The Evolution of the IRS and Taxpayer Compliance:

Some Implications for Korea

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1. Introduction

Taxpayer compliance in a tax system depends critically on the confidence the taxpayer has in both the tax collection process and about the larger issues of tax and budgetary policies. The evolution of US taxation, tax policy, and tax administration can be interesting outside the US for several reasons. First, the Internal Revenue Service (IRS) is widely viewed as one of the premier tax administration authorities in the world in terms of its administrative efficiency, professionalism, and use of technology. Second, the evolution of US tax administration reflects the interplay of history, economic forces, technology, and the political give and take which accompany any attempt to finance the public budget. For harried tax administrators and taxpayers in other countries, the history of others such as those in the US can inform and forestall the same issues and problems. Third, the increased globalization of the economy means that, increasingly, tax policy and thus tax administration, is being forced to coincide across national boundaries to prevent tax induced migration of capital and labor. Not only do marginal tax rates lead mobile workers and capital to reconsider their place of employment, so does the administrative environment within which private resources are translated into the public budget. When taxation is perceived to be unfair against usual standards of equity, or uncertain or unpredictable, taxpayers increasingly may consider relocation across national boundaries. Even concerns about the efficacy of public spending may lead to such rethinking.

Our objective in this paper is to describe the evolution of major features of US tax policy and tax administration and to analyze, on a comparative basis, if there are any implications or lessons for Korea. We take as a given the current reliance among various tax revenues in Korea, and inquire if the evolution of taxation and tax administration in the US can inform how Korea might better utilize and administer its current tax system.

By way of summary, we find that several of the problems which the US faces in the administration of its income and wage taxes are problems which Korea also faces. This is in a sense not surprising since many of the problems of taxation are universal and age-old.

Various solutions and policies in the US context to ensure taxpayer confidence and compliance are reviewed, and their practical application for Korea discussed and evaluated.

Several techniques which the US uses to enhance taxpayer confidence and complexity deserve consideration in Korea:

- Independent surveys of taxpayer attitudes towards their tax system and publication of the results of such studies
- The collection and careful auditing every few years of samples of tax returns (TCMP studies), and

promulgation of the results

- The promulgation of analysis and statistical results about the tax system to the public on an ongoing basis

- Periodic analysis of the complexity of Korea's tax laws and forms by scoring the language for clarity

In addition, several techniques used in the US for ensuring taxpayer compliance seem meritorious:

- Consideration of lowering the filing threshold to enable better collection of data for various tax and statistical purposes, and to enable tax policy to provide refundable earned income tax credits if there is national agreement on such redistributive policies;

- Absolute guarantee of privacy, and separation of authority to collect taxes from judicial enforcement of (non-tax) criminal law;

- The pro-active integration of various tax collection activities under one roof using one taxpayer id for both adults and dependents; and,

- The notification to the taxpayer that penalties and/or imprisonment result from fraudulent filing of tax returns.

The structure of the paper is as follows: Section 2 discusses a range of economic and political issues that arise from tax administration. Section 3 discusses the evolution of the US income tax since the Civil war, the evolution of tax administration in the US with special attention to more recent events underlying the 1998 IRS restructuring, and an extensive discussion of how policies and debate over privacy of tax return information has evolved. Section 4 first briefly describes recent changes in tax policy and tax administration in Korea, and then compares some institutional and empirical characteristics of Korea and US tax administration that indicate several areas of similarity and difference. Section 5 discusses possible future fiscal challenges to Korea and ways in which tax administration may respond to them.

2. Political and Economic Issues Involving Tax Administration and Compliance

The first purpose of a tax system in a modern democracy is to finance politically agreed-upon budgetary programs through spending for public goods such as national defense, infrastructure such as roads, and

education, and providing an income maintenance system which has sufficient political support to meet societal objectives. As Webber and Wildavsky(1986) point out, the overall size of the public sector in relation to the private economy will be smaller in a political democracy than in a purely religious or religious-monarch state. In ancient times the private sector was quite small. In industrial democracies it is unusual for the public sector to be more than 40% of GDP.[1]

Beyond this revenue objective lies a host of other objectives which a tax system may be called upon to achieve. For example, the structure of the tax system may achieve distributional objectives by utilizing progressive marginal tax rates, or encourage economic development through tax expenditure subsidies. It is common for various goals of a tax system to collide so that achievement of one, say progressivity, causes greater complexity and makes the tax more difficult to administer. Moreover, it is common in such complicated matters as taxation for the law of unintended consequences to obtain: raising tax rates to raise revenues can, if work effort and profits diminish due to relocation or fall in compliance, result in actually lower revenues, *ex poste,* being collected. Determining precisely when this point occurs is never an easy matter.

There are several corollaries to this observation about the relationship between a political democracy and a tax system. First, the budgetary position in a political democracy is more precarious than in other political societies, because citizen-voters typically will press government to take as little in the way of taxes as possible. Second, tax collection will be more problematical in a political democracy than in, say, a theocracy, because the collection of taxes entails an implicit consent from voters about the nature of the tax system and agreement on spending programs. When there is political disagreement or lack of unanimity on spending programs, the tax system used to finance the budget may itself lack support, and compliance may suffer. Third, when spending is in excess of revenues, and there is not widespread support for restraints on spending and/or increasing through legislation the size of the tax base and raising marginal tax rates, the political leadership must resort to: (i) bond finance for operating purposes (which is in the long run always ruinous), (ii) printing money, and/or (iii) requiring the tax administration authority to administer the tax laws more harshly. Using overly aggressive tax administration as a substitute for rational fiscal policy can, in the long-run, create tax payer animosity and reduce voluntary compliance.

2.1 Private and Social Costs of Tax Collection

From the perspective of elected officials, the cost of administering a tax system is the budgetary cost of the

[1] International comparisons of public sector size often fail to make sure that public ownership and public regulation are properly compared. For example, in the US, the tradition has been to regulate transportation, energy, and telecommunications while in Western Europe the tradition until recently has been for their to be public ownership. Both approaches attempt to deal with the problem of natural monopolies, and making sure that quantity and price serve consumer interests.

tax administration agency; however, this neglects two other considerations: the private costs which taxpayers experience to comply with the system, and the dead-weight loss to the economy from the budgetary costs of the tax administration itself:

$$SC = BC + PC + DWL$$

where :

SC = Social Cost of Taxation Administration

BC = Budgetary Cost

PC = Private Compliance Cost

DWL = Deadweight Loss from Taxes Used to Support Tax Administration

From this simple equation, we see the incentive for elected officials to trade off private costs for budgetary costs by pushing the costs of administering a tax system onto the private sector and off the public budget. Thus a withholding system is more costly to employers than a system of annual assessment that requires universal public audit activity to assure that the amounts paid over were correct. On the other hand, a withholding system permits the government to finance itself during the year on the basis of cash flow rather than having to enter the short-term capital market to finance the general budget. Withholding is also consistent with the notion of paying for public services on a current rather than delayed basis. Whether or not private compliance can be a perfect substitute for public administrative expense and activity is a matter for research.

Often, researchers define private compliance costs to include all record keeping (accounting and related time and personnel) expenses and legal expenses of individual and especially business taxpayers.[2] However, this presumes that both individuals and businesses have no reason other than taxes to keep track of their financial affairs. This certainly can lead to an overstatement of the private costs of tax administration since, at least in the business case, a company has an obligation to its shareholders to keep them informed in a systematic fashion of the financial position of the firm. For companies traded on stock exchanges, virtually every stock exchange requires that their financial position be independently audited and the audit report, in standardized format, disclosed to the public so that investors (current and potential) have accurate information to base their investment on.

2.2 Some Principles in the Allocation of Budgetary Resources for Tax Administration Purposes[3]

In economics the marginal principle is helpful in deciding on how to allocate scarce resources. Just as a

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[2] Slemrod and Blumenthal(1987)

[3] This section draws heavily on Goode(1981).

business seeks to allocate scarce capital to maximize its shareholder wealth, a public administrator will do best for his agency if resources are allocated up to the point that the marginal cost equals the marginal benefit of the last dollar. Unfortunately, marginal information on the revenue productivity of the next audit, or the productivity gain of the next dollar of computer investment is rarely available. Instead, tax administrators may look at *average* productivity figures such as revenues raised per person-year among taxes, or administrative expenses as a percentage of revenues raised.

Even before calculating such averages, there remains the threshold question of whether (marginal or average) budgetary costs or *social* costs, as defined above, should be measured against the revenue gains from such activities to decide when to stop allocating scarce resources to an activity. Certainly revenue productivity depends on the level of tax rates; this explains why federal audit activities in the US are more vigorous generally than state level audit activities---federal marginal income tax rates are multiples of their state income tax counterparts. Also, as noted earlier, there can readily be political restraints or inhibitions on the vigor which taxes are imposed in a democracy, since unhappy taxpayers may not only become less compliant, but also more politically active and outspoken in opposition to tax administrators zeal. A balanced approach to tax administration and application of managerial principles is more readily achieved if there is one tax administrative authority at the national level than if there are many, separate and independent tax agencies.

While the notion of using audits to increase taxpayer compliance is intuitive[4], one may also argue that taxpayer confidence in the fairness of tax administration is enhanced when tax audits are employed without regard to whether they find under-payments or over-payments. In this view, the government is indifferent to, or views as equally important, the correction of taxpayer errors in either direction. Thus it is important to remember that audit activities not only serve to secure revenues, through the correction of error audits also promote justice, and can enhance the long-run standing of the tax system in the eyes of taxpayers, and thereby increase long-run compliance.[5]

Tax collection is always enhanced when the taxpayer faces sound incentives to reveal information about his circumstances underlying, say, the derivation of net income, and in turn sound incentives to pay taxes on that income on a timely basis. The lag between tax accrual and actual collection can be reduced by insisting on withholding and/or timely estimated taxes being turned over, the use of the commercial banking system as an intermediary to deposit tax withholdings, and the imposition of penalties which are above the market rate of

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[4] Although see Slemrod, Blumenthal and Christian(2001) for the peculiar experimental result that the increased threat of audit led high income taxpayers to report less.

[5] See Wertz (1979) for two formal models of the allocation of tax administration resources when the agency must (1) generate a given level of revenues and (2) produce justice-as-accuracy within the budget period. The models differ in that under the first model, consideration (1) is the objective, and consideration (2) is the constraint, while under the second model the roles of (1) and (2) are reversed.

interest. If penalties are below the market rate of interest, then taxpayers will simply escrow their funds to obtain the greater return to the disadvantage of the tax collector and the treasury. Interest payments to taxpayers who overpay must be carefully constructed so that the treasury does not become an alternative to the banking system for investments.[6]

Some suggest that economic incentives be utilized to encourage taxpayers to self-enforce tax payments. The most famous is the Kaldor[7] scheme of devising a system of interlocking income, capital gains, annual wealth, personal expenditure and gift taxes so that what was not taxed in one place would be taxed in another. Personal expenditure would be administered as the excess of income over saving, and saving would be the increase in net wealth which would also be taxed so that under-reporting in one tax would necessarily lead to higher reporting and "pick-up of tax" in another. While this approach has been exceedingly unpopular when implemented, it is likely the case that the development of information technology makes it more feasible to administer today than 48 years ago when it was initially tried in India.

In the area of property taxation, economists often suggest that government give itself a first option of buying a property owner's property at the owner's self-assessed value. In this way property values can be generated from owners and kept current. Actually financing the government's purchase of properties whose values are systematically under-stated, and then reselling them at market prices may, however, turn out to be a fairly burdensome process. Moreover, some may object to the government playing such a large role in the ownership of real property.

To the extent that taxes are earmarked for particular services to the taxpayer, one may expect improved compliance. For example, when one's retirement benefit under a national defined contribution retirement system depends on one's contributions, it is reasonable to expect that the self-employed, will comply.

2.3 Some Indicators of Complexity

Charges of undue complexity are often leveled at any major tax. Other than a head tax any extant tax system will have its definitional and administrative problems which both tax administrators and taxpayers must struggle with. Whether or not the definition and administration of a particular tax base are unduly complicated is largely an empirical matter that can be informed by measuring the following key indicators of complexity:

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[6] Above market rates of interest can speed up cash tax payments as well as lead to strategic overpayments which can, if carefully constructed, help tide over an otherwise difficult budgetary situation. Of course, this sort of inter-temporal borrowing, typically from large corporate taxpayers, has its own financing problem later on since the overpayment in the form of a loan to the government has to be paid back.

[7] See Kaldor (1956) for a proposal whose attempted implementation led to his being run out of the country.

- the educational level required to read forms and associated instructions
- taxpayer error rates
- tax administrator error rates
- extent and private and social costs of litigation

Counting and weighting taxpayer and tax administrator mistakes in complying with the tax law, and the counting and valuing the extent of disagreement about the tax law are operational ways to measure complexity that go beyond what sometimes can simply be taxpayer complaints for other reasons[8].

3. Evolution of Tax Administration: General and the US

3.1 Some Historical Antecedents to Direct Taxation Today

Since the inception of the human community, the problem of financing community services for it has been a difficult one. Inevitably, the communal transformation of private or individually garnered resources into community services requires some element of subtle or explicit coercion, since some may not value their contribution of resources to be equivalent to what they receive from the community. If the few express their dissatisfaction by not contributing, their non-compliance can erode the compliance of others. As a result, the fisc might suffer in overall collections, and planned community services can not be provided due to insufficient finance.

Further, the allocation of contributed resources among competing community needs inevitably requires the creation of some sort of decision process that is accompanied by a notion of political legitimacy. In ancient times, such legitimacy derived from the standing the priest-king had before his subjects along with the realities of his commanding a significant army and maintaining an aggressive tax administration apparatus.[9] The proposition that the Egyptian priest-king was the descendent of deities, which implied that any decisions to spend and finance the spending through (in-kind) taxes and fees were similarly inspired, was not to be challenged lightly by any taxpayer who sought to be well treated himself in the afterlife, let alone currently by the priest-king’s tax collectors and army.

Complications arose before money was widely circulated because there were always issues of how much

[8] When tax reformers in the US argue that our federal individual income tax is too complex and should be replaced by a national consumption tax of the form proposed by Hall and Rabushka(1986), for example, they may not appreciate the difficulties of enforcing a subtraction value-added tax. See Strauss(1997) for an extensive discussion.

[9] See Webber and Wildavsky(1986), especially Chapter 2.

each agricultural commodity should be valued for fulfilling one's tax obligations.[10] Those who were taxed and paid in X bushels of barley would complain that obligation to pay bushels of barley was far more burdensome than those who paid in Y bushels of rice. Elaborate mechanisms were developed so taxpayers could demonstrate that they had paid their taxes, and numeracy and literacy were highly valued by tax administrators and taxpayers alike.

During times of good harvests, the priest-king often had serious problems of storing the surplus in-kind taxes which farmers paid. In many ancient societies, the central treasury, which was composed of grain and other agricultural products which could be stored, became in effect an agricultural bank as it lent its surplus commodities to areas in famine with the proviso that such loans be repaid with interest when bountiful harvests returned. Disputes arose from distant farmers and subjects about whether spoilage on route to the central treasury of in-kind taxes paid was the responsibility of the tax collector who transported commodities from afar back to the national treasury, or was the responsibility of the taxpayer until the priest-king received such payment at the palace.[11] Conversely, in times of poor harvests, the priest-king faced wide-spread underpayment of taxes and difficulties in providing for the royal household.

Economic growth often was accomplished in ancient times through wars of acquisition; however, before, during, and after such conflicts the matter of financing the means of war, the army and its armaments, created ongoing challenges to priest-kings, and subsequently to ancient monarchs around the world. Acquiring territory and population, while creating revenue opportunities, also created tax administration headaches. Distant revenue collection activities inevitably raised questions about the honesty of distant tax collection agents. The Romans and Chinese used various techniques to ensure honesty from their remote agents, and even resorted to employing only eunuchs to gather, manage, and remit taxes. Indian monarchs relied on intricate systems of spies who would, unknown to each other, pose in distant provinces as taxpayers, and return with news of their assessments and levies. If three independent spies in the same line of agriculture reported back identical tax assessments and the tax collector's refusal of their bribes, the king was satisfied that his remote tax collector was honest.[12]

3.2 US Experiences with Income Taxation

Financial emergencies often force radical revamping of revenue sources. In the US, both war and financial panic have led to the enactment of the income tax. War finance often enables political authority to resort to

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[10] Webber and Wildavsky(1986) report that a husband unable to pay his taxes in ancient times might be forced to sell his wife and daughters into slavery to fulfill his tax obligations.

[11] To the modern reader these disputes sound surprisingly like arguments about whether a tax should be origin or destination based.

[12] Webber and Wildavsky(1986), Chapter 2.

unusual tax collection authority on the justification that the existence of the community is clearly threatened if the war effort is not sufficiently funded. This was true for the US in the 19th century, and foreshadowed the modern development of the IRS.

In 1862, in the midst of the US Civil War, the North took emergency action to finance its efforts. The public debt was rising at $2 million per day and new revenue sources were desperately needed. On July 1, 1862 Congress:

- imposed the first direct US income tax which was progressive,
- created the first Commissioner of Internal Revenues to collect the income tax,
- empowered the Commissioner to collect wage withholdings from *employers*[13] and required withholding of wages paid to public employees, Senators and Representatives to Congress,
- empowered the Commissioner to collect interest and dividend withholdings from railroads, banks, trust companies, and fire, marine, life, inland, stock and mutual insurance companies, and
- accorded the Commissioner the power of search and seizure to secure revenues from non-compliant taxpayers.[14]

The Revenue Act of 1864 raised tax rates, and withholding was extended to interest and dividends of any canal, turnpike, and canal navigation companies.[15] The Civil War income tax expired in 1872, and the US was without direct taxation of income until 1894.

Enactment of the 1894 income tax was not in response to war finance needs, but to end the run on gold reserves which began with the panic of 1893. The panic resulted from an agricultural depression, reckless railway financing and resulting railway bankruptcies, and unsound banking practices. Steel production dropped by 25% during 1893 as a result of the panic and collapse of many railroads. As the panic spread, currency was actively traded in for gold which stood behind the currency. Gold reserves rapidly fell. Congress in early 1894 refused to sell bonds to protect gold reserves, and turned instead to radically revising the national tax system by replacing various specific duties with *ad volorem* taxes, and the re-enactment of the income tax. The Wilson-Gorman Tariff Act of 1894, which contained the income tax of 1894, was immediately litigated, and the individual income tax was found unconstitutional by the US Supreme Court in 1895 because the tax was not apportioned among the states on the basis of population as required by the Constitution.

The US returned to the income tax in two steps. In 1909 a federal *corporate* income tax was enacted.

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[13] Wage withholding originated as a tax administration technique in Britain 1803. See Dorris(1963), p. 115.
[14] *Ibid.*
[15] Dorris(1963), p. 116.

Structured as an excise tax on income for the privilege of doing business, it withstood constitutional scrutiny. After passage of the 16'th amendment to the Constitution permitting the taxation of individual income, the 1913 Income Tax Law was passed and has been a principal federal revenue source ever since.

US entry into World War I created immediate revenue needs to finance the effort, and the Revenue Act of 1917 was followed by subsequent measures which materially raised marginal tax rates. The 1917 legislation replaced withholding at the source (only 10 % of collections were from such withholding) by requiring instead "information reporting" at the source. Under information reporting at the source, the employer was required to provide to both employees and the IRS a calendar summary of income paid to each individual.

The economic depression of the 1930's caused widespread poverty, and the US Congress responded to the poverty of the elderly by enacting the Social Security Act of 1935. Central to the establishment of a national retirement system was the imposition of a wage tax to finance it. Initially, Social Security was structured as a defined contribution retirement plan; however, within 10 years additional benefits were provided which made it increasingly a defined benefit plan, and a major component of the US income security system. While Congress established a new agency to maintain records of pension contributions and benefits, it required the IRS to administer the wage tax under Chapter 21 of the Internal Revenue Code-Federal Insurance Contributions Act (FICA). The Social Security tax was collected through mandatory withholding under the Social Security Act of 1935; however, it was not until the Revenue Bill of 1942 that withholding of individual income taxes accrued on wage and salary income was reintroduced. US entry into World War II necessitated a radical restructuring of national finance, and a speed up in tax payments. Given the radical reallocation of private resources to the war effort, there was also a macro-economic need to immediately restrain aggregate demand with taxation. The basic features of the current withholding system were enacted in the Current Tax Payment Act of 1943 which refined and extended the 1942 tax code.

In 1961, Congress actively considered withholding of taxes due on interest and dividends; however, opposition was considerable, and Congress instead enacted very stringent information return filing by payor of more than $10 in interest or dividends. Under such information return filing requirements, the payor of interest or dividends must report the name, Social Security Number, address, and amount of dividends or interest to the Internal Revenue Service on Form 1099.

Table 1 provides some broad indicators of the nature of the federal individual income tax and the responsibilities of the IRS. In 1975, 82 million returns were filed of which 75% paid positive tax. These 82 million returns represented 38% of the population. The average positive tax per return in 1975 was $2,023. In the late 1970's and thereafter, the federal individual income tax was used as a major ingredient in the federal income maintenance system. Note that in 1998, 124 million personal income tax returns were filed or 46% of

the US population, and the average tax payment was $8,380. In 1975, 6.2 million returns claimed the Earned Income Tax Credit, and in 1998, 19 million returns claimed the credit of which 16 million received net refunds. The average EITC refund in 1975 was $205 while in 1998, due to several liberalizations of the credit by the Congress, the average refund was over $1,600.

Table 1: US Individual Income Tax Statistics

	1975	1980	1985	1990	1995	1998p
Total Individual Tax Returns Filed	82,229,332	93,902,469	101,660,287	113,717,138	118,218,327	124,723,856
US Population (1,000)	215,973	227,726	238,466	249,913	263,034	270,002
Returns as % Population	38%	41%	43%	46%	45%	46%
Taxable Returns as % Total	75%	79%	81%	79%	75%	75%
Returns with Net Tax	61,483,928	73,840,395	82,762,130	89,844,225	89,233,118	93,012,960
Total Net Tax ($1,000)	$124,382,197	$249,078,475	$321,917,289	$446,296,392	$586,128,456	$779,432,765
Average Tax/Return	$2,023	$3,373	$3,890	$4,967	$6,569	$8,380
EITC Returns	6,214,533	6,953,621	6,499,568	12,541,651	19,334,397	19765814
EITC Amount ($1,000)	$1,249,959	$1,985,996	$2,087,658	$7,542,231	$29,955,575	$31,777,371
EITC/Return	$201	$286	$321	$601	$1,549	$1,608
Refundable EITC (1,000)	4,334,159	4,996,637	4,743,200	8,698,475	15,177,901	16,364,466
EITC Refunds ($1,000)	$886,750	$1,370,169	$1,498,875	$5,266,077	$20,828,840	$27,175,330
Average EITC Refund	$205	$274	$316	$ 605	$1,372	$1,661

Source: *SOI Bulletin*, Spring, 2000, Table 2.

3.3 Evolution of the IRS as an Organization

Since its inception, the IRS has been organized in three different ways to accomplish the basic functions of any tax collection agency: operational collection, taxpayer services, taxpayer audit, internal audit, financial management, enforcement and legal and regulatory affairs, and central administration. Because the US was geographically large, the Bureau of Internal Revenue, renamed the Internal Revenue Service in 1953, always had a National Office as well as field offices. The 1863 Bureau had 300 employees at the National Office and 3,000 in the field offices. Increased use of tariffs required growth in the number of employees. In the first half

of the 20'th century, IRS was organized on a "type of tax" basis, with a highly centralized National Office and field offices that were similarly organized into Income Tax, Employment Tax, Customs etc.[16]

In 1953, the IRS was reorganized along functional lines, so that Audit, Rulings and Regulations, Technical etc. were assigned to Assistant Commissioners who were responsible across types of taxes for these functions. Field offices were integrated geographically under District Directors in the National Office, and regional offices were reconstituted to provide a buffer between field offices and the National Office.

Currently, the IRS is involved in a very ambitious restructuring effort which seeks to radically modernize its computer facilities, and change its management structure again. In 1998, after a series of difficult public hearings on types of pressure IRS agents were putting on taxpayers, the Congress passed the 1998 IRS Restructuring Act which established an IRS Oversight Board and substantially expanded the authority of the IRS Taxpayer Advocate, expanded the duties of the new Inspector General for Tax Administration, and also reorganized the administrative structure of IRS. In the new reorganized IRS, there are no longer Assistant Commissioners whose positions were established by law. Instead, the IRS is arranged along business lines, with each of the four major business lines headed by an Operating Division Commissioner. The business lines are:

- individual wage earners;
- small businesses,
- large businesses, and
- tax-exempts (including pensions).

These operating division commissioners function as the previous Assistant Commissioners did, but with different reaches of responsibility based on the nature of the taxpayer, rather than function and rather than type of tax. In some instances the change was more apparent than real. For example, the head of the tax-exempt group would have been called Assistant Commissioner for benefits and pensions but now also includes non-profits of various kinds.

The general purpose of the Act was to improve IRS internal management, isolate the Commissioner from political pressure, and provide a more friendly and understanding interface with taxpayers.

The IRS also developed a new mission statement:

[16] Dorris(1963), Chapter 3.

"Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

The mission is to be accomplished through following four new guiding principles :

- Understand and solve problems from taxpayers' point of view
- Enable IRS managers to be accountable to taxpayers
- Use balanced measures of performance to measure taxpayer satisfaction business results, and employees' satisfaction
- Foster open, honest communications and insist on total integrity

The Restructuring Act created the Internal Revenue Service Oversight Board, and provided for a substantial enlargement of taxpayer services and rights. Under the Restructuring Act, deficiency notices now contain notices of the right of the taxpayer to contact the local Taxpayer Advocate's office.

The Commissioner remains the Chief Executive Officer of the IRS. The Commissioner will continue to be appointed by the President, by and with the advice and consent of the Senate, and is removable at the will of the President. However, the Commissioner will now be appointed in renewable 5-year terms. Under the new statute, Commissioner Rossotti's first 5-year term began as of the date of his appointment. The appointment must be made from individuals who, among other qualifications, have a demonstrated ability in management.

The Internal Revenue Service Oversight Board established by the Restructuring Act will recommend to the President candidates for appointment as Commissioner and the need for removal of a sitting Commissioner. As under prior law, subject to certain Congressional reporting obligations, the Commissioner has duties and powers as prescribed by the Secretary (e.g., the power to administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party). However, the Commissioner must now consult with the Oversight Board, and the Board has review (and in some cases review and approval) authority over certain operational plans and management matters, including plans for modernization of the tax system; plans for outsourcing or managed competition; plans for training and education; the selection, evaluation, and compensation of Service senior executives who have program management responsibility over significant functions of the Service; and plans for any major reorganization of the Service. The Commissioner must submit budget requests to the oversight Board for review and approval.

The Chief Counsel remains the chief law officer of the IRS. The Chief Counsel will continue to be appointed by the President, by and with the advice and consent of the Senate, and is removable at the will of the President. The Commissioner may recommend to the President a candidate for appointment as Chief Counsel and recommend to the President the removal of the Chief Counsel.

Under the Restructuring Act, the Office of the Taxpayer Advocate is under the supervision and direction of a "National Taxpayer Advocate" (NTA). The NTA will report directly to the Commissioner. The NTA will be appointed by the Secretary, after consultation with the Commissioner and the Oversight Board. No person who has been employed by the IRS within two years of the date of appointment, except for those employees of the Office of the Taxpayer Advocate, may serve as NTA. The NTA must commit not to accept any employment with the Service for at least five years after termination of employment as the NTA.

The Restructuring Act also creates local taxpayer advocates (LTAs), whom the NTA must appoint and evaluate, and respecting whom the NTA may take personnel actions (including dismissal). The section provides that the NTA make available at least one LTA for each State, so that a local taxpayer advocate will be available to taxpayers in each State. The NTA may consult with appropriate supervisory personnel of the Service regarding these personnel responsibilities. Each LTA reports to the NTA (or the NTA's delegate). Each LTA may consult with the appropriate supervisory personnel of the Service regarding daily operation of the LTA's office. The LTA, at the initial meeting with any taxpayer seeking the assistance of LTA's office, must notify the taxpayer that the taxpayer advocate offices operate independently of any other Service office and report directly to Congress through the National Taxpayer Advocate. An LTA may, in the LTA's discretion, not disclose to the Service contact with, or information provided by, a taxpayer. LTAs' offices must maintain a separate phone, facsimile, and other electronic communication access, and a separate post office address.

While the IRS restructuring was enacted in 1998, the IRS Oversight Board was not in place until late 2000. As a result it is too early to determine whether or not this quasi-corporate form of governance will prove more effective than the earlier system. Under the new system, both the Secretary of the Treasury and the IRS can send forward proposed budgets to the House and Senate appropriation committees. How the Office of Management and Budget and the Congress will deal with possibly conflicting requests for funds and management initiatives remains to be determined. Also unknown is whether or not the Oversight Board members will be able to effectively provide oversight without there being very difficult issues of privacy and disclosure of tax return information arising.

Historically, the Commissioner of IRS reported to the Secretary of the Treasury through the Assistant Secretary for Tax Policy, typically a politically appointed tax lawyer, and more recently through the Under

Secretary for Taxation when that position was filled in Treasury. Now, the IRS Commissioner will report to internal and external authorities.

Oversight of the IRS by the legislative branch of government occurred through the tax committees of Congress, the Joint Committee on Taxation of the Congress composed of the senior members of the House and Senate tax committees, and the House and Senate committees on government operations. As a practical matter the appropriations committees did not perform oversight functions, but both the tax committees and the government operations committees periodically have held hearings on various IRS administrative matters. A question arises now about how Congressional oversight will relate to the new IRS Oversight Board.

3.4 US Income Tax Privacy and Non-disclosure Issues

A basic tenet of any self-assessed tax system is that the taxpayer must willingly reveal to the tax collector the details of his liability in conjunction with remitting taxes due for the system to work effectively. Whether or not the taxpayer *should* expect that his tax return information is a private, secret transmittal is an age-old issue. On the one hand privacy permits the taxpayer to reveal fully the details of his financial circumstances without concern that competitors or those with adverse interests in his financial situation[17] can take advantage of such information. On the other hand, public disclosure of such information is thought by some to encourage not only complete honesty on the part of taxpayers, but also complete honesty on the part of the tax collector. In this second view, the general benefits to society of public disclosure outweigh any risks to the private interests of individual taxpayers or businesses.

Historically, local property tax lists and their assessed value were publicly available in New England in the 16th and 17th centuries, and their public availability remains. Today, many states and localities provide such information on-line so they may be browsed on the Internet by anyone with Internet access.

Just as the US had periods with and without a national individual income tax, it has varied in its approach to permitting public access to part or all of individual and business income tax returns. Arguably the political debates in Congress about whether or not individual income tax returns should be public has been as controversial as the enactment of the taxes themselves.

Section 15 of the 1862 income tax law required that the list of taxpayers in each county be published in each county newspaper as well as posting the list in four public places with the hope that it would at least

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[17] In the former Soviet Union in the early 1990's, employers with computerized withholding systems refused to remit lists of individual names and tax withholding to the national tax authorities because such information was routinely sold on the black market to local mobs who used such lists to identify extortion targets.

inform taxpayers of their liabilities as well as improve taxpayer compliance.[18] In 1863, disputes arose between newspapers and the Commissioner as to whether or not the actual tax returns in their entirety might be published in newspapers.[19] In 1866, Congress considered a prohibition on the publication of the list in newspapers; however, this failed. The Revenue Act of 1870 positively prohibited the publication of any part of a federal income tax return, and empowered Commissioner Delano to promulgate regulations to accomplish the new policy of tax return privacy.

Section 34 of the 1894 individual income tax similarly contained strong tax return confidentiality provisions. After the Supreme Court found the 1894 income tax unconstitutional, the Secretary of the Treasury ordered all tax returns collected to be destroyed.

While the failed 1894 individual income tax contained strict confidentiality requirements, the enacted 1909 corporate income tax stated that the returns so filed "…shall constitute public records and be open to inspection as such." [20] The wisdom of such a policy of public access was vigorously debated. Part of the motivation for making corporate tax returns public at that time stemmed from a desire to publicly regulate large corporations (e.g. an anti-trust consideration) which were monopolizing their markets without judicial intervention. However, this policy of public disclosure was to last for less than 12 months, as the Appropriations Act of 1910 reversed policy, and made such public disclosure a matter for only the President of the United States to decide. The issue was hotly debated in the Congress for several days prior to this reversal in policy.

Section 3167 of the 1913 individual income tax law prohibited any disclosure of individual tax return information, and provided further for fines or imprisonment at the discretion of the court if a violation occurred.

This policy of tax return secrecy under the threat of fines or imprisonment was to last no more than 11 years, as the Revenue Act of 1924 completely reversed field and directed the Commissioner to make lists of individual income taxpayers, their addresses, and taxes due public in each district. Congress further empowered itself in the 1924 legislation to receive and review tax return information from the Treasury Department, enabled the states to request and receive federal tax return information to administer their own revenue laws, and permitted any shareholder owning more than 1% of a corporation's stock to examine the federal corporate tax return of the said corporation.

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[18] Zaritsky(1974), p.3-4.

[19] This income tax listing requirement was patterned after the historical listing of property assessments and property tax liabilities.

[20] *Ibid, p. 10.*

Again, this liberalization of public access to individual income tax return information was short-lived, as Congress, at the urging of the US Treasury, rescinded public access in the Revenue Act of 1926 to information on taxes paid by individuals. It left in place public access to the lists of names and addresses of persons who filed. The privacy of taxes due was again only for a limited period of time.

Eight years later, the Revenue Act of 1934 required that each return be accompanied by a "pink slip" which would contain certain tax data (total gross income, total deductions, net income, and total credits against taxes, and net taxes payable) about the taxpayer and which would be made public. Immediately after its passage in late 1934, the issue of public access to "pink slip" information was vigorously debated in Congress. Representative Better of New York stated that

> Eleanor Hanley was hailed as an exceeding lucky person when she won the $110,000in the Irish Sweepstacks 2 years ago. This New jersey woman has been hounded by gangsters and is now in an asylum. Doctors hold she is unable to handle affairs. [21]

After vigorous debate in February, March, and April of 1935, the "pink slip" provisions of the Revenue Act of 1934 were repealed and the essential features of what is now in Section 6103 of the Code enacted.

Since the "pink slip" episode of 1935, there have been two relatively recent political scandals in the US which have led to questions about whether or not the President of the United States has abused his authority to examine federal tax returns for political ends. During the period now known as "Watergate," there were widespread allegations that President Nixon had pressured the IRS to audit his political enemies (the so-called "enemies list"), and there were further allegations that selected federal tax returns were in the hands of White House political operatives of President Nixon. The Joint Tax Committee of the Congress instructed its staff to review these allegations, and held extensive hearings and examined the allegations It determined that no political opponent of President Nixon had been unduly subjected to audit or unduly taxed as a result. Moreover, it determined that the IRS had never turned over individual tax returns to White House political operatives (although they were asked to do so).

More recently, during the Clinton Administration, there were news reports that 900 federal individual income tax returns mysteriously turned up in the White House in the office of a Clinton political operative. It has been alleged that the returns were primarily of prominent officials in the Bush administration, and were being used to collect sensitive financial information which was to be put into a database maintained for

[21] Congressional Record, February 25, 1935, 2595.

political purposes. At the request of Congress the General Accounting Office reviewed the matter and did not find any criminal wrong-doing.

3.5 Permissible IRS Disclosure of Tax Return Information

While federal tax return information is quite private, it can be shared with other federal and state agencies for specific purposes and under well-defined circumstances under Section 6103 of the Internal Revenue Code. State tax agencies may receive tax return information if the state tax agency has in place privacy laws which are parallel to those in federal tax law, and has in place a signed bilateral exchange agreement with the IRS which provides for the two-flow of state and federal tax return information, and continues to pass ongoing reviews by IRS of privacy safeguards. The US Justice Department may have access to returns in criminal and civil proceedings involving tax issues. Upon written request, the General Accounting Office, which is an agency of the Congress, may have access to tax return information in conjunction with performing tax audits. The Joint Committee on Taxation and the Staff of the Joint Committee on Taxation can also have access to tax return information.

Within the US Department of Commerce, the US Bureau of the Census may obtain from the IRS tax return information. Also, the Bureau of Economic Analysis, which is responsible for measuring national economic aggregates such as Gross Domestic Product may also obtain from the IRS tax return information or tabulations of tax return information. The Division of Financial Statistics of the Bureau of Economics of the Federal Trade Commission may obtain upon written request tax return information in conjunction with specific statistical activities it is statutorily engaged in. Within the Treasury Department, individuals responsible for making economic and financial forecasts and statistical studies are permitted to use tax return information. The US Department of Agriculture, in conjunction with its periodic Census of Agriculture, is enabled to obtain after written request tax return information. The Social Security Administration is also enabled to receive tax return information that relates to specific taxes in the Internal Revenue Code. Similarly, the US Department of Labor and Pension Benefit Guarantee Corporation may receive upon written request tax return information as it relates to the administration of federal pension law, which is co-administered by the Treasury/IRS and US Department of Labor. The Secretary may, upon written request, disclose to the appropriate Federal, State, or local child support enforcement agency tax return information.

In addition to exchanging tax return information with state revenue authorities and other federal agencies for public policy and statistical purposes, IRS has since its inception been obligated to publish statistical tables about the major federal taxes, and periodic analytical studies. For better than a half century, the Statistics Division of the IRS has published the *SOI Bulletin* which contains articles by IRS statisticians about major trends in federal taxes, as well as historical tables that show the distribution of income and itemized deductions.

At least once each year state-level tables are published which provide to the public and state policy makers information about the distribution of various measures of individual income taxation. The Statistics Division also publishes various tables characterizing the size distribution of business income by industry so that the pattern over time of gross receipts, costs, taxes and the utilization of various federal tax credits can be examined.

Since the mid-1960's, the Statistics Division also has made available to interested researchers stratified random samples of anonymous individual federal tax returns. Such samples usually number about 100,000 returns per year, and contain over 150 different variables and can be obtained from the US National Archives at nominal cost ($200/year of data). Such samples of data can now be readily manipulated on a personal computer to allow the evaluation of alternative tax policies.

3.6 Major Features of IRS Audit and Penalty Provisions[22]

The assessment of penalties and interest results from the application of the IRS audit process. The IRS utilizes the following audit techniques:

Document matching.- Returns can be selected for further attention when payment reports, such as Forms W-2 from employers, interest and dividend statements (Forms 1099), and other types of information returns don't match the income reported on the tax return. If there's a mismatch, the IRS sends the taxpayer a notice that describes the basis for and identifies the amount of any tax, addition, interest, or penalty due. (IRC section 7522) The notice is not a demand for payment, and it can be challenged by the taxpayer. When challenging such a notice, the taxpayer bears the burden of proof.

Discriminant function system[23].- Many returns are selected for examination based on computer scoring. A computer program called the Discriminant Function System (DIF) numerically scores every individual and some corporate tax returns after they are processed. The DIF program rates the potential for change, based on past IRS experience with similar returns. IRS personnel screen the highest scoring returns, selecting some for an audit and identifying the items on the returns to be reviewed. The IRS holds the particulars of DIF scoring close to its vest. However, some likely high scorers include an unusually high ratio of itemized deductions to gross income, or large amounts of income not subject to withholding.

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[22] This section is based largely on the summary of Chapter 26 of the Internal Revenue Code contained in the July, 1999 Tax Analyst *Basic One Disc*.

[23] While the IRS has long used discriminant functions to select tax returns for audits, it is well known that selection using either probit or multinomial logit statistical models is more efficient than the discriminant statistical model.

Related-party audits.- Returns can be selected for an audit when they involve transactions with other taxpayers, such as business partners or investors, whose returns were selected for an audit.
Random selection.- In the past, the IRS also selected tax returns for audit though random sampling programs such as the Taxpayer Compliance Measurement Program (TCMP). Examinations under this program have been referred to as the "audits from Hell," because every item on the return must be substantiated. The TCMP audits are currently being scheduled for reintroduction in 2001.
Market Segment Specialization Program (MSSP).- The MSSP guidelines provide IRS personnel with a detailed review of the tax characteristics of specific industry segments (for example, attorneys, auto body shops, bed and breakfast establishments, check-cashing establishments, liquor stores, pizza parlors, and travel agencies), and specific items that IRS personnel should evaluate when reviewing a return from an entity within the particular industry segment.

Financial status audits.-The IRS is prohibited (as of July, 1998) from using financial status or economic reality audit techniques (so-called life-style audits) to determine the existence of unreported income of any taxpayer unless the IRS has a reasonable indication that there is a likelihood of unreported income.

During the IRS audit process, a taxpayer's rights include:

--- The right to be represented by an adviser;

--- The right to make audio recordings of interviews, provided the taxpayer gives the IRS examiner conducting the audit 10 days notice (the taxpayer must provide the recording equipment)

--- The right to claim additional deductions not claimed on the return;

--- The right to request that a particular technical question raised in the audit be referred to the IRS National Office for technical advice;

--- The right not to be subjected to unnecessary audits (a taxpayer whom the IRS has audited in either of the two previous years if there was no proposed change to the tax liability should contact the IRS and ask that it cease repeat examinations);

--- The right to claim and exercise all constitutional rights if questioned about possible criminal violations.

--- The taxpayer also has the right to be represented at the audit by an attorney, CPA, enrolled agent, enrolled actuary, or any other person, provided that the representative has written authorization.

--- If at anytime during the audit the taxpayer wants to consult an attorney, accountant, enrolled agent, or any other person permitted to represent the taxpayer, the IRS examiner will stop and reschedule the interview. The IRS need not suspend an interview when an administrative summons compels the taxpayer to attend.

The IRS has the authority to obtain taxpayer information that is not voluntarily provided. In particular, the IRS can issue a summons to compel a taxpayer's testimony and financial records if the summons serves a "legitimate purpose" and the demands are not "unreasonable." The summons must describe with reasonable certainty the books and records sought. The summons must also show the date and time for the audit, which cannot be less than 10 days from the summons date. If the taxpayer disregards the summons, the IRS can apply to the applicable U.S. district court (or U.S. commissioner) for an order directing the taxpayer to comply with the summons.

The IRS can also issue a third-party summons to someone other than the taxpayer (for example, employers, tax preparer, banks) to compel testimony and the production of records relevant to its audit of the taxpayer. The IRS cannot compel a third party to give testimony or produce records when the testimony or records are privileged (for example, attorney-client privilege). Within 3 days of service of the summons, but not later than 23 days before the date of the audit, the IRS must give notice of the third-party summons to the taxpayer. The taxpayer has 20 days to request the noncompliance by the third party until a court decides whether the third-party summons is valid. An IRS summons cannot be enforced against a person that is under a Justice Department referral (that is, the IRS has recommended a criminal tax prosecution).

Generally, the IRS must assess all tax liabilities within three years after the date a tax return was filed. The assessment period for a partnership, S corporation, or trust item passed through to and reported by the partners, shareholders, or beneficiaries is based on their returns and not the return of the partnership, S corporation, or trust. If on a tax return a taxpayer omits from gross income (or gross estate, total gifts made in the return period, or excise tax) more than 25 percent of that income, the assessment period is **six** years. There is a six-year statute of limitations to assess personal holding company tax on a personal holding company (PHC) that did not file a PHC schedule with its tax return. The period runs from the date the return was filed.

The assessment period remains **open** (that is, there is no statute of limitations) on assessment of tax liability when the taxpayer:

--- files a false or fraudulent return with the intent to evade tax;

--- willfully attempts to defeat or evade taxes;

--- fails to file a tax return;

--- fails to show or adequately disclose any gift of property or increase in taxable gifts (for purposes of a gift tax) whose value is determined under the special valuation rules;

There is no statute of limitations for imposing penalties for promoting an abusive tax shelter or for aiding and abetting an understatement. There is also no statute of limitations for imposing a penalty on a tax return preparer for willful tax understatements (although the three-year statute of limitations for collecting any resulting tax still applies).

The IRS can assess interest on unpaid or underpaid tax whenever the taxpayer has not paid a tax or civil penalty when due. If the IRS grants the taxpayer an extension of time to pay a tax or penalty, the taxpayer must still pay interest on any outstanding amounts owed. Interest is not assessed on late payments of estimated tax or unemployment tax. The IRS will assess interest on an erroneous refund or credit. The rate of interest on tax underpayments and penalties equals the short-term federal rate for the previous calendar quarter plus three percentage points; interest is compounded daily. For the first quarter of calendar year 1998, the underpayment interest rate was 9 percent; for the second, third, and fourth quarters, it was 8 percent. For the first calendar quarter of 1999, the underpayment rate is 7 percent.

Some major violations and civil penalties that the IRS can impose are:

Failure to file.-If a tax return is not filed when due, the penalty is 5 percent of the tax due as shown on the return, less any early payments and credits, for the first month and an additional 5 percent *for each month (or part of a month)* that the failure continues, not to exceed 25 percent.

If the failure to file is due to fraud, the penalty is *15 percent per month, up to a maximum of 75 percent.* If a tax return is not filed within 60 days of the due date, the minimum penalty is the lesser of $100 or the tax due shown on the return.

Failure to pay.-The IRS imposes the failure-to-pay penalty on a taxpayer who fails to pay the tax shown on a return (including a substitute return) or an assessed deficiency by the due date. The penalty is 0.5 percent of the tax shown (or assessed) for each month (or part of a month) that the taxpayer has not paid the tax (not to exceed 25 percent). If the IRS issues a notice of intent to levy, the penalty increases to 1 percent per month, not to exceed 25 percent, at the start of the first month beginning at least 10 days after the day the notice is issued.

Fraud.- The IRS will levy a civil penalty of 75 percent of the portion of any underpayment of tax that's attributable to fraud. A penalty for fraud can be imposed by the IRS only if a return is filed. The penalty won't be imposed when the taxpayer shows reasonable cause for underpayment, and that he or she acted in good faith. The imposition of a penalty for fraud on any portion of an underpayment precludes the imposition of any of the accuracy-related penalties.

Responsible person penalty.-The willful failure to collect or account for and pay over a tax or willful attempt to evade or defeat a tax by a "responsible person" required to collect, account for, and pay over the tax is subject to a civil trust fund recovery penalty. (Taxes withheld by employers from employees' wages are referred to as trust fund taxes.) The penalty is equal to 100 percent of the total tax that is evaded or not accounted for and paid over.

The IRS cannot assess a trust fund recovery penalty without first notifying a responsible person of its intent to do so, at least 60 days before making noticed and demand for the penalty. However, the IRS make initiate collection without giving the required notice if it first determines that the collection is in jeopardy. "Responsible person" is an officer or employee of a corporation, or a partner or employee of a partnership, who is under a duty to collect or account for and pay over a tax. The IRS must disclose, on the written request of a responsible person, the names of other responsible persons and whether or not they are involved in collection activities. A responsible person who pays more than a proportionate share of tax has the right to recover the excess from other responsible persons.

Aiding and abetting understatement.-The IRS can impose a penalty of $1,000 ($10,000 for a corporation) for persons who aid and abet in the understatement of a tax liability. This includes a person who:

--- aids and assists in, procures, or advises regarding the preparation or presentation of any portion of a return, affidavit, claim, or other document connected with any material matter arising under the Internal Revenue Code;

--- knows or has reason to know that the portion of the return will be used in connection with any material matter arising under the code; and

--- knows that the portion (if so used) would result in an understatement of another person's tax liability.

The term "advise" includes the actions of lawyers, accountants, and financial advisers who counsel a particular course of action, as well as actions of appraisers who fraudulently overstate the value of property in a qualified appraisal of property for which the taxpayer claims a charitable deduction. The IRS can penalize the

taxpayer whether or not he or she knew or consented to the understatement. The aiding and abetting penalty also applies regardless of whether the person rendering the bad advice charges a fee.

Frivolous returns.-A taxpayer is subject to a $500 penalty for filing a frivolous return. A frivolous return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax reported is substantially incorrect. A taxpayer is liable for the penalty if such a return was filed because of a frivolous position or a desire to delay or interfere with the administration of the tax laws. Altering or striking out the preprinted language above the signature space is also the basis for a frivolous return penalty. The $500 penalty for this offense is in addition to any other penalties, and the taxpayer must pay it in full after the IRS sends a notice and demand for payment, even if the taxpayer protests the penalty.

Failure to supply identifying number.-Taxpayers who fail to supply a social security number or taxpayer identification number for themselves, a dependent, or another person (if required) on a return are subject to a $50 penalty for each failure.

Failure to furnish tax shelter number..- A person who sells or otherwise transfers an interest in a tax shelter must also provide the tax shelter registration number or be subject to a $100 penalty. A taxpayer who claims a deduction, credit, or other tax benefit because of a tax shelter is required to attach IRS Form 8271, "Investor Reporting of Tax Shelter Registration Number," to the return. There is a penalty of $250 for each failure to report a tax shelter registration number on a return.

In addition to penalties for failing to supply information, there are penalties related to the deliberate filing of inaccurate information. If a taxpayer's return is inaccurate, the IRS may assess a 20 percent accuracy-related penalty. Various accuracy-related penalties are described below.

--- *Negligence.*- If any part of an underpayment of tax is due to either negligence or disregard of the rules and regulations but without an intent to defraud, the penalty is 20 percent of the portion of the underpayment attributable to the negligence. The term "negligence" includes any failure to make a reasonable attempt to comply with the law or to exercise ordinary and reasonable care in preparing a tax return, and failure to keep adequate books and records or to substantiate items properly. The term "disregard" includes any careless, reckless, or intentional disregard. For example, the failure of a taxpayer/payee to report properly on his own return an amount reported as paid to him by a payer on an information return is strong evidence of negligence.

The IRS will not normally impose a penalty for negligence regarding tax underpayments that are attributable to a position contrary to a revenue ruling or notice if the position has a realistic possibility of being

sustained on its merits. If the taxpayer's position is contrary to a rule or regulation, a penalty for "disregarding" will not be imposed if the taxpayer discloses the position if contrary to a regulation), has a reasonable basis for being sustained, and is a good-faith challenge to the IRS's interpretation of the law. Note that the "reasonable basis" test is stricter than the "realistic possibility" test.

--- *Substantial understatements.*-A 20 percent penalty is imposed on any portion of an underpayment of tax that is attributable to any substantial understatement of income tax, self-employment tax, or unrelated business income tax. An understatement is "substantial " if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for corporations other than S corporations and personal holding companies). An understatement is the excess of the amount of actual tax liability over the amount of tax incorrectly shown on the return or withheld, reduced by any rebate.

The understatement is reduced to the extent that it is attributable to any item (other than tax shelter items) for which there is or was substantial authority or the relevant facts affecting the item's tax treatment are adequately disclosed on the return, and there is a reasonable basis for the taxpayer's treatment of the item. For tax shelter items, a non-corporate taxpayer's understatement is reduced only to the extent there is or was substantial authority for that treatment and the taxpayer reasonably believed his or her treatment was more likely than not proper.

Substantial authority exists for the tax treatment of an item if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions in light of the pertinent facts and circumstances. Substantial authority includes the Internal Revenue Code (and other relevant statues); temporary, proposed, and final regulations; revenue rulings and revenue procedures; tax treaties and official explanations of them; court cases; legislative history, including General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memorandums; actions on decisions and general counsel memorandums; and IRS press releases, notices, and announcements.

--- *Valuation misstatements.*- The IRS may impose a 20 percent penalty for any of the following substantial valuation misstatements:

--- any value (or adjusted basis) claimed on an income tax return that is 200 percent or more of the correct figure;

--- section 482 transfer price adjustments if the price for any property (or its use) or services on a tax return is 200 percent or more, or 50 percent or less, of the correct figure;

--- a net increase in taxable income for a tax year (without regard to carryovers) resulting from all section 482 adjustments in the transfer price of any property (or its use) or services that (with adjustments) exceeds the lesser of $5 million or 10 percent of the taxpayer's gross receipts.

The penalty equals 20 percent of the portion of any income tax underpayment that results from the misstatement (except to the extent the IRS imposes the fraud penalty). The penalty does not apply unless the amount of the underpayment for the tax year attributable to all the misstatements for the year exceeds $5,000 ($10,000 for corporations other than S corporations or personal holding companies).

--- *Overstating pension liabilities*.-If a taxpayer substantially overstates pension liabilities for a tax year, the IRS will impose a 20 percent penalty if the overstatement results in an income tax underpayment of $1,000 or more. The penalty increases to 40 percent for a "gross" overstatement. A pension liability is substantially overstated if the actuarial determination of the liabilities taken into account in computing the contribution deduction is at least 200 percent of the correct amount.

There are numerous civil penalties for violations that pertain specifically to tax preparers (including suspension from practice before the IRS). In addition to imposing civil penalties, the IRS may request a U.S. district court to enjoin a preparer from engaging in specific misconduct, but only if an injunction is appropriate to prevent recurrence of the misconduct. If the court finds that the preparer has repeatedly engaged in misconduct and an injunction is not sufficient to prevent the preparer's interference with proper tax administrations, it can enjoin him or her from practicing. A tax practitioner's willful or reckless failure to comply with the realistic possibility standard may also result in suspension from practice before the IRS. In general, the term "income tax return preparer" means any person who prepares for compensation any tax return or claim for refund.

Understatement of liability.- Penalties are imposed on income tax return preparers for understatements of liability on a return or a claim for refund. A $250 penalty is imposed for an understatement of tax liability that's due to a position for which there was not a realistic possibility of being sustained on its merits. And a $1,000 penalty applies for an understatement of tax liability that's due to a reckless or intentional disregard of rules or regulations.

Generally, a position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead that person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.

Liens and levies.- If the IRS is unable to work out a payment solution, it may file a lien, serve a notice of levy, and seize and sell the property (unless it is exempt) of the delinquent taxpayer (whether it is held by the taxpayer or someone else). The proceeds of the sale are applied to the balance of any unpaid taxes. Property seized can be real, personal, tangible, or intangible, including receivables and securities. The IRS can also levy on present and future wages. There are exceptions for some income and property (for example, clothing, schoolbooks, tools). The IRS may not seize residential property to satisfy a liability of $5,000 or less (including tax, penalties, and interest). And the IRS may not seize a taxpayers principal residence without the written approval of a U.S. district court judge or magistrate.

The IRS must give 30 days' notice to the person in possession of the taxpayer's property before placing a levy on the property, except when collection is in jeopardy. (IRC section 6331(d)) If a person fails or refuses to surrender the property, the IRS can impose a penalty plus costs and interest. If the IRS is unable to sell seized property for the minimum necessary to pay the tax liability, it can return the property to the taxpayer and add the cost of the unsuccessful sale to the unpaid tax liability.

If the IRS wrongfully places a levy and seizes property, it may return the property seized, proceeds from the sale of the property, or the amount of money levied. The IRS will consider such an action only on written request from the taxpayer/property owner. If the IRS does return property or money, it does so with interest at the standard overpayment rate.

The IRS also can place a federal tax lien against a taxpayer's property for payment of delinquent taxes (including any interest, additional amounts, additions to tax, assessable penalties, or accrued costs). The priority of tax liens is governed by federal law. The general rule is that a lien "first in time is first in right." However, a tax lien is subordinated to some later liens that arise either before notice of the tax lien (Form 668) is filed or before the other lienor has actual knowledge of it. This protects purchasers for adequate consideration without actual notice, mortgagees, and other lienors whose rights arose before notice of the tax lien was filed. It also protects certain interests arising even after the notice was filed; for example, attorney's liens and some security interests.

Refunds.- If a taxpayer pays the IRS an amount that is in excess of his or her tax liability, the IRS issues a refund. A tax overpayment can result from either a direct payment by the taxpayer or the withholding of too much money from the taxpayer's income. It includes the part of a correct tax paid after the applicable assessment period has run. An overpayment can be recovered as a refund or a credit by the taxpayer. However, the IRS must first credit the overpayment (including interest) against any past due tax liability, including interest and penalties.

Interest.-The payment of interest on tax overpayments is allowed. The interest is compounded daily and runs from the date of the overpayment to a date not more than 30 days before the refund is made, or to the (unextended) return date for the amount against which the overpayment is credited.

Compromises..-Civil or criminal tax cases can be compromised by the IRS after assessment but before referral to the Department of Justice (after referral to DOJ, compromise can be made only by the Attorney General). The IRS will compromise a civil tax liability on two grounds only: (1) doubt as to liability on the part of the taxpayer; or (2) inability of the taxpayer to pay. The taxpayer can request installment payments. If the IRS agrees to a compromise, the taxpayer must agree to a suspension of the statute of limitations for the tax at issue while the compromise is pending plus one year. The taxpayer and the IRS can conclusively settle a tax dispute by entering into a final agreement to close either a tax year that has ended, or a specific past or future transaction.

Criminal Cases.-The IRS may refer cases to the Department of Justice for criminal prosecution. Criminal matters include:
--- Tax evasion. A willful attempt to evade taxes is punishable by a fine of up to $100,000 ($500,000 for corporations) and up to five years' imprisonment, plus the costs of prosecution.

--- False or fraudulent tax advice. Any person who willfully aids in, or procures, counsels, or advises the preparation or submission of a materially false or fraudulent return or other tax document is subject to a criminal penalty of up to $100,000 ($500,000 for corporations) and up to three years' imprisonment, plus the costs of prosecution.

--- Willful failure to file a return, supply information, or pay tax.

--- Willfully furnishing a false or fraudulent statement, or failing to furnish required tax statements to employees.

4. Tax Administration in Korea

4.1 General

The role of tax administration has been important since the National Tax Administration Office, now named the National Taxpayer Service (NTS), was founded in 1966. Initially, the central responsibility of the Office was to collect as much revenue as possible which was used in turn through the national budget to drive

rapid economic growth. As the tax base was not transparent, many policy tools in tax administration, e.g. tax audits, were aggressively used to maximize the tax revenue. The Office achieved its revenue targets in the 1960's and 1970's. More recently, taxpayers have begun to criticize the tax administration as being unfair and subjective in the application of tax law. Tax evasion became popular. Horizontal inequity surrounding the tax treatment between salary income and self-employed income especially became a serious issue in tax policy.

There have been many empirical studies estimating the degree of tax evasion in Korea. Even though the precise extent of evasion is controversial, it is generally accepted that Korea has a significantly high level of tax evasion. For example, Yoo (1997) showed that the size of tax evasion in value added tax was around 9.8%, and 6.7% of the total revenue from value added tax in 1993 and 1994 respectively. Also Yoo and Hyun (1998) reported international comparisons of the level of under-reporting for self-employed groups: Korea had a level of 20% of under-reporting, Taiwan 16%, Germany 8%, and Russia 75%[24]. These studies indicate that tax evasion in Korea is relatively high.

In 1999, Korean tax administration was dramatically reformed. The goal of the 1999 reforms was to increase the level of voluntary compliance under a self-assessed tax system.

4.2 Tax Administration Reform in 1999

Tax administration is costly since it implies administrative costs for tax authority and compliance costs for taxpayers. There are two types of tax administration; one is government assessment and the other is self-assessment. The total cost with the self-assessment method decreases, as compliance costs for taxpayers are decreased since it becomes easier as time goes by. However, government assessment does not have an incentive to decrease administrative costs. It is well known that self-assessment is a more efficient form of tax administration.

Before 1996, the government assessed the tax burden of taxpayers. To accomplish this, the government needed extensive financial information about each taxpayer under the government assessment system. Thus tax authorities spent much time and effort collecting extensive financial information about each taxpayer. When self-assessment was introduced into the individual income tax in 1996, taxpayers became responsible for providing information themselves on their tax return. Even though the system has changed to self-assessment, the actual management has tended to remain as one of government-assessment.

This is especially true in the taxation of small business. The tax authority makes predetermined information that shows the annual turnover and the level of income by various types of business. This information is made available to taxpayers. Under this mechanism, taxpayers report their turnover and income by just following their guidelines of the groups with the amounts for their turnover and income.

[24] This study applied the same methodology to four different countries by using micro-data set, so that it might be difficult to compare this figures with other empirical results.

However there was no incentive for the self-employed group to report their turnovers and incomes accurately and honestly.

Since 1999, the tax administration has been oriented to induce taxpayers to voluntarily comply with the self-assessment system. Accompanying this change in emphasis were the following major changes in Korean tax administration.

First, the organization of tax administration was changed from one organized along specific taxes to one organized on the basis of tax functional. Since the foundation of the tax authority in 1966, the tax office was organized into an income tax division, value added tax division, excise tax division, property tax division and so forth. In 1999, the tax administration was reorganized according to functional responsibilities: tax audit division, taxpayer service division, tax return processing division, appeals and litigation and so forth.

Second, taxpayer information from various sources is now integrated into one computerized database which permits extensive cross-checking. The information might be related to the income and expenditure for each taxpayer. Much information has been collected by other, non-tax agencies. Because such information was not systematically shared with the tax authorities, tax officers spent a great deal of time collecting such information. Hyun (1998) interpreted this duplication of effort to be a social cost, and found that it was as much as 10% of the total budget of tax authority. All information on each taxpayer interrelates to crosscheck the degree of tax evasion of each taxpayer[25].

4.3 Information Sharing

Information about the income of each individual is very important for non-tax public policies which are income-conditioned. If spending policies for income maintenance or health are directed to persons whose income is no properly measured, the policy will not be successful. Non-tax agencies in Korea had historically had a difficult time accurately measuring the actual income of potential beneficiaries. However, the tax authority has a long history of obtaining the correct income of each individual.

In Korea, the benefit levels under the public pension and public medical insurance systems are topical public policy areas, and which depend on accurate information about the income of each individual and household. Much of the debate over proper public pension and medical insurance policies revolves around

[25] Actually, the computer system of tax authority changed dramatically in 1997. As the real-name transaction system in finance was introduced in 1996, an integrated computer network to support it was developed for several years. The establishment of the Tax Integrated System, which is also called TIS, has led to an efficient tax administration. However, much information that was kept by government agencies were not systematically shared with tax authorities until 1999.

the issue of the annual tax burden on those whose income is from salary and those whose income is self-employment. There is evidence because the income of the self-employed is under-reported.[26] Moreover, they do not have a system to share the income database obtained by the tax authority. Thus, each system must establish and maintain a separate database and develop some methodologies to characterize possible under-reporting. There has been much argument about whether or not the information on income possessed by the tax authorities should be shared with other government agencies to execute other policies. The current system of separate databases has led to high administration cost as well as a high compliance cost.

There are several practical problems involved in sharing income information, beyond overcoming bureaucratic reluctance. The problem involves the income of self-employed group, as the salary income group is generally subject to withholding. In Korea, the self-employed have an obligation to file a tax return once per year. However, a large number of the taxpayers are exempt from filing tax return, as their incomes are under the threshold amount. Table 2 shows this case among all personal income taxpayers in 1998. Only around 36% of total taxpayers under the global income tax file their tax returns. Thus this means almost 64% of total taxpayers are not obliged to file tax returns which means the tax authority does not have information about these groups. Another problem is that a high number of taxpayers filing tax returns do not provide bookkeeping records when they have filed tax returns. Table 2 shows this situation in detail. Only 40% of taxpayers with tax return filings submit bookkeeping records to substantiate their reported income. The incomes for the remaining taxpayers are estimated by the tax authority with various indirect information. It is well known that estimated income is much lower than the actual income of the self-employed group.

Consequently, the tax authority has information about only a portion of taxpayers, not all taxpayers. Moreover, the information about more than half taxpayers with tax return filings are not correct. Sharing with other government agencies the income information that tax authorities keep should solve such practical problems.

[26] The collection of self-employment taxes is problematical in the US as well; however, because the IRS collects the Social Security tax, and the Social Security Administration makes payments to retirees, cross-checking of self-employment taxes against beneficiary status can help collect delinquent taxes. See GAO(1999) for the results of such matching, and discussions of alternative solutions to the under-reporting problem suggested by senior IRS and Treasury officials to the Congress.

Table 2: Characteristics of Korean Individual Income Taxpayers (1998)

(unit: persons)

Total Taxpayers (1) Taxpayers under Tax Threshold Taxpayers to File Returns (2)	3,495,183 2,245,873 1,249,310
(2)/(1) (%)	35.7
Total Number of Tax Returns (1) Bookkeeping Taxpayers (2) Tax Returns by Estimated Income	1,225,614 495,045 717,950
(2)/(1) (%)	40.4

5.0 Comparison of US and Korea Tax Administration

5.1 Selected Administrative Features

The Signature Line.-When a taxpayer in the US signs his personal tax return or, on behalf of the corporation, signs the corporate tax return, he is confronted with being prosecuted for perjury in the US if the information is not "true, correct, and complete." Signature on a Korean personal or corporate tax return does not inform the taxpayer immediately of what being less than complete entrails. Instead, the taxpayer is advised by the NTS that he may be subject to penalties under Article II of the Tax Administration Act of 1998. (See Table 3).

Burden of Proof.-under the US system of self-assessment, the taxpayer is obligated to demonstrate that the administrative agency is, at least initially, in error, while in the Korean system, the tax administrator is required to demonstrate that the taxpayer is in error. While the Korean provision seemingly may safeguard the taxpayer, it does not protect the taxpayer against non-uniform enforcement of the tax law. Under the US system of burden of proof, the taxpayer must demonstrate and create an evidentiary record that supports his contention that the tax authority is in error.

Statue of Limitations.- Generally, the US tax law provides for longer periods during which the tax authority can reopen a tax case against a taxpayer with the likely result that taxpayer compliance is enhanced. Note that this unlimited authority is across all US taxes, whereas longer open periods under Korean tax law relate to inheritance and gift tax.

Abusive Tax Shelter.-here we note no comparable Korean provisions to US provisions.

Civil Penalties.- in virtually all comparisons, US penalties are larger than their Korean counterparts, when measured as a percentage of tax evaded or tax due, and, further, there are a variety of circumstances in which

there are US civil penalties and no Korean counterpart: for aiding and abetting an understatement, for filing a frivolous return, and failure to provide a taxpayer or tax shelter ID. Further, US tax law provides specifically for 20% penalties related to willfully reporting inaccurately on a tax return.

Criminal Penalties.-Under US law, intentional tax evasion is punishable by fines of $100,000 and 5 years in jail in the case of an individual income taxpayer, and $500,000 and up to 3 years in the tax of intentional corporate tax evasion. Under Korean law, intentional and severe tax evasion can be equivalently treated as suicide criminal, which is lifetime in prison. However, it is seldom applied to this strict prosecution.

Table 3 : Comparison of Penalty Warning on US vs. Korean Personal and Corporate Tax Returns

	US Jurat	**Korean Jurat**
Individual Income Tax	Under penalty of perjury, I declare that I have examined this return and accompanying schedules, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	I report my tax statement under the rule of Income Tax Act.
Corporate Income Tax	Under penalty of perjury, I declare that I have examined this return, including accompanying schedules and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge	I report the tax statement under the rules of Corporation Tax Act and National Tax Basis Act.

Table 4: Comparison of Selected US and Korean Administrative Tax Rules and Penalties

Administrative Tax Provision	US Rule	Provision	Korean Rule	Provision
Burden of Pro of in Dispute	Taxpayer Dispute over IRS Assessment	Taxpayer has burden of proof to show IRS assessment is wrong in first instance	Taxpayer Dispute over NTS Assessment	NTS has burden of proof
Statute of Limitations	General	3 years	General	5 years
	Omissions > 25 % income	6 years.		
	False or Fraudulent Return	Unlimited	False or Fraudulent Return	10 years
	Willful Attempt To Evade Taxes	Unlimited	Willful Attempt To Evade Taxes	10 years
	Failure to File Return	Unlimited	Failure to File Return	7 years
	Failure to Show Gifts (Gift & Estate Tax)	Unlimited	Inheritance & Gift Tax	10 years
			Fraudulent and Willful Attempt to Evade Inheritance & Gift Tax	15 years
	Promotion of Abusive Tax Shelter	Unlimited	No Provision	NA
Civil Penalties	Failure to File	5%/month up to 25% of Tax Due	Failure to File	20%
	Fraudulent Failure to Fil	15%/month up to 75% of Tax Due	No Provision	NA
	Failure to Pay	.5%/month up to 25% of Tax Due	Failure to Pay	0.05% per day
	Fraud	75% of Underpayment	Fraud	Less than 300% of Total Tax evaded
	Responsible Person Penalty	100% of Total Tax evaded	Fraudulent Failure to File or No payment by Employer for Withholding	100% of Total Tax evaded
	Aiding & Abetting Understatement	$1,000	No Provision	NA
	Frivolous Return	$500	No Provision	NA
	Failure to Provide SSN	$50	No Provision	NA
	Failure to Furnish Tax Shelter ID	$100	No Provision	NA
Accuracy Penalties	Negligence	20% of Underpayment	No Provision	NA
	Substantial Understatements	20% of Tax	No Provision	NA

Administrative Tax Provision	US Rule	Provision	Korean Rule	Provision
	Valuation Misstatements	20% of Tax	No Provision	NA
	Overstating Pension Liabilities	20% to 40%	No Provision	NA
Return Preparer	Understatement of Liabilities	$250	Not Specifically Coded for Violating Rules	NA
	Reckless Disregard of Rules	$1,000	Not Specifically Coded for Violating Rules	NA
Criminal Penalties	Tax Evasion (personal and corporate tax)	$100,000 and up to 5 years in prison	Tax Evasion	200-500% of tax evaded/ 5 years – lifetime in prison
	Tax Evasion (tax preparer)	$500,000 and up to 3 years in prison		

5.2 Comparison of Performance in Tax Administration: Korea and USA

If we focus on approximately the past 30 years (1969-1998), we note that total employment in the IRS grew from 66,000 in 1969 to a peak of 116,000 in 1992. Since 1992, total IRS employment has dropped to 98,000. During this same period, the US population grew from 202 million to 271 million persons. Figure 1 displays graphically the employment of National Office workers, which has varied between 3,800 and 9,700 and Field Staff which has varied between 62,300 and 107,900. Collections per employee have grown very dramatically during the same period: from $2.8 million to $18.0 million per employee (see Figure 2). Finally, IRS operating costs as a percentage of collections during 1969-98 have varied between .4% to .6% (see Figure 3).

Figure 1: IRS National and Field Staff: 1969-98

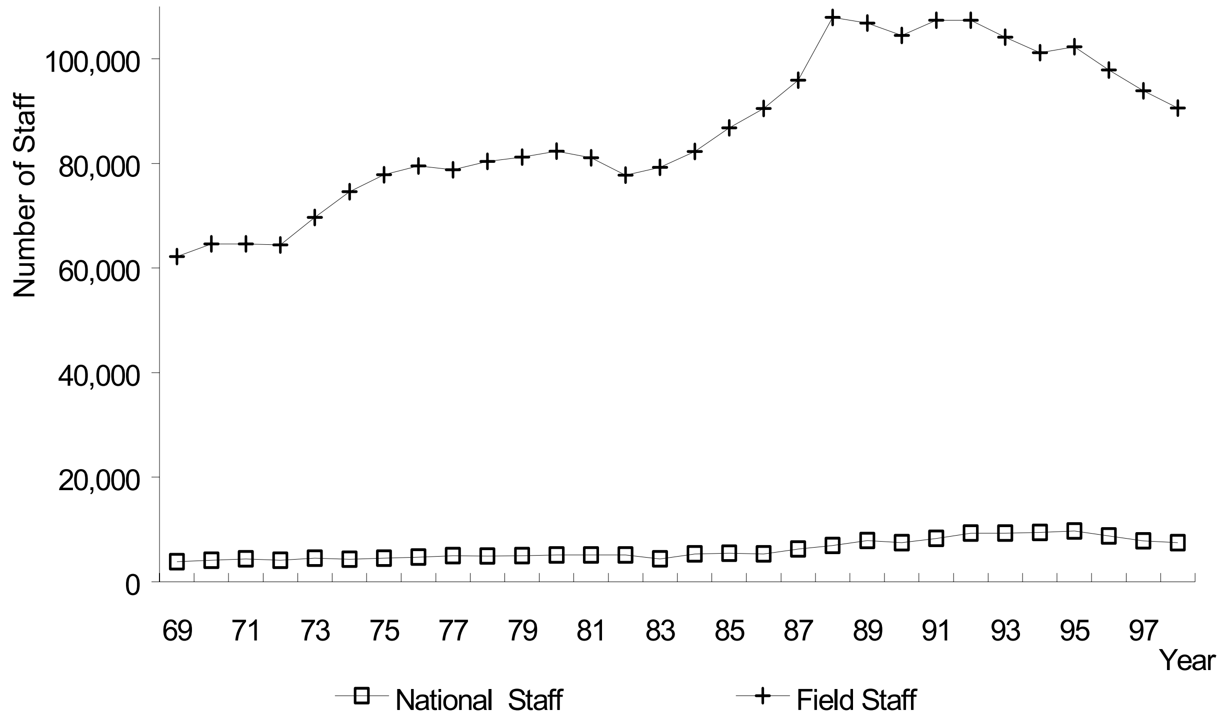


Figure 2: IRS Collections/IRS Employee:1969-98

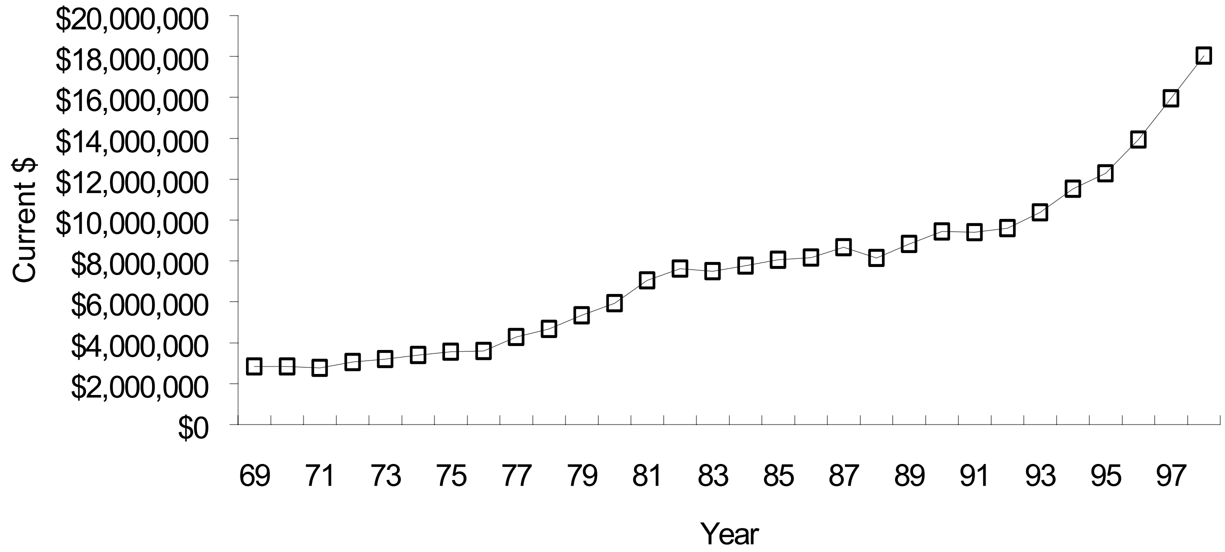
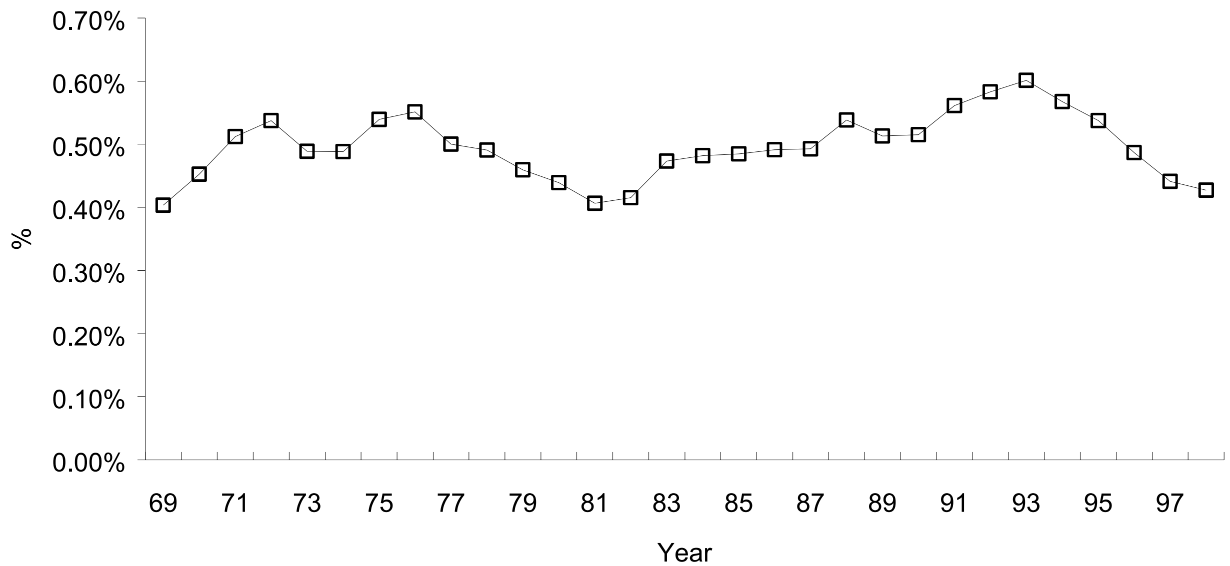


Figure 3: IRS Costs as % Collections:1969-98



We compare the two different systems of tax administration between Korea and USA. The measurement of performance might be useful information to evaluate the tax administration in a quantitative way. Due to limited information that both systems have, we use relatively rough information to compare the two systems. The input factors might be prerequisite for comparing these tax administrations. Typical input factors for producing tax administration are capital and labor. We compare tax administration labor effort by using the total number of tax officers per thousand taxpayers. Table 5 and Figures 4 show the comparison of such labor input over time between the two countries. We find that Korea has a bigger labor force in producing services provided in tax administration. This difference is quite large; after 1996, Koreas' tax administration labor force was three times bigger than the labor force in the USA. However, the pattern of each country is different over time. Korea shows a decreasing tendency in the utilization of tax administration labor over time, while the USA shows a more stable pattern.

Trying to compare the performances of the tax administration between the two countries and since this can not be evaluated with one single index measurement, we use two indexes. One of the most commonly used indexes is the collection cost per tax revenue. Even though this index does not represent the performance or the level of efficiency in tax administration, this index has been popularly applied to comparative analysis. Table 6 and Figure 5 compare collection costs per 100 units of tax revenue between the two countries. Clearly, Korea has a higher collection cost than USA. Currently, the collection cost in Korea is almost double that in the US. Tax administration in Korea used to depend upon government assessment, and this led to a higher level of collection cost than USA. Korea shows a declining pattern in collection cost while the USA shows a stable pattern. As dramatic reform in tax administration has been executed recently, collection cost will be reduced in the near future.

We also use the level of delinquent taxes as an index to compare the performances of the two systems. Table 7 and Figure 6 compare the ratio of delinquent tax payment to the total tax revenue over time. Note that for Korea, delinquent tax payments are more than 15% larger than of the US. Moreover, , the ratio increased to 24% in 1998.[27] This pattern is quite different than that in the US which has remained at about 2%.

When we compare several indices related to the productivity of tax administration, we find that the US federal tax administration is more efficient system in tax administration than Korea. Of course, these findings cannot totally be depended on, because they are based on limited information to evaluate tax administration in the two countries. However, this initial result suggests there is merit in further analyzing ways that tax administration can be improved in Korea. Also, these comparisons do not reflect the impact of the 1999 tax administration reforms which were designed to improve tax compliance generally.

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[27] Korea began to have an economic crisis from the end of 1997. The level of delinquent taxes in 1998 reflects this economic situation.

Table 5: Tax Officers per a Thousand Taxpayers

(Unit: %)

Year	Korea	USA
1980	5.6	0.87
1985	4.5	0.85
1990	3.9	0.91
1995	2.7	0.88
1996	2.6	0.82
1997	2.5	0.77
1998	2.5	0.72

Source:

Figure 4:Comparison of Tax Officers per 1000 Taxpayers in Korea and US: 1980-98

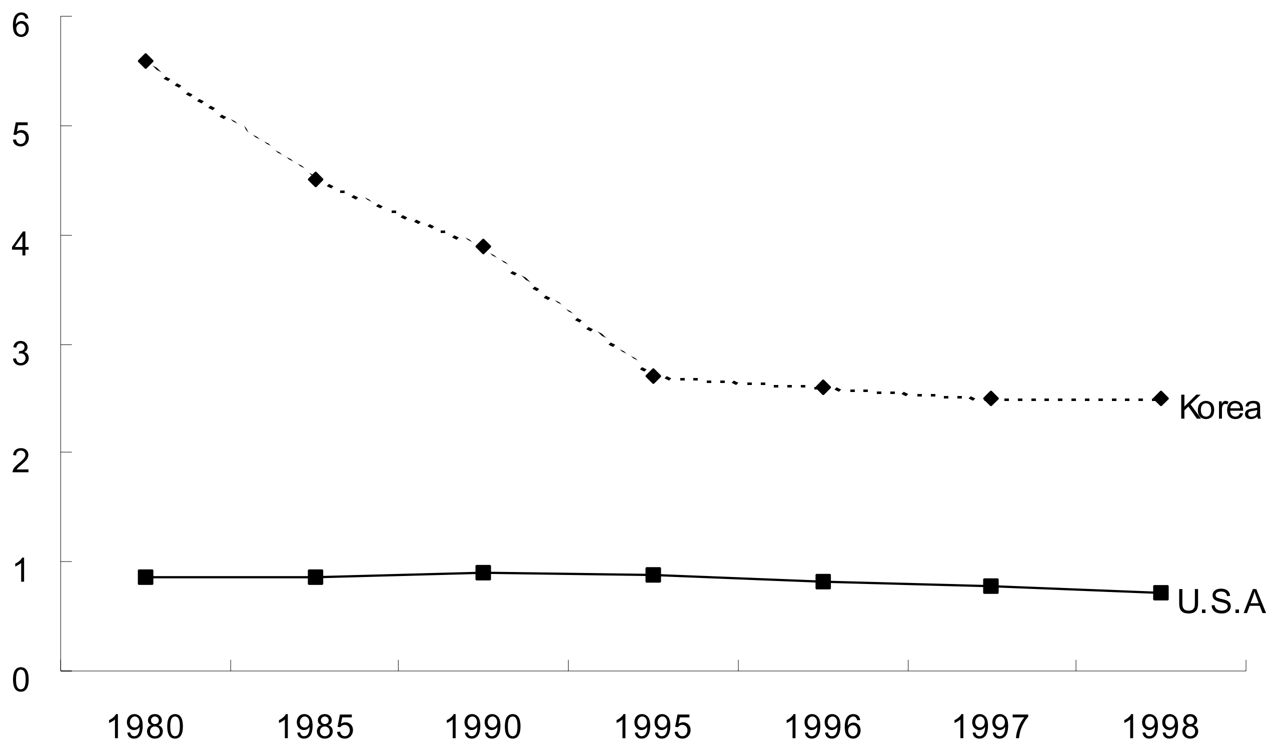


Table 6: Collection Cost as Percent of Tax Revenue (%)

Year	Korea	USA
1977	1.53 %	0.50 %
1978	1.41	0.49
1979	1.27	0.46
1980	1.21	0.44
1981	1.26	0.41
1982	1.28	0.42
1983	1.18	0.47
1984	1.15	0.48
1985	1.15	0.48
1986	1.13	0.49
1987	1.05	0.49
1988	0.97	0.54
1989	0.96	0.51
1990	0.93	0.52
1991	0.99	0.56
1992	0.98	0.58
1993	0.97	0.60
1994	0.92	0.57
1995	0.91	0.54
1996	0.93	0.49
1997	0.91	0.44
1998	0.91	0.43

Figure 5: Tax Collection Costs as % of Tax Collections in Korea and the US: 1977-1998

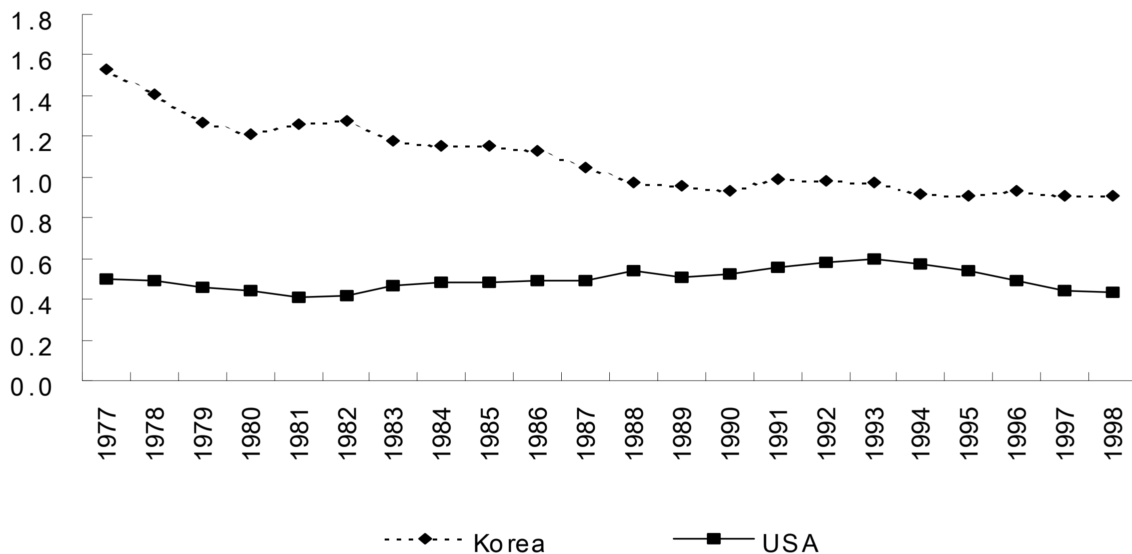
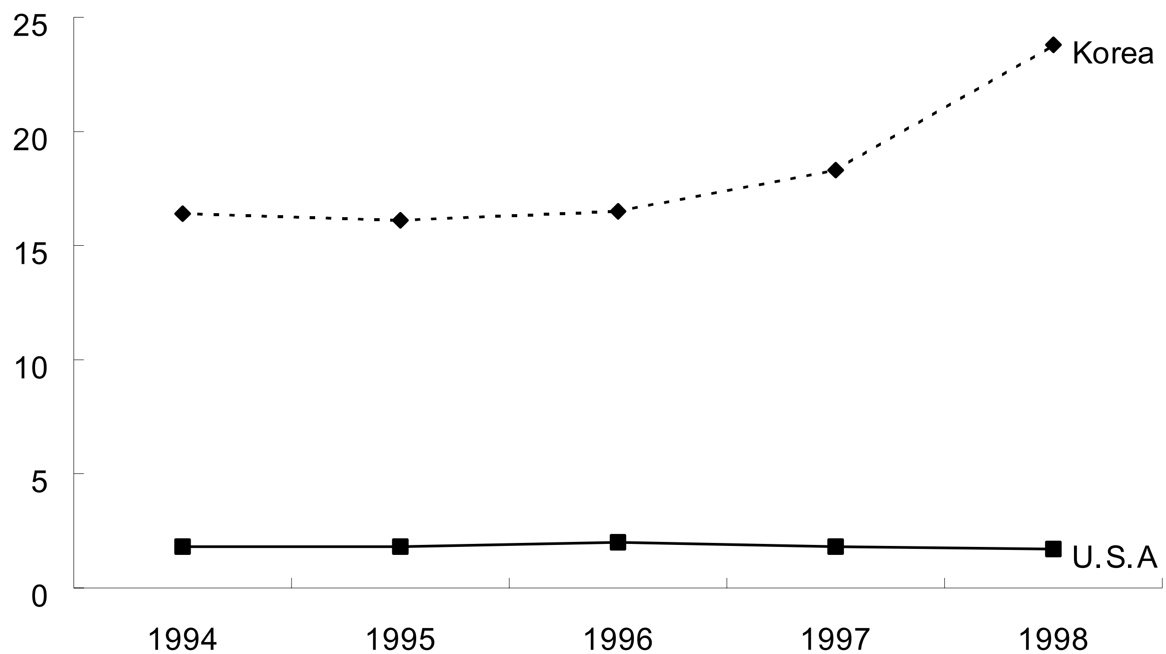


Table 7: Comparison of Delinquent Payment: Total Delinquent Taxes/Total Revenue Unit: (%)

Year	Korea	USA
1994	16.4	1.8
1995	16.1	1.8
1996	16.5	2.0
1997	18.3	1.8
1998	23.8	1.7

Source:

Figure 6: Delinquent Payments as % of Total Taxes in Korea and the US: 1994-1998



5.3 Comparative Evidence on Use of Tax Audit

The tax audit is one of most effective tools to maintain taxpayer's compliance; however making international comparisons of tax audit policy is not simple or easy to accomplish. As a first step, we use the proportion of taxpayers audited as an index for comparison. Table 8 shows the tax audit rate for Korea and US in recent years. We find that Korea has a much lower audit rate in the individual income tax than USA. However, the tax audit rates for the corporate income tax are similar. Note that in Korea the tax audit rate for value added tax is at a higher rate for corporations than for individuals. (The US does not have a federal value added tax; two states in the US, New Hampshire and Michigan, have value added taxes.)

Thus, while Korea has a high level of tax non-compliance as indicated by the importance of delinquency payments relative to overall tax collections, the tax audit rate is quite low, especially in the case of individual income taxes. With the tax reforms of 1999, NTS has tried to strengthen its tax audit policy. To accomplish this, of course, requires more specialized and highly trained personnel, budgetary resources to obtain them, and increased management oversight.

The process of selecting taxpayers for audit requires careful consideration. USA has long history to efficiently select taxpayer for audit by using TCMP data, and it gives taxpayers confidence in tax audit policy. Korea has spent careful consideration for selecting taxpayers for audit by using big database for taxpayers, which is called the Tax Information System or just TIS. However, the process for selecting taxpayers for audit has not been promulgated to the public, as TCMP system is not being executed in Korea. Taxpayer's mistrust toward tax audit might be one of serious issues that Korea's tax administration faces currently.

Table 8: Comparisons of Rates for Tax Audit

(Unit: %)

	Korea (1999)	USA (1997)
Individual Income Tax	0.26	0.99
Corporate Income Tax	2.36	2.09
Value Added Tax		
- Corporation	0.93	-
- Individuals	0.14	-

Source: Internal Revenue Statistics, Data Book, Publication 55B, 1998.

National Tax Service, Annual Statistical Book, Korea, 2000.

5.4 Comparative Evidence on Compliance

The level of tax compliance is very important information that can be used to evaluate the efficacy of the

tax administration policy. One typical way to measure the degree of tax compliance is to take a random sample of tax returns, and subject them to a very rigorous audit. The TCMP has been used in the US as a way to ascertain where compliance problems may occur, and to inform through the use of DIF functions auditors where to look. Such samples of returns in which every line is audited, is a very rich information source about income sources and taxpayer's characteristics. Through TCMP, IRS has promulgated the various outcomes of tax compliance[28]. It should be noted that in the 1990's the TCMP process was suspended by Congress, although the 2001 IRS budget contemplates its reinstatement.

Table 9 shows some aggregate results of the last three IRS TCMP studies, and indicates that underreporting income is the single largest source of taxpayer compliance when measured in terms of taxes not collected.. Overall, the "costs" of noncompliance with the US federal individual income tax has been on the order of 17 to 18% of properly measured collections.

The publication and discussion of TCMP results can lead to positive changes in tax laws and improved taxpayer compliance. The 1982 TCMP study reported that the taxpayers with children living away from home (primarily attending college) overstated the number of exemptions on the parents tax returns by 50%.[29] In 1986, a so-called "kiddie tax" was imposed that generally required taxpayers to list their dependents name and Social Security Number. In the year subsequent to enactment there were 8 million fewer exemptions claimed on federal tax returns. There was no public outcry about this new reporting requirement, and, of course, federal tax revenues were enhanced as a result.

Table 9: Estimates of US "Tax Gap" from TCMP Studies:

Tax Gap Component	**Tax Year ($ Billions of taxes)**					
	1985		**1988**		**1992**	
	Low	**High**	**Low**	**High**	**Low**	**High**
Total	9.6	9.8	11	11.2	13.5	13.8
Underreporting Gap	43.6	44.6	46	47.1	57.2	58.6
Underreported Income	8.8	9.1	10.9	11.3	14	14.4
Overstated Offsets	8.8	9.1	10.9	11.3	14	14.4
Net Math Error	-0.2	-0.2	0.2	0.2	0.1	0.1
Total	52.2	53.5	57.1	58.5	71.3	73.1
Under Payment Gap Total	7.1	7.1	11.2	11.2	8.4	8.4
Gross Tax Gap	68.9	70.4	79.3	80.9	93.2	95.3
Voluntarily & Timely Paid	303.3	303.3	381.4	381.4	457	457
"True" Tax Liability	372.2	373.7	460.7	462.3	550.2	552.3
Gap as % of True Liability	18.5%	18.8%	17.2%	17.5%	16.9%	17.3%
Gap as % of Voluntarily Paid	22.7%	23.2%	20.8%	21.2%	20.4%	20.9%

Source: IRS(1996), Table 1, p. 5.

[28] IRS(1996) shows the degree of tax compliance in various ways.
[29] See Steuerle(1986), Table 4-1, pp. 42-3.

Korea does not have TCMP data, so that NTS cannot inform the public about how well or poorly taxpayers comply with the tax laws. The absence of a Korean TCMP makes it difficult to compare the degree of tax compliance between two countries. There are, however, indirect methods to do this. Schneider and Enste (2000) surveys empirical findings on the size of the underground economy for many different countries. They find that the amount of underground economy with respect to GDP is 38-50% in Korea, and 8-10% in USA. From this we conclude that Korea has a much higher level of tax non-compliance than USA. This comparison then suggests that Korea should consider ways to improve compliance through a structural change in tax administration and/or finding ways to improve taxpayer attitudes so taxpayers voluntarily increase their level of tax compliance.

6. Challenges to Korea's Tax System

6.1 Some Implications and Suggestions about Recent trends in Korea's tax system

Korean collection costs as a percentage of total tax collections has been falling which is by itself an indicator of growing administrative efficiency. In 1977, Korean tax collection costs were 1.53% of total collections as compared to .5% in the US. By 1998, Korean tax collection costs were .91% of total collections compared to .43% for the US.

On the other hand, delinquency payments have been growing percentage of Korea's tax collections and have been over an order of magnitude greater than in the US. In 1998, delinquency payments were 23.8% of tax collections in Korea while only 1.7% in the US. The large differential suggests that the incentives for compliance in Korea's tax system may not be strong enough to convince taxpayers to pay promptly and accurately.

In the US, public discussion and debate about federal tax administration is an ongoing process. Public hearings that allow taxpayers to comment as well as Treasury and IRS managers to respond by Congressional oversight committees, ongoing studies by the GAO of tax compliance and tax administration, and the annual Congressional budgetary process through which IRS must obtain its funds provides ample publicity about the successes and shortcomings of the IRS. Periodically the IRS has contracted with Lou Harris, the polling company, to obtain independent, reliably measured data on taxpayer attitudes. The TCMP process, which is scheduled to begin again, permits IRS to know with great accuracy where compliance problems occur. The relative open-ness of US tax administration is accompanied by extreme secrecy and privacy surrounding the financial information of each taxpayer and the IRS. Through this mixture of openness or transparency and assured privacy, taxpayer confidence in the US has been maintained at a high level, and voluntary compliance achieved at relatively little budgetary cost.

Computerization of virtually all sources of income, the universal application of Social Security Numbers to children aged 6 or more has meant to US taxpayers that not fully reporting will more likely entail an audit than in previous decades. Computerized matching of information reports from financial institutions has created stronger incentives for taxpayer compliance. A byproduct of greater voluntary compliance is that a given level of revenue can be raised with lower marginal tax rates than if non-compliance is widespread.

The problem that Korea may be facing, then, to increase taxpayer compliance, is to improve taxpayer confidence so that statutory rates can be lowered. Several techniques which the US uses to enhance taxpayer confidence and complexity deserve consideration in Korea:

- Independent surveys of taxpayer attitudes towards their tax system and publication of the results of such studies

- The collection and careful auditing every few years of samples of tax returns (TCMP studies), and promulgation of the results

- The promulgation of analysis and statistical results about the tax system to the public on an ongoing basis

- Periodic analysis of the complexity of Korea's tax laws and forms by scoring the language for clarity

One advantage of using the personal income tax system as an adjunct to the income maintenance system is that it provides a positive incentive for tax return filing. As long as the manipulation of the file returns can be done in an efficient and timely fashion, increasing coverage of the tax system can improve taxpayer morale, because the tax administrator will be able to describe with confidence the impact of the tax system on the electorate because it will have all the data in hand. This observation leads to the suggestion of:

- Lowering the filing threshold in Korea to enable better collection of data for various tax and statistical purposes, and to enable tax policy to provide refundable earned income tax credits if there is national agreement on such redistributive policies;

As noted in the historical review of US personal income tax administration, a civil war led the North to adopt very aggressive policies in order to finance its efforts. The power of search and seizure, and the separation of the judicial authority from the tax authority are very powerful tax administration tools to ensure taxpayer compliance. Similarly, the integration of retirement tax collection responsibility under the general tax

authority provides for several types of cross-checking, especially with the self-employed, that can ensure higher levels of compliance. However, unless there is taxpayer confidence in the independence of the tax authority from political and other economic pressures, such authority can be abused to the taxpayer's disadvantage, and ultimately to the disadvantage of confidence in the system (and voluntary compliance).

6.2 Unification As A Possible Fiscal Strain

Korea now faces dramatic change in the relationship between South and North Korea. While it is difficult to predict the ultimate path and timing that could lead to unification of South and North Korea, it is likely that when political unification is achieved, there will be many complex economic ramifications that will not only impact North Korea, but also impact South Korea. While unification could reduce defense outlays in the future as a percent of GDP, it is also true that North Korea's infrastructure will require substantial investment from South Korea. Also, the speed at which publicly owned assets in North Korea can be privatized is difficult to predict. Much will depend on how private property rights are devised for North Korea, and the manner in which monetary integration takes place.

In Germany, the decision to create parity between the two currencies when labor productivity was three times higher in West Germany continues to create very serious, and unanticipated high levels of unemployment in the former East Germany. By the mid-1990's real wages in West and former East Germany had risen 3%/year while labor productivity fell 2%/year in former East Germany with the predictable result that unemployment in the former East Germany has risen by a factor of more than 2.0[30] In 1996, employment in the former East Germany was 70% of its 1990 pre-unification level.

There are several studies which estimate the cost of unifying South and North Korea. However, there is wide variation in the cost estimates. Noland (2000) estimates infrastructure investment costs, which would be financed by South Korea, to range between $1 billion and $2 billion/year. Table 10 shows what this unification cost means in relation to South Korea's budget and taxation level. These infrastructure cost estimates are around 1 – 2% of the national budget, and about 1.6 – 3.2% of national tax revenue.

Table 10: .The Estimated Cost of Unifying South and North Korea

Unification Cost (A)	(A) / National Budget	(A) / National Tax Revenue	(A)/ GDP
$ 1 billion (1.2 trillion won)	1.0%	1.6%	.25%
$ 2 billion (2.4 trillion won)	2.0%	3.2%	.50%

Note: The National budget is from consolidated budget account of central government, and is 121 trillion won.

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[30] IMF(1997), p. 51.

National tax revenue is 75.6 trillion won. All values are in 1999 won. Source: Noland(2000).

Whether or not such additional strain on the national budget is realistic remains an open issue; however, if one looks at the experience of German unification, one finds that unification was far more costly. Official transfers from the national budget to finance infrastructure investments from 1991-97 averaged .7% of GDP. Overall net transfers for income maintenance, aid to the Lander, infrastructure, business promotion and other programs from the national budget averaged better than 4% of GDP. [31] Such transfers have been about 38% of former East German GDP.

6.3 Unification as a Tax Administration Problem

Various observers of the South Korea tax system note rather high levels of non-compliance especially among the self-employed. A question immediately arises about how Korean taxpayers might react to much higher levels of taxation to support unification, and the possibility that non-compliance might markedly rise. From a strategic vantage point, there may be merit in considering mechanisms to improve taxpayer compliance before unification occurs.

[31] IMF(1997), p. 95.

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