



1994

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Recommended Citation

Shirley D. Peterson, *Reform and Reinvention: The Internal Revenue Code and the Internal Revenue Service*, 47 SMU L. REV. 51 (1994)

<https://scholar.smu.edu/smulr/vol47/iss1/8>

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REFORM AND REINVENTION: THE INTERNAL REVENUE CODE AND THE INTERNAL REVENUE SERVICE

*Shirley D. Peterson **

IN this essay, I hope to provide a somewhat unique perspective on the tax system, focusing on the future of both the Internal Revenue Code and the Internal Revenue Service. I have two recommendations for fundamental reform of the tax system: the first calls for a complete replacement of the Internal Revenue Code, and the second calls for restructuring the system for administering the law. The first requires action by Congress; the second can be accomplished by the Internal Revenue Service. I will start with a plea for fundamental reform of the Internal Revenue Code.

I. TAX LAW REFORM

Eighty years have passed since the income tax was first enacted, and, while the system has served the nation well, I believe that the time has come to assess its continued viability. Eight decades of amendments and accretions to the Code have produced a virtually impenetrable maze. The rules are unintelligible to most citizens — including those holding advanced degrees and many who specialize in tax law. The rules are equally mysterious to many government employees who are charged with administering and enforcing the law. The need for simplification is apparent from the sheer weight of the Internal Revenue Code and its regulations, which now comprise eight volumes of fine print.

The current level of complexity undermines compliance and breeds disrespect for the law and for those agencies of government charged with its in-

* This essay is based on a speech given April 14, 1993 at the Southern Methodist University School of Law. Mrs. Peterson recently returned to Steptoe & Johnson as head of the Firm's tax practice after having served as both Commissioner of Internal Revenue and Assistant Attorney General, Tax Division, United States Department of Justice.

Mrs. Peterson headed the IRS during a critical juncture in its history. The agency is undergoing revolutionary changes in its philosophy, culture, and organization. As Commissioner, Mrs. Peterson championed IRS programs to reduce taxpayer burden and to improve the quality of service. During her tenure, the IRS won the President's Award for Quality and was selected as the best managed agency in the Federal Government.

Prior to her service as Commissioner, Mrs. Peterson was the Assistant Attorney General, Tax Division, United States Department of Justice. In addition to supervising the activities of the Tax Division, Mrs. Peterson argued on behalf of the United States before the United States Supreme Court and other Federal Courts of Appeals.

Prior to her government service, Mrs. Peterson practiced law for nearly twenty years at Steptoe & Johnson.

terpretation and administration. Complexity also imposes an undue burden on our citizens and on businesses who must divert scarce resources from productive activity to tax compliance efforts. The overall cost of tax compliance reaches into the tens of billions of dollars annually.¹ Surely those resources could be put to more productive use as this nation seeks to improve its competitive position in a global economy.

Granted, there is no easy solution to this problem. Republican and Democratic Presidents alike have condemned the current system, but no one has succeeded in correcting it. Jimmy Carter called the tax code "a disgrace to the human race,"² and Warren G. Harding is reported to have said:

I can't make a damn thing out of this tax problem. I listen to one side and they seem right, and then . . . I talk to the other side and they seem to be right. . . . I know somewhere there is a book that will give me the truth, but I couldn't read the book. I know somewhere there is an economist who knows the truth, but I don't know where to find him and haven't the sense to know him and trust him when I find him. . . . What a job.³

And that was in 1922! Imagine what President Harding would say if he were faced with the Internal Revenue Code (Code) in 1993!

We have seen many attempts at tax reform and simplification but none of these efforts have confronted the basic problem — the Code itself. The key question is: Can we define "income" in a fair and reasonably straightforward manner? Unfortunately, we have not yet succeeded in doing so.

In my view, it is time to stop tinkering at the margins. It is time to start over. I believe that the current income tax system should be *replaced* with a new, simplified system that would enhance the country's competitive position, encourage savings, and be less burdensome to taxpayers.

I want to emphasize that I do not favor "adding on" new taxes. Rather, I urge the total revision of the current system. Several blueprints for reform already exist.⁴ Those blueprints have been designed by both Democrats and Republicans, and they offer a variety of options for a new system.

One alternative repeals the current income tax and replaces it with a vastly simplified income tax. Another alternative substitutes a value added or consumption tax for the current income tax. In order to address concerns about regressivity, the consumption tax could be accompanied by a simplified income tax that would be imposed only upon persons having incomes in excess of, say, \$50,000. Another alternative replaces only the existing corporate tax with some form of value added or business transfer tax.

1. Dan Sheviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 920 n.87 (1992); O. Slemrod & N. Sorum, *The Compliance Costs of the U.S. Individual Tax Systems*, 37 NAT'L TAX J. 461 (1984) (estimating that taxpayers spent \$3 to \$3.4 billion on professional tax assistance alone).

2. Robert L. Turner, *Reagan Tune on Taxes has Familiar Ring*, BOSTON GLOBE, June 9, 1985, at A5.

3. Remarks of Warren G. Harding (1922), reported in JOSEPH R. CONLIN, *THE MORROW BOOK OF QUOTATIONS IN AMERICAN HISTORY* 135 (1984).

4. DAVID F. BRADFORD, U.S. TREASURY DEPT. BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984).

I mention these alternatives only for illustrative purposes. The more important point is to focus on the desired characteristics of any replacement tax. In my view, the desirable characteristics are as follows: The tax should be simple; it should be fair; it should be easily understood and easily administrable; it should minimize opportunities for tax avoidance; it should encourage savings, and it should enhance the country's competitive position in a global economy.

Measured by any standard, the current law fails to meet these objectives, and, unfortunately, the President's pending proposal is equally deficient.⁵ Indeed, the pending tax proposal is a step backward from reform. Higher rates are inevitably accompanied by more deductions, exemptions, and credits that add yet additional complexity to the Code. The President's proposal, once again, paves the way for tax shelters such as those that nearly swamped the Internal Revenue Service and the courts prior to the 1986 reforms. Moreover, the proposal does nothing to encourage savings or to improve our competitive position abroad.

The President's proposal was necessarily put together hastily, and it does not purport to constitute fundamental reform. However, President Clinton has shown a willingness to attack tough problems, and I hope that he will have the courage to tackle this one as well. Indeed, I hope that a commitment to fundamental change will be embraced by Democrats and Republicans alike and that they will get started *now*. The restructuring that is needed cannot be accomplished overnight. We need to begin the effort immediately.

I recommend that the President appoint a bi-partisan commission and direct it to design a tax system having the characteristics outlined above. In my view, the time has come to put simplification and reform ahead of politics.

II. REINVENTING THE IRS

Turning from the law itself to the *administration* of the law, I want to discuss changes underway at the Internal Revenue Service. Tax administration has important practical implications for all Americans, and it is especially important if the call for restructuring of the law goes unanswered.

In the twenty-first century, how will you file your return? How many forms will be necessary and how much time will they take to complete? How efficient will your audits be? What quality of assistance can you expect from the IRS?

These questions will be answered not so much by my words today as by the actions that are taken in the next few years. The Internal Revenue Service holds in its hands a golden opportunity to revolutionize today's tax system. But it will need the help of tax professionals and tax educators as it seeks to move beyond the constraints of the past and truly "reinvent" itself.

5. The majority of President Clinton's tax proposals are contained in the 1994 Budget Reconciliation Bill, H.R. 2264, 102d Cong., 1st Sess. (1993).

"Change" is fast becoming the watch word of this decade. We witnessed an election where the promise of "change" played a key role. Even in the private sector, organizations both large and small are hard at work to determine what changes will be necessary for the world of tomorrow. Other government agencies and foreign tax administrators are engaged in a similar self-examination. On a global level, mankind seems to sense the importance of this moment in history. In all sectors of our society, dedicated men and women are examining the *status quo* and deciding that we must do better. Poised before a new century, we must seize this moment — and the Internal Revenue Service is doing just that.

Like businesses and tax administrators around the world, the IRS recognizes that it must shift its focus to the needs of its customers — that is, the taxpayers whom it serves. Ten years ago, perhaps even five years ago, this statement may have been considered radical, but today it reflects no more than an objective, business-like assessment of the facts. The IRS realized some years ago that fundamental change was necessary. The fact is: If we do not change our system for collecting taxes, it will fail us. It will break down from the sheer inability to handle the volume of returns and taxpayer inquiries received by the IRS.⁶ Without change, the IRS cannot continue to administer and enforce the law effectively.

I will spend a few moments describing for you the nature of the changes that are contemplated at the IRS and what those changes will mean for you and for tax administration.

First, I want to emphasize that all of the proposed changes are firmly grounded in the IRS three major objectives: to improve voluntary compliance, to reduce taxpayer burden, and to improve quality driven productivity and customer satisfaction. This is the framework for change. To fill in the framework, I want to talk about three changes that are underway at the IRS: namely, changes in philosophy, programs, and organizational structure.

III. CHANGE IN PHILOSOPHY

The first basic change is one in philosophy of tax administration. This new approach to tax administration grows out of a recognition of the fundamental nature of the IRS as a service organization. That means it must focus on its customers. Sound business principles suggest that we cannot attract and retain good customers unless we give them attention, respond to their problems, and provide meaningful assistance. In the past, the IRS focused heavily on tax evaders and those who fail to comply and devoted less time to taxpayers who try to comply, but fall short. The tax system cannot continue in this fashion. The tax laws, as well as IRS procedures and work processes, are too complex for us to assume that even the best-intentioned taxpayers can meet their obligations with ease. You have only to consider a

6. I.R.S. News Release FS-92-2 (Jan. 19, 1992) (discussing increasing staffing costs and shrinking IRS workforce); see Denise M. Topolnicki et al., *Surprise: The IRS Gets More Helpful*, MONEY, Mar. 1990, at 97 (noting that the error rate for tax assistance provided by IRS staff was nearly 50% in 1988 and over 40% in 1989).

couple of statistics to appreciate the need for new approaches: Ten million non-filers in 1990 and a voluntary compliance rate hovering at 83-85%.⁷ Each percentage of noncompliance costs our country more than \$7 billion.⁸ That is simply not acceptable.

History has proven that the Internal Revenue Service's traditional approach cannot sustain a desirable level of compliance. This realization has led to a change in the IRS philosophy of tax administration. This new philosophy is at the core of one of the major strategies for change. The IRS calls it Compliance 2000.⁹ Under this program, the IRS gets involved with taxpayers up-front in the process, before mistakes are made. The agency actively seeks out and tries to help those who are having difficulty in complying, and tries to help. It provides easier access to better education and assistance programs, and it focuses its enforcement resources in far more sophisticated and effective ways. Perhaps more importantly, under the Compliance 2000 philosophy, the IRS will identify the root causes of non-compliance and move to address the underlying cause. This is a dramatic departure from the IRS' traditional after-the-fact, one-on-one enforcement efforts. Overall, I believe that the new philosophy will improve long-term voluntary compliance, which is the very heart of our tax system.

IV. CHANGE IN PROGRAMS

The second basic change involves IRS programs, including new research and enforcement programs. These program changes will combine an emphasis on customer service with greater efficiency in handling the flow of information received.¹⁰ The IRS plan is to "reengineer" its work processes, to make its programs more responsive to the needs of taxpayers, and to simplify the environment for filing returns and making payments. These efforts will rely heavily upon the modernization of the IRS antiquated computer systems — systems that were designed thirty-five years ago and are inadequate to meet current needs.

The IRS is engaged in one of the largest technological changes of our time, a 10-year multi-billion dollar initiative to update the IRS computer and information systems.¹¹ The project, known as Tax Systems Modernization¹² can transform the IRS by providing instant access to information. It will allow the IRS to eliminate most erroneous enforcement notices, to reduce processing time and processing errors, and to eliminate annually six to seven million unnecessary contacts with taxpayers. In short, Tax Systems Modernization will provide sophisticated tools to give IRS employees the information they need to do a better job.

7. I.R.S. News Release IR-92-94 (Sept. 30, 1992).

8. *Id.*

9. I.R.S. News Release IR-92-21 (Mar. 6, 1992).

10. Topolnicki et al., *supra* note 6, at 97.

11. I.R.S. News Release FS-92-2 (Jan. 19, 1992) (discussing initiative and budget requests for updating computer systems).

12. *Id.* (discussing the Tax Systems Modernization project); I.R.S. News Release FS-91-9 (June 12, 1991) (discussing same).

Tax Systems Modernization is a key to delivering one-stop service, a benefit that taxpayers have come to know from dealing with commercial entities like banks. If banks can resolve a customer problem with one telephone call, why can't the IRS do the same? One-stop service will encourage telephone contact and stem the flow of paper correspondence to the IRS.

Even more importantly, Tax Systems Modernization will facilitate alternative filing and payment methods that will simplify the environment for both taxpayers and the IRS. The IRS vision is to maximize electronic transactions and to minimize paper. IRS systems and employees are staggering under the weight of over a billion documents it processes every year.¹³ The IRS must move to an era of paperless returns to manage the workload created by an increasing population and more sophisticated financial transactions.

The IRS already has underway a successful electronic filing program. Unfortunately, the principal incentive for electronic filing today is fast refunds. With the help of its outside stakeholders, the IRS needs to build additional incentives for electronic filing and market it for the inexpensive, easy, accurate alternative that it should be. The IRS hopes that by the end of the decade more than 100 million returns will be filed electronically each year and that virtually *all* tax payments will be made electronically.

As we move into an electronic era, it is exciting to consider what the future could hold. Wouldn't it be nice if a taxpayer could walk into an IRS office, a library, or a bank, punch a few buttons on a computer and thereby satisfy the filing requirement? Wouldn't it be nice if corporate tax returns and all data necessary to audit the return were input directly into IRS computers? These options are possible, and I hope that the IRS will be positioned to bring them to life in the twenty-first century.

The IRS may even be able to eliminate the return requirement for as many as 40 million filers, for whom it would determine the tax and send a refund or balance due notice. The IRS also hopes to deliver a Single Wage Reporting System that would eliminate the duplicative paper filing of W-2 Forms and other employment information.¹⁴

The IRS is also undertaking more research and focusing on compliance within "market segments." Tax returns will be assigned for examination to agents specializing in the taxpayer's line of business. The result should be a higher quality of audits and improved compliance.

V. CHANGE IN ORGANIZATIONAL STRUCTURE

I turn now to the third major change, that is, organizational structure. Tax Systems Modernization and better customer service alone cannot bring the IRS to the future it envisions. In fact, its current organizational structure might constrain its ability to make the most of its new technology. For

13. I.R.S. News Release FS-91-9 (June 12, 1991); I.R.S. News Release FS-92-3 (Jan. 1992) (noting that the IRS received over a billion information documents included with tax returns).

14. I.R.S. News Release FS-92-3 (Jan. 1992).

decades, the IRS has been a strictly functionalized, hierarchical organization. Its 115,000 employees are supervised through fourteen levels of management.¹⁵ The IRS is reviewing its organizational structure, and it has several studies underway that will eventually come together to produce the IRS of the twenty-first century. Senior executives are charged with designing new operating concepts and procedures that will lead the IRS to a leaner, flatter organization that can accomplish its objectives more efficiently.¹⁶ I believe this type of restructuring will be a critical element of successful organizations in the twenty-first century. Functionalized, hierarchical organizations, based on command and control, are becoming a thing of the past. We must move beyond "command and control" into an environment where diverse groups relate horizontally and work together harmoniously.

VI. KEYS TO SUCCESS

The IRS has set ambitious goals for itself, goals that require a single-minded dedication to its cause. These are the factors that I consider essential to the success of this vision.

First, the IRS needs investment. Tax Systems Modernization requires a significant commitment of resources over and above what it takes to keep the tax system efficient and operational through the filing season.

Second, the IRS needs training — training as a priority, budgeted as a long-term investment and not just a current expense. The plan is to redesign and enhance the training program to provide IRS employees with the knowledge and skills they will need to operate in the new environment. In fact, "I.R.S. University" should be in place by 1994. This concept envisions an integrated curriculum of first rate courses in tax law, accounting and financial analysis, and information systems technologies. The IRS wants a highly skilled workforce empowered to deliver the future. The training program will also help IRS employees and managers to develop outstanding interpersonal skills. IRS employees and managers will need relational abilities to function in a less hierarchical and authoritarian environment.

Third, a critical element of success is leadership — both within the IRS and the private sector. Within the IRS, I am proud to say that fine leadership is an abundant commodity. It exists at all levels of the organization among the dedicated career employees who make the system work. Moreover, I am confident that the new Commissioner will be a superb leader as well.

Such massive change will also require leadership from you and other stakeholders. It is time for the private sector to move beyond its traditional relationship with the IRS and take some responsibility for the fair and equitable administration of the tax system. The IRS needs your objective insights and your experience. It needs suggestions even when the result could

15. I.R.S. News Release FS-92-2 (Jan. 29, 1992).

16. I.R.S. News Release FS-82-8 (Jan. 18, 1982) (reporting changes in the IRS organizational structure in the early 1980s).

mean a higher tax liability. It needs the professions and industry committed to helping everyone "do right" by the government.

VII. CONCLUSION

To summarize, the two subjects that I have addressed, reforming our tax system and reinventing the IRS, cannot happen overnight. The Congress and the IRS must implement these changes through responsible and thoughtful actions over the next eight to ten years. However, over that short period, we should expect them to achieve:

With respect to the law:

- complete restructuring of tax laws to produce a system:
 - that is simple to understand and administer;
 - that reduces the compliance burden on taxpayers;
 - that prevents tax avoidance;
 - that encourages savings; and
 - that enhances the country's competitive position in a global economy.

With respect to the agency that administers the law, the IRS vision is:

- a voluntary compliance rate well in excess of 90 percent;
- one-stop service by telephone for all taxpayers;
- 100 million electronic returns and a dramatically reduced reliance on paper submissions of any kind;
- single wage reporting;
- all tax payments made by electronic funds transfer;
- instant access to all relevant information;
- an emphasis on customer service;
- geographic flexibility in location of employees and operations through electronic linkages;
- cross-functional and less hierarchical organizational structures; and
- a highly skilled and empowered workforce with superior computer skills, detailed knowledge of tax law, and outstanding interpersonal skills.

I hope that the President and Congress will have the courage to recommend tax law reform. In addition, President Clinton and Vice President Gore have emphasized their commitment to "reinventing" government. In pursuit of that promise the IRS could serve as the prototype for fundamental reform of the delivery of government services to the American people.

The IRS is making service to its customers, as well as cooperation and communication, a centerpiece of the way that it does business. But the best efforts of the IRS in administering the law cannot fix the fundamental problems caused by the law itself. That takes political will. It is time for our elected representatives to move beyond politics and face this problem.

I am convinced that the future holds great promise for an improved system of tax administration. The opportunity is there. We have only to seize it.

Article

