

Reform and Modernization of the Tax Compliance Process

By William J. Kambas

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In "Simple Filing for Average Citizens: The California Ready Return," Prof. Joseph Bankman describes a simplified tax-filing program developed to streamline the compliance process.¹ California's Ready Return program allows eligible taxpayers to receive state completed returns for review, correction, and subsequent remittance for final processing by the state.² The program is based on the idea that governments already have enough information to provide prepared returns to large portions of society and therefore should.³ It automates portions of the tax compliance process.

Prof. Bankman believes that an automated tax return preparation program, if adopted by the federal government, will save taxpayers and government "time, money, anxiety, frustration and anger"⁴ thereby relieving the "headache of burdensome record-keeping, lengthy in-

¹Joseph Bankman, "Simple Filing for Average Citizens: The California Ready Return," *Tax Notes*, June 13, 2005, p. 1431 (hereinafter "Simple Filing").

²An "eligible individual" is someone "who in 2003 did not itemize and had wage income only, and appeared to fall into that same category in 2004." It is significant to note that the "eligible" population was approximately seven million people (or approximately 40 percent of California taxpayers). *Id.* at 1432.

³This population generally consists of those individuals that historically have only Forms W-2 and 1099 income and take the standard deduction.

⁴"Simple Filing," *supra* note 1, at 1431. See also Joseph Bankman, "Panel: Issues Associated with 'Return-Free' Filing, Meeting of the President's Advisory Panel on Federal Tax Reform," May 17, 2005, available at <http://www.taxreformpanel.gov/meetings/meeting-05172005.shtml>.

structions, and complicated schedules, worksheets, and forms"⁵ that defines the tax compliance process for large portions of society.

Automation may be beneficial to the tax compliance process, but protection of taxpayers' personal data is an important aspect of the proposed procedural tax reform. Accordingly, the development of a data protection infrastructure should be part and parcel of tax compliance modernization. This article seeks to expand the discussion regarding the development and implementation of an automated system.⁶ It is intended to buttress Prof. Bankman's position by acknowledging the valuable contribution of modern technology toward an efficient tax compliance system. However, the article questions whether sufficient efforts have been taken to protect taxpayer data.⁷ In so doing, this article highlights some recent events that illustrate taxpayer data vulnerabilities and suggests methods of minimizing those vulnerabilities. This article concludes with a discussion of the shift in relationship between the taxpayer and the governments resulting from automation.

Although this article raises concerns for data protection, it does not argue that our current system is more likely to result in accurate reporting or more likely to safeguard taxpayer data. Modern technology is an invaluable asset to efficient government and the implementation of modern technologies should be welcomed — but not without due regard for the vulnerabilities it may bring or societal norms it alters. Comprehensive analysis of the many aspects of our current tax compliance system and the effect of modern technology on it (including detailed analysis of the confidentiality provisions of section 6103, the Office of the Privacy Advocate, privacy impact assessments (PIAs), the significance of *Payne v. United States* and related cases, public-private/state-federal data sharing, and so forth) shall be addressed in future articles.

Enabling Automation

Data mining is basically a sophisticated query — a process of manipulating voluminous data into manageable and understandable configurations. It is also the technological process that facilitates multiple areas of the

⁵Statement by the President's Tax Reform Panel, "America Needs a Better Tax System: Statement by the Members of the President's Advisory Panel on Federal Tax Reform," available at <http://www.taxreformpanel.gov/04132005.pdf>.

⁶This article, however, neither addresses nor is concerned with the role or impact of tax preparation services such as TurboTax, H&R Block, or others.

⁷The author has reviewed the California Franchise Tax Board's (FTB) Frequently Asked Questions as well as the general information available on the FTB's Web site.

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tax compliance process — including automated tax return preparation. Generally speaking, it is the automated extraction or reorganization of pieces of information for some specified use.⁸ Data mining processes find trends, patterns, and relationships contained in large databases.

Typically, data mining in the tax compliance process is used to attribute pieces of information to respective taxpayers. Last year, the Government Accountability Office released a report titled *Data Mining: Federal Efforts Cover a Wide Range of Uses*, GAO-04-548, finding that data mining is increasingly employed by multiple government agencies, including the IRS. Additionally, Verenda Smith, government affairs associate at the Federation of Tax Administrators, explained that data mining has also been embraced by state agencies. As Smith said, data mining is “the new trend. It’s where everybody is headed,” because it can be used for audits, return analysis, and even to facilitate statistical research. In summary, data mining is a prerequisite for comprehensive automation.⁹

The California Ready Return program relies on data queries. The state has certain information in its databases and must manage that data, organize it, process it, and present it on individualized tax returns.¹⁰ The more information managed, the more sophisticated the query. Those queries are at the center of an automated tax compliance program.

Data Protection and Safeguards

Prof. Bankman does not address data protection (or data privacy) as a significant concern for an automated tax system. There is little concern, he states, because no new information is collected; the information is already in the government’s computers.¹¹ He further states that the program actually enhances privacy rights by letting taxpayers know what information government already has.

However, history shows that data collection is not the only trigger for privacy concerns. Rather, concerns rise at all phases in the use and maintenance of personal data.

⁸This may be an oversimplification, but it is sufficient for the purposes of this article. To be more specific, data mining is defined as the “nontrivial process of identifying valid, novel, potentially useful and ultimately understandable patterns in data.” See U.M. Fayyad et al., “From Data Mining to Knowledge Discovery: An Overview,” in *Advances in Knowledge Discovery and Data Mining* 6 (1996). As Tal Zarsky points out, the common denominator in a definition for data mining is “the discovery of new information from an existing database.” See Tal Z. Zarsky, “‘Mine Your Own Business!’: Making the Case for the Implications of the Data Mining of Personal Information in the Forum of Public Opinion,” 5 *Yale Symp. L. & Tech.* 1 (2003).

⁹Prof. Bankman has pointed out that the California Ready Return program does not currently use data mining processes. However, data mining is the next generation of basic database queries. Further, given the increased use of data mining by state and federal authorities, it is a logical component to procedural tax reform.

¹⁰Prof. Bankman emphasizes that the Ready Return program does not increase the amount of information about taxpayers that is reported to the state.

¹¹“Simple Filing,” *supra* note 1, at 1433.

Confidence in our tax system is contingent on the proper protection of taxpayers’ data. Establishing that confidence is a cornerstone for effective tax reform.

Confidentiality exists, but data protections may still be necessary.

Taxpayer data is considered confidential.¹² Officers or employees of the United States, or other persons who have access to returns or return information, are prohibited from disclosing that information.¹³ Section 6103 provides that “returns and return information shall be confidential, except as authorized by this title.” There are numerous exceptions, which I will not detail in this article, but one deserves attention.¹⁴ There is an exception for the disclosure to state tax authorities, to the extent necessary for the administration of state tax laws, subject to some restrictions.

Although taxpayers’ personal data generally qualifies for confidential treatment, modernization (such as automation) dictates the introduction of new processes. Data sharing and other permissible uses of taxpayer data raise the need for modernized internal data protections and modernized accountability.

On June 24, 2005, Reuters’ security correspondent Caroline Drees reported that the IRS “is investigating whether unauthorized people gained access to sensitive taxpayer and bank account information.” As a test in April 2005, the GAO tapped into IRS databases “without authorization, and gleaned information such as bank account holders’ names, social security numbers, transaction values, and any suspected terrorist activity . . . [The GAO] . . . said the data was at serious risk of disclosure, modification or destruction.”

IRS internal databases are not the only concern. Private databases are also victims of mistake or malice — which is a concern because governments often resort to the private sector for the latest and greatest in data management services. In fact, it has been widely reported that at the end of June 2005 the IRS renewed a five-year, \$20 million contract with ChoicePoint to provide data processing services to the agency. ChoicePoint, among other private entities, has been subject to data security problems.¹⁵ Those incidents should not preclude government contracting with private companies or scare off new

¹²Section 6103(a).

¹³A taxpayer can bring a civil action against the United States if an employee of the government knowingly or negligently discloses any return or return information or against an individual if the disclosure is made by a person who is not an employee of the government and punitive damages where disclosure was made willfully or as a result of gross negligence. Section 7431(a).

¹⁴Generally speaking, exceptions include disclosures to persons designated by the taxpayer, to state tax officials, to persons having a material interest in the information (such as a partner in a partnership), to congressional committees, to some federal officers and employees for purposes of tax administration and law enforcement, and to other governmental agencies such as the Department of Commerce, Federal Trade Commission, or Treasury for statistical use.

¹⁵After awarding the contract, the IRS issued a statement that a security review has been ordered to make sure the new contract will not endanger taxpayer confidentiality.

technology. Rather, they reinforce the need for proper infrastructure for data security and taxpayer redress.

Those risks are neither new to the government generally, nor to the IRS specifically. Back in 1993 the IRS established the Office of the Privacy Advocate, which has been assigned with ensuring that the IRS incorporates privacy protections into new processes and procedures. The mandate of the office suggests recognition by IRS management that traditional government responses to privacy are insufficient to address the broader privacy concerns that IRS activities raise and that are potentially overlooked during planning for new technology and new ways of doing business.

One of the most significant achievements of the Office of the Privacy Advocate was the development of the PIA. The PIA was established to enhance confidence and integrity in IRS practices. For example, a PIA is required for the implementation of new computer systems.¹⁶

Unfortunately, neither the Office of Privacy Advocate nor the PIA creates a taxpayer right to privacy. They may not even protect against privacy problems that do occur.

Early in June 2005, the U.S. Supreme Court let stand a Fifth Circuit decision holding that an IRS special agent was not liable for damages to a taxpayer for disclosures of confidential tax return information.¹⁷ The Fifth Circuit held that even though the IRS agent's conduct was improper and erroneous, he acted in good faith. Because the taxpayer did not have a right to the privacy of his personal data, there was no remedy under law for the disclosure of confidential information. Accordingly, concerns remain regarding the accountability and enforcement of privacy protection standards.

Whether data problems arise out of malice or mistake, they are difficult to remedy. Experience shows that the IRS is reluctant to give up a claim of income when it has an information statement in the taxpayer's name.¹⁸ Under an automated system similar to the California Ready Return program, the burden of correcting mistakes would likely fall on those without the means to correct the mistake.

As the saying goes, "to err is human," but mistakes should be avoided and tax reform should not be implemented absent careful scrutiny. Precautionary measures to protect against identity theft, malicious use of data, and even mistaken disclosure are legitimate reasons for data protection safeguards.

Looking Forward

Privacy concerns are not insurmountable. Accordingly, the development of an automated tax compliance system should begin with the development of comprehensive standards for privacy protection. For example,

taxpayers should be given notice, access, security, and redress as well as sufficient enforcement at all stages of the collection, maintenance, and use of their personal information. That includes the implementation of an infrastructure to quickly address complaints, concerns, and safeguards.

Those are basic principles and are known as the fair information practice principles (FIPP). They are reflected in the federal Privacy Act of 1974 but apply only to federal government computer databanks and are subject to various exemptions. Incorporating comprehensive privacy protection, such as the enactment of FIPPs, as part of any automated tax compliance system will help balance the efficiency of automation with adequate data protection.

A key aspect to the FIPP is the establishment of accountability. Taxing agencies that use modern technology to facilitate processes could implement direct audit and control mechanisms — perhaps similar to the control requirements mandated by the Sarbanes-Oxley Act of 2004. That would provide taxpayers with automated, tamper-proof, and timely information regarding the safeguarding of personal information. Used in conjunction with effective security and redress, inadvertent (or malicious) data disclosures would be easily monitored and remedied.

The president's tax reform panel should consider the incorporation of accountability features into automation technologies to facilitate security and redress. Prof. Nimrod Kozlovski points out that those features of accountability should include: (1) audit trails that maintain records of a system's activity, application processes, and a user's activity, to monitor the use of internal systems as well as law enforcement connection to private databases; (2) predictive analysis tools to control and report anomalous use and potential misuse; (3) appliances to interoperate with external auditors to check the system's usage and run random checks; and (4) anonymized and "cleaned" report functions to enable the production of automated detailed reports without disclosing sensitive or proprietary protected information.¹⁹ That would create an important system of checks and balances. It also would facilitate executive, legislative, and judicial controls over the tax compliance process.

Participatory Governance

As enticing as a return-free society is, there is no question that tax itself is necessary.²⁰ Assuming data protection concerns can and will be addressed, one must still inquire whether an automated tax system is beneficial for society in the long run.²¹ Questions include

¹⁶See generally Office of Privacy Advocate, Internal Revenue Service, *Privacy Impact Assessment Version 1.3* (1996); GAO, *Confidentiality of Tax Data: IRS' Implementation of the Taxpayer Browsing Protection Act* (1999).

¹⁷*Payne v. United States*, 125 S. Ct. 2550 (2005).

¹⁸Janet Spragens and Nancy Abramowitz, "Low-Income Taxpayers and the Modernized IRS: A View From the Trenches," *Tax Notes*, June 13, 2005, p. 1407, at 1416-17 (hereinafter "A View from the Trenches").

¹⁹Nimrod Kozlovski, "Technology in Service of Accountability — Watch the Watchers," presented at an ISP PORTIA workshop, Yale Law School, Jan. 26, 2005, available at <http://islandia.law.yale.edu/isp/index.html>.

²⁰As Oliver Wendell Holmes said, taxes are "the price we pay for civilized society."

²¹Scholars have observed that the law is not just an instrument for dispensing justice. It is also "a constitutive societal force shaping social relations, constructing meaning, and defining categories of behavior." Paul Schiff Berman, "Telling a Less

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whether automation in the tax compliance process encourages involvement in government; whether data mining and automation encourage additional governmental tracking of taxpayer activity; and whether the technological infrastructure for data mining and automation minimize concerns regarding the development of a “database nation.”²²

A well-developed tax system requires equity, explicitness, simplicity of compliance, and economy of administration.²³ Accordingly, changes in tax law and process “should be designed to make the law more equitable, easier to comply with, more conducive to economic growth, and less likely to interfere with private economic decision-making.”²⁴ Efficiency in the tax compliance process therefore is fundamental to effective tax reform, and automation — which, at least on the surface, is cost-effective and makes tax laws easier to comply with — should be integral to reform proposals.

However, automation carries risks as well.²⁵ Federal modernization, for example, implemented as part of the Internal Revenue Service Restructuring and Reform Act of 1998, which introduced many areas of technological developments and brought “efficiency gains,” also introduced “increasing reliance on specialized offices and computer generated notices.” When problems arise, they “have often come at the expense of fairness [to low-income taxpayers].”²⁶ Accordingly, prudence dictates thorough analysis of anticipatable risks.

IRS Commissioner Mark Everson has observed that the compliance process can be a “unifying” experience for the American public.²⁷ But increased complexity in the compliance process threatens that experience. Increased complexity in the compliance process, said Prof. Michael Graetz, “no longer links the American people to their government.”²⁸ Economist Eugene Steuerle added that “tax complexity promotes chaos and confusion and gives the taxpayer a ready excuse for inattention to detail merging toward outright noncompliance.” Taken together, those thoughts illustrate that Americans were once unified, in fact linked, with their governments through the exercise of tax compliance.²⁹ Recently, how-

ever, that relationship is challenged because the compliance process has become a mere burden, rather than remain a proud responsibility.

Years of volunteering with the IRS’s volunteer income tax assistance program has shown me that many taxpayers appreciate, and significantly benefit from, guidance in the tax compliance process. That guidance serves as a conduit for participation in the government-taxpayer exchange. It illustrates that guidance can be instrumental to the U.S. system of participatory governance.³⁰ Guidance, however, should not be mistaken with relief from responsibilities. The Ready Return program, by automating portions of the tax compliance process, tilts the scales from guidance toward relief from responsibilities. Automation also depersonalizes the compliance process. It risks the reduction of taxpayer awareness of the fiscal process and thereby risks the dilution of responsible fiscal citizenship.³¹

Further, the Ready Return program does not change the fact that the laws and regulations that define our current system of taxation are difficult for a majority of taxpayers to understand. That difficulty is a primary reason for discontent with the system as a whole. Accordingly, procedural tax reform should be undertaken as a complement to the reform of federal and state tax laws. Procedural and legal tax reforms should go hand in hand.

Chaos and confusion may be mitigated by hiding the complexity. If hiding complexity is the goal, the Ready Return program, as it stands now, may be the answer. If education, or tax law transparency, is the goal, detailed analysis of proper procedural tax reform may be required. Most concerning is that the Ready Return program caters to low-income taxpayers who may have few other connections to their governments or do not have the means to navigate complex governmental bureaucracies. As such, when questions arise, an overly simplified tax compliance process would not be able to restrain the flood of complex questions that would likely arise on review of the automatically prepared tax return.

As discussed above, I do not argue that our current system is superior to a modernized tax compliance system that employs efficiency-promoting processes and technologies. However, modernized processes and technologies do bring shifts in cultural and social norms. Because the tax compliance process is integral to the U.S.

Suspicious Story: Notes Toward a Non-Skeptical Approach to Legal/Cultural Analysis,” 13 *Yale J.L. & Human.* 101, 104 (2001).

²²Simson Garfinkel, *Database Nation: The Death of Privacy in the 21st Century* (2001).

²³See Adam Smith, *Wealth of Nations* (1776)

²⁴Michael J. Graetz, “Paint-by-Numbers Tax Lawmaking,” 95 *Colum. L. Rev.* 609 (1995).

²⁵See “A View from the Trenches,” *supra* note 18.

²⁶*Id.*

²⁷Testimony of Mark W. Everson, Commissioner of Internal Revenue, Before the President’s Advisory Panel on Federal Tax Reform, Mar. 3, 2005, available at http://www.taxreformpanel.gov/meetings/pdf/everson_03032005.pdf (hereinafter “Testimony of Commissioner Everson”).

²⁸Michael J. Graetz, “A Fair and Balanced Tax System for the Twenty-first Century,” in *Toward Fundamental Tax Reform* 40, 50 (Alan J. Auerbach and Kevin A. Hassett eds., 2005).

²⁹In the 1920s, Treasury Secretary Andrew Mellon stated that “Nothing . . . brings home to a man the feeling that he personally has an interest in seeing that government revenues are not squandered, but intelligently expended, as the fact that he

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contributes individually a direct tax, no matter how small, to his government.” Similar thoughts were repeated in 1955, when IRS Commissioner T. Coleman Andrews stated that “Americans should be educated, not coddled. It did a citizen good to come face to face with his tax bill.” See Joseph Thorndike, “Hurts So Good,” Op-Ed, *The New York Times*, Apr. 15, 2005.

³⁰Mark Everson says that “paying taxes is a unifying experience fundamental to our democracy and respect for the rule of law.” Concerning the size of our system, “last year [2004] 183 million people filed individual tax returns.” (Commissioner Everson notes that the tax compliance process involves considerably more people than voted in the last presidential election, which involved approximately 116 million people). “Testimony of Commissioner Everson,” *supra* note 27.

³¹Richard A. Musgrave, “Clarifying Tax Reform,” *Tax Notes*, Feb. 5, 1996, p. 731.

system of participatory governance, alterations and modifications should be undertaken after thorough analysis of the multiple effects it could have on a taxpayer — including where new questions could arise.

New Confusions?

The Ready Return program could create new confusions in the return review process. Although the Ready Return program seemingly reduces the need for taxpayer attention to detail, it may actually require further attention as taxpayers are required to review their returns. How can an inexperienced taxpayer know, for example, that as an independent contractor, Form 1099-MISC income may be subject to self-employment tax, estimated tax filing requirements, and may be offset by expenses paid to generate that income, unless they have already engaged in the confusing act of sorting through those forms and instructions? In other words, a system of automated returns may in fact lead to greater inattention to detail than our current system does. The consequences of that inattention may not be experienced on the initial filing, but it may well be experienced on audit or when questions arise during later tax periods.

Although the Ready Return program is limited to eligible individuals and may use only simple queries to generate prepared returns, it is logical (and even tempting) to expand the program once it is well-established in society. That expansion could include intergovernmental database linking to obtain increased access to taxpayer information. As Prof. Daniel Solove has pointed out, the government has:

the power to compel individuals to reveal a vast amount of personal information about themselves — where they live, their phone numbers, their physical description, their photograph, their age, their medical problems, all of their legal transgressions throughout their lifetimes whether serious crimes or minor infractions, the names of their parents, children, and spouses, their political party affiliations, where they work and what they do, the property that they own and its value, and sometimes even their psychotherapists' notes, doctors' records, and financial information.³²

The type of disclosure that Prof. Solove speaks of makes tax simplification a foregone conclusion — if the government can unilaterally assemble all this information, there is little need for taxpayer participation in the tax compliance process — until there is a problem. That is a radical change to the voluntary nature of our state and federal tax systems. It turns the tax compliance process into a billing exercise.

³²Daniel Solove, "Modern Studies in Privacy Law: Notice, Autonomy and Enforcement of Data Privacy Legislation: Access and Aggregation: Public Records, Privacy and the Constitution," 86 *Minn. L. Rev.* 1137, 1138 (2002).

In Conclusion

Procedural rules play a crucial role in compliance with tax laws.³³ Accordingly, tax reform should address procedural complexity. Automation is but one of many valuable tools for the modernization of our federal and state tax systems. As Prof. Bankman suggests, it should be seriously considered. The challenge lies in developing a cohesive system that is safe in use and protective of constitutional values.

³³See Leandra Lederman and Stephen W. Mazza, "Addressing Imperfections in the Tax System: Procedural or Substantive Reform?" 103 *Mich. L. Rev.* 1432 (2005) (reviewing David Cay Johnston's book *Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich — and Cheat Everybody Else*).