rather than utilizing a sizable portion of its budget to conduct audits, the IRS could now concentrate its efforts on other pressing endeavors, including (1) the identification of unscrupulous tax return preparers, (2) the detection of identity theft perpetrators, and (3) the enhancement of IRS services to taxpayers.

1. Identification of Unscrupulous Tax Return Preparers

Given the complexity of the tax system, tax return preparers often play a pivotal role in the tax return submission process, assisting taxpayers in the fulfillment of this critical civic duty. Many tax return preparers are highly trained professionals (e.g., certified public accountants and lawyers); if and when they act unscrupulously, they risk suspension or loss of their professional licenses. Unfortunately, most tax return preparers lack any formal training and have little downside risk if they are derelict in their duties.[135]

By way of background, well over a century ago Congress decided that the Department of the Treasury should be able to regulate taxpayer representatives who practice before the agency, enacting what has become known as Circular 230.[136] Initially, this legislation enabled the

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[134] *See* Toder, *supra* note 2, at 372 ("With the caveat that estimates are very imprecise and the degrees of imprecision can change, we note that the measured tax gap has been quite stable over time in relation to 'true' tax liability.").

[135] *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., MOST TAX RETURNS PREPARED BY A LIMITED SAMPLE OF UNCONTROLLED PREPARERS CONTAINED SIGNIFICANT ERRORS 3 (2008), *available at* https://www.treasury.gov/tigta/auditreports/2008reports/200840171fr.pdf. ("Pursuing abusive preparers is part of the IRS' strategy to reduce the tax gap, which researchers estimate to be $290 billion based on 2001 data."); U.S. GOV'T ACCOUNTABILITY OFFICE, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, PREPARERS MADE SERIOUS ERRORS (2014), *available at* http://www.gao.gov/assets/670/662356.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, CHAIN PREPARERS MADE SERIOUS ERRORS (2006), *available at* http://www.gao.gov/new.items/d06563t.pdf; Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 TAX NOTES 767, 767–68 (2013) ("[S]ignificant concerns have been raised about incompetent and unscrupulous preparers and their negative impact on taxpayers and tax compliance. If a preparer makes inflated claims that the IRS later rejects, or fails to claim benefits to which the taxpayer is entitled, the taxpayer suffers. If a preparer makes inflated claims that the IRS does not detect, federal revenue collection suffers.").

[136] *See* Bryan T. Camp, *'Loving' Return Preparer Regulation*, 72 TAX PRAC. 604 n.6 (2013) (noting that in 1921 the Treasury Department promulgated regulations (aka Circular 230) that sought to regulate tax practitioners, namely, attorneys and accountants, who practiced before

Treasury Department to regulate "agents, attorneys, or other persons representing claimants before the Department."[137]

The enabling statute presently reads as follows:

> (a) Subject to section 500 of title 5, the Secretary of the Treasury may—
> (1) regulate the practice of representatives of persons before the Department of the Treasury; and
> (2) before admitting a representative to practice, require that the representative demonstrate—
> (A) good character;
> (B) good reputation;
> (C) necessary qualifications to enable the representative to provide to persons valuable service; and
> (D) competency to advise and assist persons in presenting their cases.[138]

Until 2011, the Department of the Treasury sought to regulate essentially four categories of tax professionals, namely, attorneys, certified public accountants, enrolled agents, and enrolled actuaries.[139] In 2011, however, Treasury promulgated new regulations that sought to expand the category of those regulated to include all tax return preparers, mandating that they pass qualifying examinations and take continuing education classes.[140] In two different cases—*Loving v. Commissioner*[141] and *Ridgely v. Lew*[142]—judges rebuffed the IRS, invalidating these regulations. More specifically, in terms of preparing taxpayers' returns, these two court decisions held that tax return preparers were neither "practicing" before the IRS[143] nor functioning as taxpayers' "representatives,"[144] both of which are predicates under the enabling statute.

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the agency; "[t]he three basic regulatory efforts before 1921 were: Circular 13 (Feb. 6, 1886) (concerning internal taxes), Circular 94 (Oct. 4, 1890) (same), and T.D. 32974 (Nov. 30, 1912) (concerning Customs)").

137 Original text of 31 U.S.C. § 330(a), 23 Stat. 258 (1884).

138 31 U.S.C. § 330(a).

139 *Id.* § 10.3; *see also* JONATHAN G. BLATTMACHR, MITCHELL M. GANS & DAMIEN RIOS, THE CIRCULAR 230 DESKBOOK, at § 4:6 (2006).

140 76 Fed. Reg. 32,286 (June 3, 2011).

141 Loving v. IRS, 920 F. Supp. 2d. 108 (D.D.C. 2013), *aff'd*, Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014).

142 55 F. Supp. 3d. 89 (D.D.C. 2014).

143 *Loving*, 742 F.3d at 1018 ("All of this underscores that tax-return preparers do not practice *before the IRS* when they simply assist in the preparation of someone else's tax return."); *Ridley*, at 95 (2014) ("[A] CPA hardly "practices" before the IRS when he simply prepares and files a taxpayer's refund claim, before being designated as the taxpayer's representative and before the commencement of an audit or appeal.").

144 *Loving*, 742 F.3d at 1016 ("The term 'representative' is traditionally and commonly defined as an agent with authority to bind others, a description that does not fit tax-return

For the time being, Congress does not seem inclined to pass legislation that will expand the scope of those regulated to include tax return preparers.[145] That being the case, the IRS will be on its own to identify unscrupulous tax return preparers, of which there are apparently many.[146] This identification exercise promises to be a resource-intensive task insofar as unscrupulous tax return preparers who lack a professional license do not commonly appear listed in any directory or telephone book or on any website; and they may not even register for a preparer taxpayer identification number (PTIN),[147] making their shadowy existence and the identification process problematic and challenging. Even after the IRS identifies these unscrupulous tax return preparers, the agency's tasks are far from over: the U.S. Justice Department has to then be contacted to bring injunction actions against these actors.[148] Unless the latter are imprisoned, they are apt to continue their practices.

2. Detection of Identify Theft Perpetrators

Identity theft is a crime that largely did not exist until the turn of the twenty-first century. However, over the course of the last decade or so,[149] particularly as the so-called Information

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preparers."); Ridley, *supra* note 142, at 95 ("Thus, Section 330's use of the term 'representative' excludes refund claim preparers. . . .").

[145] Many bills were introduced to extend Treasury's authority over tax return preparers, but all have been rejected in committee. *See* Taxpayer Protection and Preparer Fraud Prevention Act of 2013, H.R. 1570, 113th Cong. § 2 (2013); Taxpayer Bill of Rights Act of 2012, H.R. 6050, 112th Cong. § 202 (2012); Taxpayer Bill of Rights Act of 2012, S. 3355, 112th Cong. § 202 (2012); Taxpayer Bill of Rights Act of 2010, H.R. 5047, 111th Cong. § 202 (2010); Taxpayer Bill of Rights Act of 2010, S. 3215, 111th Cong. § 202 (2010); Taxpayer Bill of Rights Act of 2008, H.R. 5716, 110th Cong. § 4 (2008); Taxpayer Protection and Assistance Act of 2007, S. 1219, 110th Cong. § 4 (2007); Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, S. 1321, 109th Cong. § 203 (2006); Taxpayer Protection and Assistance Act of 2005, S. 832, 109th Cong. § 4 (2005); *see also Loving*, 742 F.3d at 1020 ("[W]e find at least some significance in the fact that multiple Congresses have acted as if Section 330 did not extend so broadly as to cover tax return preparers.").

[146] *See supra* note 135.

[147] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT 11-336, TAX PREPARER REGULATION: IRS NEEDS A DOCUMENTED FRAMEWORK TO ACHIEVE GOAL OF IMPROVING TAXPAYER COMPLIANCE (2011), *available at* http://www.gao.gov/assets/320/317247.pdf.

[148] *See* Press Release, Dep't of Justice, Federal Court Permanently Shuts Down Iowa Tax Preparers (July 14, 2011), available at https://www.justice.gov/opa/pr/federal-court-permanently-shuts-down-iowa-tax-preparers; Press Release, Dep't of Justice, California Court Bars Four Men from Promoting Alleged Stock-Loan Tax Fraud Scheme (Sept. 15, 2009), *available at* http://www.justice.gov/opa/pr/2009/September/09-tax-954.html (425 tax-related injunctions issued from 2001 to 2009).

[149] *See* FED. TRADE COMM'N, IDENTITY THEFT AND DATA SECURITY (2015), *available at* https://www.ftc.gov/news-events/media-resources/identity-theft-and-data-security ("Identity theft tops the list of consumer complaints that are reported to the FTC and other enforcement agencies every year.").

Age has come into full bloom, this crime has become rampant throughout the country, annually plaguing millions of people.[150]

Identity theft comes in a variety of different forms. To achieve their objectives, perpetrators sometimes steal people's mail and credit card information; other times, they phish on the Internet to collect vital personal information.[151] What has become all too common is that these criminals seek taxpayers' tax returns, which provide them with a treasure trove of information and which facilitate their ability to perpetrate identity theft.[152]

In the sphere of tax refunds, identity theft is no small problem. The Government Accountability Office (GAO) reported that the IRS prevented approximately $24.2 billion in stolen identity refund claims in 2013.[153] This was the good news. The bad news was that the IRS apparently sent out a stunning $5.8 billion in fraudulent refunds.[154] This problem shows no signs of abating anytime soon.[155]

In light of this crime epidemic, the IRS should forcefully respond. To date, the IRS has not sat idle as it has tried to strengthen its computer security systems, help victims, and pursue the criminals. This compliance effort has not come cheaply: the agency currently dedicates 3,000 employees to combat this fraud.[156]

Even so, more needs to be done, and a narrower tax gap would provide the IRS this opportunity. A narrower tax gap would give the IRS the ability to dedicate additional resources,

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[150] *See* ERIKA HARRELL & LYNN LANGTON, VICTIMS OF IDENTITY THEFT, 2012 (2013), *available at* http://www.bjs.gov/content/pub/pdf/vit12.pdf (estimating the number of identity theft victims nationwide to be 16.6 million, or 7 percent of all U.S. residents sixteen or older).

[151] *See* KRISTIN FINKLEA, CONG. RESEARCH SERV., IDENTITY THEFT: TRENDS AND ISSUES (2014), *available at* https://www.fas.org/sgp/crs/misc/R40599.pdf.

[152] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-132T, IDENTITY THEFT: TOTAL EXTENT OF REFUND FRAUD USING STOLEN IDENTITIES IS UNKNOWN (2012), *available at* http://www.gao.gov/assets/670/665368.pdf.

[153] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-119, IDENTIFY THEFT AND TAX FRAUD: ENHANCED AUTHENTICATION COULD COMBAT REFUND FRAUD, BUT IRS LACKS AN ESTIMATE OF COSTS, BENEFITS AND RISKS 11 (2015), *available at* http://www.gao.gov/products/GAO-15-119.

[154] *Id.*

[155] *See* Michael S. Schmidt, *Hacking of Tax Returns More Extensive Than First Reported, IRS Says*, N.Y. TIMES, Aug. 17, 2015, at A17, *available at* http://www.nytimes.com/2015/08/18/us/politics/hacking-of-tax-returns-more-extensive-than-first-reported-irs-says.html?_r=0 ("The Internal Revenue Service said Monday that hackers had gained access to the tax returns of more than 300,000 people, a far higher number than the agency had reported previously.").

[156] *See* Press Release, Internal Revenue Serv., IRS Conducts Identify Theft and Refund Fraud on Many Fronts (Jan. 2014) (FS-2014-1), *available at* http://www.irs.gov/uac/Newsroom/IRS-Combats-Identity-Theft-and-Refund-Fraud-on-Many-Fronts-2014.

as well as to reallocate existing resources, to the identity theft problem; thus, the IRS could redouble its efforts to improve its computer security systems and their ability to screen for fraud, to help taxpayers navigate the difficult plight of having their stolen refunds recovered, and to capture those who commit these acts. Such efforts on the agency's part would hopefully rekindle renewed confidence in the entire tax system.

3. IRS Service Enhancement

Due to resource inadequacy and resource mismanagement, the IRS has fallen short of delivering adequate service to taxpayers. For example, phone lines to taxpayers are not being properly staffed, and written response times to taxpayers' inquiries are reprehensible.[157] As a whole, taxpayers have never relished dealing with the IRS; now, their worst fears are being realized.

If the IRS did not have to devote a large portion of its limited resources to audit taxpayers' tax returns, it could instead invest in improving taxpayer service.[158] Direct improvements would include the dedication of additional employees to respond to taxpayers' telephone and written inquiries. Moreover, additional funds could be used to better train IRS employees so that their responses would be more timely and accurate. Such improvements would vastly increase taxpayer satisfaction, perhaps crystallizing in the form of higher taxpayer compliance.

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[157] *See* NAT'L TAXPAYER ADVOCATE, OBJECTIVES REPORT TO CONGRESS: FISCAL YEAR 2016, at 1 (vol. 1) (2015), *available at* http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2016-JRC/Volume_1.pdf ("With funding down about 17 percent on an inflation-adjusted basis since FY 2010, and with the IRS having had to implement large portions of the Patient Protection and Affordable Care Act (ACA) and the Foreign Account Tax Compliance Act (FATCA) this year without any supplemental funding, sharp declines in taxpayer service were inevitable" (citation omitted).); NAT'L TAXPAYER ADVOCATE, 2014 ANNUAL REPORT TO CONGRESS 3–25 (2014) ("Most Serious Problem: Taxpayer Service: Taxpayer service has reached unacceptably low levels and is getting worse, creating compliance barriers and significant inconvenience for millions of taxpayers."), *available at* http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2014-Annual-Report/Volume-One.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-156, 2012 TAX FILING: IRS FACES CHALLENGES PROVIDING SERVICE TO TAXPAYERS AND COULD COLLECT BALANCES DUE MORE EFFECTIVELY 2 (2012), *available at* http://www.gao.gov/assets/660/650962.pdf ("However, IRS's level of telephone service (the percentage of callers seeking live assistance who receive it) declined to 68 percent. In addition, of the 21 million pieces of paper correspondence IRS received, about 40 percent were considered overage (meaning that IRS did not respond within 45 days of receipt), an increase compared to last year.").

[158] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-151, TAX GAP: IRS COULD SIGNIFICANTLY INCREASE REVENUES BY BETTER TARGETING ENFORCEMENT RESOURCES (2012), *available at* http://www.gao.gov/assets/660/650521.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-603, IRS 2013 BUDGET: CONTINUING TO IMPROVE INFORMATION ON PROGRAM COSTS AND RESULTS COULD AID IN RESOURCE DECISION MAKING (2012), *available at* http://www.gao.gov/assets/600/591463.pdf.

Better IRS service also extends to indirect improvements in how the agency functions. For example, additional resources would enable the IRS to modernize some of its antiquated technology systems, which are pivotal to limiting the number of false positives that the agency's systems generate while simultaneously improving tax compliance. In particular, utilizing redirected funds, the IRS could accelerate the implementation of two important programs: the Reporting and Document Matching Program and the Return Review Program. The first program ". . . is intended to be used to improve business taxpayer compliance by matching business information (e.g., 1099-K) tax returns with individual tax returns to identify potential income under reporting."[159] The second program ". . . is expected to make use of leading-edge technology to detect, resolve, and prevent fraud."[160]

A final agenda item that the IRS might seek to pursue with these redirected funds is the agency's ability to offer prepared tax returns. Following the lead of California's highly acclaimed and successful ReadyReturn Program[161] (a program that prepares and distributes prepared state income tax returns on behalf of many low-income taxpayers who can then submit, modify, or reject them), the IRS could try to replicate the program at the national level.[162] Were a

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[159] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-14-534R, INTERNAL REVENUE SERVICE: ABSORBING BUDGET CUTS HAS RESULTED IN SIGNIFICANT STAFFING DECLINES AND UNEVEN PERFORMANCE 21 (2014), *available at* http://www.gao.gov/assets/670/662681.pdf.

[160] *Id.*

[161] *See* Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, 107 TAX NOTES 1431 (2005) (highlighting California's ReadyReturn pilot program).

[162] *See* William G. Gale, *Remove the Return*, *in* TOWARD TAX REFORM: RECOMMENDATIONS FOR PRESIDENT OBAMA'S TASK FORCE 40, 44 (2009), *available at* http://www.taxanalysts.com/www/freefiles.nsf/Files/TowardTaxReform.pdf/$file/TowardTaxReform.pdf ("First, and most important, the task force should recommend gradually moving an increasing number of people to a 'return-free' tax system. This could be either a fully return-free system, which would feature exact withholding, or, more likely, a tax agency reconciliation system, in which the IRS sends households a provisional tax return for confirmation or changes. These systems are feasible; they already exist in several developed countries. And a recent California experiment with a tax agency reconciliation system was successful and popular."); HAMILTON PROJECT, THE SIMPLE RETURN: REDUCING AMERICA'S TAX BURDEN THROUGH RETURN FREE FILING 3 (2006) (Policy Brief No. 2006-04), *available at* http://www.hamiltonproject.org/files/downloads_and_links/The_Simple_Return-_Reducing_Americas_Tax_Burden_Through_Return-Free_Filing_Brief.pdf ("With the Simple Return, the IRS would use the information about income that it already receives from employers and banks to send prefilled tax returns to taxpayers who have sufficiently simple finances. The program would be voluntary. Taxpayers who prefer to fill out their own tax forms or to pay a tax preparer to do it could use the Simple Return as the basis for their own calculations, or simply set it aside and file their taxes the conventional way."); U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON RETURN-FREE TAX SYSTEMS: TAX SIMPLIFICATION IS A PREREQUISITE 1 (2003), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/noreturn.pdf ("The Internal Revenue Service Restructuring Act of 1998 (P.L.105-206) calls for the Secretary of the

program of this nature adopted, it would greatly alleviate the administrative burden that many taxpayers annually endure when preparing their own tax returns.

In sum, even in the face of a shrinking tax gap, the IRS would necessarily continue to monitor taxpayer compliance, retaining the agency's important deterrent role. However, as the landscape around the IRS changes, the agency should adapt. If there are external factors that enhance tax compliance, the agency should redeploy its limited resources to areas of greater productivity. Three such areas of possible redeployment include the identification of unscrupulous tax return preparers, the detection of identity theft perpetrators, and the enhancement of IRS service to taxpayers. Although these areas of improvement are not targeted directly at enhancing taxpayer compliance, they would indirectly contribute to its amelioration.

V. CONCLUSION

Intentionally or unintentionally, some taxpayers pay less than they owe in tax and, as a result, the tax gap will thus remain a permanent fixture of the tax system.[163] Even so, there are compelling reasons to believe that several trends exist that will likely have a powerful impact in curtailing the tax gap's size. These forces include the growing use of electronic methods to finance and close economic transactions, which helps generate a traceable trail of commerce; the expanding presence of third-party compliance measures that take advantage of computer advances to monitor taxpayer economic activities; and the increasing concentration of economic activity in "large" business enterprises, in which there is more direct and indirect tax compliance oversight.

Because the stakes are so enormous, clarity is paramount. It therefore behooves the government to conduct another comprehensive tax gap study to ascertain the exact magnitude of revenue loss currently besetting the nation's tax system. And the time to conduct such a comprehensive study is now, as it will hopefully confirm what this analysis is predicting, namely a smaller tax gap.

Admittedly, there are many potential obstacles on the near- and far-term time horizons that may impede the withering of the tax gap. Some obstacles are obvious. If, for example, Congress continues to underfund the IRS, more taxpayers will likely join the ranks of the noncompliant.[164] Other obstacles are less obvious. Consider three such examples: (i) technology may actually increase the possibility for tax evasion (e.g., bitcoins and other forms of virtual currency may become more commonplce),[165] (ii) globalization and the associated factor mobility (especially capital mobility) mean that some forms of income are increasingly mobile and may

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Treasury to develop procedures for the implementation of a return-free system in the United States for 'appropriate' individuals by 2007.").

[163] Hence, the title to our piece is not "Closing the Tax Gap."

[164] *See supra* note 157 and accompanying text.

[165] *See generally* Thomas Slattery, *Taking a Bit Out of Crime: Bitcoin and Cross-Border Evasion*, 39 BROOK. J. INT'L LAW 829 (2014); Sarah Gruber, *Trust, Identity, and Disclosure: Are Bitcoin Exchanges the Next Virtual Havens for Money Laundering and Tax Evasion?*, 32 QUINNIPIAC L. REV. 135 (2013).

more easily be masked,[166] and (iii) the presence of complicated tax laws also can create supposed platforms of legal tax avoidance methods that sometimes transform into illegal tax evasion.[167]

Therefore, the jury is still out. While there appear to be strong economic and technological trends that suggest the tax gap is closing, there are countervailing obstacles that have recently emerged that portend that an end of the tax gap is not in clear sight. If this analysis is correct and the tax gap is truly withering, this systemic change in the tax system has important public policy implications. These policy implications should not be ignored or shelved; instead, Congress and the IRS can and should immediately act upon them.

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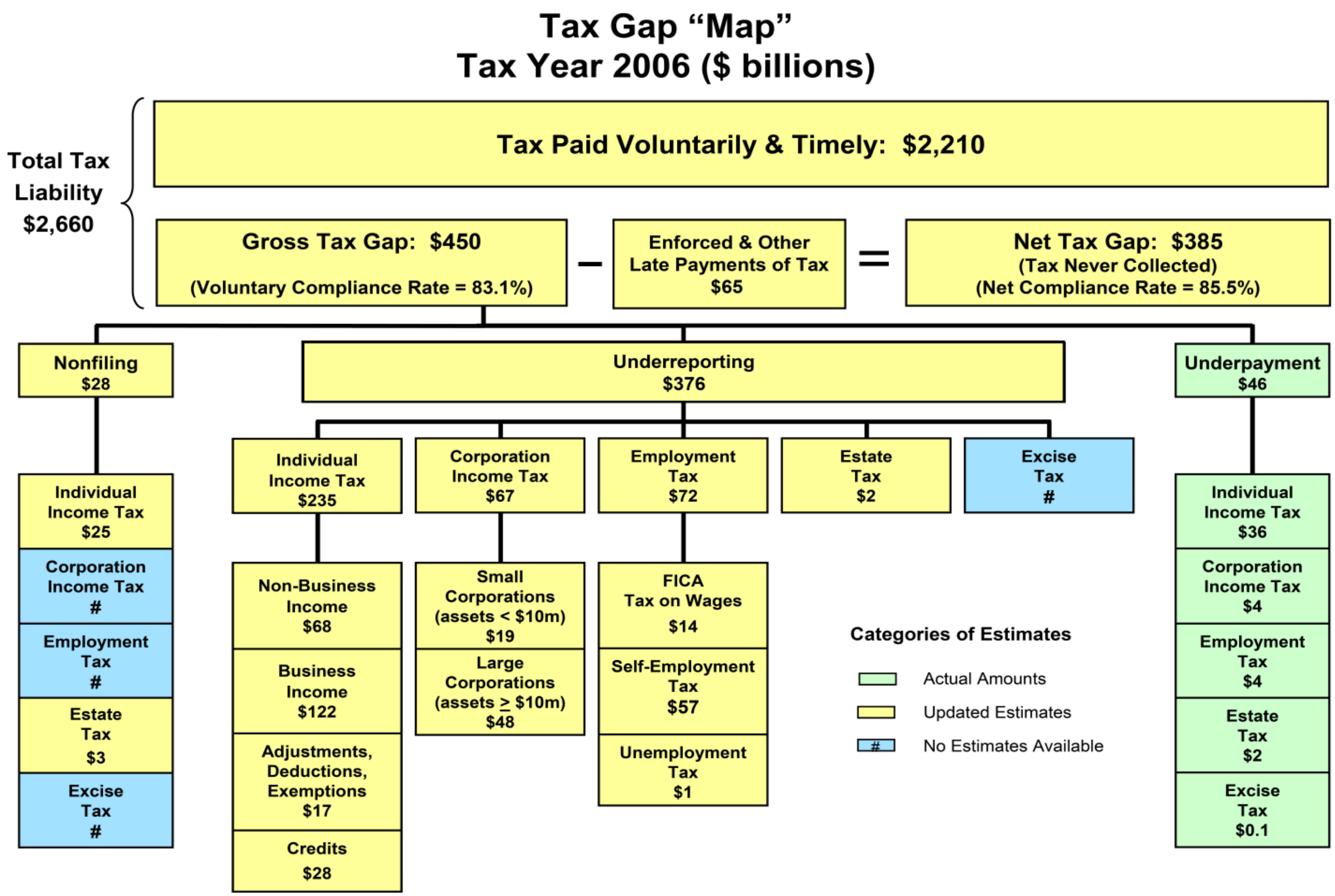
[166] *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1576 (2000) ("However, greater capital mobility and international tax competition allow investors to escape taxation easily by shifting capital to low- or no-tax jurisdictions.").

[167] *See, e.g.*, Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 57 NAT'L TAX J. 877, 884 (2004) ("To be sure, creative compliance is facilitated because the tax law is exceedingly complex and open to alternative interpretations, and this undoubtedly facilitates ethical rationalizations of positions taken.").

APPENDIX



Tax Gap "Map"
Tax Year 2006 ($ billions)
Total Tax Liability $2,660
Tax Paid Voluntarily & Timely: $2,210
Gross Tax Gap: $450
(Voluntary Compliance Rate = 83.1%)
–
Enforced & Other Late Payments of Tax $65
=
Net Tax Gap: $385
(Tax Never Collected)
(Net Compliance Rate = 85.5%)
Nonfiling $28
Underreporting $376
Underpayment $46
Individual Income Tax $25
Corporation Income Tax #
Employment Tax #
Estate Tax $3
Excise Tax #
Individual Income Tax $235
Corporation Income Tax $67
Employment Tax $72
Estate Tax $2
Excise Tax #
Non-Business Income $68
Business Income $122
Adjustments, Deductions, Exemptions $17
Credits $28
Small Corporations (assets < $10m) $19
Large Corporations (assets ≥ $10m) $48
FICA Tax on Wages $14
Self-Employment Tax $57
Unemployment Tax $1
Individual Income Tax $36
Corporation Income Tax $4
Employment Tax $4
Estate Tax $2
Excise Tax $0.1
Categories of Estimates
Actual Amounts
Updated Estimates
#
No Estimates Available