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IRS AND THE TAX GAP

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, FEBRUARY 16, 2007

Serial No. 110–9

Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

U.S. GOVERNMENT PRINTING OFFICE

33–390 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
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IRS AND THE TAX GAP

FRIDAY, FEBRUARY 16, 2007

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m. in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Cooper, Schwartz, Kaptur, Becerra, Doggett, Blumenauer, Berry, Boyd, McGovern, Sutton, Andrews, Scott, Etheridge, Hooley, Moore, Bishop, Ryan, Barrett, Garrett, Hensarling, Conaway, Campbell, Tiberi, Porter, Alexander, and Smith.

Chairman SPRATT. Good morning. I will call this hearing to order. I am pleased to open today's hearing on the IRS and tax gap.

I welcome our panel of witnesses: Mark Everson, Commissioner of the Internal Revenue Service; Treasury Inspector General for the Tax Administration, Russell George; GAO's Director for Tax Issues, Michael Brostek; the National Taxpayer Advocate, Nina Olson; and the Director of Tax Policy Studies at the Cato Institute, Chris Edwards.

We will first hear from the Commissioner of the Internal Revenue Service Mr. Everson, and then we will turn to the other witnesses for a second panel after questions of Mr. Everson.

Given our committee's jurisdiction and our commitment to getting the country's fiscal house back in order, our focus today will be on the so-called "tax gap." the tax gap is the difference between taxes legally owed and taxes actually collected. The Internal Revenue Service has developed a recent estimate of the size of our tax gap, the most recent being 2001, which was $345 billion, a sizable sum, and that was 6 years ago. The gap has, in all likelihood, grown even larger by now, but even that tax gap from 6 years ago is $1 billion more than last year's unified budget deficit, which was $248 billion.

This suggests that, if we can only do a better job of collecting taxes that are already current policy, already in the current Tax Code, our fiscal situation could be substantially better. The persistence of the tax gap means that we have larger deficits than we would otherwise rack up and a growing legacy of debt for our children and grandchildren. Saddling future generations with this huge mountain of debt is not just a budgetary problem, but it raises fundamental issues of moral fairness.

There is another issue of fairness at work here as well. The tax gap is unfair to the scrupulous taxpayers, the vast majority who

end up having to pay more in taxes because of those who do not pay what they obviously owe in taxes. So, as we try to get the budget back on the right track, for the sake of both fairness and practicality, a good place to look and look carefully is the tax gap and what we can do to collect better what is already owed the United States Government. That is why we have assembled this group of witnesses today to help us understand more about how we can narrow this tax gap and reap the benefits.

I look forward to the witnesses' testimony. As I said, we will first hear from IRS Commissioner Everson and then entertain questions for him, and once those questions are completed, we will call up our second panel. But before turning to the Commissioner, let me turn to our Ranking Member Mr. Ryan for his opening statement.

Mr. RYAN. I thank the Chairman, and I am excited that we are having this hearing today because this is an issue that we are going to be talking about quite a bit in the days to come as we assemble our budget. We are talking about this over on the Ways and Means Committee as well, and as you can see, Commissioner, there is a lot of Member interest here.

First, I think it is important to note that the pro-growth tax policy and the tax relief that we have passed have helped to significantly increase the revenues that are now coming into the Federal Government. In fact, we have seen double-digit revenue growth for 2 consecutive years, the first time that this has happened since the 1980s, and again, through the first 4 months of fiscal year 2007, revenues are coming in at a rate of 9.8 percent over last year. So right along with our economy, revenues are continuing to grow at a robust rate.

Clearly our budget challenges are on the spending side rather than on the revenue side, but I understand that we are here to talk today about how we might close the so-called "tax gap" or the difference between the amount of taxes owed and the amount actually collected to get even more revenue. This tax gap has proven extremely difficult to define. I have spent the last 6 years on the Ways and Means Committee looking at this issue, and it is tougher than it first seems. We are never really sure how big it is, and we really do not know whether closing it would actually bring in much additional revenue, but beyond that, we have got to ask ourselves whether or not it is worth it to significantly increase enforcement and to try and get after what we are calling the "tax gap" because this could come with considerable costs.

Back in the mid-1990s, you remember the hearings that were occurring here at the time. Congress saw a parade of taxpayers complaining about how IRS enforcement tactics were violating their rights. To relieve this, Congress passed the IRS Restructuring and Reform Act. The IRS has come a long way since that time, and IRS Commissioner Everson is really to be commended for that progress. They have done a great job of developing a very respectful relationship with the American people, and clearly that is something I would imagine Members on both sides of the aisle would want to preserve and see continue. So I think we need to be extremely careful that we do not reverse that progress and force the IRS back into the time when the American taxpayers consider compliant enforcement methods an actual threat.

Furthermore, I think there is great danger that if we significantly increase enforcement and paperwork requirements to try and close this gap, we could be placing a larger burden on those who can afford it least, on the individuals in our small businesses who are struggling to compete in the global marketplace.

Finally, I think it is also important to note that, while we have very limited data on the so-called "tax gap," we do know that more than 80 percent of the tax gap is thought to be a result of simple individual taxpayer error. So what we are really talking about is well-meaning Americans who misunderstand one or more portions of the Federal Government's 17,000-page Tax Code and 66,000 pages of accompanying regulations.

As the Treasury Department concluded in its 2006 Comprehensive Strategy for Reducing the Tax Gap report, the fact is that most Americans simply do not understand how to calculate their taxes because our Tax Code is too complex. Trying to comply with the current Tax Code is also tremendously difficult and costly for small-business owners. According to the Tax Foundation, the cost of Tax Code compliance has more than doubled in the past 10 years and was at $265 billion in 2005, placing a large drain on our economy.

So, clearly, the key to get after all of these taxpayer errors is to first reform the IRS Tax Code. This would provide significant improvement in taxpayer compliance rates and get us as close as we will ever be to closing the tax gap, while avoiding adding immense new taxpayer burdens and returning to a free reform-style IRS. I think if we really want to get at this, which we clearly do—we want people to pay the taxes that they owe, end of story—that is what the fair thing to do is, but the question is do we do it with an army of IRS agents and more complexity to the Tax Code and make it more burdensome for those who can least afford it, like individuals and small businesses, especially when we have a challenge of global competition, or do we clean the whole code up, reform the IRS Code and make it much easier for people to willingly and easily comply with the Tax Code?

That seems to be, to me, the crux of this debate, and I hope we can flesh that out as this hearing and others like it continue on.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman SPRATT. Just to follow up on one thing that Mr. Ryan mentioned, you say that we do not have a revenue problem, that we have a spending problem. We do have a revenue problem, I think you will agree, with the alternative minimum tax. If we cannot stop it from applying to middle-income taxpayers, who are well in this target range right now, we are going to see millions of middle-income taxpayers paying the alternative minimum tax, and it was never meant to be imposed upon them. But to repeal it, to change it, to revise it, we have to come up with a substantial portion of revenues to make up for the revenues that will be lost due to the repeal or to the revision of the alternative minimum tax, and this is one source I think we should look to first. Let us see what we can squeeze without bearing down overmuch on the taxpayers out of the tax gap.

So, for that reason, among others, we welcome you today, Mr. Commissioner. We are glad to have you.

Before turning to you, let me ask for unanimous consent that all Members who wish may be able to submit an opening statement for the record at this point.

Chairman SPRATT. And I would like to say, if you have a statement, you can submit it for the record, and we will make it part of the record so that you can summarize it as you see fit. The floor is yours, Mr. Commissioner, and thank you again for coming.

STATEMENT OF MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you, Mr. Chairman, Ranking Member Ryan and members of the House Budget Committee.

I am pleased to be with you this morning to discuss the President's fiscal year 2008 budget proposals that cover this subject of tax compliance. I am glad that the committee has an interest in this subject of tax administration. This is my first appearance before the committee.

Before I start, I would like to introduce my daughter Emma. If you could stand up, Emma. She is here today because Fairfax County has decided to close the schools for the third day, and we did not let her sleep late. She came down for a civics lesson, and if I get any particularly tough questions, she is quite good, and I am going to ask her to answer them, so—but thank you.

I have been in this job almost 4 years now, and during this period, we have worked hard to rebuild IRS enforcement capabilities. We have made real progress. Over the last several years, I would suggest we have restored respect for tax enforcement and the need to comply with the law, but I would add that we have not done so at the expense of service to taxpayers. At the IRS our working equation remains service plus enforcement equals compliance. That is not service or enforcement. You have to do both. I think we have a pretty good balance right now and are making strides in both areas.

Turning to the President's 2008 budget request for the IRS, I want you to know that I am pleased with the submission which provides almost a 5 percent increase from the 2007 funding level. Most significantly, the request not only augments our enforcement activities, but also devotes monies to rebuild our system's infrastructure and increase our research capabilities. I feel that the request reflects Secretary Paulson's and Director Portman's confidence that the IRS will use these monies wisely and generate a real return for the Government.

I know that a subject of keen interest to the members of the committee and to many others in Congress is the tax gap. By the "tax gap," I mean the difference between taxes owed the government and those actually paid on a timely basis. Before taking your questions, I would like to make several observations about the tax gap.

First, while the most recent National Research Program study did a good job of updating our numbers and sizing the gap, we need more research to better identify the sources of noncompliance. We need to conduct this research on a timely and continuing basis.

Second, we cannot audit our way out of the tax gap, and while simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, I would

note that we will actually have to complicate the tax laws to change the behavior of noncompliant taxpayers, as an example, by requiring more information reporting.

Third, in recent years we have made considerable progress in improving compliance, as indicated by the steady growth in enforcement revenues. Those are the direct monies that we receive from our audit-collection and document-matching programs.

Fourth, to quickly and dramatically reduce the tax gap would take Draconian steps that would fundamentally alter the relationship between taxpayers and their government, require an unacceptably high commitment of enforcement resources and risk imposing unacceptable burdens on compliant taxpayers.

That having been said, there are reasonable steps that can be taken to improve compliance. We have made 16 such proposals. In order to further improve tax administration, I ask the Congress to both fully support the President's 2008 budget request for the IRS and to enact the 16 accompanying legislative proposals into law.

Before closing, since this is my first appearance before this committee, I would like to explain the nature of my duties and how they impact my ability to answer some of the questions you may wish to pose. As Commissioner of Internal Revenue, I oversee our Nation's tax administration system. I do not, however, develop tax policy proposals or take a position on them as a part of the legislative process. Questions on tax policy issues are better addressed to Treasury Secretary Paulson or Assistant Secretary Solomon.

Beyond the fact that policy questions are outside of my lane, there are very practical reasons for the IRS not to be drawn into policy conversations. If, for example, a Commissioner were to take a position against a piece of pending legislation on policy grounds, and then the Congress were to actually pass it into law, the public might be skeptical concerning IRS implementation of the statute because of the Commissioner's previously stated opposition to the legislative proposal. In the tax policy area, the IRS' role is limited to advising on the potential compliance impact of legislative proposals.

Having offered that clarification, Mr. Chairman, I am happy to take your questions. Thank you.

Chairman SPRATT. Thank you very much.

[The prepared statement of Mark Everson follows:]

PREPARED STATEMENT OF MARK EVERSON, COMMISSIONER OF INTERNAL REVENUE

Good morning Chairman Spratt, Ranking Member Ryan and Members of the Committee on the Budget. I am pleased to be here this morning to discuss the President's FY 2008 Budget request, and the IRS' efforts to improve compliance with our nation's tax laws.

A COMMITMENT TO SERVICE AND ENFORCEMENT

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

IMPROVING TAXPAYER SERVICE

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides good quality service through a variety of channels, such as its Web site, toll-free telephone lines and Taxpayer Assistance Centers. This

is supported by the metrics that we use to measure the effectiveness of our taxpayer service efforts. In category after category we continue to see improvement in the numbers in our telephone services, electronic filing, and our IRS.gov access. This is demonstrated by the following:

• Electronic filing by individuals continued to increase, up 6 percent from TY 2005 (3 percentage points) to 54 percent of all individual returns.

• The level of service for toll-free assistance was 82 percent, about the same level of 2005 and up substantially from 2001. The level of customer satisfaction with the toll-free line remains 94 percent, the same as last year.

• The tax law accuracy of toll-free response improved to 91 percent from 89 percent in the prior year.

• Taxpayers continued to find IRS.gov a useful source of information about the tax system and how to comply with their tax obligations. Visits to the IRS Web site jumped nearly 10 percent in 2006 to more than 193 million visits.

• More taxpayers used the online refund status tool "Where's My Refund." In 2006, there were 24.7 million status checks, up nearly 12 percent from 2005.

Clearly, more work needs to be done by the IRS to improve services. But we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 through a Congressional mandate. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

• Improve and expand education and awareness activities: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.

• Optimize the use of partner services: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.

• Enhance self-service options to meet taxpayer expectations: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.

• Improve and expand training and support tools to enhance assisted services: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

• Develop short-term performance and long-term outcome goals and metrics: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint will be sent to Congress soon. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year Strategic Plan for taxpayer service.

The Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance. More details on TAB Phase 2 will be available when the report is delivered to Congress.

While TAB remains a work in progress, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the Blueprint. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The Blueprint also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to

funding for research regarding non-compliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

EXPANDING ENFORCEMENT EFFORTS

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 44 percent. Since 2003, Federal government receipts have also increased by $600 billion. In FY 2006, the Federal government collected over $2.4 trillion in total receipts. This is an historic level, with annual receipts up 12 percent over FY 2005 alone. In the past two years the U.S. has seen the highest year-to-year revenue growth in 25 years. Revenue growth has been the greatest for corporate taxes and high income individual taxes—both areas where we have substantially increased our enforcement presence in recent years.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 77 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to 0.98 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in the category rose by almost 80,000 as compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5.03 percent in FY 2004 to 6.30 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,591 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by nearly 30 percent growing from 3,305 in FY 2001 to 4,289 in FY 2006.

Finally, examinations of tax exempt organizations have also risen. In FY 2001 5,342 tax exempt examinations were closed. This has risen to 7,079 in preliminary FY 2006 numbers.

THE PRESIDENT'S FY 2008 IRS BUDGET REQUEST

The first step in continuing the progress we have made to improve service and voluntary compliance is approval of the President's FY 2008 budget request for the IRS. That request is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the FY 2007 House-passed Joint Resolution (JR) level of $10.6 billion.

The request includes $3.6 billion in appropriated resources for taxpayer service and $7.2 billion for enforcement, an increase of 0.9 and 5.8 percent, respectively, over the FY 2007 JR level. This increase includes $56 million in initiatives supporting taxpayer service and $291 million is initiatives supporting enforcement. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The Budget also requests $282 million for Business Systems Modernization. This is a $69 million and 33 percent increase over the level in the House passed Joint Resolution.

If approved, we project that these investments will increase annual enforcement revenue by $699 million dollars a year, once the new hires reach full potential in FY 2010. This does not include the indirect benefits of these investments, which as I will discuss later in my testimony, could be several times the direct return on investment. In addition, we estimate that the legislative proposals for improving compliance that are in the Budget, which I discuss later, will generate $29.5 billion over the next ten years.

In addition to the broad goals of continuing the improvement of service and enforcement, the President's Budget request for the IRS will support a number of initiatives.

ENHANCING TAXPAYER SERVICE

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the Internet, Taxpayer Assistance Centers (TACs), and Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS and reduces overall inadvertent noncompliance.

The FY 2008 Budget contains two significant taxpayer service initiatives. First, we are requesting $5 million to expand volunteer income tax assistance. This taxpayer service initiative will help expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

Second, the budget contains a $10 million request to begin implementation of the TAB. As part of the TAB effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

• Contact Analytics provide a tool for evaluating contact center recordings for the purpose of improving understanding of service levels for potential enhancements.

• Estimated Wait Time provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.

• Expanded Portfolio of Tax Law Decision Support Tools enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.

• Spanish "Where's My Refund?" adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to receive the same level of customer service on the web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Website enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

IMPROVING COMPLIANCE ACTIVITIES

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of its regular examination program, the IRS is expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

The IRS is also expanding its efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are six specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These include:

• Providing $73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance. This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating for possible criminal referral, persons who have evaded taxes. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.

• Providing $26.2 million for increasing compliance for large, multinational businesses. This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the re-

porting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.

• Providing $28 million for expanded document matching in existing sites. This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

• Providing $6.5 million to increase individual filing compliance. This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.

• Approving $15 million to increase tax-exempt entity compliance. This enforcement initiative will deter abuse within tax-exempt and governmental entities (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (6 percent) and employee plan/exempt organization determinations closures by over 9,000 (8 percent) by FY 2010.

• Appropriating $10 million for increased criminal tax investigations. This will help us to aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which includes an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity, foster deterrence and enhance voluntary compliance.

In addition to these initiatives, I should stress to you the importance of allowing us to continue with the private debt collection program. The use of private collection agents (PCAs) was authorized by the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus using IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years. From September 7, 2006, when cases were first assigned to PCAs, through December 31, 2006, PCAs collected more than $11 million in net revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of between $1.4. billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government

of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate PCAs' potential to help improve compliance and perhaps even to show the government how to be more effective in its own efforts.

REDUCING OPPORTUNITIES FOR EVASION

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

• Expand information reporting—Specific information reporting proposals would:

1. Require information reporting on payments to corporations;
2. Require basis reporting on sales of securities;
3. Expand broker information reporting;
4. Require information reporting on merchant payment card reimbursements;
5. Require a certified taxpayer identification number (TIN) from non-employee service providers;
6. Require increased information reporting for certain government payments for property and services; and
7. Increase information return penalties.

• Improve compliance by businesses—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

1. Require electronic filing by certain large businesses;
2. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
3. Amend collection due process procedures applicable to employment tax liabilities.

• Strengthen tax administration—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

1. Expand IRS access to information in the National Directory of New Hires database;
2. Permit the IRS to disclose to prison officials return information about tax violations; and
3. Make repeated failure to file a tax return a felony.

• Expand penalties—Penalties play an important role in discouraging intentional non-compliance. Specific proposals to expand penalties would:

1. Expand preparer penalties;
2. Impose a penalty on failure to comply with electronic filing requirements; and
3. Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

The proposed budget provides $23 million to implement these initiatives. This will fund the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

ENHANCING RESEARCH

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively.

Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for Tax Year (TY) 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled (i.e., 1988 or earlier).

The NRP provided accurate data for determining the sources of noncompliance and for measuring changes in compliance rates over time. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target its resources and effectively provide the best service possible and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts. Research is also critical in helping the IRS to establish benchmarks against which to measure progress in improving compliance.

The FY 2008 Budget would fund two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.

Unlike the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance data each year, and by combining samples over several years will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.

The second research program funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

CONTINUING IMPROVEMENTS IN INFORMATION TECHNOLOGY

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the FY 2008 Budget reflects that commitment. The FY 2008 Budget requests $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure. This infrastructure initiative will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers; automated call distributor hardware; mission critical servers; and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget requests a total of $282.1 million to continue the development and deployment of the IRS' Business Systems Modernization program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. In fact, our objective is that IRS operate similarly to what one expects from one's bank; account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Armed with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform, which is expected to take two years.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

IMPLICATIONS FOR THE TAX GAP

On September 27, 2006, the Office of Tax Policy in the Department of Treasury forwarded to Congress the outline of a comprehensive strategy to reduce the tax gap. It detailed a seven-prong approach needed to implement a multi-year strategy to reduce the tax gap. Many of the specific elements in our FY 2008 Budget request support this approach.

Put simply, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while

minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

It is important to understand, however, that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

DISTINGUISHING THE TAX GAP FROM RELATED CONCEPTS

The tax gap is not the same as the so-called "underground economy," although there is some overlap (particularly in the legal-sector cash economy). The tax gap numbers do not reflect taxes owed on income generated from illegal activities. This makes up a significant portion of the underground economy. However, what we think of as the underground economy does not include various forms of tax noncompliance, such as overstated deductions or claiming an improper filing status or the wrong number of exemptions. These are all included in our calculations of the tax gap.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, even though we do not have the ability to distinguish clearly the amount of non-compliance that arises from willfulness from the amount that arises from unintentional mistakes. We expect future research to improve our understanding in this area.

If all reporting errors were unintentional, we would expect to see a relatively even balance between over reporting and under reporting. However, since taxpayer overstatements of tax appear to be much smaller than understatements of tax, one can reasonably infer that much of the gap is the result of intentional behavior.

THE MOST RECENT ESTIMATES

The results of the NRP individual income tax reporting compliance study were combined with earlier estimates concerning other taxpayer segments such as corporate taxpayers resulting in an estimate of the overall gross tax gap for Tax Year 2001 of approximately $345 billion. The net tax gap, or what will remain after enforcement and other late payments, is estimated to be about $290 billion, corresponding to 13.7 percent of estimated total liabilities.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one's full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). We have separate estimates for each of these three types of noncompliance.

Underreporting constitutes over 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, individual income tax underreporting was approximately $197 billion or about 57 percent of the overall tax gap. The NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) of the underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e., statutory adjustments, non-business deductions, and exemptions) and from overstated tax credits.

FEDERAL GROSS TAX GAP ESTIMATES, TAX YEAR 2001

Tax Gap Component	Gross Tax Gap ($ billions)	Share of Total Gap
Individual income tax underreporting gap	197	57%
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	39	11%
Corporate and Other Underreporting	49	15%
Non-Filers	27	8%
Underpayment	33	10%

FEDERAL GROSS TAX GAP ESTIMATES, TAX YEAR 2001—Continued

Tax Gap Component	Gross Tax Gap ($ billions)	Share of Total Gap
Total Gross Tax Gap	345	100%

Note: Detail does not add due to rounding

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self-employment tax together, we see that individual underreporting constitutes approximately two-thirds of the overall tax gap.

The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding, and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage than wages. For example, there is about a 4.5 percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage of 8.6 percent. As expected, amounts generally not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

OBSERVATIONS ON THE TAX GAP

In the context of the President's Budget request, I would like to make several observations about the tax gap.

First, while the most recent NRP study did a good job of updating our numbers, we need more research to better identify the sources of non-compliance on a timely and continuing basis.

Second, I think it is well understood that we will never be able to audit our way out of the tax gap. And, while simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, we will actually have to complicate the tax laws to go after the non-compliant taxpayers (e.g., by requiring more information reporting).

Third, we have already made considerable progress in improving compliance as indicated by the steady growth in enforcement revenues in recent years.

Fourth, to reduce the tax gap dramatically will take some draconian steps, ones that will fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers. Nevertheless, there are reasonable steps, which I have outlined in this statement that can be taken to improve compliance.

SUMMARY

The FY 2008 Budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving compliance.

Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This 4:1 return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We have no means to measure this indirect impact, but research suggests it is at least three times as large as the direct impact on revenue.

Our role is not unlike that of a highway patrolman. He will never be able to ticket every speeder, but he attempts to position himself in areas where he knows that his time is more likely to be spent productively. He also knows that every time he pulls a speeder over, other motorists see that and slow down as well.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's FY 2008 Budget contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting.

An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W-2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The FY 2008 Budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I anticipate that some of this year's Budget proposals will be criticized, perhaps because of concerns about their potential impact on small businesses. Our proposals are part of an effort to help small businesses and all other taxpayers pay less by collecting more of the taxes that are owed. In addition, while the information reporting proposals will inevitably impose some burden on compliant taxpayers, they are designed to minimize that burden and to help the IRS better target its audit resources, thereby reducing the number of burdensome audits that result in little or no change to compliant taxpayers' reported liability. The challenges that a small business faces are difficult enough without having to compete directly with noncompliant competitors. We have an obligation to support those compliant small businesses by ensuring that their competitors are also paying their fair share. This is not only a matter of fairness, but also a way of supporting compliant small businesses in their efforts to remain compliant.

Finally, full funding of the budget request will enable the IRS to improve its research with respect to the tax gap. Despite all of our progress, there is still much we do not know about the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have many limitations.

Tax gap estimates are useful for understanding the general areas and levels of noncompliance and the scope of the problem, but they are far from exact measurements. With the exception of the individual income tax gap, the estimates do not adjust for noncompliance that goes undetected during examination, and estimates are not even available for certain (minor) components of the tax gap.

It is also important to understand that the NRP study looked only at TY 2001 individual income tax returns. The study provided no new information on anything other than the reporting behavior of individual income taxpayers. The data used to estimate corporate compliance and other tax gap components are much older. The estimates are based on data such as the Taxpayer Compliance Measurement Program (TCMP), which we ceased doing in 1988.

To collect more data, we are currently doing an NRP study of reporting compliance of businesses filing Form 1120S (Subchapter S) returns. This involves approximately 5,000 Form 1120S returns from Tax Years 2003 and 2004, taken from a nationwide random sample. This is the first time the IRS has conducted a reporting compliance study across tax years, and it will require that we knit the data together to provide a comprehensive picture. We expect the study to continue through 2007.

Beginning in October 2007, the IRS will begin ongoing annual research activities that will ensure we have the most up to date compliance data possible to measure portions of the tax gap, focus our resources, and improve our audit selection criteria.

While I am confident we have made a significant dent in the tax gap, the lack of current data makes it difficult to quantify exactly how big of a dent has actually been made.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

Chairman SPRATT. Would you take a stab at what the size of the so-called "tax gap" is today?

Mr. EVERSON. Well, let us put up the tax gap map.

As you indicated, our research on this was conducted in 2001. What happened was the last time we had really updated this previous to that was in 1988, and then we stood down in our research programs for a period of years, largely at the behest of the Congress, this feeling that the audits that you did to get the numbers were intrusive, and it was a pretty tough climb, as was indicated back in the 1990s.

What we did in 2001—you can see the areas on this map that are sort of the underreporting. The gap has three components. There is an underreporting component, and that is the biggest piece of it, over 80 percent; then there is a nonfiling component, which is about 8 percent of it; and then there is an underpayment component. That is where somebody files a return, but then they just do not full pay, or they do not pay at all. So those are the three pieces of it.

What we did in 2001 was we conducted 46,000 audits of individuals. We did not look at corporations. We looked at individuals. And so these blue lines or blue cones there—boxes—under the underreporting, talk about the numbers that we estimated for individuals, and of the total gross tax gap in 2001, which we estimated at $345 billion, the underreporting piece was $285 billion, and the individual income tax piece of that was almost $200 billion, and if you look over here, we draw these two together. That is a self-employment tax. This gap is really derivative of this piece, the underreported business income from individuals. So, if you link all of those together, some two-thirds of the tax gap, we would estimate, is tied to the individual income tax reporting.

I readily concede that this $30 billion on corporation income tax was probably understated. What we did here was we simply took our old research, and then we updated it for changes and sizes of the economy.

The point I always make, though, Mr. Chairman, is that, when you look at that, I would not have reallocated or I do not think any Commissioner would have reallocated our resources, because we were already doing quite a bit on the corporations with much higher audit rates.

To get to the question about where is it today, there are a couple different things. Obviously, if the noncompliance rate, which here was estimated at 16 percent, remains steady, and the economy grows, the tax gap grows, but there are other things that happen. There are mixed changes in the revenue streams. There are rate reductions in capital gains and other areas, so that all impacts the gap as well.

The other thing I would say is, if we go down to the enforcement revenue chart, the other thing that has happened is, in the 1990s, we drew down our enforcement resources by over 25 percent. We stepped back from really doing all that we could in enforcement. We, very clearly, had to improve services, but we did so at the ex-

pense of our enforcement activities. We have now brought the enforcement back, as I indicated.

What this chart does is—the blue lines are the monies that we get in on our collection activities. The yellow strip is the money that we get in from our document-matching activities, and the green lines up top are the monies that come in from our audit, our exam activities, and you can see that between 2001 when those monies totaled about $34 billion—and now this past fiscal year they came up to $49 billion—that is an increase of some $15 billion because of our enforcement activities. But the other point about this is that, when we audit you, Mr. Chairman, even if you are as clean as a whistle, if one of your colleagues is a little more aggressive and might be inclined to overstate the deductions, they hear about that audit—people talk—and there is an indirect impact, and those individuals—because of the experience that you have had, they are less likely to overstate or to cheat, whatever you want to call it. It is not unlike the State trooper under the bridge who does not just pull over the guy doing 80. Everybody who sees that State trooper slows down and does a better job of obeying the law.

What this chart does is it takes a look at and makes an assumption, which we think is pretty conservative, about the indirect effects that I am talking about. Very simply it says, if there is a 3-to-1 indirect effect, then what you would get is—on that $15 billion of extra enforcement effort since 2001, maybe you have clawed back something like $60 billion. So that is the other thing that is happening in here that I would draw your attention to in terms of if you are trying to say, "What will we do? Where are we now?" you would look at a variety of different factors, and I think you would also look at some improvement.

The last thing I would say, and I am sorry I have gone on so long here, is that one of the problems, as I indicated, is getting research. The President's budget requests $41 million of incremental funding for the IRS, which we will put into the base so that now, instead of just having a 2001 update and then waiting a whole bunch of years, we will start to work on this on a regular basis, and that is—the real key is to get regular recurring research on all of the different facets of this and to be able to have a more timely conversation.

Chairman SPRATT. Using the factor you used, that 16 percent, can you give us an updated current dollar estimate of what the tax gap is in 2006-2007?

Mr. EVERSON. I would decline to do that, sir, just because there are so many moving parts.

What we are going to do now is we are going to start to—we are working on updating the research right now on 1120S corporations, which we have not done any research on that in a long time, and we are going to restart doing the individuals shortly, but I think it would really be very difficult because of all of the factors I have outlined.

Chairman SPRATT. Well, you indicated, I believe, that the factor in deriving the $345 billion figure represented 16 percent of the GDP.

Mr. EVERSON. No. No, sir. What I said is it is about a 16.3 percent noncompliance rate as what we estimated, yes, sir.

Chairman SPRATT. Do you have any back-of-the-envelope calculation for how much additional agents or additional audits, how much marginal income and incremental effort brings in?

Mr. EVERSON. Yes. What we have said, sir, is with the monies we have requested in the President's budget, which, as I again indicated, would be about—do you want to bring up the budget chart—5 percent, you can see, as I indicated, the first thing we are doing is we are asking for money for infrastructure. Improving the infrastructure to us is critical because it supports not just the enforcement, but also the service side, the processing of the returns, the ability to communicate with the taxpayers, which is very important. But we have a big enforcement increment there, as you can see, almost $250 million.

What we have done is—we can show a direct impact, we believe, or a correlation on things like adding auditors. There are some areas where we do not show a number. It would be like adding criminal investigators. We do not draw a direct point, but what happens here with this basket of proposals is we anticipate that after you hire the workforce and then you train them, which takes, of course, a couple of years, that you would get to a point where on this basket you would get something like $700 million of direct incremental revenues.

The President's budget, as I mentioned, has 16 legislative proposals that run from the reporting of gross receipts for small businesses—from credit card issuers—that does get after this issue on small businesses that cuts both ways, as Mr. Ryan was talking about it. If you look at all of those 16 proposals, they have been scored by the Treasury economists as adding after, by 2010, about $3.5 billion, and there is no direct impact necessarily on that, and the way they have calculated it, I think their calculations are pretty conservative.

If you think also about the normal growth in productivity that the IRS would have and just say that that is 2 percent a year, over a 3- or 4-year period that would get you another $4 billion, let us say, of these enforcement revenues that I am talking about.

I do not know if everybody can follow that, but, in a business, you would expect us to get more productive; and I am saying, if you steady state our funding, I would expect the organization to do something along that line. If you take that productivity increase and you take the incremental enforcement increase of $700 million, you would probably get a total of about $5 billion of direct impact. Then you could add an indirect impact on that.

So, all things considered, when I testified Wednesday before the Senate, your counterpart committee in the Senate, it was that if you compare 2006 and 2010 and if you do all of these things—if you fund us at the increment and you adopt the legislative proposals—I believe it is fair to say that you would probably get another $20 billion pop or more from where we are now. But that does not score. I mean, one of the issues here, as you know, is that does not score.

The only things that you folks score are the legislative proposals, none of the impact. We are just a drag. We had $500 million. That is a $2.5 billion drag on the budget even though we make money, which is kind of hard to understand.

Chairman SPRATT. A couple more questions, and then others will have similar questions, I am sure.

You have not mentioned havens and shelters; and there are certain havens that, to most of us, look like blatant devices for evasion, the Cayman Islands with one building having 12,000 firms domiciled there. Can you tell me what the IRS is doing in that regard and what you need to have done legislatively to go after some of these cases of blatant evasion?

Mr. EVERSON. Yes, sir. You are addressing what is a very important issue and what is a real compliance challenge for the IRS, and I would suggest to you that our estimates do not include either illegal activity here in the country or—I do not think that they have a particularly good—we do not have as good an idea as we ought to have about what is going on in some of these countries that you are talking about because the whole idea is that they are trying to obscure information from us.

Now what we have done is we have significantly stepped up what we are doing in the corporate arena and in the high-income individual arena, and when we do see indications that there may be some abuse we will follow that as best we can, including criminal. There are criminal matters that we have brought.

This is a bigger issue in the international community. The OECD established a group of tax administrators some 4 years ago in about three dozen countries, and it is sort of unusual to have an American-run OECD group, but I actually chair that group of tax administrators now. We met in Seoul in September, and the statement that we issued talks about tax avoidance as a growing international problem. We are looking at it across borders.

We have commissioned a study of the role of intermediaries, because a lot of this is put together by investment banks, accounting firms and law firms; and the other thing we have done here is the IRS led an effort. We formed a Joint International Tax Shelter Information Center here in Washington where we have counterparts from the U.K., Canada and Australia, and we meet. They work side by side and share information, all of them treaty obligations or standards, to try to get some of this.

But as to what you have just raised, the tax havens are amongst the most challenging areas for us to get after.

Chairman SPRATT. One final question, some years ago, there was a move on the part of the IRS to improve and to make a lot more rigorous information reporting. For example, there was a proposal to require contractors who make payments to vendors, suppliers and subcontractors above a certain amount to file what amounted to a 1099 or a W-2 or something like that so that these could be correlated to that payee's account as gross income.

I chaired the subcommittee at that time with Chris Cox, and we held a hearing on all of these subjects, and the small business folks came and testified that, number one, it would be unduly onerous, but number two, even if the IRS got that information, it would not know what to do with it because it did not have anywhere near the equipment—the computers and scanners and everything else—that they needed to keep track of these payments on a volume basis.

Do you have the wherewithal today to have that necessary complement to that kind of enforcement effort?

Mr. EVERSON. This gets at the infrastructure question, and we do have monies in the budget to address the proposal we have made. If you will allow me for just one minute, I do want to get to the core of this point.

Chairman SPRATT. Sure.

Mr. EVERSON. If we go to the tax gap map again just for a second, Lenny, if you look at that individual income tax number that has the 197 and you drop down there, the biggest piece of this is the underreported business income, $109 billion.

Let us go to the visibility chart now.

As we look across these 46,000 returns, there are some very clear conclusions, and these are not going to really surprise anybody. Out at the left here, where you have the spreading of some of these amounts that we are talking about, that is your wage income where you have substantial information reporting and withholding. That is to say that, if there is a police officer in your district, Mr. Chairman, that individual is not cheating on their salary. The noncompliance rate on their salary is 1 percent. That is de minimus. That is because we get the information.

Chairman SPRATT. Withholding. How is that?

Mr. EVERSON. The information of withholding.

If we have the information reporting, you get to a 4.5-percent noncompliance rate. All the way out here at the right, though, it indicates that the noncompliance rate is about 50 percent where there is no reporting.

So what we have done is we made some proposals last year to try and get after this, and we have added some proposals this year, but the centerpiece and the proposal I would particularly draw to your attention is we would like to get the reporting of the gross receipts by credit card issuers to us, and we want to do this. We think that this would—this is not the collection of new information that each one of us gets a bill from the credit card company issuer. They know how much they have reported, and the business gets a summary of what they get as well. So you are not capturing new information. What you are doing is you are sending the information to the IRS, and it is not a small business that has to send that information to the IRS. It is a pretty big business. The credit card issuers are pretty big.

What this would do is, if you had a dry cleaning business, for example—and let us assume that the typical breakdown of that revenue is 50-percent credit and 50-percent cash—and if you were reporting to us $1 million in revenues and then we got a notice from a series of credit card issuers that there was actually $1 million of credit card revenues from that business, that would raise a real red flag and might prompt an audit. It would certainly prompt the communication. The other thing it would do is it would change behaviors.

Let me just draw one simple example about the impact of reporting. The last time that Congress really went after the Tax Code was in 1986, as you will recall. After 1986, on the face of the 1040, taxpayers put down the Social Security numbers of their dependents. The next year, even though the IRS had not phased in any matching capability yet—it did not have the infrastructure to do that—it had to work on this, which gets to your question—the next

year, 5 million dependents vanished, 5 million. So what you really have here is you have an interaction in the change in behavior. So you need to do two things.

You need to build the infrastructure, which we will do. We need the money to do that, and we have got some in the request to do that, but you will change the behaviors if you do some of the third-party reporting.

Chairman SPRATT. This is clearly an area where we need to be working in tandem.

We very much appreciate your testimony, and others now have questions, Mr. Ryan to begin with.

Mr. RYAN. Thank you, Mr. Chairman.

I guess I will just pick up where we were leaving off. Let me go back to the estimate you just gave us in answering the chairman's question. Because, you know, for the Budget Committee purposes, we have got to find out how much is this and how much is recoverable, then to the question of how do you score this stuff.

You are telling us that you think, with about $5 billion in direct and then maybe another $15 billion indirect, you know, having the trooper under the bridge, that it is about $20 billion additional revenue that can be recovered without resorting to sort of draconian things. But that banks all of those 16 legislative changes you would make, the additional people at the agency? That is about $20 billion you are saying?

Mr. EVERSON. That is by 2010. That is the delta between 2006 and 2010. That is right. I think that is in the ballpark. And, again, this is an area where it is very hard to be precise because these things have a—I think they have a reinforcing effect throughout the system. If you just do the IRS stuff, the budget stuff, but you do not change the Code, that does not get to the powerful force that everything is happening.

Mr. RYAN. So it will take years to phase in these reforms to get to that $20 billion number?

Mr. EVERSON. Absolutely. Let me give you one very clear example on this.

One of the proposals is basis reporting for securities. The way that would work is that you would not put that in going back for——

Mr. RYAN. You would go prospective.

Mr. EVERSON. You would go prospective.

So that would roll in over a period of years, starting with purchases down the road; and then each year you would get more purchases and you would be capturing more information.

Mr. RYAN. Okay. Now on to this credit card idea, because I am trying to get a better handle on this. That seems to be sort of one of the bigger pieces of your legislative package.

Last year, when the administration first proposed requiring banks to provide annual information reports to the IRS on total payment of credit card reimbursements to merchants, the Treasury's estimate was that this would raise $225 million over 10 years. This year, it seems like the proposal is a little narrower than last year's proposal, but Treasury is estimating that this will raise $11 billion over that period. What is the basis for this tremendous increase in your revenue estimate?

Mr. EVERSON. You will have to, honestly speaking, refer that to them, because I do not make those estimates. Those are estimates made within tax policy by the economists.

Mr. RYAN. Well, give me an idea of last year's proposal versus this year's proposal.

Mr. EVERSON. I do not think we are making a substantially different proposal. We want the information reporting of gross receipts by a credit card issuer to a business, and that is the long and the short of the proposal. I actually do think—as a whole, I would say I think that the Treasury estimates are on the conservative side. Now there is a reason why they do that, and it gets back to the chairman's last question.

The experience has been that you will put in something new and then it will not always be administered effectively by the service, so that gets in there, but I think that is a number, I believe, that is reasonably conservative, sir.

Mr. RYAN. Okay. So I guess that is sort of puzzling to me. You know, we do a lot of scoring around here. How you see a score go from $225 million to $11 million is interesting.

You are talking about not the credit card companies' reporting their information to the IRS. You are talking about banks' reporting the information to the IRS on behalf of their clients, right?

Mr. EVERSON. Yes. There is a difference between, as I understand it, the banks and the issuer. It is the issuer of the credit card that has all of the information.

Mr. RYAN. It is not Visa, MasterCard, Discover. It is every bank in America that has a merchant as a customer is reporting their merchant data——

Mr. EVERSON. If they are in the credit card business, yes, sir.

Mr. RYAN. Right. So, if a bank issues a credit card, which I think most do, they are the ones who are supposed to report this.

Now how is this data square with, you know, your typical AGI measurement? How do credit card receipts square with measuring the profit and, therefore, the taxable income of a merchant?

Mr. EVERSON. Well, the merchant—and where a lot of this problem is is in the Schedule C filers. That is the biggest number that is a part of what I indicated where you are not incorporated. You are doing the business, and if you are showing your receipts, you have to report your receipts to the IRS. You have got a number there. We are going to have a different number or we are going to have information reporting that is coming in that says what you got in the credit card receipts from—it would probably be from a series of issuers for just the reason that you indicated. It would not be just—people do not just accept the American Express.

Mr. RYAN. You will have 1,000 customers in a given year at a dry cleaner's. I do not know. I cannot even think of the number. But let us say you have 10,000 people who come to your dry cleaner's in a given year with all of their different credit cards. So for you to audit that dry cleaner, you are going to have to have the banks of each of those 10,000 customers report to you the credit card receipts that go from that bank to that dry cleaner, and then you are going to look at that data. Is that basically what you would do?

Mr. EVERSON. Well, that would all be electronically communicated to us or transmitted to us; and I do not think, as I have had conversations with systems people, that this is that heavy a lift. If you do something—this is not like we get suspicious activity reports——

Mr. RYAN. I am just trying to understand the proposal.

Mr. EVERSON. Yes, yes. No, they capture that data. They know how much they did over the course of the year with you if you are the merchant. They are just giving us that data. They have that data. That is different from, say, asking, which we do—we have suspicious activity reports you are familiar with when you have large cash transactions. That takes the creation of a different business process within a bank, say, to look at that and then do a special report. Here you are talking about the rolling up of the information which they already roll up by customer and then give it to us.

Mr. RYAN. Okay, and then you are just going to look and see if there is something that stands out?

Mr. EVERSON. Yes. And, again, I think this would potentially have even a bigger impact than it is scored for, because a lot of the indirect, some of that is in there, but this would make a big change.

Mr. RYAN. One quick last one.

Your budget also proposes that all contractors who receive payments of $600 or more in a calendar year from a particular business would be required to furnish the business with the contractor-certified TIN, the Taxpayer Identification Number. The business would then be required to verify the contractor's TIN with the IRS. If a contractor fails to furnish an accurate TIN, the business would be required to withhold the flat percentage of gross payments and do withholding.

How does this work in practice? I mean, there have got to be tens of millions of contractors who would be subject to this requirement, and do you have the capability of, on a real-time basis, furnishing this TIN to people who call up and request it?

If you want to give that to me in writing, that would be great.

Mr. EVERSON. I will certainly do that, sir.

Mr. RYAN. My time is getting short. Thanks.

[The information follows:]

Since October 2003, payers of certain income reported on Forms 1099 B, DIV, INT, MISC, OID and PATR have had the ability to match their payee name and taxpayer identification number with the information contained in IRS tax records for that payee. This service is provided to payors in an attempt to assist them with perfecting the Form 1099 prior to filing an information return with the IRS. As the law requires, the IRS may impose a penalty to payors who fail to obtain an accurate TIN from the payees with whom they conduct business.

Current IRS operations provide an on-line interface for registered users to submit the name and TIN (Taxpayer Identification Number) of a payee to the TIN Matching program and receive a response regarding the status of the match request. This process may be accomplished via an interactive on-line input, whereby the user receives an on-screen instantaneous response or, via a bulk file submission which is transmitted to the IRS by a secure mailbox assigned to the user by the IRS. The processed file is returned to the requestor anywhere between 2-24 hours and accommodates requests of up to 100,000 TIN/name combinations per file.

The budget proposal would increase the overall TIN perfection rate for all payors of non-employee compensation reported on Form 1099-MISC, not just the payors who voluntarily utilize the TIN Matching program. If this proposal were enacted, the expansion of this voluntary program to mandatory usage for TIN verification of

contractors (1099-MISC non-employee service providers) may result in a substantial amount of user traffic for both the interactive and bulk features. Any staffing or other resource issues related to increased volumes would be addressed as part of implementation.

Chairman SPRATT. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman; and thank you, Mr. Everson, for appearing before us.

You noted that this is your first appearance before the committee, and you have been on the job for 4 years. I do not think it should go unnoticed that this is the Budget Committee. I have been on it for 4 years, and it is a shocking dereliction of our duty that we did not have the IRS Commissioner here before.

If we look at the government as an enterprise, to ignore the revenue side of the income statement is truly an amazing oversight. So I would like to congratulate the current management of the committee for conducting things in a businesslike fashion. We should have regular visits.

We can discuss exactly how big the tax gap is. I think it is important to remember the many flaws in our Code, I think, going all the way back to Jimmy Carter. I think he called it an abomination. So what we are discussing is a gap in complying with an abomination. It is our job as lawmakers to try to improve that abomination, to make it easier to comply with and to cut out some of the loopholes. I worry sometimes that there is barely enough law left to hold the loopholes together.

We have seen an astonishing increase in so-called "tax expenditures." with 17,000 lobbyists in Washington who lobby the Ways and Means Committee alone, most of them are seeking tax expenditures; and that, of course, does not create a tax gap. That creates someone who does not have to pay taxes because they were able to be successful in persuading Congress that he did not need to pay taxes.

According to the GAO testimony that is coming out following you, the number of tax expenditures is up to $847 billion a year. That is a lot of money, and I am sure many of these are quite legitimate, but perhaps some of them are less legitimate, and the analytical question I want to focus on is this—and this was presented to this committee before by Pam Olson, a former Treasury official.

She pointed out that, as bad as entitlement programs are—and they are burgeoning beyond our ability to pay for them—that tax expenditures are even worse because, as she put it, these are unmeasured and immeasurable losses in revenue, unverified and unverifiable losses in revenue.

So while we can conduct estimates of what a tax expenditure costs, we do not really know. There is not the methodology in place to be accurate in giving us an estimate of foregone revenue.

So I would suggest that our colleagues on Ways and Means need to be particularly careful, now that we are under new and improved management, in handing out these things because they are so difficult to measure and to verify.

Of course, if you cannot succeed in persuading Congress to get a tax break, well, then the next best thing is to hope that the IRS will be slow in noticing there is a problem; and I wonder about your efforts in coordinating—and, of course, you do not want to in-

vade client privacy—with the big four or big five accounting firms to find out their experience.

Because, as a former investment banker and businessman, I have worked with probably several hundred small businesses, and I have noticed that when they were forced to adopt real accounting standards it was amazing how many hunting dogs were found on the payroll, how many minor children were hired as janitors to take out the garbage and other worse abuses, sometimes including an entire industry that had adopted overly lenient accounting standards. A lot of these are practices known to our brethren in the big four/big five accounting firms, and I would suggest that your employees would learn a lot if they talked more frequently with those folks.

It seems to me that we are in a situation right now where the government needs more revenue. We need to arrive at it legitimately, and no one wants a tax increase. So I would hope that we could encourage more of our taxpayers to remember the proper basis for their stocks. I thought when we filled out those forms we were supposed to tell the truth, that if you bought Intel or GE at XYZ price—and it is pretty easy to look up—that that should be reported honestly on the return.

As you point out, the large majority of noncompliance is underreporting of business income, and I hope our friends in the business community would help encourage their members to report honestly their true revenues and to be fair about claiming these new tax breaks because, as the GAO again will point out following you, there is a $32 billion noncompliance problem. Because we give someone a tax break and that is not good enough, then they exaggerate the tax break; and to have a $32 billion problem grow on top of $847 billion in tax expenditures is truly an amazing situation.

So I appreciate your good work. We look forward to seeing more of you before this committee.

Mr. EVERSON. Thank you. I appreciate your comments.

If I could just respond very briefly, one of the challenges in the system is about visibility. You will write a law, and it could take 10 or 20 years before anybody really knows what the impact of that is because it takes us sometimes a year or 2 to write the regulations that interpret the law.

Then in the corporate area, where there is a lot of complexity, we may not be auditing those companies for years; and then you get into challenges that go into our appeals, our administrative system or, ultimately, in the courts. So your visibility can be 10 or 20 years down the road before this gets resolved. That is not in anybody's interest.

Simplifying the Code is clearly something that is very important that we have got to get after, but I have to say there is a tension there between that and a representative democracy because you are paid by your constituents to get the best deal for the industries or for the people in your districts. That means a different deal all too often. So simplification is a very tough thing to get after, but it would help a great deal, and we do meet regularly with the accounting firms, and we can do more of that.

Chairman SPRATT. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

Thank you, Mr. Commissioner.

Before I begin, I am a little shocked about the 5 million dependents who have vanished in 1 year. I am hoping that the IRS is looking into it so we can track down those people and bring them home.

Mr. EVERSON. That is right.

Mr. GARRETT. Yes. I appreciate your speaking with us today. I am sure members of both sides of the aisle believe that it is the obligation of all of us—I am sure we all do—to pay our appropriate tax to sustain the country, but when we discuss tax avoidance and tax schemes, you know, I thought of the words of Judge Learned Hand. He had a comment on this.

He said that anyone who may arrange the failures so that his taxes shall be as low as possible is not bound to choose a pattern which best pays the Treasury. It is not even a patriotic duty to increase one's taxes over and over again. The courts have said that there is nothing sinister in so arranging failures as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do it right for everyone, and no one owes any public duty to pay more than the law demands.

So here we are just trying to find out those who are paying less than what the law demands.

Mr. EVERSON. That is entirely correct, sir.

Mr. GARRETT. Right. Part of the question goes to the issue of the complexity of the Tax Code. The ranking member pointed out there are 17,000 pages, 60-some-odd thousand, I guess, pages of rules. I would be curious how many members around here actually still do their own taxes. I stopped doing my taxes a number of years ago because of that complexity; and, as it gets more and more complex, I assume that puts a burden on both the taxpayer and the IRS and that is, in part, what adds to the tax gap—isn't it—the basic complexity of the Code.

Mr. EVERSON. What I say, sir, is that complexity obscures understanding.

What that means is that the taxpayer who seeks to be compliant has difficulty doing so and can ultimately throw up his hands and say, "Why bother?" Then, on the other hand, the taxpayer who seeks to be noncompliant counts on the complexity and uses the complexity to obscure things and to avoid detection by the IRS. So simplification is something that I strongly favor.

Mr. GARRETT. Yes, and if I go back to my constituents back home tomorrow or the next day and I ask them about the idea of greater enforcement, the first question or comment that most people would say is, "Well, I pay my legitimate share. I am paying what I am supposed to be paying. It is too much," they will all say, "but I pay my fair share."

Their first gut reaction is, yes, if there somebody out there who is not paying, then the IRS and the government should do everything they can do to track them down. But the flip side argument of that is, if I explain to them, "Well, in order for us to do that, there may be added complications or added burden on you, the honest taxpayer, in additional requirements or in additional intrusions by the IRS and forms in addition to what you are talking

about here as far as the administration's recommendations," then their response might be a little bit different.

Mr. EVERSON. I agree with both of those observations. We say that we want—our service obligation is to help taxpayers understand their obligation and facilitate their participation in the system but that enforcing the law is important because average citizens do pay their taxes, and they have every right to expect that neighbors and competitors are doing the same.

Some have criticized our 16 proposals, legislative proposals, as meager, but both the Secretary and I are acutely conscious of this second issue you are talking about. We feel what we try to do is craft things that are minimally burdensome that do not get to be too much, and each extra step you are going to take in this arena will get more resistance just for the reasons you are getting at, sir. They will touch more compliant people, and they will be more burdensome.

So what we would like to do is get what we have got here now, and then if there is stomach for more, we will continue to talk, but we do not want to go too far on this.

Mr. GARRETT. And I hope either side of the aisle would as well, because it does put a burden on the legitimate taxpayer as to what the dishonest crook out there is doing. This may be beyond your area of comment, but I am just curious.

Is there anything either in the proposals that you are making here, considering today, as far as the administration's proposals or other proposals that have been out there to try to get at this tax gap that look at the overall impact that it would have on the competitive nature of our whole new global economy that you will place on small businesses and mid-sized businesses as well?

Mr. EVERSON. Again, I think that we are sensitive to that. As I think you know, the Secretary has particularly been clear on looking at this whole question of the regulatory environment. I think that we are comfortable that what we have put in here thus far does not really get to where it is too burdensome.

Mr. GARRETT. Okay. Thank you. I appreciate it.

Chairman SPRATT. Mr. Becerra of California.

Mr. BECERRA. Mr. Commissioner, thank you very much for being here, and I look forward to working with you on some of these matters. I know that when you have been before us in Ways and Means we have talked about this, and I know we have tried to figure out ways to tackle this in a more efficient way.

Give me a quick sense. I know that the IRS underwent an automation of its computer systems and so forth and it did not work too well at first, but, overall, how much did that cost and is it completed yet?

Mr. EVERSON. What happened was there were several sort of false starts that took place on this, one in, I guess, the early 1990s and then——

Mr. BECERRA. And I am just trying to find out how much have you spent.

Mr. EVERSON. I would have to get you a figure, but we have each year now a separate appropriation that, for the last couple of years, has been running between $200 million and $400 million a year. We actually brought it down, and now we are bringing it back up.

Mr. BECERRA. Okay. My point here is that, if we could help you get automated in ways that are modern and comprehensive so that your system is compatible with systems with other agencies and so forth or with other private sector entities, then it is probably going to be easier to move towards compliance through the Internet system, through the new wireless systems that we have in place today around the world.

Mr. EVERSON. You are entirely correct.

If you go back to that budget chart, the most important number in there for me is this $146 million increment—or, pardon me, it is $143 million on the infrastructure modernization side. In fact, if you asked our operating people right now, somebody running the unit, we can give you $5 million or we could spend $5 million on getting better systems to support your people, they would, to a person, take the systems money and the infrastructure money. So you are right.

Mr. BECERRA. So if you have a $345 billion gap and you know that a major portion of that is coming from those who are in the small business arena who are not filing all of their information and, for example, the proposal that you have in your budget that would try to get us towards using the credit card of a business or of an enterprise to try to—or credit cards that are used to make purchases with that commercial enterprise, you could do a better job of tracking what is going on. If you could find a system, an IT system, that could help make it easier for the banks and commercial enterprises that have to report all of that information on credit cards, you could then probably do a pretty decent job of collecting far more than the cost of that IT system that you acquire to try to do a better job of collecting.

Mr. EVERSON. They are collecting this information.

What we would have to do is—any time we do new document matching, we have to adjust our system and then we have to work with them. This last year—at the end of 2004, we mandated electronic filing for large corporations. That had never been done before, and that information started to come in this past year, 2006 for 2005. That required new software and real changes for us and for the companies. So systems is important.

Mr. BECERRA. Is it fair to say that efficient investment in IT infrastructure pays off for you?

Mr. EVERSON. It is essential, and it does pay off.

Mr. BECERRA. Okay. Could you use more than what you have in your current budget?

Mr. EVERSON. Now that is dangerous territory here.

Mr. BECERRA. I did not say "did you want" or I am not asking——

Mr. EVERSON. No. No. Well, I am going to be very clear here, as I was in the Senate.

I am asking for every penny of this request but not a penny more, and what I said is we have to be extremely careful in this area because what happens——

Mr. BECERRA. You need not go into it, because I am going to run out of time, and I know what you are going to have to say. Let me move to another question.

Given your testimony and the charts that you showed us, if I were a wage earner, if I got a check and I had deductions—and, by the way, I guess all of us as Members of Congress do. We are wage earners, we get a paycheck, and out of that paycheck every month is deducted—or every 2 weeks or however often you get paid—is deducted the income taxes that we are supposed to pay along with the FICA taxes and Social Security and so forth. Whereas, if you are an independent businessperson, you independently file the paperwork to the IRS to document what taxes you should pay.

Given your testimony, if I am a wage earner, I think I am the knucklehead in this process. Because if I own a business, I get to report what I want, but if I work for that business, it gets reported automatically, and the charts show it, that wage earners are the ones who pay. The honest folks are the folks who probably make the least amount of money. The folks who are not paying are the folks who can most afford to pay their taxes.

I hope what we can do is work with you to make sure that we get rid of that tax gap of $345 billion when we have a budget that exceeds $200 billion and that we do more to make sure that the wage earner is not having to compensate for the folks who are not paying their taxes by paying more out of their paychecks every month or every week and that we do a little more. I hope we can work with you because I think it is extremely unfair, and it seems to me it is ripe for a revolt by those who are getting taxes deducted every month.

Mr. EVERSON. Two points if I could respond briefly.

First of all, there is disparate treatment between wage earners and others.

The second thing I would say is I also view it as a matter of fairness in the small business community because—probably most of you are homeowners, but we have all been given two different quotes for a job at our house, one by somebody who is playing all by the rules and another that is a better quote by somebody who is not. The person who is not paying the taxes on his or her business has an unfair competitive advantage. That should be a concern to all of us, too.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Commissioner, welcome, and thank you for your service to your Nation. You have a thankless job. You may be the only man in America less popular than we are. We thank you for that.

Commissioner, according to GAO, apparently since 1970 the compliance rate for taxes has been at 86 percent. So through roughly 15-20 Congresses—Republican and Democrat—through roughly six or seven presidents—Republican and Democrat—through I do not know how many different IRS Commissioners, apparently this tax gap has remained fairly constant. So I think all of us on this committee would certainly share the goal of ensuring that every American pays their fair share of taxes, not a penny less, not a penny more. I know that we are always searching for that elusive pot of free money out there, the easy fix, but why should I not be skeptical? If it is such an easy fix, why hasn't it been done before now?

Mr. EVERSON. I think that your observations in the broadest sense are quite fair, and there are some who say, let us just get rid of the tax gap, and then we have taken care of our fiscal issues here. It is not that easy, and it is not that easy for a variety of reasons.

One is it gets into this issue of how much of a presence you would want to have for the IRS. The other gets into the very real issue we are talking about of burden and adding more reporting.

So what I think we have done is we believe there is opportunity here, sir, and what we have made is what I would consider some pretty significant proposals, but it does not say you are going to eliminate or hugely reduce that gap just because of the difficulty and the many complicated things you get into if you try to do it.

Mr. HENSARLING. Also, Commissioner, is it possible that the cure could be worse than the ill?

Let me just state the ridiculous. You could corner an IRS agent in every small business and home in America. Do you know what I mean?

Mr. EVERSON. Yes. Let me say this, and I have not said this. We enjoy the best system in the world. Let us all be clear on that. Our system is the envy of other countries. I meet with a fair number of international counterparts, and we have got a great system here, so we want to make it better, but we could make some real mistakes here if we overreach.

Mr. HENSARLING. Well, in speaking of possibly the cure being worse than the ill, according to the Tax Foundation, the compliance cost has doubled over the last 10 years, and now there is a $265 billion drain on our economy. I mean, that is a huge figure, a huge transaction cost.

Theoretically, might we raise more Fed revenue, say at 90 percent compliance instead of a hundred? In other words, if we could somehow figure out how to take part of that $265 billion being devoted to compliance, instead turn it more into economic growth, capitalizing more small businesses, increasing revenue bases, isn't it at least theoretically possible that we don't want a hundred percent compliance because that would create less revenue than, say, 90 percent compliance.

Mr. EVERSON. I think what you are saying is common sense, that to get after every last nickel here, that causes a whole series of costs to get in there, and burden is important. We have an Office of Burden Restriction, and we are constantly seeking ways to reduce burden and simplify it within our purview.

Mr. HENSARLING. Speaking of simplification, and I know at the outset of your testimony you said you weren't here to promote a favorable and predictable tax policy over another, but would you be in a position to offer an opinion that if our sole goal—if our sole goal was to close that tax gap, have you run models on either the flat tax or the fair tax and what the tax gap might be under one of those two policies? Would we have a smaller tax gap if Congress adopted one or the other?

Mr. EVERSON. I have not run those models. People at the Treasury may look at this.

What I say about legislative proposals of VAT or a flat tax is that my observation is that you can't compare a perfect theoretical sys-

tem with an imperfect actual system. So you need to make sure you look at these things fairly.

As an example, I know from discussions of my colleagues in the U.K. There are real compliance issues with the VAT. You need to bear that in mind when you have those conversations.

Chairman SPRATT. Mr. Doggett.

Mr. DOGGETT. Thank you for your service, Commissioner, and your testimony. It is a measure of the new direction in which this Congress is moving that you are here today.

Several of my colleagues have used the term "shock"; and I have to say, frankly and sincerely, that I view your responses as shocking. As I understand your testimony as the Internal Revenue Service Commissioner, you are unable to tell us or the American people—to give us an estimate that you believe is reliable, that you can feel comfortable with, of what the gap is between taxes owed and taxes collected in America today.

Mr. EVERSON. I think that is correct, sir, because we don't have the precise numbers.

Mr. DOGGETT. If you put your tax gap map back up, we can get a better understanding. Because your tax gap map—as you pointed out, the last time that you did any study of this matter was tax year 2001, right?

Mr. EVERSON. And it takes several years to complete a study.

Mr. DOGGETT. That is a tax year that ends on December 31st of 2001, the end of the first year of the Bush administration. And in tax year 2002, tax year 2003, tax year 2004, tax year 2005, you didn't do a study, you said, because you were told to stand down at the request——

Mr. EVERSON. No, no, no, sir. What I said was that we had done—the last time before 2001 was in 1988 and then nothing was done in the intervening years because, during the 1990s, the Service was told to stand down.

Mr. DOGGETT. To stand down, and you also had a 25 percent reduction in your enforcement resources.

Mr. EVERSON. At the end of the 1990s, in 1996 through about 2002, and so——

Mr. DOGGETT. And the study that you did in 2001, as I understand it, you said there is a $3 billion figure there for corporations. You didn't really study that in 2001. You used old data. So that has not been studied.

Mr. EVERSON. That has not, and I believe that is understated.

Mr. DOGGETT. You indicated that one of the areas that you have found most of the greatest challenges is on the tax havens, and the biggest chunk you believe from your chart is business income. I realize much of that is not related to tax savings, but I was concerned that in your legislative recommendations you don't really seem to have much of anything to deal with that other than the 163(j) provision on related party interest deductions which the Ways and Means Committee should put a stop to and change but instead asked you to do a study. Is the study complete?

Mr. EVERSON. I don't have an answer for that. That is a Treasury issue. What you are getting to is more legislative policy proposals, sir.

Mr. DOGGETT. And you have input on those, but these are really Treasury's recommendations?

Mr. EVERSON. Again, what I am talking about here is more tax compliance.

Mr. DOGGETT. Let me turn to an area that is within your jurisdiction. I wrote you about this 3 weeks ago, and I know that some other colleagues wrote you about it. That was the report in the New York Times on January 12th saying that the IRS, when it came to large and mid-size business audits, basically had a catch-and-release program, that you limit the time of your auditors. That if your auditors find other tax avoidance schemes, they are only there to go for the tax avoidance scheme that they were sent to.

Employees were interviewed, auditors were interviewed, retired auditors were interviewed in a number of States indicating that, though there had been an increase in collections, that they said that could be explained by the fact there are so many more tax avoidance schemes out there and that the IRS limited the access of the auditors to information. You set up a way that they would be rewarded on the faster they closed the case, not based on how effective they were.

I asked you for a report about what I thought were very disturbing practices as reported in the Times, as editorialized in the times. Are you near——

Mr. EVERSON. I am happy to respond to that, sir.

Mr. DOGGETT. Will you have a more complete report?

Mr. EVERSON. If we haven't responded, I sent a letter earlier this week on that issue to, I think, one that came in before yours, and I will send you a complete response.

But I am glad you raised this because I spoke to this the other day in the Senate. If you could go to—yes.

First, let me say this: Currency is important. It is shameful that things take years and years to get resolved. That serves neither the corporation's interest nor the government's interest. The compliant taxpayers need to get issues resolved because there is a real cost of certainty and the government needs to move quicker. In any given examination, decisions are going to be taken, and there will be a tension between the employee conducting that examination and the manager.

I think we get things, by and large, correct; and if somebody thinks that something is being left behind and they think it is being done intentionally, they may object because they could get more. But the manager has to make the decision as to whether at a certain point they can be more productively used elsewhere. That is a basic question.

I wouldn't say to you, sir, that we get it right each and every time. But when I look at the big picture—and, yes, we are trying to drive down a cycle time—I am reassured by the statistics.

If I could just show you these. It is a little hard to read, but this takes the Es/Ex class of 10 to $250 million per corporation and this takes the Es/Ex class of over $250 million. It says that in 2003 the number of audits that we did on the smaller class had declined over a 30-year period, until I got here, to 3,800 audits; and I had said for the bigger companies, they declined to 3,300 and that the amount of money set up was less than a billion here and the

amount of money was just over $12 billion. Now that has increased in 2006 to 4,300 audits. We didn't have much coverage here. We want to increase it. And the amount of money we set up has grown to $25 billion.

You could argue that maybe there is more, and I am sure there is more. You got the chart. But I would point out to you the other statistics, that the corporate receipts as a percentage of GDP have increased during this period, corporate profits have increased, but they have gone to their highest level as a percentage of the GDP in 18 years. You have to go back to 1978 or—pardon me—yeah, I guess it will be 1988. It may be 28 years. But, anyway, it is a long time since they got up to 2.7 percent or wherever they are now.

When I look at the big picture, sir, I think this is all working. We are doing more. We are trying to move faster. I don't doubt that some people don't like that.

The other things we have done is we have changed our personnel policies here. We rotate people off the big companies. They can get too cozy, frankly, by staying 5 or 6 or 7 or 10 years; and that is not good. So not everybody is happy.

Chairman SPRATT. Mr. Campbell of California.

Mr. CAMPBELL. Thank you, Mr. Chairman; and thank you, Commissioner Everson. I have a series of kind of unrelated informational questions.

First one is, my understanding is the Senate Finance Committee has talked about perhaps having the IRS build online tax preparation software through a Web portal as a suggestion on the tax gap. Is that something you think will reduce the tax gap or not?

Mr. EVERSON. This is a very important issue. It could be helpful.

I would say to you, as a general matter, right now 80 percent of the returns right now are prepared with the use of some computer software; and returns are so complex or the Code is so complex that I am sure people couldn't comply if they didn't go through the software.

When you get into the issue of should there be a portal developed, I am reluctant to embrace that idea at this time, first because, going back to the chairman and other comments about it, the infrastructure, this is not an easy thing to do if you really want to do it, and I don't think we are ready to do it.

The other thing I would say——

Mr. CAMPBELL. Have you ever estimated how much it would cost?

Mr. EVERSON. Clearly, it is a hefty price tag.

The other point I would make that I think is very pertinent here is the acceptance of the IRS, as some have indicated here today, is better than it was. There is a big industry out there, and they will go to war when this policy is pursued. They already did that in California when California tried to extend the free file alliance. They had big pictures of, you know, dogs eating steaks. There will be a collision here, and I don't welcome that as trying to run a system where people have trust in the IRS.

Mr. CAMPBELL. I am from California and was in the state legislature during that whole issue.

But I will say there are a lot of privacy concerns having to do with this. The California proposal is going to keep track of entries

and strokes. So if someone put in $300 of charitable contributions and erased it and put in $400, they would have kept that. There would be a whole lot of privacy——

Mr. EVERSON. There would be a lot of allegations about it.

Mr. CAMPBELL. Another issue relating to the tax gap—and I am curious how we get to this. Computing the correct tax is an art, not a science. And you can put together everyone in this room and have them do the best job they can of interpreting the laws and regulations to come up with the correct tax, have the IRS do the same thing, and there could be a gap between those two with completely honest people.

If there weren't ambiguity, there wouldn't be Tax Court, there wouldn't be revenue rulings, private letter rulings, et cetera. It can come all the way from anyone who gives a piece of furniture to the Salvation Army, and what is that worth, to a major corporate reorganization or something.

Mr. EVERSON. Yes.

Mr. CAMPBELL. Is that included in the tax gap or—because there is a gap between honest interpretation of the law.

Mr. EVERSON. You are absolutely correct. And the resolution of that uncertainty is a very important facet of our system, and the fact that it happens fairly, it happens—we have a group that is independent within the IRS appeals group that takes a real look at this, and then people do go into the courts. This is one of the reasons why getting the right number on corporations is so difficult, because it takes so many years off and to figure out where the courts will land on the interpretation of a statute. It is a real challenge. If I had one observation, it is the stuff takes too long to resolve, frankly.

Mr. CAMPBELL. Okay.

The $20 billion number you gave as a delta 2010 for your ideas for closing, I was unclear if that was the cumulative total to that point or if that was the annual total at that point.

Mr. EVERSON. It is the second, sir. It is the lift you would get between 2006 and 2010.

Again, you have to fund the service. We would have to get—and that is dependent upon adequate funding in the outyears, too, so you get continued productivity lists and all of the legislative proposals.

Mr. CAMPBELL. On your credit card proposal, one thing I was unclear about. If you get from the banks the merchant credit information, will it have detail or is it just going to be a total single number?

Mr. EVERSON. It would be a total number.

Mr. CAMPBELL. Then the last thing is just kind of getting back to the preparation and privacy issues, that another thing with, frankly, in my view, with either online tax preparation, frankly, even e-mail filing and stuff, there is so much—we have had problems with the veterans' information with information getting out. If everything on an individual's tax return, which can include bank account numbers, all kinds of, I mean, everything about that individual were present on any computer anywhere and the only place it would be is within the IRS, shouldn't we have privacy concerns with that?

Mr. EVERSON. This is another reason to support the infrastructure request, because we do have money for heightened security in there. We work very hard on this issue. It is a constant challenge, I have to say; and it is a very important issue. So I agree with you.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman; and, Mr. Commissioner, we appreciate you being here.

I don't happen to think you are one of the most unpopular people in the country. I get a little embarrassed when people joke about it. Because what you said is true. Our tax system is the envy of the civilized world.

When you don't have a tax system that people can have confidence in, then you have bribery, then you have underfunding of government services, then you have back-channel activities, you have corruption. This is an indice of civilization and a democratic function.

Mr. EVERSON. I agree with you entirely, sir.

Mr. BLUMENAUER. I just personally find it offensive that people make the IRS sort of a second-class citizen, not just casual jokes. But what we saw this Congress do—I saw it when I first came here—vilifying the IRS, the people who worked for it, exaggerating pretty dramatically some problems and resulting in what we saw in terms of severely restricting your ability to manage the agency, you and your predecessors, resulted in lots of money being lost and corners being cut.

There are people who are saying, well, this is confusing, and so certainly there is problems. But if it were just a matter of confusion, then we would see as many people being confused and overpaying as underpaying.

It seems there is a pretty systematic problem with a lot of people who are confused in ways that cheat the government and put their competitors who play by the rules—and most business people do—put them at a disadvantage.

Mr. EVERSON. I agree with that as well, sir.

Mr. BLUMENAUER. So the fact that this Congress under Republican control, I am sad to say, while you were increasing the complexity of the Tax Code, talking about it being too complex but adding thousands of pages of regulation and new taxes, starve the ability of IRS for compliance.

So I am pleased that our leadership is bringing you here before the Budget Committee. I hope you will have a better reaction from the Ways and Means Committee now so that we don't pile on all sorts of things, while claiming we are for simplification, making your job more difficult, doing it in the back room and the dark of the night at the last minute so that it is a nightmare for you to even try to comply with what Congress passes.

Mr. EVERSON. The only thing I would say is I have been on the job 4 years, and I think I have been treated fairly and the service has been treated fairly by both sides of the aisle during that period of time.

Mr. BLUMENAUER. I think you are a very generous man. I think the record of what happened—and it happened just before your watch——

Mr. EVERSON. It happened back in the 1990s.

Mr. BLUMENAUER [continuing]. In terms of dragging people in, flogging them, making all sorts of goofy and outrageous actions.

I recently met with about a dozen tax professionals in my community, top-drawer people, some of whom I have known for years, some who are new friends, seeking advice and counsel. There was one that had had an audit in the last 8 years. They were saying, you know, it is fascinating in terms of what doesn't happen any more. They had suggestions in terms of our having some sense of the positions that are funded, in terms of the revenue they generate, that that is what a business would do. Because this pattern of mistakes is not random, it is purposeful.

Mr. Chairman, my question, as much to the committee as to the Commissioner, deals with the bizarre notion of scoring. What is being suggested to us is that, by giving the resources to the IRS to do things like having just gross amounts of money reported as a little bit of enforcement action, a little bit of infrastructure, is going to produce far more tax revenue than it costs; and everybody will agree to that at some level. Yet under the way that our budget rules work, that is a cost right now. It is a difficulty for our budget—for our appropriators. It is difficult for you in terms of crafting the budget, even though in the 10-year budget window it will pay for itself many, many, many times over.

I have talked to the Director of CBO about some of these areas where our scoring rules have a perverse effect of actually costing money and misstating the economic impact over a 5- or 10-year period. I would hope that there would be some way working, for example, with the Commissioner of IRS and with CBO and with the certified smart people and the staff on both sides of the aisle that we could go back and look at some of these scoring conventions from a present-value perspective. Because I think it is perverse. I think it is costing us money. It is preventing investments that make sense.

We are starting to do that in some areas of government finance, and it is something that I planned on bringing to the committee later. I want to bring it up now. It is cheaper for the government to spend billions of dollars cleaning up after a disaster than spending a couple——

Chairman SPRATT. Mr. Blumenauer, that is why we are holding this hearing, to lay the basis for a lot of things like that.

Mr. BLUMENAUER. It is the scoring, Mr. Chairman, is something that I would like to address.

Chairman SPRATT. I understand, but this is part of the exploration of that issue.

Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman; and I would like to, curiously, agree with my good colleague, Mr. Blumenauer's rant about the Ways and Means Committee. We have got a bill on the floor today, 976, that does exactly what he said: It was done in the dark of night and done—and I agree with my colleague.

Mr. BLUMENAUER. Will the gentleman yield?

Mr. CONAWAY. No, I won't. You had about 8 minutes on your 5 minutes. I am using mine.

Compliance audits that—in other words, for the research that you do—and, again, thank you for being here. I appreciate that. John and I are colleagues in another realm. Appreciate you being here.

Would you describe what a compliance audit looks like? Is it unfair to describe it as a colonoscopy?

Mr. EVERSON. I think that was the way the research had been done in 1988, and I think that was one of the contributing factors that got this to stand down. We worked pretty hard in this last cycle to make sure we weren't going to ask for information that we already had or that was out of line. So we very much revised the procedures, and we didn't get but a handful of complaints in terms of those 46,000 reviews that we did.

Mr. CONAWAY. We are now 6 years away from that research. Tax rates are lower now than they were in 2001, which I believe personally contributes to better compliance when the penalty for reporting or the result of reporting is not as draconian at the rates we currently have applied as the rates before.

When do you think you will do your next round.

Mr. EVERSON. Right now, we are working on the 1120-Ses, trying to get some better numbers of the corporations. But we will start later in the next year on updating some of the work on individuals. And what we will do, instead of just doing a huge number like that, we are going to try to do a smaller sample and try to get different elements on it and get updated on a continuing basis.

But I am sorry to say it takes several years. Because by the time you go through all of the audits and then what you have to do is you do the work and then you have got to massage the data. Because it is different if you get Bill Gates' return rather than mine in your random sample.

Mr. CONAWAY. I would have thought, given your position, they would have been about the same.

Mr. EVERSON. I wish it worked that way. It is not a sheriff in a county.

Mr. CONAWAY. With respect to this industry that we have created in effect as a result of a very complex Internal Revenue Code, which the IRS has nothing to do with other than just trying to implement it and enforce the rest of us to comply with it—and I will leave some of it out—all of the various businesses out there that seek to assist us—I use ProSeries or not a commercial—but, technically, I could do my return without a computer. I would never want to really even try it, because it wouldn't be close to being right.

Does IRS work with these various preparers to make sure that they—the system they put in place in which millions of taxpayers seek to honestly comply with, that they are, in fact, getting it correct? Is there some sort of exchange with them?

Mr. EVERSON. We work very close with them, and it gets to the point of the late action by the Congress on the extenders.

One of the issues on this is we have to work and test their software and make sure it interacts and everything else. So we go through a whole series of routines to make sure that those products interact with us correctly.

Mr. CONAWAY. I know that is on the e-filing piece but on the way they compute.

Mr. EVERSON. The way they interpret the law? No. I would suggest to you that it doesn't matter whether that would be a vendor of a computerized product or a big accounting firm. Practitioners—we depend on practitioners in this country to help taxpayers understand the law, and that gets to the number of—this question your colleague asked a few minutes ago. It is another point. Some people say, well, if only the IRS was doing this, that would be very distasteful. So that is why there is some resistance to this idea of getting a portal where the IRS interprets the law for you.

Mr. CONAWAY. I want to commend you for your reluctance to embrace an IRS-computed tax return, because I do think the private sector does it better. It is more nimble.

For example, the changes made in December, there are certain pieces on that that 1040 itself doesn't provide for and you have had to issue some additional instructions. But the software providers have had to fold that into their system, and I think they are much more nimble as a result.

Mr. EVERSON. They are assuredly more nimble.

Mr. CONAWAY. And that is not to denigrate the IRS, but you have just got a different side of the table.

In the spirit of keeping within my 5 minutes, I would yield back.

Chairman SPRATT. Mr. Andrews of New Jersey.

Mr. ANDREWS. Thank you very much for your very thorough and comprehensive answers this morning. Your daughter should be very proud of you. I am glad she is here this morning.

Sir, what was the number you gave us as to your forecast of revenue gain off this idea of the gross receipts of the credit card companies?

Mr. EVERSON. The number that is in the current estimate is about 10 or 11 billion over a period of several years and——

Mr. ANDREWS. I wanted to ask you how it is derived. If we look at the data from the 2001 study on underreporting and if we put aside a State tax, excise tax, and employment tax and simply look at corporate returns and individual returns, my data indicate that there is a 200—the 2001 study indicated $227 billion a year of underreporting. Do you have any estimate as to how much of that underreporting might be at least put into question or identified if we made this reform with the gross receipts of the credit cards being reported to IRS?

Mr. EVERSON. I think that is what we are saying. You would recover that. That is a number over a period of years, as opposed to an annual number, and I would have to get you what the annual number is. It ramps up a little bit. It ramps up very quickly. But it goes after this underreported business income of a $109 billion and the understatement of the gross receipts by largely Schedule C filers.

Mr. ANDREWS. So is it your estimate that the underreporting is $109 billion?

Mr. EVERSON. That is on the individual income tax side, sir. If you want to—do you have that breakout of the 110?

Mr. ANDREWS. Here is what I am trying to square here. The 2001 study talked about annual underreporting of $227 billion and the

two categories that I talked about. And I assume that a lot of that is people that are getting cash income and not reporting it.

Mr. EVERSON. There is some cash, and what this does here, that takes the biggest piece of that chart, the 110, and says where it is.

Mr. ANDREWS. And this idea that you have, which I applaud, is a way to sort of identify the most likely targets who are exploiting that. In other words, if I run a business and you know I am reporting that 85 percent of my receipts come from credit cards and history tells us in that kind of business is really 50-50, to use that example, I am a likely target for an audit, as I understand it.

Mr. EVERSON. Obviously, different businesses run at different ratios.

Mr. ANDREWS. But there would be profiles. For example, in dry cleaning, if the normal is 50-50 credit to cash, and I file a return and it shows that 85 percent—if you look at the credit card receipts, 85 percent of my receipts are credit card and only 15 percent is cash, you are probably going to take a look at me—that is the idea—IRS.

I guess what you would do, it depends on what information we would get coming in, and I think what you are getting at is this doesn't get a cash—as an—but what it would do, though, it would give you the most prime targets for audits, I would think. It is a targeting tool, isn't it?

Mr. EVERSON. It has got two things. One, it would indicate problem areas, but, two, this very real change in behaviors that would take place, people who know the information is coming to us, they respond more honestly.

Mr. ANDREWS. All which makes me think this: You may be rather significantly underestimating the value you may get from this. Why is the number so low that you would get from this?

Mr. EVERSON. I don't do the estimate, sir; and I do believe the estimates are conservative. I wouldn't put a precise number on them, but I think what you get is there is an historical reluctance to overstate the numbers. And I think JCT would feel that way, the joint committee, and part of it is that sometimes we will put a provisional law there and the IRS won't follow up.

Mr. ANDREWS. I think this is wise to underestimate, but I, frankly, believe that those estimates significantly understate the value of this idea. Because if you had sufficient infrastructure and you had sufficient auditors, this would be a very effective targeting system as to who was understating income, which would let you chase cash, which would have a deterrent effect on people running more of a cash business and have the trooper sitting under the bridge.

I will close with one other comment. Has the Service looked at State governments who have been particularly effective in reducing their own tax gaps? Have you looked at States who have had success in this area?

Mr. EVERSON. We work very closely with the States. As you appreciate, most States, their income tax system thrives off of the Federal system. We work with them on a continuing basis and, an actual fact, we are in the—particularly in the shelter area, we are now leveraging our work with them where States like California and New York will—if we can't get after something, they will pur-

sue an investigation, and we will ride their assessment, instead of the other way around.

Mr. ANDREWS. My time is about up, but I would ask if you could submit for the record any best practices that you have identified from the States that the committee could take a look at.

Mr. EVERSON. Certainly, sir.

[The information follows:]

We have identified the following best practices from the states.

California

The IRS and California Franchise Tax Board (FTB) have a long history of working together. Examples include:

• Compliance detection and enforcement efforts to address the tax shelter problem.

• A Voluntary Compliance Initiative (VCI) in 2004 which allowed California taxpayers engaged in potentially abusive tax avoidance transactions to correct their state income tax returns. The final results of the FTB VCI were 1,202 taxpayers who reported $1.4 billion in additional tax liabilities by filing 2,289 amended tax returns for tax years 1990 though 2002. Results were provided to IRS and federal assessments were made based upon the state findings.

The State of California Board of Equalization (BOE) started publishing a list of the top delinquent taxpayers who owe sales and use taxes. The information is published on the agency web site and includes the taxpayer's name, address, and lien filing date. Since published, one taxpayer has paid in full and several others have come forward to request payment arrangements.

FTB has adopted the same method for delinquent taxpayers who owe personal income taxes. The agency is issuing warning letters to the top 250 delinquent taxpayers prior to publishing the list on the agency web site.

The City & County of San Francisco Office of the Assessor-Recorder is interested in providing a monthly listing of all taxpayers who transferred their real property by recording no consideration or quitclaim deed and claiming that it was a gift.

Virginia

The Virginia Department of Taxation sorts information received from the IRS on Forms 1099-MISC and W-2 prepared by a business by volume, which is then compared to the business return. If the business return is not compatible with the IRS documents, an assessment is made.

The Department of Taxation also matches real estate property transactions received from counties to information received from the IRS. High dollar transactions are researched to determine if the Forms W-2, 1099 and 1098 information is consistent with the transactions.

Montana

The state of Montana publishes a listing in major city newspapers of the top delinquent taxpayers which results in payment of accounts.

Chairman SPRATT. Thank you.

Mr. Porter of Nevada.

Mr. PORTER. Thank you, Mr. Chairman.

Please don't take this personal, but I think most Americans and most Nevadans would rather have a root canal than a visit by the IRS. I appreciate what you are doing. I think things have improved significantly. But American people are scared to death of having an IRS agent show up at their door, and I know they are all hard-working individuals that work for the IRS.

Mr. EVERSON. I still twinge when I get a letter from the IRS, and it is usually on my health benefits.

Mr. PORTER. Well said.

Then you take into account small businesses or mom-and-pop businesses or the chief cook or bottle washer, they are in at 6 o'clock and they go home at midnight and they are having trouble with paperwork, making sure they stay on top of everything. They are afraid they are going to have any wages garnished by employ-

ees. Tax Code 17,000 pages, Tax Rule 66,000 pages. The rich seem to benefit from the complexity of the tax laws because they can afford to hire people to take care of them; and, in the reports for OMB, it is 6.4 billion hours that are spent.

But I guess my question is, is how has the Tax Code changed really fundamentally since the 1980s and do you think it has gotten more complex?

Mr. EVERSON. First, I agree with your observation that, basically, that we have got to be careful here or the inference I think you are making because of a perception about the IRS. We are the government to many people and there is a wariness, and we don't want to overdo the enforcement, very clearly.

The second point, clearly, the Code has gotten more complex.

I also agree with your point that it is the well-to-do, the rich and the big companies that can find ways around this.

I tell people—I have told this story so often, and I will probably never be invited back. But I gave a speech 2 years ago to the New York State Bar Association Taxation Section. There were 98 tables of 10 there, and those people are not representing EITC taxpayers.

Mr. PORTER. Wouldn't it just be simpler to make a fundamental reform to make it easier so more and more Americans can report accurately?

Mr. EVERSON. I certainly am a big advocate of simplifying.

Mr. PORTER. Out of 10 returns, 10 are going to be different. There are 10 different experts;

As we talk about a tax gift, I think most Americans would pay if it would be much easier.

My next question is, part is underreported by undocumented and illegals that are in this country? What amount of taxes are we losing because they have been undocumented?

Mr. EVERSON. I don't have a number for that, sir; and, in some ways, because what we do is our approach is we want your money whether you are here legally or not. The way the law works, if it provides a protection, we get—we do have several million of filers who are filing with an ITIN, and they are meeting their obligation. They are filing their taxes even though they may not be entitled to be in the country. So they are following that obligation.

But I don't have a precise number on people who are illegally here and who are not meeting that obligation.

Mr. PORTER. So would you have for a later date any estimates on the amount of revenues that are being lost? Is there a way you can compile that?

Mr. EVERSON. I don't think we would be able to answer that in the short term.

Mr. PORTER. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Etheridge of North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Thank you, Commissioner, for being here; and let me say as a Member of Congress who served at several levels and has been in business for 19 years, most businesses don't like to see you come, but it makes sure you clean your books up and get them in order. Been there, done that.

But let me ask you one question: You mentioned the tax gap is a difference between taxes owed and taxes paid timely.

Mr. EVERSON. Yes, sir. If you go back to that——

Mr. ETHERIDGE. I want to make sure I had the definition accurate. Because timely is different than taxes paid.

Mr. EVERSON. That is exactly right, sir.

Mr. ETHERIDGE. There is a difference.

Mr. EVERSON. That is when you file a return and you owe us $5,000 and you only send us $1,000.

Mr. ETHERIDGE. Now, let me ask the question a little differently, because it gets to—just some information. You said that you would have the 2006 and 2007 update finished. When will that be finished and available?

Mr. EVERSON. You mean when we next update our research? It would be several years later. We are looking at how long it is going to take us to do that now. We will try to speed it up compared to what we did in the past, but if we are working on 2007, it would certainly be several years.

Mr. ETHERIDGE. Would you share that with the committee?

Mr. EVERSON. We absolutely will, sir, and we will have new numbers on the 1120-Ses. We are finishing up those.

Mr. ETHERIDGE. That would be helpful. Thank you.

In looking at the data you had talked about earlier, that roughly 54, 55 percent of current individuals are filing electronically——

Mr. EVERSON. That has increased steadily.

Mr. ETHERIDGE [continuing]. Do you have a number of the percent of corporate filers who are filing electronically?

Mr. EVERSON. What we did was—I don't have an overall number. What we did was we mandated at the end of 2004 that the big companies, those that were in a certain asset class and filed 250 returns, that includes employment returns they had to file electronically, and they all came in this last year, and this will have a huge and positive impact on our work because we will be able to array the data and only look at things that are really out of line.

Mr. ETHERIDGE. Let me ask you a question as it relates to—you touched on earlier I think, before. Is there a mechanism in the Code or in your office—I am a small business person. I collect Social Security, FICA taxes on my employees. If I don't turn it in, that is not my money. That money belongs to the employees who may collect it and then match it.

Mr. EVERSON. Yes.

Mr. PORTER. Is there a trigger at some point if I don't send that money in—if I haven't filed I guess you won't know. If I haven't filed, is there a trigger?

Mr. EVERSON. Yes. This is an area in terms of our collection workforce we look at the most rigorously. Because what happens is this can pyramid and compound very rapidly.

What happens is, typically, I would say more often than not, a small business gets extended, they get in trouble, and they say I am not going to send it in this quarter because things are going to get better the next quarter. There are very few people who are intentionally using the government as a bank, but it compounds quickly, and it is very hard to work your way out of it.

So our revenue officers, they get right on this to the best of their capability, and they work. And what they do, sir—and I have been

out with a couple of them—they try to make a determination of whether the business can pay it off or not.

What they say is, first of all, can you make current payments. If you are not capable of making the payments from now forward, then what they will do is they will basically end up shutting the business down itself.

Mr. ETHERIDGE. The reason I ask this question is that an employee who gets in some trouble but the employees, depending on who they are, how many, they have lost their quarters for Social Security.

Mr. EVERSON. Yes.

Mr. ETHERIDGE. And that is delay. If it is a year, they lost a whole year in their retirement earnings towards Social Security benefits, correct, because it is not paid?

Mr. EVERSON. If it is not recorded, that would be correct. I am not sure exactly how it works on the Social Security end.

Mr. ETHERIDGE. Anyway, I think that is correct. The reason I ask that question because I think it is important that we trigger that.

Let me touch one more piece, because my time is running out. One of the things I think that bothers taxpayers the most—and we just had a case in our State of a person who was of some substantial position and an attorney wound up doing time for tax evasion using the Tax Code illegally and is going to spend some time thinking about it now that they have been caught.

My point is that every time one of these pops up, it really has people losing faith in our system. Because if somebody gets away with at least a little, people lose faith.

Let me thank you for your paying attention to that. Because I think it does help and, by and large, it helps the little guy who is paying every month, who has no choice.

Mr. EVERSON. Thank you.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Thank you.

Mr. Bishop.

Mr. BISHOP. Thank you, Mr. Chairman.

Commissioner, it is nice to see you again. Thank you.

I have a just a couple of questions. First, an observation. I guess I am surprised to hear the question raised, is it worth it? I mean, as I understand it, there is $350 billion on the table in one form or another. And I mean I am just quite surprised to hear that the question raised of is it worth it to go after that or some portion of it. I cannot imagine us having any other problem of that magnitude either on the revenue side or on the expenditure side of our budget where we would ask that question. So my own answer is, yes decidedly, it is worth going after.

Mr. EVERSON. Yes, sir.

Mr. BISHOP. The first question I have is, the corporate income tax piece of that $350 billion is, if I got your numbers correctly, approximately $250 billion in large corporations and approximately $5 billion in small corporations. I think that is what your chart said.

Mr. EVERSON. That is what I said, sir.

I also added the fact that that was not based—as you can see, these are older estimates and so I believe that was clearly understated.

Mr. BISHOP. My question is, I know the concern that we have is does enhanced enforcement run the risk of impairing the dynamic that exists between taxpayers and the IRS and will we be creating more problems than we are solving. But isn't going after large corporations, doesn't that constitute low-hanging fruit? Are we really worried about our relationship with large corporations who have the capacity to employ the very best tax advice, the very best legal advice and are thriving in our economy? I mean, do we really worry about whether or not increased enforcement is going to somehow impair their ability to do business?

Mr. EVERSON. I think there is a different dynamic between the relationship between the IRS and the large corporations than there is between the IRS and the individuals.

We have very high audit rates, as we talked about before. We are doing a lot in that area. We want to do more. There is $26 billion in the enforcement moneys that would go towards the corporations. We have got a pretty aggressive program on them.

Mr. BISHOP. If I remember your numbers right now, I think we are auditing something like 17 percent of returns of large corporations. Is that——

Mr. EVERSON. That is correct, but that is the number which has the 10 million up—if we look at the biggest players, that number is much higher. It is about double that.

Mr. BISHOP. And with the increased moneys that you are requesting for the fiscal year 2008 budget, how will you be able to move that number?

Mr. EVERSON. I don't think the number itself would move as a percentage that dramatically. It would be the way we deploy that money and the kinds of issues we would be going after. But you are not going to see that dramatically ramp up their——

Mr. BISHOP. One more question. The unreported business income, if I remember correctly, was estimated at about $109 billion; and the credit card reporting proposal that you have, would you think it is a conservative effort, but it would pick up about 11 percent of that.

Mr. EVERSON. But those are apples and oranges there. The 109 or 110, that is an annual number, whereas the credit card number, that is over the period of the budget.

Mr. BISHOP. So $11 billion is the cumulative number.

Mr. EVERSON. That is the cumulative number over the 10-year life of the projection.

Mr. BISHOP. So it is only about 1 percent then.

Mr. EVERSON. I would have to look at the individual years. We have been talking about 2010. I would have to take a look at what we would project for that.

Mr. BISHOP. I am not trying to be difficult here, but I am focusing on a number here. If it is $11 billion cumulative over the course of the budget window, that is about a billion a year. So that would be about 1 percent of the total problem; is that about right?

Mr. EVERSON. I understand your math, yes.

Mr. BISHOP. One thing I can do—and my question is, can't we do better? If we have a $109 billion problem, can't we come up with a set of these potential solutions that allow us to knock that down by more than 1 percent?

Mr. EVERSON. We haven't gotten into it too much today. There are some who have said these are major proposals. The Secretary and I have gone over this. We are pretty clear on this. We want to get the funding for the IRS and sustain that. Then we want to get these proposals. And if these proposals, which I think are going to generate, sir, quite a bit of controversy, as you have seen here this morning——

I was in the Small Business Committee last year, and it pretty well shut down because of this credit card proposal. I think that we will come back, and we will work with the Congress. If we get these through, we will talk about doing some more, but I think those are important steps.

Mr. BISHOP. Thank you.

Chairman SPRATT. Mr. Boyd.

Mr. BOYD. Thank you very much, Mr. Chairman; and, Commissioner Everson, thank you for being here.

I want to start, Mr. Chairman—I am sorry that Mr. Ryan stepped out of the room and also that Mr. Conaway and Mr. Blumenauer have left. I wanted to start by correcting the record.

I was a little bit amazed at the statements or the rancor between Mr. Conaway and Mr. Blumenauer. But let the record reflect that the vote that we are going to take on the bill, the tax bill today, is a bill that was developed and written and cosponsored by the Democratic chairman, Charlie Rangel, and the Republican Ranking Member, Jim McCrery, and working together with each other and passed out of the Ways and Means Committee without a dissenting vote. So one of the things, Mr. Chairman, that many Members of this Congress have exhorted, you and the leadership of this new Congress, is to stop the partisan rancor and rhetoric and lower it a little bit; and I would challenge all of those in this committee to do that. I am sorry, again, that Mr. Ryan is not here, but I am sure we can talk about that some other time.

Commissioner Everson, I strongly support the statements of many, including Mr. Porter from Nevada, who favor simplification. You said it best: Simplification is something that you strongly favor. You made an argument for that by saying that complexity hurts those who wanted to comply and helps those who want to cheat.

Mr. EVERSON. Correct, sir.

Mr. BOYD. I think that is what you said.

Mr. EVERSON. Yes.

Mr. BOYD. Given the tax gap.

So as to my question, though, given the tax gap and ways that you can solve this, I don't think there has been any discussion today about the private collection initiative.

Mr. EVERSON. Yes, that is right.

Mr. BOYD. Could you talk a little bit about that and address, number one, I know how that is working, what they are trying to collect. I know the taxpayer advocate has some problems with it, what are his problems and how you are trying to address them.

Mr. EVERSON. Certainly, sir. I think you will hear from the advocate in the next panel.

The simple truth here is that, even because of attrition, government attrition is quite high now. It is high within the IRS as well. There are only so many people you can bring on and hire at any given time, so that even with the increment that we have got in the budget proposal, even if we—we are pretty well maxed out on what we can bring on, and it would be a period of years, a period of years of adding people to the IRS before we would get to a capacity where we could work some of these cases that we are giving to the private collection agency.

This was passed into law—I think it was in the Jobs Act at the end of 2004. What we are doing is we are implementing this. We have implemented starting in September. Got about $11 million, came in January. We have a set of standards that we hold the contractors to that are comparable to what the IRS has held, and I would say to you my assessment is so far so good. I know that there are many who want to stop it.

I had a conversation with Chairman Rangel on this up in Harlem just a week or two ago, but I think—I was with Senator Grassley on that—we should give this a chance to work and see how it goes. We are working very hard on it. The people I have on it meet with me monthly to tell me how it is going, and I think we should stick with it for a while and see how it goes.

Mr. BOYD. So, to refresh everybody here, that you are only going after taxes that people have admitted that they owe, return files, file returns but just didn't pay the bill.

Mr. EVERSON. That is absolutely correct.

One of the challenges that we have in our collection area now that—as we brought up the other enforcement and we are doing more audits. You audit somebody and you make an assessment and you have to collect that money. So our collection people are busier because we brought back the enforcement. What the collection agencies are working on is really the simplest thing, where somebody has agreed that they owe that amount of money.

Mr. BOYD. Thank you very much. I yield back.

Chairman SPRATT. Thank you, Mr. Boyd.

Mr. Ryan would like a moment for clarification.

Mr. RYAN. I stepped out of the room for a second when you mentioned the Ways and Means Committee. I didn't hear what you mentioned, but I wanted to just certify and clarify that the tax bill we are considering was done in regular order in the Ways and Means Committee. It was done in a bipartisan way. I serve in Ways and Means. We marked it up in the middle of the day in the committee in regular order. Ms. Schwartz was there. So that, in fact, was the case. I was going to mention to the gentleman who mentioned it that that was, in fact, the case. So I want to get that for the record.

Mr. BOYD. Thank you very much.

Chairman SPRATT. Ms. Schwartz from Pennsylvania.

Ms. SCHWARTZ. Thank you, Mr. Ryan, for correcting that. You may want to mention to Mr. Conaway that—he mentioned it was done in the dark of night, and it wasn't. I agree when we can work

in a bipartisan way. When we agree, why fight about that? So thank you.

I wanted to follow up on some of Mr. Boyd's comments, and nice to meet you, Mr. Commissioner.

Mr. EVERSON. Thank you for waiting.

Ms. SCHWARTZ. Thank you.

There is a specific issue I wanted to follow up on private collections, how that is working. As you may know, I represent the 13th Congressional District in Pennsylvania. There is a rather large IRS facility in my district, and I visit that facility. In spite of some of the negative comments about how people might feel about IRS workers, I can tell you that, meeting with those workers, they are very proud of the work they do. They feel good about it. They would like to continue doing it.

The fact that there are 2,800 employees that are going to be laid off in that one facility in my district is very significant; and given these are employees, some of whom, as I understand it, would need some retraining to do some of the kind of work that is now being contracted out to private collection agencies and, actually, we are paying far more for those private collection agencies than we do if we are going to do it in-house, my staff gave me some information on this.

They were talking about a net return when the IRS does it itself. So it is a compliment to you, I guess, and to workers. About $0.97 cents on the dollar. It costs about $0.03 on the dollar when we do it in-house. By contracting it out to these private collection agencies, the net return is $0.76 on the dollar. So that we are losing $0.21 on the dollar.

Now these are taxpayer dollars, also. These cents add up, that we are actually spending more to collect these dollars.

So my question to you is really two-fold, is that why not use the 2,800 people in my district who are going to lose their jobs who want to stay, might need some retraining, to do this next—this different level of job but would like to do that and why not use them? Particularly when we know that two factors, one, we are spending more when we use private collection agencies, not getting the dollars back that we might, and there have been issues raised on the other side that I agree with. There are concerns about the potential confidentiality of very personal information being out there.

You know, one of the things, we actually may not like to hear from the IRS, but you kind of trust you keep this information to yourself. That is one of the aspects I think most Americans do believe in.

So if you would address specifically, you know, the decision that has been made—it is an option—but the decision that has been made to substantially downsize our IRS workers or employees who are dedicated and knowledgeable and want to continue to do the good work in order to spend more taxpayer dollars by using private agencies outside.

Mr. EVERSON. I presume you are in Philadelphia?

Ms. SCHWARTZ. Yes.

Mr. EVERSON. I think there are a couple of issues in there that are getting a little bit mixed.

We have talked this morning about the increase in electronic filing, and as the number of returns that are filed electronically has increased, that has resulted in a phasing down, obviously fewer paper returns and a smaller footprint of workforce in our submission processing pipeline. We have already—Mr. Bishop's area has a center, and we have worked through in Memphis as well, and Philadelphia is in line and, ultimately, we will get down to a much smaller footprint.

Ms. SCHWARTZ. What percentage of those 2,800 is that? All of those people?

Mr. EVERSON. I don't know of exact—that is a new number for me. I will certainly take a look at this hearing at Philadelphia, but we have had a long-standing plan to phase out, to consolidate submission processing of paper returns as that grows down.

As we have done that, we have tried to make sure that we are anchoring as much work in those centers and add work to those centers from other areas where we can. And, as you know, we are also making an investment in moving into the post office there in Philadelphia. The campus right now in Philadelphia is probably our worst facility of the big campuses. We want to do the same thing there that we have done in Kansas City, where we just reopened a much modernized, great facility.

Ms. SCHWARTZ. I was not impressed with the facility. I was impressed with the workers.

Mr. EVERSON. We are delighted that we are going to be able to go down downtown and upgrade the post office.

We are working where we can to, obviously, find opportunity for those individuals. We are committed to that, and I will relook at it since you are raising it in terms of opportunities.

But, again, as to collection itself, we do have issues as to how many people you can bring on and train and get going. And I would say to you again, as I just said to your colleague, we do—it would be a period of several years before we would be able to change our employment profile and get after the same kinds of accounts that we are doing now in the private collection agency.

I don't challenge—I am not the author of that $0.03 cost figure, so I am not vouching for that, but I have said readily that this could be done more cheaply by our people.

Ms. SCHWARTZ. My time is almost up now, but if you had the option, which you do not, but if you had the option to do it in-house would that—you would be able to do that. You would be pleased to do it. I am not sure what we are——

Mr. EVERSON. We happily take on all duties that the Congress assigns us.

Ms. SCHWARTZ. I do appreciate the opportunity to follow up with you about the IRS.

Mr. EVERSON. Maybe we can visit sometime and see how the work progresses in the new facility.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

Chairman SPRATT. One housekeeping deal as we wrap up.

I ask unanimous consent that any member who did not have the opportunity to ask questions today or who would like clarification be given authority to submit questions for the record. We would appreciate your cooperation in providing us answers.

Mr. EVERSON. Certainly, sir.

Chairman SPRATT. You were an excellent witness. We appreciate your forthrightness and your full answers as well as your forbearance. Thank you very much for coming, and we look forward to working with you on these objectives that are set out in the budget this year.

Mr. EVERSON. Thank you, Mr. Chairman. I appreciate the opportunity to be here.

Chairman SPRATT. The next panel will consist of Russell George, who is the IG for Tax Administration; Michael Brostek, who is the Director of Tax Issues; GAO Nina Olson, the National Taxpayer Advocate, IRS; and Chris Edward, who is with the Cato Institute.

I welcome all of you before our committee, and I will say to each one of you that, if you have written testimony, we will accept it for the record and make it, in its full, as part of the record and allow you to summarize as we go forward. You have been patient to wait. You have been good to prepare and to come here for this hearing.

We are notified that we need to be on the floor at around 1:00 o'clock, so we are going to try to wrap this up in an hour if we can.

Mr. George, just for a good starting point, let us start with you, if you will.

STATEMENTS OF THE HON. J. RUSSELL GEORGE, INSPECTOR GENERAL FOR TAX ADMINISTRATION, U.S. DEPARTMENT OF THE TREASURY; MICHAEL BROSTEK, DIRECTOR, TAX ISSUES, STRATEGIC ISSUES TEAM, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE; AND CHRIS EDWARDS, DIRECTOR OF TAX POLICY STUDIES, CATO INSTITUTE

STATEMENT OF THE HON. J. RUSSELL GEORGE

Mr. GEORGE. Thank you, Mr. Chairman, and at the outset, may I say it is an honor to appear before you. As you may recall, you and I worked together almost a dozen years ago when I was Staff Director of Chairman Stephen Horn's subcommittee and you were a member of that committee, and even at that time we looked at issues such as the very one that we are discussing today.

Chairman Spratt, Ranking Member Ryan, members of the committee, thank you for the invitation to appear before you today to discuss opportunities for closing the tax gap. The tax gap is a complicated subject which at times appears simpler than it really is. It is generally accepted that, every year, the IRS fails to receive roughly $345 billion owed to the Federal Government. As has been noted, that figure is considered the gross amount not received. The net amount of the tax gap is thought to be approximately $290 billion. TIGTA, however, has expressed some doubts about the accuracy of these figures. We are concerned that the IRS does not have a complete picture of the magnitude of the problem, which is an essential starting point to addressing the problem. Nonetheless, in 2006, the IRS updated its estimate of the tax gap based on data from the 2001 tax year.

While the updated information on individuals is important since they comprise the largest segment of the tax gap, there is no new

information about employment, corporate and other taxpayer segments. The Service does not have firm plans to update the information study for these segments, as you heard earlier. There are opportunities for the IRS to pursue new initiatives related to the tax gap.

In our reviews of IRS programs, we have made recommendations that would enhance the effectiveness and the efficiency of the IRS' tax compliance programs. The IRS has appropriately refocused audit attention on high-income taxpayers. However, this has been done through an increase in correspondence examinations as opposed to face-to-face reviews. Correspondence examinations limit the tax issues that can be addressed. High-income households typically have a large percentage of their income that is not subject to third party reporting and withholding. Without additional third-party reporting, it is difficult to determine whether these taxpayers have reported all of their income.

To improve tax compliance and business tax filings, TIGTA has recommended that the IRS establish a comprehensive document matching program for the various business documents it receives similar to its program for verifying individual wage earnings. Although implementing such a program among businesses would be difficult, it could identify significant pockets of noncompliance among business taxpayers.

Over the years, the IRS has had several strategies for reducing the tax gap attributable to individual nonfilers. Unfortunately, the IRS, since it was reorganized in 2002, each IRS business division has been responsible for tracking and monitoring its own action items. There is no formal system in place for coordinating and tracking across all IRS business divisions. In response to a 2005 audit report, the IRS took some steps to improve efficiency in working nonfiler cases, including the development of a nonfiler work plan. However, the IRS still does not have a single executive charged with overseeing its nonfiler efforts. It needs one.

In 1993, the IRS developed a voluntary compliance program for the food and beverage industry, which was extended to the cosmetology industry. The program has been successful. In tax year 1994, $8.52 billion in tip wages were reported. In tax year 2004, the amount exceeded $19 billion. Despite this success, the IRS has not expanded the program to include other industries which I believe will further enhance tax receipts.

The IRS needs to focus more attention on its role as a collector of Social Security and Medicare taxes. These taxes are primarily paid through payroll taxes with help from employees, matching amounts paid by employers as well as through self-employment taxes. However, the procedures the IRS uses to implement this program have flaws. TIGTA recently conducted a review of tax returns that were processed in 2005. We estimated that the IRS has assessed $20 million in taxes, but with changes to the procedures, the IRS could have assessed approximately $20 million more. We recommended several changes to this process which could result in an additional $108 million in Social Security and Medicare taxes each year.

Finally, to better address a growing number of investments made abroad by U.S. residents estimated at $7.2 trillion in 2003, TIGTA

has recommended that the IRS make better use of the foreign source information it receives from tax treaty countries. We have also recommended that prior to issuing refunds to foreign partners, the IRS implement an automated cross-check of withholding claims against available credits for partnerships with foreign partners.

Mr. Chairman, while the IRS clearly needs the resources it has requested, it also must use the resources it has more efficiently and effectively.

Chairman SPRATT. Let me just stop you at that point and make a point.

Has your office submitted any legislation, proposed legislation, to reduce these recommendations to recommendations that were submitted to Congress or are they simply held internally within the Internal Revenue Service?

Mr. GEORGE. Well, within the budget, the Department in conjunction with the IRS submitted legislative proposals that we have not had a role in, Mr. Chairman, and we have not independently submitted legislation.

Chairman SPRATT. Are the recommendations you just enumerated part of the requests that the administration has made to Congress this year——

Mr. GEORGE. Part of the budget——

Chairman SPRATT [continuing]. The 15 or 16 different things that the Commissioner just——

Mr. GEORGE. We are in the process of reviewing those, Mr. Chairman.

Chairman SPRATT. Okay. Excuse me. Go ahead.

Mr. GEORGE. Actually, that concludes my oral testimony, sir.

[The prepared statement of J. Russell George follows:]

PREPARED STATEMENT OF HON. J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

INTRODUCTION

Chairman Spratt, Ranking Member Ryan, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss the tax gap.

The objective of our tax system is to fund the cost of government operations. The Internal Revenue Service (IRS) attempts to meet this objective by administering a tax system that provides adequate funding for the Federal Government while ensuring fairness to all taxpayers. But, as we know, the system has failed to capture a significant amount of the tax revenue that is owed, which we call the tax gap. The IRS defines the tax gap as "the difference between what taxpayers are supposed to pay and what is actually paid."[1]

It is worth noting, that if we were to capture the estimated annual tax gap of $345 billion, it would completely offset the projected fiscal year (FY) 2007 budget deficit of $172 billion and provide a surplus of $173 billion.[2] Considering it in those terms, the tax gap poses a significant threat to the integrity of our voluntary tax system. Therefore, one of my top priorities for TIGTA is to identify opportunities for improvements to the IRS' administration of our tax system. Similar to nearly all other Federal agencies, the IRS has limited resources to apply to the objectives it seeks to achieve. Nevertheless, the IRS must face the challenge of trying to increase voluntary compliance and reduce the tax gap.

When I testified on the tax gap last year, I reported that some of the most challenging barriers to closing the tax gap are tax law complexity, incomplete information on the tax gap and its components, and reduced IRS enforcement resources. These same barriers exist today. However, while tax law simplification may help close the tax gap, a portion of the tax gap may also be closed through more effective tax administration and enforcement, as well as a commitment of additional resources for those efforts.

My remarks will briefly discuss the size and source of the tax gap and then present some of TIGTA's significant findings and recommendations to improve tax administration and help reduce the tax gap.

THE TAX GAP: ITS SIZE AND SOURCES

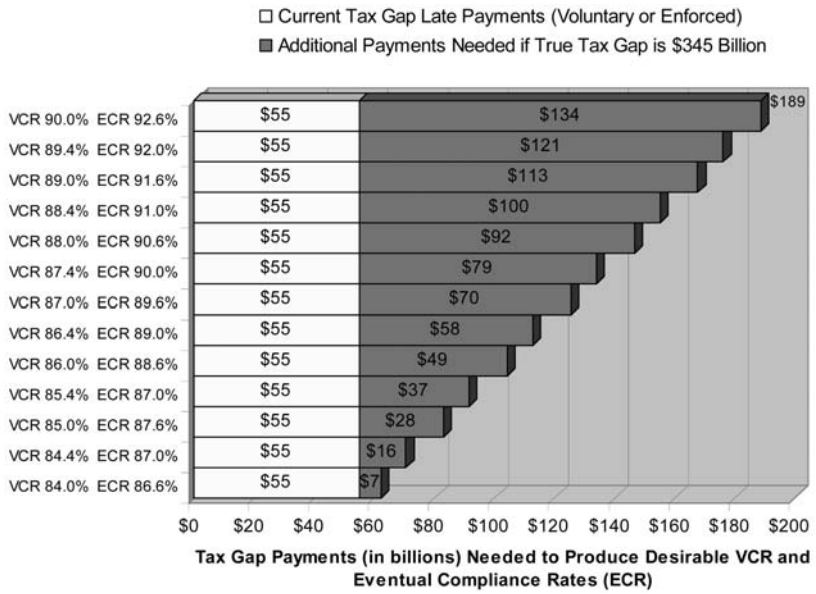
The IRS describes the tax gap as having three primary components—unfiled tax returns, taxes associated with underreported income on filed returns, and underpaid taxes on filed returns.[3] Within the underreported income component, the IRS has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes.[4]

In 2006, the IRS updated its estimate of the tax gap, which had been based on data for tax year (TY) 1988. The new estimate was based on data obtained from the National Research Program (NRP) for TY 2001 individual income tax returns.[5] Data from the NRP were used to update the 2001 tax gap figures. The IRS' most recent gross tax gap estimate is $345 billion with a corresponding voluntary compliance rate (VCR) of 83.7 percent.

In any discussion about whether a specific VCR goal can be met, the logical starting point would be an assessment of the reliability of the measurement data. In April 2006, my staff reported results of a review to determine whether the IRS' compliance efforts and strategies will enable it achieve a greater VCR by 2010.[6] In all three compliance areas across the major tax gap segments—nonfiling, underreporting and non-payment—TIGTA has concerns about whether the tax gap projections are complete and accurate.[7] While TIGTA has concerns about the overall reliability of the tax gap projections, the review of the tax gap estimates was not meant to be critical of the efforts the IRS took in re-establishing compliance measurement. On the contrary, TIGTA commended the IRS for restoring these critical measurements and for designing them to be much less burdensome to taxpayers than previous efforts. The IRS' updated estimate is based on the best available information.

When considering the updated tax gap estimate, TIGTA found it instructive to analyze what additional amounts the IRS would have had to collect to increase voluntary compliance at different estimated intervals for TY 2001. Figure 1 shows the range for TY 2001 based upon the total tax liability for TY 2001, as estimated in February 2006. The IRS has proposed in the FY 2007 budget that the VCR will be raised from 83.7 percent to 85 percent by 2009. Accordingly, if the total tax liability remained constant, the IRS would have to collect, on a voluntary and timely basis, $28 billion more in TY 2009, thus reducing the gross tax gap to $317 billion. To reach 90 percent voluntary compliance by TY 2010,[8] the amount voluntarily and timely collected for TY 2010 would be an additional $134 billion, thus reducing the gross tax gap to $211 billion if the total tax liability remained constant.

FIGURE 1: ADDITIONAL VOLUNTARY AND TIMELY PAYMENTS REQUIRED TO REACH SPECIFIED VCR LEVELS[9]



SOURCE: Treasury Inspector General for Tax Administration

In summary, TIGTA concluded in its review of the updated tax gap estimate that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the VCR. Although having new information about TY 2001 individual taxpayers is better when compared to the much older TY 1988 information from the last TCMP survey, some important individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information about employment, small corporate, large corporate, and other compliance segments is available. With no firm plans for further studies or updates in many areas of the tax gap, the current tax gap estimate is an unfinished picture of the overall tax gap and compliance.

THE IRS NEEDS TO OVERCOME INSTITUTIONAL IMPEDIMENTS TO MORE EFFECTIVELY ADDRESS THE TAX GAP

Institutional impediments in this context of tax administration are the established policies, practices, technologies, businesses processes or requirements that add unintended costs or are no longer optimal given changes to strategies, goals, and technologies. The costs of these impediments include lost opportunities and the delayed development of innovative solutions.

Impediments can also be perceived as opportunities. The removal of an impediment creates opportunities to achieve increased efficiency and effectiveness in tax administration. TIGTA's perspective is that the current institutional impediments the IRS faces can give way to beneficial opportunities.

INCOMPLETE COMPLIANCE RESEARCH

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the TY 2001 individual taxpayer NRP was approximately $150 million. According to IRS officials, resource constraints are a major factor in NRP studies and affect how often the NRP is updated. Operational priorities must be balanced against research needs. From FY 1995 through FY 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS' budget submission to the Department of the Treasury for FY 2007 requested funding to support ongoing NRP reporting compliance studies. The IRS Oversight Board[10] supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment for continual updating of the studies, the information will continue to be stale and less useful in measuring voluntary compliance.

The IRS' National Research Program (NRP) is designed to measure taxpayers' voluntary compliance, better approximate the tax gap, and develop updated formulas to select noncompliant returns for examination. The first phase of this program addressed reporting compliance for individual taxpayers, and data from this phase were used to produce the updated estimates of this portion of the tax gap. These initial findings should enable the IRS to develop and implement strategies to address areas of noncompliance among individual taxpayers.

The second phase of the NRP, which has begun, focuses on Subchapter S corporations (Forms 1120S). TIGTA recently reviewed the on-going NRP study of Subchapter S corporations and reported that the study was effectively planned.[11] The NRP study is on target, with just over 17 percent of the examinations closed as of November 3, 2006. Revenue agents conducting the examinations received appropriate and timely training. A multi-layered quality review process is in place, and feedback is provided when appropriate to resolve any problems identified. The study should provide valuable data when completed.

While the IRS is actively involved in managing and monitoring the NRP study, TIGTA noted some areas in which there can be further improvement. Some NRP study results may not be complete, accurate, or provide information sufficient to update existing return selection formulas.

- The NRP study instructions contained criteria for line items on tax returns that are mandatory to select for examination. Eleven of 61 tax returns that TIGTA reviewed contained these line items, but the items were not identified for examination.
- The NRP study process includes capturing demographic information about each business examined. This information was available in 9 of the 62 cases reviewed (the data were not always available because TIGTA reviewed in-process cases). In two of the nine cases, some of this information was inaccurate.
- The Examination function relies in part on selection formulas to identify tax returns that have greater potential for tax adjustment. An independent review of this NRP study's sampling methodology and sample size[12] expressed concern that the sample size may not be large enough to update the current selection formulas, and recommended that other techniques be explored to analyze the results.

The three concerns TIGTA noted could reduce the reliability of the NRP study results. However, the IRS is taking or has planned actions that should reduce these risks. Final decisions on how to address these concerns cannot be made until more of the examinations are completed. As a result, TIGTA did not recommend any additional actions the IRS should take. However, TIGTA will monitor the adequacy of the IRS' decisions and actions to address the concerns in future reviews.

The individual and Subchapter S corporation NRP initiatives allow the IRS to update return-selection models for more effective return selection for its compliance efforts.

In 2005, TIGTA reported that the return-selection formulas, developed in the 1980s, only accounted for the selection of 22 percent of the corporate returns selected for examination in FY 2004.[13] Updated selection models should contribute to more effective use of the IRS' compliance resources.

In April 2006, TIGTA recommended that the IRS Commissioner continue to conduct NRPs on a regular cycle for the major segments of the tax gap.[14] TIGTA also recommended that the IRS augment the direct measurement approach, and devise indirect measurement methods to assist in quantifying the tax gap. The IRS agreed with these recommendations, subject to available resources. In addition, TIGTA recommended that the IRS Commissioner consider establishing a tax gap advisory panel that includes tax and economic experts to help identify ways to better measure voluntary compliance. The IRS agreed to look into establishing such an advisory group with the intent of using it to validate and improve estimation methods.

INCREASE THE ECONOMY, EFFICIENCY AND EFFECTIVENESS OF COMPLIANCE STRATEGIES

TIGTA has made several recommendations to improve the efficiency and effectiveness of IRS operations. These improvements would help the IRS address the tax gap. Some of TIGTA's more significant recommendations concern:

- Less Effective Examination Techniques Used for High-Income Taxpayers.

- Incomplete Document Matching.
- Regulations for Granting Extensions of Time to File Delay the Receipt of Taxes Due.
- Uncoordinated Nonfiler Strategy.
- Limited Tip Program Expansion.
- Unclear Offer in Compromise Program Requirements.
- Incomplete Payroll Tax Assessments.

LESS EFFECTIVE EXAMINATION TECHNIQUES USED FOR HIGH-INCOME TAXPAYERS

In July 2006, TIGTA reported the results of its review of the IRS' increased examination coverage rate[15] of high-income taxpayers.[16] The increased coverage has been due largely to an increase in correspondence examinations,[17] which limit the tax issues the IRS can address in comparison with face-to-face examinations. In addition, the compliance effect may be limited because over one-half of all high-income taxpayer examination assessments are not collected timely.

The examination coverage rate of high-income taxpayers increased from 0.86 percent in FY 2002 to 1.53 percent in FY 2005. Included in this statistic is an increase in the examination coverage rate of high-income tax returns, Forms 1040 with a Schedule C. This examination coverage rate increased from 1.45 percent in FY 2002 to 3.52 percent in FY 2005. However, the increase in examination coverage is due largely to an increase in correspondence, rather than face-to-face, examinations. While face-to-face examinations increased by 25 percent from FY 2002 through FY 2005, correspondence examinations increased by 170 percent over the same period.

As a result, the percentage of all high-income taxpayer examinations completed through the Correspondence Examination Program grew from 49 percent in FY 2002 to 67 percent in FY 2005. The increase in correspondence examinations for high-income taxpayers who filed a Schedule C was even larger. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FYs 2002 through 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were conducted by correspondence.

High-income households typically have a large percentage of their income that is not subject to third-party information reporting and withholding. The absence of third-party information reporting and withholding is associated with a relatively higher rate of underreporting of income among business taxpayers. It is difficult to determine through correspondence examination techniques whether these taxpayers have reported all of their income.

In FY 2004, the IRS assessed more than $2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of $1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Based on a statistical sample of cases,[18] TIGTA estimates that approximately $1.2 billion (86 percent)[19] of the $1.4 billion has been either abated[20] or not collected after an average of 608 days—nearly two years after the assessment was made. Our conclusion is that the Examination and Collection programs for high-income taxpayers may not be positively affecting compliance, given the substantial assessments that have been abated or not collected.

TIGTA recommended that the IRS complete its plan to maximize the compliance effect of high-income taxpayer examinations. TIGTA also recommended that the plan should include the mixture of examination techniques, issues examined, and collection procedures. The IRS agreed with our recommendations.

INCOMPLETE DOCUMENT MATCHING PROGRAMS

TIGTA has also identified improvements that should be made to improve compliance in business tax filing.[21] The GAO has reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000.[22] Although individual wage earners who receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist. TIGTA has recommended that the IRS evaluate all types of business documents it receives to determine whether this information can be used to improve business compliance. In its response to our recommendations, the IRS wrote that it could not implement this recommendation at that time. However, the IRS also shared its belief that ongoing efforts would provide the results that our recommendation hoped to achieve and asked for the opportunity to continue its efforts.

An IRS study, based on TIGTA recommendations, found that in FY 2000, business information documents[23] reported $697 billion of potential taxable income.[24] Fur-

thermore, business information documents identified 1.2 million unresolved IRS business nonfiler tax modules. An IRS tax module contains records of tax liability and accounting information pertaining to the tax for one tax period. TIGTA has also reported on issues related to the increasing global economy. Investments made abroad by U.S. residents have grown in recent years, nearly tripling from $2.6 trillion in 1999 to $7.2 trillion in 2003. To address the tax compliance challenges presented by foreign investments, TIGTA recommended that the IRS make better use of the foreign-source income information documents received from tax treaty countries. TIGTA also recommended that, prior to issuing refunds to foreign partners, the IRS implement an automated crosscheck of withholding claims against available credits for partnerships with foreign partners.[25]

Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance among business taxpayers.

REGULATIONS FOR GRANTING EXTENSIONS OF TIME TO FILE DELAY THE RECEIPT OF TAXES DUE

Taxpayer payment compliance means that the amounts owed are paid on time. However, for decades, the IRS has allowed taxpayers with extended return filing due dates to send in late payments and pay only interest and small failure-to-pay penalties. Obtaining an extension of time to file a tax return does not extend the due date for tax payments, and failure-to-pay penalties are typically assessed when payments are made late, even if the taxpayer has received an extension.

In 1993, IRS management eliminated the requirement to pay all taxes by the payment due date in order to qualify for an extension of time to file. Once an extension has been granted, the taxpayer is exempt from a 5 percent per month delinquency penalty[26] for the period of the extension. TIGTA evaluated the impact of these rules on individual and corporate taxpayers and found that 88 percent of untimely tax payments for returns filed after April 15 were attributable to extended-due-date taxpayers.[27] Corporations are required to pay estimates of their unpaid taxes in order to be granted extensions. However, TIGTA found corporate estimates to be highly flawed; in calendar year (CY) 1999 alone, approximately 168,000 corporations received an extension, yet failed to pay $1.8 billion in taxes when they were due.

TIGTA projected that the tax gap from extension-related individual income tax underpayments would amount to approximately $46.3 billion in CY 2008, of which approximately $29.8 billion would not be paid until after the end of FY 2008. Due to the more complex nature of corporate taxes, similar figures were not available for corporations, although TIGTA estimated that by TY 2008, approximately $768 million in additional corporate taxes would be timely paid if TIGTA's recommendations were adopted. The IRS agreed to study TIGTA's recommendations.

UNCOORDINATED NONFILER STRATEGY

According to the IRS' February 2006 tax gap estimate, individual and estate tax non-filers accounted for about 8 percent of the total tax gap[28] for TY 2001. Corporate income, estate and excise tax non-filing estimates were not available. The IRS study, together with previous IRS studies, indicates the tax gap for individual non-filers almost tripled from $9.8 billion in TY 1985 to about $27 billion[29] in TY 2001.

In the past, the IRS has had several strategies for reducing the tax gap attributable to individual non-filers. The most recent National Non-filer Strategy, which was developed for FY 2001 through FY 2003, was made obsolete in July 2002 when the IRS was reorganized. Since then, each IRS business division has been responsible for tracking and monitoring completion of its own action items. Consequently, there has been no formal system in place for coordinating and tracking all actions across all IRS divisions.

In November 2005, TIGTA reported that as increasing voluntary compliance remains an organization-wide effort, the individual business divisions within the IRS have taken steps to improve efficiency in working non-filer cases.[30] The actions taken by business divisions included:

- Consolidation of the Automated Substitute for Return Program[31] into one campus.[32]
- Computer programming changes to enhance automated processing of returns created by the IRS for non-filing businesses, as authorized under Section 6020(b) of the Internal Revenue Code.[33]
- Refinement of the processes for selection and modeling of non-filer cases each year through risk-based compliance approaches. The intention is to identify and se-

lect the most productive non-filer work and to apply appropriate compliance treatments to high-priority cases.

• Increased outreach efforts by the SB/SE Division through its Taxpayer Education and Communication function.

• An increase in the number of cases recommended for prosecution by the Criminal Investigation Division from 269 in FY 2001 to 317 in FY 2004 (an increase of 17.8 percent).

However, these were not coordinated activities that were planned and controlled within the framework of a comprehensive strategy. Since FY 2001, each business division has independently directed its own non-filer activities. The IRS did not have a comprehensive, national non-filer strategy or an executive charged with overseeing each business division's non-filer efforts. TIGTA concluded that the IRS needed better coordination among its business divisions to ensure resources are being effectively used to bring non-filers into the tax system and ensure future compliance. The IRS also needed an organization-wide tracking system to monitor the progress of each business division's actions.

In addition to better coordination and an organization-wide tracking system, the IRS also needed measurable program goals. TIGTA suggested three measurable goals that could be established:

• The number of returns secured from non-filers.

• Total payments received.

• The recidivism rate.

Without such measurable program goals, the IRS is unable to determine whether efforts to improve program efficiency and effectiveness are achieving desired results. The IRS agreed with all of TIGTA's recommendations. For FY 2006, the IRS developed its first comprehensive non-filer work plan.

LIMITED TIP PROGRAM EXPANSION

Historically, the IRS has been concerned about employees not reporting tips earned in industries in which tipping is customary. An IRS study showed that the amount of tip income reported in CY 1993 was less than one-half of the tip income, leaving over $9 billion unreported. To address this underreporting, the IRS developed the Tip Rate Determination and Education Program (the Tip Program), which is a voluntary compliance program originally designed for the food and beverage industry. It was modeled after the tip compliance agreement used by casinos in the former IRS Nevada District. The Tip Program offers employers multiple voluntary agreement options designed to provide nonburdensome methods for employers and employees to comply with tip reporting laws. The Tip Program was extended to the cosmetology industry in 1997 and the barber industry in 2000.

Since the Tip Program was introduced, voluntary compliance has increased significantly. In TY 1994, tip wages reported were $8.52 billion. For TY 2004, the amount exceeded $19 billion. To date, over 16,000 employers, representing over 47,000 individual establishments, have entered into tip agreements.

TIGTA reviewed the Tip Program and reported that the IRS has not consistently monitored the establishments in the food and beverage and cosmetology industries that had entered into tip agreements since FY 2000 to determine if tip agreements secured actually increased tip income for these establishments.[34] Additionally, due to the voluntary nature of participation and limited IRS resources, disparity with the number of tip agreements secured between various locations across the country is an issue.

In FY 2006, the IRS did not plan to actively solicit any new tip agreements beyond the gaming industry. The majority of FY 2006 Tip Program staffing was to be expended on soliciting and monitoring tip agreements with the gaming industry and on audits of casino employees.

Recognizing that the Tip Program has not reached some small businesses in the food and beverage industry, the IRS developed the Attributed Tip Income Program (ATIP). The Department of the Treasury approved the ATIP Revenue Procedure on July 11, 2006 and the ATIP Revenue Procedure was issued on July 28, 2006. The ATIP Revenue Procedure aims at increasing tip reporting for small businesses that report at least 20 percent of their tip income as charged tips. It should provide benefits similar to those of previous tip reporting agreements for employers and employees who report tips at or above a minimum level of gross receipts.

The IRS plans to test the ATIP with the food and beverage industry for three years. The ATIP Revenue Procedure was designed as a three-year pilot to provide time to assess its impact on tip reporting compliance. It will take up to this length of time to assess whether the ATIP Revenue Procedure has achieved its goal and to consider whether it is appropriate to expand and modify it for other industries.

TIGTA recommended several improvements to the IRS' Tip Program, including expansion to the cosmetology and taxi/limo industries. The Tip Program has not expanded to the taxi/limo industry. TIGTA estimated that the IRS could achieve $342 million in additional tax assessments over five years if it resumes soliciting new tip agreements with the cosmetology industry and expands the agreements to the taxi/limo industry.

The IRS agreed with TIGTA's recommendations, including consideration of expanding the Tip Program after evaluating the results of the ATIP with the food and beverage industry. If the ATIP proves successful, the IRS should develop similar procedures for specific industries, including the cosmetology and tax/limo industries.

UNCLEAR OFFER IN COMPROMISE PROGRAM REQUIREMENTS

The IRS has the authority to settle or compromise Federal tax liabilities by accepting less than full payment under certain circumstances. This is accomplished through an Offer in Compromise (OIC). An OIC is an agreement between a taxpayer and the Federal Government that settles a tax liability for payment of less than the full amount owed. Improving the methods for identifying candidates for the OIC could result in substantial benefits since taxpayers generally do remain in compliance when offers are accepted. However, between FYs 1996 and 2005, only approximately 24 percent of the 1.1 million offers received by the IRS were accepted. Over this same 10-year period, 50 percent either did not meet preconditions of filing an offer or were returned to the taxpayer (e.g., for missing information) during the offer evaluation.

Taxpayers who wish to participate in the program initiate an offer; however, this attracts offer applications from taxpayers who do not qualify for the program or taxpayers who do not fully understand the depth of financial verification the IRS conducts before accepting an offer. TIGTA analyzed offer dispositions and reported the following:[35]

- A significant number of offer applications do not meet the preconditions of filing an offer. Those offers not meeting the preconditions are returned to the taxpayers (as not-processable returned offers) without further consideration. However, the IRS must evaluate the processability of all offers received except those based upon Doubt As to Liability.[36]
- The IRS returns a substantial number of the offers determined to meet the preconditions to taxpayers during the offer evaluation process, without having fully evaluated the offers. This occurs, for example, when taxpayers no longer meet the preconditions of offer filing or did not provide information requested during the course of the offer evaluation. The IRS closes these cases as processable returns.

The high rates of returned offers occurred because requirements of the OIC program were not always clear to taxpayers. In addition, taxpayers had little to lose; if their offers were not accepted, collection of their taxes was, in effect, delayed. The OIC application fee implemented by the IRS during FY 2004 was intended to reduce the number of frivolous offers; however, this fee is not applicable to offers that are considered to be not-processable. Also, in light of the potential benefit of a fresh start, the fee may not be significant to some taxpayers.

The IRS effectively monitors accepted offers to ensure compliance with the terms of the offers. TIGTA reviewed a sample of 84 taxpayers whose offers were accepted during FY 1999. The IRS had identified noncompliance in 33 (39 percent) instances and took appropriate action to resolve the noncompliance. At the time of TIGTA's review, 96 percent of the 84 taxpayers were in compliance with the OIC payment terms and the five-year compliance requirements for filing their returns and paying the taxes due.

The IRS conducted a more comprehensive analysis[37] of individual taxpayer compliance with filing and paying requirements for offers accepted during CYs 1995 through 2001. According to that analysis, approximately 80 percent of the individual taxpayers remained in compliance. This includes taxpayers who received the first collection notice but did not receive any subsequent notices.

Also, taxpayers remain in compliance after the five-year monitoring period. TIGTA's review of a sample of 245 taxpayers whose offers were accepted between October 1, 1994, and December 31, 1998, determined that 220 taxpayers (90 percent) were compliant with filing and payment requirements on tax periods subsequent to the five-year monitoring period.[38]

INCOMPLETE PAYROLL TAX ASSESSMENTS

Social Security and Medicare taxes are paid to the Department of the Treasury from two primary sources (1) payroll taxes consisting of amounts withheld from employees and matching amounts paid by employers and (2) self-employment taxes.

Employers are generally required by law to withhold from their employees' incomes the employees' shares of Social Security and Medicare taxes. Included in the employer's calculation of these taxes are wages earned by the employees and tips received by the employees and reported to the employer. One-half of the calculated tax amount is withheld from the employee's wages and the employer pays a matching amount. Self-employed taxpayers must pay the entire amount of Social Security and Medicare taxes themselves in the form of self-employment taxes.

Social Security and Medicare Tax on Unreported Tip Income (Form 4137) was originally designed to calculate only the Social Security and Medicare taxes owed on tips not reported to an employer, including any allocated tips[39] shown on the Wage and Tax Statement (Form W-2). Forms 4137 are filed as attachments to U.S. Individual Income Tax Returns (Form 1040). Form 4137 has the effect of assessing only the worker's share of these taxes on the tip income. Although not originally developed for this purpose, Form 4137 is also used by certain taxpayers to report wages other than tips.[40] These taxpayers include employees whose employers are granted Section 530[41] relief and workers in dispute with their employers as to their employment status (employee or self-employed).

Because Form 4137 can be used to report wages, it is possible for some taxpayers to use the form inappropriately. This occurs when taxpayers who are truly independent contractors or self-employed individuals use the form to avoid paying their full share of Social Security and Medicare taxes. By using the form inappropriately, taxpayers reduce their share of these taxes by almost one-half. Self-Employment Tax (Schedule SE), not Form 4137, should be used by these taxpayers to pay their legitimate share of Social Security and Medicare taxes. Even when taxpayers rightfully report wages on Form 4137 because their employers have misclassified them as self-employed, Social Security and Medicare taxes are underpaid, in this case by the employers who failed to pay their share of the taxes.

TIGTA reviewed a statistical sample of 350 Forms 1040 with 357 Forms 4137 attached (each Form 1040 can have up to two Forms 4137 attached) processed in CY 2005 and determined that:

- The IRS is not assessing the employer's share of Social Security and Medicare taxes on unreported tip income. TIGTA estimated $20 million in Social Security and Medicare taxes on tips were assessed, and the IRS could have assessed approximately $20 million more in Social Security and Medicare taxes on tips reported on Form 4137.
- The lack of a specific form or adequate written instructions increases the burden on taxpayers trying to report Social Security and Medicare taxes on wages. TIGTA estimated this burden increase affected about 377,850 taxpayers filing Forms 4137 during CY 2005.
- Many taxpayers appear to be reporting self-employment income as wages on Form 4137 to pay less Social Security and Medicare taxes. TIGTA estimated the IRS could have assessed approximately $88 million more in Social Security and Medicare taxes on these wages each year.[42]

TIGTA recommend that the IRS revise Form 4137 to capture the data necessary to properly assess the employer's share of Social Security and Medicare taxes on unreported tip income, revise instructions regarding use of the form, and revise IRS training and procedures to reflect the changes. Using the revised Form 4137, the IRS should develop a compliance program to assess the employer's share of taxes on the unreported tip income. In addition, TIGTA recommended that the IRS create a new form to properly assess the worker's share of Social Security and Medicare taxes on wage income, provide instructions regarding use of the form, create IRS training and procedures regarding the form, and develop a compliance program to ensure the form is used properly and the appropriate amounts of Social Security and Medicare taxes are assessed.

As the tax collectors for the Social Security program, the IRS must help taxpayers meet their tax responsibilities by assessing and collecting the proper amount of employment taxes in this area. By making TIGTA's recommended changes, the IRS could assess an additional estimated $108 million[43] in Social Security and Medicare taxes each year.

INCREASE RESOURCES IN THE IRS ENFORCEMENT FUNCTIONS

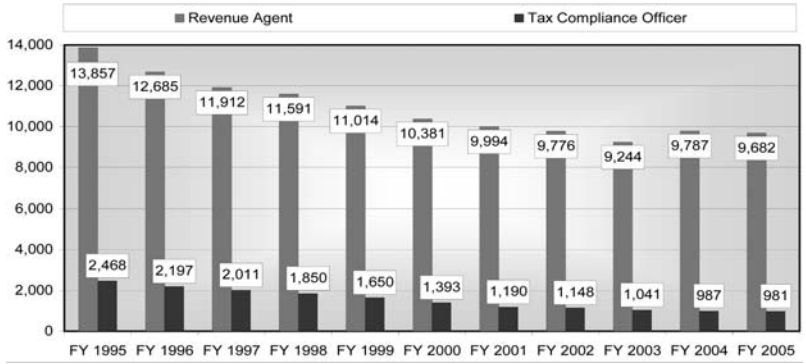
Increased resources would help the IRS with its efforts to close the tax gap. However, in addition to increased resources, the IRS must also focus its efforts on ways to increase the economy, efficiency, and effectiveness of its operations, which would allow the IRS to devote more resources to its efforts to close the tax gap.

In September 1979, the GAO testified before Congress that "The staggering amount of income, at least $135 billion, on which taxes are not paid is shocking."[44]

The GAO's testimony focused on the actions the government should take. The recommended actions included ensuring that the level of the IRS' audit activity did not decline. Unfortunately, while there have been periods of increases in compliance staffing, the IRS has also experienced declines over the years.

The combined Collection and Examination functions enforcement personnel[45] declined from approximately 22,200 at the beginning of FY 1996 to 14,500 at the end of FY 2005, a 35 percent decrease. Even though the IRS has started to reverse many of the downward trends in compliance activities, the Collection and Examination functions' enforcement staffing level is not much higher than the 10-year low experienced in FY 2003. The President's FY 2008 proposed budget for enforcement is approximately 5.7 percent more than the FY 2007 Continuing Resolution (CR) and requests an additional $246 million to expand enforcement activities. Without this additional funding, the IRS will not be positioned to increase enforcement activity above the level provided for in the FY 2007 CR. Additionally, the FY 2007 CR amount for enforcement is almost $48 million less than the FY 2006 funding.

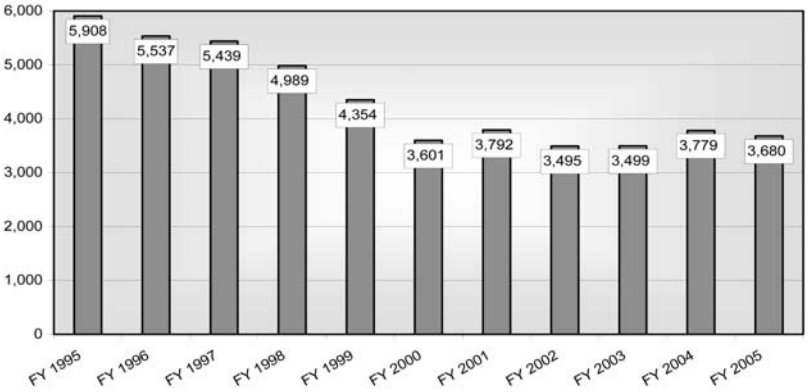
FIGURE 4: EXAMINATION STAFFING



SOURCE: TIGTA analysis of IRS' Audit Information Management System Table 37

The numbers in the preceding chart represent the number of Examination function staff conducting examinations of tax returns, excluding management and overhead staff. During FY 2005, revenue agent and tax compliance officer (formerly referred to as tax auditor) staffing decreased, and the combined total is now nearly 35 percent lower than it was at the beginning of FY 1996.

FIGURE 5: COLLECTION FUNCTION STAFFING



SOURCE: IRS Collection Reports

The numbers in the preceding chart represent the Collection field function staffing at the end of each FY 1995 through 2005. The number of revenue officers working assigned delinquent cases, excluding management and overhead staff, decreased slightly during FY 2005 and is nearly 38 percent fewer than at the start of FY 1996.

One effect of the lack of resources in the Collection function is that the Queue,[46] has increased significantly since FY 1996. In FY 1996, there were over 317,000 balance-due accounts worth $2.96 billion in the Queue. In FY 2004, these figures had increased to over 623,000 balance-due accounts worth $21 billion. Additionally, the number of unfiled tax return accounts in the Queue increased from over 326,000 in FY 1996 to more than 838,000 in FY 2004.

The number of balance-due accounts "shelved," or removed from the Queue altogether because of lower priority, has also increased significantly. In FY 1996, less than 8,000 of these balance due accounts were shelved, but in FY 2004, more than 1 million of these accounts were removed from inventory. From FY 2001 to FY 2004, approximately 5.4 million accounts with balance-due amounts totaling more than $22.9 billion were removed from Collection function inventory and shelved. Additionally, in FY 2004 alone, more than 2 million accounts with unfiled returns were shelved.

If increased funds for enforcement are provided to the IRS in upcoming budgets, the resource issues in the Enforcement functions will be addressed to some degree. In addition, use of Private Collection Agencies is allowing the IRS to collect more outstanding taxes. The IRS needs to be vigilant in overseeing these contractors to ensure that abuses do not occur. However, past experiences with lockbox thefts and insufficient contractor oversight provide valuable lessons toward reducing the likelihood of similar issues occurring when contracting out collection of tax debt.[47]

Overseeing the IRS' private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight.

There are many areas in which increased enforcement could address noncompliance. For example, a TIGTA audit found that a significant number of single shareholder owners of Subchapter S corporations avoided paying themselves salaries to avoid paying employment taxes.[48] We estimated this would cost the Treasury approximately $60 billion in employment taxes over five years. Under current law, the IRS must perform an examination of these taxpayers to determine reasonable compensation. To accomplish this on any scale would require significant compliance resources.

Additional resources might also help the IRS address the growth in fraudulent returns filed by incarcerated individuals. On June 29, 2005, I testified before the House Committee on Ways and Means' Subcommittee on Oversight about this growing problem.[49] Although prisoner tax returns account for only 0.43 percent of all refund returns, they account for more than 15 percent of the fraudulent returns identified by the IRS. Refund fraud committed by prisoners is growing at an alarming rate. The number of fraudulent returns filed by prisoners and identified by the IRS' Criminal Investigation function grew from 4,300 in processing year 2002 to more than 18,000 in processing year 2004 (a 318 percent increase).[50] During that same period, all fraudulent returns identified grew by just 45 percent.

The IRS' Fraud Detection Centers screen tax returns based on criteria that identify potentially fraudulent filings. The number of returns screened is based on these criteria and the available resources. During processing year 2004, Fraud Detection Centers screened about 36,000 of the approximately 455,000 refund returns identified as filed by prisoners. Resources were not available to screen the remaining 419,000 tax returns. Those returns claimed approximately $640 million in refunds and approximately $318 million of Earned Income Tax Credit (EITC). For those unscreened returns, over 18,000 prisoners incarcerated during all of CY 2003 filed returns with a filing status as "Single" or "Head of Household" and claimed more than $19 million in EITC. Since prisoners were incarcerated for the entire year, they would have had neither eligible earned income to qualify for the EITC nor a qualified child who lived with them for more than six months.

The IRS also needs to focus efforts on improving the economy, efficiency and effectiveness of its operations. For example, in 2002, the IRS decided to reduce the number of its human resource positions and to consolidate some of its support operations. The IRS determined that 741 Full-Time Equivalents (FTE)[51] could be eliminated from its headquarters and field offices. This was just one part of a series of initiatives the IRS intended to use to realign approximately 12,000 positions to front-line tax professional positions over the following two years.

Through the use of early retirements, buyouts, normal attrition, placements elsewhere, and involuntary separations,[52] the IRS was able to meet its desired reduction of human resource positions. However, the IRS does not track vacated and reassigned individual positions. While the other IRS initiatives involved in the effort to

reassign 12,000 positions to the front-line were not reviewed, TIGTA determined that from FY 2003 to FY 2005, the number of employees in mission critical positions[53] increased by only 1,216, far short of the goal the IRS documented in its request to the OPM.[54] TIGTA did not determine why the IRS did not achieve its goal.

In a plan submitted to the OPM, the IRS cited specific benefits that would be realized if it received authorization to offer early retirements and buyouts. The plan indicated that the IRS would save an average of $2,746 per employee. However, neither TIGTA nor the IRS could determine if savings were realized. The IRS' Human Capital Office did not prepare any analysis to determine the total costs of, or any savings associated with, offering the early retirements and buyouts. After the IRS was granted the early retirement and buyout authorities, it did not formally assign responsibility for overseeing the reorganization to any single office or individual. As a result, no one was responsible for monitoring the reorganization to ensure that the benefits outlined in the plan to the OPM, such as the realignment of staff to mission critical positions and cost savings, were actually achieved.

TIGTA recommended that the IRS monitor and report on the progress of any IRS reorganization initiative, including how effectively the IRS achieves proposed reductions or staffing realignments. TIGTA also recommended that the IRS identify and track all costs incurred and any savings realized and that the IRS follow all early retirement and buyout rules and regulations. The IRS agreed with TIGTA's recommendations.

The FY 2008 IRS proposed budget shows a net increase of $409.5 million to enhance the IRS' infrastructure and invest in modernization. This increased investment in the IRS infrastructure is necessary to ensure the capability to administer the tax laws, collect the revenue and to better position the IRS to reduce the tax gap.

According to the IRS, the $409.5 million will allow the IRS to increase enforcement revenue by $699 million by 2010. The legislative proposals contained in the budget are projected to increase revenue by approximately $2.9 billion a year. At these levels, the tax gap will not be seriously reduced. Even if these initiatives indirectly increased compliance 10 fold, the tax gap would still exceed $300 billion.

The budget also contains $41 million for non-NRP research. TIGTA believes that by employing enhanced research methods, the IRS will be better positioned to develop more effective and efficient solutions to non compliance, which should lead to reductions in the tax gap.

Although increasing enforcement is important in addressing the tax gap, the IRS must exercise great care not to emphasize enforcement at the expense of taxpayer rights and customer service. Customer service goals must be met and even improved upon, or people will lose confidence in the IRS' ability to meet part of its mission to provide America's taxpayers with quality service by helping them understand and meet their tax responsibilities.

CONCLUSIONS

The IRS faces formidable challenges in completely and accurately estimating the tax gap and also in finding effective ways to remove institutional impediments and optimize its opportunities to increase voluntary compliance. Strategies have been identified to decrease the tax gap and improvements can be realized; however, sufficient resources are needed to ensure compliance with the tax laws.

Mr. Chairman and members of the committee, I appreciate the opportunity to share my views on the tax gap and the work TIGTA has done in this area. I would be happy to answer any questions you may have.

ENDNOTES

[1] Hearings on Bridging the Tax Gap Before the Senate Committee on Finance, 108th Cong. (2004) (statement of Mark Everson, Commissioner of Internal Revenue).

[2] In January 2007, the Congressional Budget Office estimated that if today's laws and policies did not change, Federal spending would total $2.7 trillion in 2007 and revenues would total $2.5 trillion, resulting in a budget deficit of $172 billion. The additional funding that is likely to be needed to finance military operations in Iraq and Afghanistan would put that deficit in the vicinity of $200 billion.

[3] This definition and the associated categories have evolved over time. IRS tax gap estimates in 1979 and 1983 included unpaid income taxes owed from illegal activities such as drug dealing and prostitution. That practice was discontinued in the 1988 estimate. Reasons given for excluding this category are: 1) the magnitude of the illegal sector is extremely difficult to estimate; and 2) the interest of the government is not to derive revenue from these activities, but to eliminate the activities altogether. Earlier tax gap figures such as those for 1965 and 1976 only included underreporting. While figures for more recent years (1992, 1995, 1998 and 2001) are more comparable, they are essentially the same estimates adjusted for the growth in the economy. Thus, comparing the figures does not show real growth in the tax gap. Lastly, comparisons

among years are not done in constant dollars, so any real growth in the tax gap cannot be determined through this IRS data.

[4] This category includes the lesser amounts of overclaimed credits and deductions.

[5] Prior to the National Research Program, tax gap estimates were based on the results of the IRS Taxpayer Compliance Measurement Program (TCMP), which was a systematic program of tax return examinations conducted to facilitate the compilation of reliable compliance data. The last TCMP process involved TY 1988 individual income tax returns.

[6] Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections (TIGTA Reference Number 2006-50-077, dated April 2006.

[7] The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The portion of the gross tax gap that is not eventually collected is called the net tax gap.

[8] This is the amount previously described in this report that was called for by Senator Baucus. See Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections (TIGTA Reference Number 2006-50-077, dated April 2006.

[9] Payment of the $55 billion estimated by the IRS as late or enforced payments does not affect the VCR. However, it does affect the total amount collected by the IRS. Therefore, TIGTA developed the Eventual Compliance Rate term that shows the effect of these payments when coupled with additional voluntary and timely payments that do affect the VCR.

[10] According to the IRS Oversight Board Web site (irsoversightboard.treas.gov), it is an "independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction."

[11] The National Research Program Study of S Corporations Has Been Effectively Implemented, but Unnecessary Information Was Requested From Taxpayers (TIGTA Reference Number 2007-30-027, dated January 30, 2007).

[12] An Evaluation of The Sample Design for The National Research Program Study of Subchapter S Corporations (Mathematica Policy Research Inc., dated May 12, 2005).

[13] The Small Business/Self-Employed Division Is Beginning to Address Challenges That Affect Corporate Return Examination Coverage (TIGTA Reference Number 2005-30-130, dated August 2005).

[14] Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections (TIGTA Reference Number 2006-50-077, dated April 2006).

[15] The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns in the same category filed in the previous year.

[16] While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited (TIGTA Reference Number 2006-30-105, dated July 25, 2006).

[17] Correspondence examinations are important compliance activities focusing on errors and examination issues that typically can be corrected by mail. They are conducted by sending the taxpayer a letter requesting verification of certain items on the tax return. These examinations are much more limited in scope than office and field examinations in which examiners meet face to face with taxpayers to verify information.

[18] TIGTA selected the sampled cases from those completed in FY 2004 to provide sufficient time for collection activities.

[19] Margin of error + 5.05 percent.

[20] Abatement occurs when the IRS reduces an assessment, in this case from reversing examination findings that had uncovered apparent misreported income, deductions, credits, exemptions, or other tax issues.

[21] The IRS Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns (TIGTA Reference Number 2002-30-185, dated September 2002).

[22] General Accounting Office, Pub. No. GAO-04-358, TAX ADMINISTRATION: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000 (2004).

[23] The IRS receives over 30 different types of business information documents yearly. Most of these forms have a legal requirement for issuance to corporations. The three information documents most often issued to business nonfilers are Forms 1099-B (Proceeds from Broker and Barter Exchange Transactions), 1099-MISC (Miscellaneous Income), and 4789 (Currency Transaction Reports).

[24] Internal Revenue Service, Report of BMF IRP Nonfilers for TY 2000 (Corporations, Partnerships, and Trusts), Research Project 02.08.003.03, SB/SE Research (July 2004).

[25] Stronger Actions Are Needed to Ensure Partnerships Withhold and Pay Millions of Dollars in Taxes on Certain Income of Foreign Partners (TIGTA Reference Number 2001-30-084, dated June 2001); Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data (TIGTA Reference Number 2005-30-101, dated July 2005).

[26] The Delinquency Penalty is also known as the Failure-to-File Penalty, although it only applies to taxpayers who both file late and fail to pay all taxes by the tax payment deadline.

[27] The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers (TIGTA Reference Number 2003-30-162, dated August 2003); Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws (TIGTA Reference Number 2004-30-106, dated June 2004).

[28] The non-filer tax gap is the dollar amount of taxes not paid timely on delinquent and nonfiled returns.

[29] The estimated tax gap of $27 billion in TY 2001 was comprised of $25 billion for individual income tax non-filing and $2 billion associated with estate and gift tax. The estimate is developed from other tax gap data sources and is not derived from direct data sources. So, the growth in the dollar amounts in the estimate track the increases in other tax gap estimates.

[30] The Internal Revenue Service Needs a Coordinated National Strategy to Better Address an Estimated $30 Billion Tax Gap Due to Non-filers (TIGTA Reference Number 2006-30-006, dated November 2005).

[31] The Automated Substitute for Return Program focuses on high-income taxpayers who have not filed individual income tax returns but appear to owe significant income tax liabilities based on available Information Reporting Program information.

[32] The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

[33] Internal Revenue Code Section 6020(b) (2005) provides the IRS with the authority to prepare and process certain returns for a non-filing business taxpayer if the taxpayer appears to be liable for the return, the person required to file the return does not file it, and attempts to secure the return have failed.

[34] Additional Enhancements Could Improve Tax Compliance of Employees Who Receive Tips (TIGTA Reference Number 2006-30-132, dated September 15, 2006).

[35] The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes (TIGTA Reference Number 2006-30-100, dated July 2006).

[36] Offers submitted on the basis of Doubt As to Liability represent disputes over the existence or amount of the tax liability and apply to the specific tax periods that are in question.

[37] IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, September 2004.

[38] The number of tax years for which taxpayers were compliant after completion of the offer monitoring period varies based on the offer acceptance date. At the time of TIGTA's review, taxpayers in the sample had been compliant from one to five tax years after the offer monitoring period.

[39] When the amount of tips reported by an employee of a large food or beverage establishment is less than 8 percent (or an approved lower rate) of the gross receipts, other than nonallocable receipts, for the given period, the employer is required to allocate tips to the employee. If the employee is reporting more than the 8 percent, there would be no allocated tip amount.

[40] For tax purposes, tips are generally considered to be wages. However, for purposes of this report, wages are defined as compensation other than tips paid to an employee.

[41] Revenue Act of 1978, Pub. L. No. 95-600, Section 530, 92 Stat. 2763, 2885-86 (current version at Internal Revenue Code Section 3401 note).

[42] Draft Report: Social Security and Medicare Taxes Are Not Being Properly Assessed on Some Tips and Certain Types of Wage Income (TIGTA Audit Number 200630005, dated February 13, 2007).

[43] This is comprised of approximately $20 million in Social Security and Medicare taxes on tips and approximately $88 million in Social Security and Medicare taxes on wages.

[44] Statement of Richard L. Fogel, Associate Director, General Government Division before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

[45] Collection and Examination function staff located in field offices, excluding management and overhead staff.

[46] An automated holding file for unassigned inventory of lower priority delinquent cases that the Collection function does not have enough resources to immediately assign for contact.

[47] Federal Requirements Need Strengthening at Lockbox Banks to Better Protect Taxpayer Payments and Safeguard Taxpayer Information (TIGTA Reference Number 2002-30-055, dated February 2002); Insufficient Contractor Oversight Put Data and Equipment at Risk, (TIGTA Reference Number 2004-20-063, dated March 2004).

[48] Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (TIGTA Reference Number 2005-30-080, dated May 2005).

[49] Hearing to Examine Tax Fraud Committed by Prison Inmates, 109th Cong. (2005) (statement of J. Russell George, Inspector General) and The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners (TIGTA Reference Number. 2005-10-164, dated September 2005).

[50] Processing year refers to the year in which taxpayers file their returns at the Submission Processing Sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.

[51] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2005, 1 FTE was equal to 2,088 hours. For purposes of this report, we are using the terms FTEs, employees, and positions synonymously.

[52] An involuntary separation is any separation against the will and without the consent of the employee, other than for misconduct or delinquency. The most common cause for an involuntary separation is a reduction in force.

[53] The IRS uses the term mission critical occupations to define occupations deemed critical to front-line operations as well as those occupations that provide direct support to front-line operations. Mission critical positions are specific positions within those occupations.

[54] Staff Reductions in Support Operations Did Not Result in Significant Increases in Mission Critical Positions (TIGTA Reference Number 2006-10-175, dated September 28, 2006).

Chairman SPRATT. Thank you very much.

Ms. Olson.

STATEMENT OF NINA E. OLSON

Ms. OLSON. Thank you, Mr. Chairman, Mr. Ryan and members of the committee. Thank you for inviting me to testify today about the tax gap. I believe there are three principal steps that can be taken to address this gap.

First, Congress should simplify the Tax Code. Corporate tax shelters and abusive schemes pursued by individual taxpayers exist solely because there are ambiguities and complex laws that they can exploit. At the same time, tax law complexity confounds taxpayers and is responsible for the significant majority of taxpayer reporting errors.

Second, Congress should consider expanding third-party information reporting and, in certain situations, withholding requirements. IRS data show a direct correlation between third-party information reporting by payers of income and tax reporting compliance by the recipients of income. Where tax is withheld from income, taxpayer reporting compliance is above 99 percent. Where income is reported to the IRS, such as interest on dividends on a Form 1099, taxpayer reporting compliance is above 95 percent. Where income is not reported to the IRS, taxpayer reporting compliance drops below 50 percent. Expanded information reporting would reduce the tax gap significantly, and backup withholding can be used where taxpayers repeatedly underpay their taxes, but both must be done with care to avoid placing undue burdens on the payers of income tax. I discuss this issue in more detail in my written statement.

I will devote the rest of my testimony today to my third point because it falls squarely within your committee's jurisdiction.

I believe the rules by which the IRS is funded need to be fixed so that the IRS receives adequate resources to collect taxes. As a starting point, we should keep in mind that the IRS functions as the Accounts Receivable Department of the Federal Government. On a budget of about $10.6 billion, the IRS currently collects about $2.24 trillion a year. That translates to an average return on investment, or ROI, of about 210 to 1, but the congressional budget rules do not recognize the IRS' unique role as the revenue generator for the Federal Government. Rather, the budget rules treat spending for the IRS exactly the same way they treat spending for all other Federal programs. The IRS is placed within a category of spending programs that is subject to a spending ceiling, and the relevant appropriations subcommittee then allocates dollars between the IRS and the other agencies. Thus, the IRS competes dollar for dollar against classic spending programs for resources, and there is no explicit mechanism in the budget process for recognizing the revenue that the IRS collects. These procedures make little sense. If the Federal Government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

Since the IRS is not a private company, maximizing the bottom line is not and in and of itself should not be an appropriate goal, but the public sector analogy should be to maximize tax compliance, especially voluntary tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. No one seems to dispute this premise, but the current budget rules treat

the IRS as a classic spending program, and a change in the rules will be required if the IRS is to be treated the way a company would treat its Accounts Receivable Department.

In the last 3 years, the administration has proposed and Congress has considered a mechanism known as "program integrity caps" to give the IRS additional funding. While these cap adjustments are better than nothing, they suffer from two flaws. First, they do not address the fundamental problem I am raising, which is that decisions about IRS funding levels should be made on the basis of maximizing tax compliance, not fitting within a cap. Second, the program integrity caps have generally been used to provide additional funding for tax law enforcement without providing any additional funding for taxpayer service. This is happening because the IRS can document that it collected $48.7 billion through direct enforcement actions last year, and budget crunchers can compare this figure with the dollars spent on enforcement to compute a positive return on investment.

The problem with this approach is that $48.7 billion is only 2 percent of the revenue that the IRS collected. The remaining 98 percent of revenues were collected through some combination of taxpayer service and the indirect or deterrent effects of enforcement. The IRS current strategic plan is based on the formula of taxpayer service plus enforcement equals compliance, but there are no data that show whether there is a greater need at this time for service or enforcement. In the absence of such data, I think it is misguided to provide disproportionate increases to enforcement simply because we have measurement tools to compute the ROI with respect to 2 percent of our collections.

In my written statement, I describe some recent and expected reductions in taxpayer service and the negative effects these reductions could have on compliance.

In conclusion, I urge the committee to consider making changes to the budget rules to provide funding for the IRS at a level designed to maximize tax compliance and that does not short-change taxpayer service as taxpayer service may provide an equal or greater ROI than enforcement. In focusing on what the IRS can do to reduce the tax gap, I suggest that giving the IRS the tools to do the job in conjunction with proper oversight is the single most helpful step Congress can take.

Thank you.

[The prepared statement of Nina E. Olson follows:]

PREPARED STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE

Mr. Chairman, Ranking Member Ryan, and distinguished Members of the Committee, thank you for inviting me to testify today about "The IRS and the Tax Gap."[1] In the National Taxpayer Advocate's 2006 Annual Report to Congress, issued last month, I made a recommendation to address the tax gap that falls squarely within the jurisdiction of the Budget Committee—namely, to change the budget rules by which IRS funding decisions are made to provide funding at whatever level will maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. I will describe my proposal in more detail below after first summarizing the components of the tax gap and describing my perspective on the best strategies to address it.

I. Why the Tax Gap Matters

In my 2006 report, I designated the tax gap as the second most serious problem facing taxpayers (after the alternative minimum tax). From a taxpayer perspective, I am deeply concerned that compliant taxpayers are paying a great deal of money to subsidize noncompliance by others. Using data from the IRS's 2001 National Research Program study, if we divide the estimated 2001 net tax gap of $290 billion[2] by the estimated 108,209,000 households that existed in the United States in that year[3] we see that each household was effectively assessed an average "surtax" of about $2,680 to subsidize noncompliance.[4] That is an extraordinary burden to ask our nation's compliant taxpayers to bear every year, and it is imperative that we take steps to reduce that burden.[5]

Noncompliance has a corrosive effect on tax compliance. If compliant taxpayers believe that everyone else is paying his or her fair share, they are likely to remain compliant. But no one wants to feel like a "tax chump." If compliant taxpayers feel like they are overpaying, some will reach a point where they resent it and stop complying or comply at a lower level.

In other words, there is a degree to which compliance breeds more compliance and noncompliance breeds more noncompliance. That is largely why each additional dollar the IRS collects is thought to increase federal revenue by substantially more than a dollar. Greater compliance—whether brought about through taxpayer service or enforcement—can pay for itself many times over.

II. Overview of the Primary Causes of the Tax Gap

Last year, the IRS substantially updated its tax gap estimates as a result of a set of audits it performed on individual income tax returns filed for 2001. The results of the audits show that withholding and third-party information reporting are the key drivers of tax compliance. Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (e.g., interest and dividends)—yet less than 50 percent on income not subject to third-party information reporting.[6]

At the same time, the complexity of the tax code is a driver of noncompliance because it creates loopholes that aggressive taxpayers can exploit. Corporate tax shelters and abusive schemes pursued by individual taxpayers exist largely because of ambiguities in the law. Tax-law or procedural complexity is also responsible for the significant majority of taxpayer reporting errors.[7]

Finally, the lack of funding provided to the IRS to maximize taxpayer service (especially outreach and education) and enforcement (where the IRS was only able to conduct face-to-face audits of one out of every 435 taxpayers last year) prevents the IRS from maximizing tax compliance.[8]

III. Broad Strategies to Address the Tax Gap

Broadly speaking, I have advocated three strategies for closing the tax gap: (1) fundamental tax simplification, with an emphasis on making economic transactions more transparent; (2) expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and (3) a more robust IRS compliance program that appropriately balances taxpayer service and enforcement.

A. Tax Simplification

In my annual reports to Congress, I have highlighted numerous examples of tax law complexity and described the consequences of that complexity for taxpayers and tax administration. For taxpayers seeking to comply with the law, complexity presents a huge obstacle. To cite a few examples, the alternative minimum tax (AMT) and the earned income tax credit (EITC) affect millions of taxpayers yet present substantial compliance burdens. The sheer number of alternative incentives that the tax code provides for saving for education and retirement baffles many taxpayers, including sophisticated taxpayers.

For taxpayers seeking to exploit loopholes, complexity presents countless opportunities. Many law firms, accounting firms, and investment banking firms have made tens of millions of dollars by scouring the Code for ambiguities and then advising taxpayers to enter into transactions, with differing levels of business purpose or economic substance, to take advantage of those ambiguities. The IRS devotes significant resources to identifying these transactions and challenging them, where appropriate, but many are legitimate under existing law and many more fall into a grey area.

A simpler tax code could reduce these administrative challenges enormously.

Moreover, traditional economic analysis focuses on the goals of equity and efficiency in writing the tax laws. To those, I would add transparency. To the extent we can revise the Code to provide greater transparency of payments of income without imposing undue burden on taxpayers, the higher compliance rates associated with third-party information reporting can be more readily achieved in a broader array of transactions.

B. EXPANDED THIRD-PARTY INFORMATION REPORTING

Expanding third-party information reporting would clearly improve compliance, but we must be realistic in taking into account the burden third-party information reporting imposes on payors of income. If our sole objective were to maximize the amount of tax revenue, we could simply require that anyone making a taxable payment to another person report the payment to the IRS. But requiring everyone making a taxable payment to file a report with the government would impose more burden than most of us would be willing to bear. No one wants to be obligated to file a document with the IRS every time he takes a cab ride, has someone mow his lawn, or calls a plumber to fix a broken faucet.

To address the tax gap, we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose. In many cases, we will ultimately decide that it is inappropriate to impose a reporting requirement. But in some cases, we may decide that requiring reporting is appropriate.

To cite one example, I recommended in my 2005 Annual Report to Congress that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, the absence of cost-basis reporting provides an opportunity for noncompliance that the IRS rarely will detect without an audit.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make compliance much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about $25 billion a year.[9] IRS officials studying the NRP data believe the revenue loss is substantially lower, but they agree that the level of underreporting reaches into the billions of dollars.[10] We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.

I am pleased that bills were introduced in both the House and the Senate last year to implement our proposal, and I am pleased that the Treasury Department has included it among the revenue proposals it sent to Congress earlier this month. Bipartisan bills have been introduced in the new Congress by Congressmen Rahm Emanuel and Walter Jones in the House and by Senators Evan Bayh, Tom Coburn and 11 other original co-sponsors in the Senate. I strongly urge Congress to enact this measure.

Another example: Under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity.

For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a Form 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, we recommend that corporate taxpayers (including Subchapter S corporations) be subject to Form 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.

We also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction and sales sites. As with current rules governing Form 1099 reporting, such reports could be subject to a de minimis annual exemption (say, $600). One recent study found that 700,000 Americans reported that eBay sales constitute their primary or secondary source of income.[11] The IRS must have the tools needed to address under-reporting of this income.

My office has made a number of proposals to reduce the tax gap both through more third-party information reporting and through other methods. The Exhibits that follow my statement summarize our main recommendations.

C. A MORE ROBUST IRS COMPLIANCE PROGRAM THAT APPROPRIATELY BALANCES TAXPAYER SERVICE AND ENFORCEMENT MEASURES

The IRS can do more—much more—to improve tax compliance.

Despite a finding by a leading IRS researcher that the direct and indirect benefits of IRS's preparing tax returns for low income taxpayers pays for itself many times over,[12] the IRS has reduced by about half the number of tax returns it helps low-income taxpayers prepare in its walk-in sites.[13] Despite the challenges individuals who start small businesses face in learning for the first time about the legal requirements they face as employers (including the payroll responsibilities of income and employment tax withholding, paying over tax to the IRS, reporting to the IRS, and reporting to the employee), the IRS has substantially reduced its field outreach operation.[14] Despite the number of taxpayers in certain states with taxable income from farming activities, the IRS has apparently declared questions about farm income and expenses "out of scope" for IRS walk-in sites in those areas.[15]

On the enforcement side, the IRS is currently conducting face-to-face audits of only about one out of every 435 tax returns.[16] It does not have the resources to pursue a significant percentage of its accounts receivable. And the private debt collection initiative, a controversial program that is projected to raise only about $1.4 billion over the next 10 years,[17] results from the IRS's lack of resources to pursue these cases itself.

IV. A PROPOSAL TO REVISE THE CONGRESSIONAL BUDGET RULES TO IMPROVE IRS FUNDING DECISIONS

A. OVERVIEW OF THE PROBLEM OF IRS UNDERFUNDING

The Internal Revenue Service is effectively the Accounts Receivable Department of the United States Government. On a budget of about $10.6 billion,[18] the IRS currently collects about $2.24 trillion a year.[19] That translates to an average return-on-investment (ROI) of about 210:1.[20]

Rather than recognizing the IRS's unique role as the revenue generator for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies.

The current budget procedures work essentially as follows: Early each year, a spending ceiling is established for a category of programs that in recent years included the Department of Transportation, the Department of the Treasury (of which the IRS is a part), the Department of Housing and Urban Development, the Judiciary, the District of Columbia, and independent federal agencies.[21] The House and Senate Appropriations subcommittees with jurisdiction over this grouping of federal programs must apportion the total number of dollars it receives among them. If more funding was provided for transportation programs, for example, less funding was available for the IRS. Thus, the IRS competes dollar-for-dollar against many other federal programs for resources.

These procedures make little sense. The IRS collects about 96 percent of all federal revenue.[22] The more revenue the IRS collects, the more revenue Congress may spend on other programs or may use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for other purposes.

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. If the IRS were given more resources, studies show the IRS could collect substantially more revenue.

Former IRS Commissioner Charles Rossotti has written:

When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with the IRS budget. The reaction was usually "Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn't you be able to get it?"[23]

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS. Over the past few years, Congress has focused increasing attention on the "tax gap"—the difference between taxes owed and taxes paid. As part of this discussion, it should be recognized that the IRS currently suffers from a "resources gap," and the IRS's lack of resources is a significant impediment to its ability to help close the tax gap and thereby reduce the federal budget deficit.[24]

B. THE CONSEQUENCES OF UNDERFUNDING THE IRS

The failure to fund the IRS at appropriate levels leads to two sets of consequences. First, the IRS lacks the resources to collect a significant amount of unpaid tax, resulting in a larger tax gap and a larger budget deficit. Second, the lack of resources often leads the IRS to take steps that are, in my judgment, unwise from the standpoint of tax compliance and taxpayer rights.

1. Failure to Collect Unpaid Taxes

In his final report to the IRS Oversight Board in 2002, former Commissioner Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from nonfilers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS lacked the resources to handle cases worth about $29.9 billion each year. It placed the additional funding the agency would have needed to handle those cases at about $2.2 billion.[25]

Significantly, this estimate reflects only the potential direct revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between six and 12 times the amount of the proposed adjustment.[26]

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in additional federal revenue assuming the funding is wisely spent.

2. Bad Results

a. Outsourcing Tax Collection

In the same report, former Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional $296.4 million, the agency could collect $9.47 billion.[27] That translates to a return on investment of 32:1. Among collection cases handled solely through phone calls, the IRS has estimated an ROI of about 13:1.[28]

Because Congress has not provided IRS with sufficient funding to work these accounts, the Administration requested the authority to outsource the collection of certain tax debts to private collection agencies. Congress granted the requested author-

ity in 2004,[29] and the IRS began to send cases to private debt collectors in September of 2006.

Under the terms of the program, the IRS is paying out commissions of up to 25 percent of each dollar collected to the private collection agencies. The IRS is also bearing significant additional costs to create, maintain, and oversee the program.[30]

Internal IRS estimates show that the IRS, if given the funding, could generate a substantially higher ROI than private contractors receiving commissions of nearly 25 percent can produce. For each dollar a PCA collects, the IRS will receive about 75 cents and the PCA will keep about 25 cents, resulting in an ROI of, at best, about 3:1. The significant administrative costs the IRS is incurring to run the program, including the opportunity costs of pulling experienced IRS personnel off higher dollar work to assist with this initiative, reduce the ROI further. Despite supporting the use of private debt collectors because of IRS resource limitations, IRS Commissioner Mark Everson has repeatedly acknowledged that IRS employees could collect unpaid taxes more cheaply and efficiently.[31]

The result of underfunding the IRS in this area is that the government is not maximizing its revenue collection and the risk of taxpayer rights violations has been heightened due to the use as collectors of non-governmental employees who will receive only limited taxpayer-rights training.[32]

b. Neglect of Important Taxpayer Service Programs

The IRS has long acknowledged that taxpayer service plays a significant role in promoting tax compliance. In fact, its current strategic plan is based on the principle: "Service + Enforcement = Compliance."[33] Yet two examples illustrate the neglect of important services that likely is resulting in a higher tax gap.

Tax Return Preparation. The IRS historically has prepared tax returns for low income taxpayers at its walk-in sites (called "Taxpayer Assistance Centers," or "TACs "). Low income taxpayers generally qualify for the earned income tax credit (EITC), which is a refundable credit that caps out at $4,536 in 2006. Studies show that the average overclaim rate for EITC benefits is between 27 percent and 32 percent.[34] IRS personnel who prepare tax returns are trained to ask questions that minimize the likelihood of EITC overclaims and thus can save the government hundreds of dollars per return. Yet to free up resources for other program initiatives, the IRS has substantially reduced return preparation at its TACs. The number of tax returns it prepared dropped from 665,868 in FY 2003 to a projected 305,000 in FY 2006.

IRS data for tax years 2002 through 2004 suggest that EITC returns prepared by IRS TACs may be significantly more compliant than self-prepared and commercially prepared returns. Discriminant Function (DIF) scores[35] for self-prepared returns were between 21 and 26 percent higher than returns prepared at the TACs and between 25 and 31 percent higher than returns prepared by commercial preparers.[36]

These findings are corroborated by examination results for EITC returns for these tax years. As compared with TAC-prepared returns, average audit assessments among EITC returns for tax years 2002—2004 ranged from about $640 to $1,300 higher for self-prepared returns and from about $820 to $1,300 higher for commercially prepared returns.[37] Similarly, a study conducted in 1996 that examined the relationship between IRS return preparation and compliance over a ten-year period showed that an increase in the number of returns prepared by the IRS correlates with improvements in compliance among filers of individual returns.[38]

Small Business Outreach. IRS data show that self-employed taxpayers account for the largest chunk of the tax gap and indicate that the tax compliance rate for self-employed taxpayers runs at about 43 percent.[39] Much of the underreporting is deliberate, but some is not. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

After the IRS Restructuring and Reform Act of 1998, the IRS developed a function known as Taxpayer Education and Communications, or "TEC." TEC was the IRS's outreach arm to small businesses to try to educate them about the complexity of their tax obligations. For 2002, TEC was named the Small Business Administration's agency of the year for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small business and self-employed taxpayers.[40] Yet in the name of achieving "efficiencies," TEC was "realigned" in February 2005 through a merger with other outreach functions and redesignated as "Stakeholder Liaison." Prior to the realignment, TEC had 536 em-

ployees. After the realignment, Stakeholder Liaison staffing included 219 employees.[41] In my view, the reduction in TEC staffing will reduce tax compliance and place a greater burden on IRS enforcement personnel.

I cite these examples to make two points. First, although I disagree with certain decisions the IRS has made, the failure to provide the IRS with adequate resources to collect taxes has forced the IRS to cut corners in places where corners should not have to be cut. Second, I cite the examples of tax return preparation and TEC to underscore the important role taxpayer service plays in promoting tax compliance. As I discuss below, additional funding for the IRS should be provided in a balanced manner. The revenue derived from direct enforcement actions may be easier to measure, but the effects of taxpayer service may be equally significant and perhaps more significant.

C. RECOMMENDATIONS

1. Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: "What level of funding will maximize tax compliance, particularly voluntary compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?" and then set the IRS funding level accordingly, without regard to spending caps.

This recommendation, in my view, boils down to simple common sense. Just as a business could not survive if it did not seek to maximize revenue collection, the federal government has less revenue to spend (or use to reduce the deficit or cut taxes) if it fails to optimize tax collection. Taxes are truly the lifeblood of government, for without tax revenue, there would be no government programs. As the National Taxpayer Advocate, I will be the first to raise objections if the pursuit of revenue proceeds without due regard for protecting taxpayer rights and minimizing taxpayer burden. But the existing budget rules, which pit the revenue center of the government in direct competition with cost centers and do not have a mechanism for explicitly taking into account the revenue the IRS is likely to generate, are not logical. The congressional budget rules are the one piece of the tax gap over which your committee has direct control, and I urge you to consider improvements to the process.

One way to implement the proposal I have outlined would be to keep the IRS within its existing appropriation bill but break that bill into two parts—one providing a funding cap for the IRS and one providing a funding cap for all other programs under that bill. The budget committees would set the funding cap for the IRS.[42] The appropriations committees then would retain discretion to appropriate funds at the cap or at a lesser level and to provide direction concerning how the funds are to be spent. The rules should explicitly authorize the committees to set the cap at a level that they believe will maximize tax compliance, especially voluntary compliance, with due regard for the protection of taxpayer rights and minimization of taxpayer burden. In setting the cap and making funding decisions, the budget and appropriations committees would consider the President's budget request as well as input from the tax-writing committees, the Congressional Budget Office, the Joint Committee on Taxation, the Government Accountability Office, the Congressional Research Service and any other office that they choose to consult to obtain revenue estimates and guidance concerning the likely return on IRS spending.

We offer this approach only as an illustration of a way to implement the general principle we are recommending. We do not have sufficient expertise in the congressional budget process to craft a comprehensive solution, and we are cognizant of the important roles that the budget committees, the appropriations committees, and the tax-writing committees play. Our overriding recommendation is simply that the committees of jurisdiction collaborate to devise and implement procedures that reflect the general principles we have outlined.

We note that in each of the past three years, the Administration has proposed a contingent budgetary mechanism known as a "program integrity cap" in an attempt to provide the IRS with additional funding. Under this mechanism, additional funding for tax-law enforcement would have been provided if, but only if, Congress agreed to fund at least the existing base of enforcement activities. The Senate has endorsed the concept, but the House did not go along. Although there may have been subtle differences in detail, a similar approach was used in FY 1995 to give the IRS additional funding.[43] Because the Budget and Appropriations committees have become familiar with this mechanism, it may be a viable way to channel additional funding to the IRS.

However, we have two concerns about the use of program integrity caps. First, the mechanism operates simply to mitigate the effects of what we are arguing is a flawed conceptual approach to funding the IRS. It would not alter the existing framework under which the IRS competes for funding against other government programs, and it would not peg future IRS funding decisions to the goal of maximizing tax compliance. I believe a change to the process along the lines of what I am recommending would be far preferable in the long run and would be more likely to result in a consistent ramp-up in funding year-over-year. Second, the mechanism in the past has been proposed solely to boost enforcement spending (i.e., the additional funding could be used only for tax-law enforcement and would only be provided if Congress agreed to fund at least the existing base of enforcement activities). As discussed below in more detail, tax compliance is a function not only of enforcement but also of taxpayer service, and it is important to maintain a balanced approach between the two. If program integrity caps are used in the future, we urge that consideration be given to providing additional funding for taxpayer service as well as enforcement.

2. In allocating IRS resources, Congress should keep in mind that tax compliance is a function of both high quality taxpayer service and effective tax-law enforcement, and it is essential that the IRS continue to maintain a balanced approach to improving tax compliance.

As noted, recent attempts to give the IRS additional funding beyond the levels provided under the spending caps have focused exclusively on providing additional funding for enforcement activities. That is so largely because the direct ROI resulting from enforcement actions is somewhat susceptible to measurement, while the deterrent effect of enforcement actions and the effect of taxpayer service are too amorphous to quantify. However, it is important to emphasize that direct enforcement revenue in FY 2006 came to only $48.7 billion, or 2 percent, of total IRS tax collections of $2.24 trillion.[44] The remaining 98 percent of IRS tax collections resulted from a combination of taxpayer service programs and the indirect (i.e., deterrent) effect of IRS enforcement actions. To make budgeting decisions by striving to maximize the 2 percent of collections without grappling adequately with what is required to maximize the remaining 98 percent of collections is a bit like letting the tail wag the dog.

The Administration's FY 2008 budget request acknowledges this dilemma. It states: "The IRS cannot currently measure either the impact of deterrence or service, but they are positive."[45] In fact, there are no reliable data that show whether the IRS would achieve a greater ROI if it spends additional funds on service or on enforcement. In the absence of such data, one might think the government would err on the side of assisting taxpayers in complying with the law rather than disproportionately ramping up enforcement. If Congress continues to provide the IRS with greater increases for enforcement each year simply because the ROI of direct enforcement can be quantified, the cumulative effect of those increases over time will be to relatively shift the IRS away from taxpayer service and toward tougher enforcement—with no evidence that such a shift will increase revenues and with the possibility that such a shift might decrease revenues.

As former Commissioner Rossotti has written:

Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.[46]

Because of recent budget pressures and additional service obligations brought about by the late passage of the tax extenders bill and the administration of telephone excise tax refunds, the IRS is actually expecting that it will reduce the percentage of phone calls it answers from the mid-80s to the mid-70s this year, if not lower. The IRS has been working hard on a five-year taxpayer service strategic plan, developed in response to a Senate Appropriations directive in FY 2006. This plan was developed in collaboration with my office and the IRS Oversight Board. It is an excellent product, and it describes well how the IRS can improve its ability to meet taxpayer service needs.

I urge you to keep in mind that taxpayer service provides a positive ROI, and the ROI of taxpayer service may even exceed the ROI of enforcement. The budget rules should be crafted to ensure that the ability to score direct revenue gains resulting from enforcement does not drive results that may be counterproductive. Perhaps the "scorekeepers" could use a blended ROI of taxpayer service and enforcement actions to support a balanced approach to additional IRS funding.

Many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (e.g., outreach and education), while IRS audits constitute a far more costly retail operation that requires individual taxpayer contact. The IRS should pursue a balanced approach to tax compliance that puts priority emphasis on improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.[47]

3. Congress should provide increases in IRS personnel funding at a steady but gradual pace, perhaps two percent to three percent a year above inflation. We do not think the IRS can ramp up its staffing more quickly without encountering significant transitional difficulties. However, Congress should consider providing more rapid funding increases for technology and research improvements, as the transitional challenges of absorbing additional resources are probably less significant in these areas and the potential exists to generate substantial productivity gains.

In former Commissioner Charles Rossotti's final report to the IRS Oversight Board in 2002, he described the serious total staffing shortages the IRS was facing. He stated that the IRS needed "steady growth in staff in the range of 2 percent per year."[48] The context shows he was discussing real increases (i.e., increases above those required to maintain current services).

At first blush, real annual staff growth of two percent might appear to be an extremely limited request, but the IRS faces significant challenges in adding and training staff. Examination and collection procedures, in particular, are complex, as is the underlying tax law, and experienced personnel must be pulled off revenue-producing priority cases to provide extensive training to new hires. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate taxpayer rights.

However, the IRS probably can absorb more rapid funding increases in technology and research, both of which have the potential to increase IRS productivity substantially.

Better technology would allow the IRS to achieve significant efficiencies in a broad range of taxpayer service and enforcement areas. For example, it would allow the IRS to offer taxpayers a wider range of e-filing options to increase the number of taxpayers who file their returns electronically rather than on paper (which would save IRS the cost of manually entering data from the roughly 64 million individual income tax returns it received on paper in FY 2005),[49] and it would allow the IRS to expand its document-matching capabilities, which tend to produce high returns on investment because automated processes are relatively inexpensive to operate and maintain.

Better research would allow the IRS to assess the most cost effective ways of meeting taxpayer service needs and to target its limited enforcement resources to maximize its return on investment. We discuss the importance of obtaining more accurate ROI estimates for the IRS's major categories of work under Recommendation #4 below.

In the past, congressional support for additional IRS funding has come in fits and starts. It will not be helpful to provide too much additional funding immediately. It also will not be helpful to provide additional funding for a year or two and then to change direction. To maximize the IRS's ability to do its job, the IRS needs to receive gradual but steady real increases in its total funding every year for at least the next five to ten years.

4. To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work.[50]

In this connection, Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the marginal ROI that the IRS has achieved for each category of work.

To provide Congress with meaningful information, the IRS will need to conduct more research to improve the accuracy of its ROI calculations. As we have noted above, direct enforcement revenue constitutes only about two percent of the revenue the IRS collects. Ninety-eight percent of the revenue the IRS collects derives from its taxpayer service programs and the indirect deterrent effect of its enforcement activities. Yet the IRS currently does not have adequate data on which to make accurate estimates of the ROI of its various categories of work, including taxpayer service programs and the indirect effect of its enforcement activities as a whole and broken down by their key components. Developing better data should be made a priority objective. Moreover, ROI estimates should include costs relating to the downstream consequences—such as increased phone calls or correspondence, Appeals conferences, and Taxpayer Advocate Service cases—of the various categories of IRS work.

We acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, we have recommended in the past and continue to believe that this information will aid the IRS substantially in making resource allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.[51]

V. Conclusion

The tax gap is a serious problem because it deprives the government of revenue it needs and it creates inequities between compliant taxpayers and noncompliant taxpayers. There is no silver bullet that will eliminate the tax gap. I believe significant progress can be made, however, by following an approach that emphasizes fundamental tax simplification, expanded third-party information reporting, and a more robust IRS compliance program.

The Budget Committee has the jurisdiction to change the existing budget rules that, in my view, have unreasonably constrained IRS funding and limited the agency's ability to maximize tax compliance. I urge the Committee to use its jurisdiction to improve the process by which IRS funding decisions are made.

VI. EXHIBIT A: CASH ECONOMY—ADMINISTRATIVE RECOMMENDATIONS

	Recommendation	Summary	Reason
1	Expand use of Electronic Federal Tax Payment System (EFTPS)	Send self-employed taxpayers a letter to remind them when estimated tax payments are due and offer the option of paying electronically, by phone or via automatic monthly (or biweekly) withdrawals from the taxpayer's bank account free of charge.	Self-employed taxpayers who want to comply with their estimated tax payment obligations sometimes fail because they have difficulty estimating income, remembering oddly spaced payment dates (April 15, June 15, September 15 and January 15), and saving enough money each quarter. When they fail to pay enough estimated taxes, they are more likely to understate their liability.
2	Revise Form 1040, Schedule C	Include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099.	This revision would encourage taxpayers to report income even if it is not subject to information reporting. Taxpayers are more likely to report income that is reported to the IRS by third parties on information returns, such as Forms 1099. Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it. Separating out gross receipts on the income tax form as we propose would likely improve compliance by emphasizing to taxpayers that income not reported on information returns is still subject to tax. It may also suggest to them that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.

VI. EXHIBIT A: CASH ECONOMY—ADMINISTRATIVE RECOMMENDATIONS—Continued

	Recommendation	Summary	Reason
3	Revise business income tax return forms	Include two questions: (1) Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business? (2) If yes, did you file all required Forms 1099?	These two questions would encourage taxpayers to comply with information reporting requirements. They would also suggest to taxpayers that the IRS is looking at information reporting compliance and that there is additional risk to avoiding the information reporting requirements by paying contractors ''under the table.'' Payments reported to the IRS on information returns are much more likely to be reported on the payee's income tax return. Thus, increased information reporting compliance would cause contractors (payees) to report more of their income.
4	Implement more voluntary withholding agreements	Encourage taxpayers to enter into voluntary withholding agreements by agreeing not to challenge the classification of workers who are a party to such an agreement. (Statutory authority exists under IRC sss 3402(p)(3), but the IRS may need to work with the Treasury Department to issue regulations before it can use its authority and may prefer additional legislative authority.)	Research shows that taxpayers are most compliant in paying taxes on income subject to withholding. Unlike payments to employees, payments to independent contractors are generally not subject to withholding. Businesses sometimes have difficulty determining whether service providers should be classified as employees or independent contractors and the IRS often challenges such determinations. These agreements could reduce both underreporting by payees and the controversy associated with worker classification.
5	Institute backup withholding more quickly	Require mandatory backup withholding to begin more quickly when taxpayers provide an invalid TIN to the payor.	By the time a payor receives a backup withholding notice from the IRS, the payee (service provider) may no longer be receiving payments from the service recipient. Thus, the IRS has lost the opportunity for backup withholding. For additional information see National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (MSP: Limited Scope of Backup Withholding Rules).
6	Use more available information	Use more of the information available from state and local governments as well as information from Forms 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business) when selecting returns for audit and when auditing them.	The IRS currently uses information from Forms 8300 to identify returns that may have unreported income. It also receives and uses state income tax audit reports as well as sales tax records, which a cross-functional team has concluded could be used more consistently and effectively. States and localities also impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts. Such information may be useful in detecting unreported income. Local property taxes are also based on the value of real and personal property. Taxpayers whose property holdings are disproportionately large in comparison to the income reported on their federal income tax returns may be underreporting their income. The IRS could combine all of this information, perhaps in conjunction with the UI-DIF (or to improve it), for selecting returns for audit and auditing them.

VI. EXHIBIT A: CASH ECONOMY—ADMINISTRATIVE RECOMMENDATIONS—Continued

	Recommendation	Summary	Reason
7	Establish local compliance planning organizations	A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness.	Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information and feedback so that it can adjust its strategy to effectively address local compliance issues. If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete. However, if the IRS could motivate a critical number of businesses in a given market to report their income, then the market price for their goods or services would increase so that businesses could both compete and pay their taxes. As the IRS's activity starts to affect market prices, research suggests it could produce a dramatic increase in voluntary compliance in the local cash economy as it changes local norms. A national cash economy program office could replicate successful local strategies nationwide.
8	Create a cash economy program office	The cash economy program office would coordinate research, outreach, and compliance efforts aimed at improving income reporting compliance among cash economy participants, as the EITC program office has done with respect to EITC compliance.	The EITC Program Office coordinates EITC related activities, measures the results of its initiatives and takes responsibility for ensuring that the program works as intended, even though it relies on many other parts of the IRS to achieve its goals. As with EITC initiatives, responsibility for initiatives that may improve income reporting by cash economy participants is dispersed throughout the IRS. Nobody at the IRS with the authority to coordinate research, outreach, and compliance efforts takes primary responsibility for reducing underreporting among cash-economy participants. As a result, the IRS is not as effective as it could be in improving compliance among cash-economy participants. For example, a cash-economy program office could work with IRS Research to measure the impact of initiatives to reduce underreporting by cash-economy participants. TIGTA and GAO generally agree that such measures would help the IRS to reduce the tax gap. A cash-economy program office could also be justified on the basis that the EITC has a program office and the amount of the tax gap attributable to cash-economy participants dwarfs the amount of the tax gap attributable to EITC claimants.
9	Educate cash economy participants	Educate cash economy participants about the benefits of reporting their income and study the effect of such efforts to determine whether they are cost effective.	In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in retirement benefits; disability benefits; survivors benefits; Medicare benefits; access to credit; earned income tax credits; and the ability to gain admission to the U.S. or a visa-status adjustment for family members or employees. The IRS could test this concept by educating taxpayers through outreach and various media targeting cash-economy participants in communities where compliance is low and such benefits are not well known. Researchers have suggested that publicity about such benefits, when combined with other enforcement initiatives, may significantly improve reporting compliance in a given community.

VI. EXHIBIT A: CASH ECONOMY—ADMINISTRATIVE RECOMMENDATIONS—Continued

	Recommendation	Summary	Reason
10	Obtain more and better research	Sponsor research to identify the most effective use of IRS resources after taking into account the direct and indirect effects of IRS activities on tax revenue.	IRS researchers have previously estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment. However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance. The IRS does not have current research to show where the next dollar is best spent. We do not even know whether the next dollar is better spent on enforcement or taxpayer service. Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.

VII. EXHIBIT B: CASH ECONOMY—LEGISLATIVE RECOMMENDATIONS

	Recommendation	Summary	Reason
1	Amend IRC sss 3406 to encourage compliance in certain cash-economy transactions	Amend IRC sss 3406 to create a three-pronged reporting and payment system that encourages compliance by: • Instituting backup withholding on payments to taxpayers who have demonstrated ''substantial noncompliance''; • Releasing backup withholding on payments to taxpayers who become ''substantially compliant'' and who agree to schedule and make future payments through the Electronic Funds Transfer Payment System (EFTPS); • Providing that payors will not be required to institute backup withholding on taxpayers who present payors with a valid IRS ''Compliance Certificate''.Current withholding and information-reporting provisions do not adequately capture income from transactions in the cash economy. Unreported payments include: • Deliberate ''under the table'' cash payments. • Payments that are reported with an invalid TIN or payee/TIN mismatch. • Payments subject to information reporting that are not reported.	Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. Payors wishing to comply with their information-reporting obligations may be reporting payments to independent contractors who have supplied invalid TINs. Under existing provisions, these payors may not know that a payee's TIN is invalid until several payments have been made. Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is $50.
2	Amend IRC sss 6302(h) to require IRS to promote estimated tax payments through EFTPS. Amend IRC sss 6302(h) to require IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by FY 2012.	Current law requires IRS to use EFTPS to collect at least 94 percent of depository taxes. In contrast, the IRS received less than one percent of all estimated tax payments through EFTPS in tax year 2004.	Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers. EFTPS has the potential to alleviate some estimated tax problems because it is convenient and relatively easy to use. Moreover, taxpayers can use EFTPS to schedule automatic estimated payments.

VII. EXHIBIT B: CASH ECONOMY—LEGISLATIVE RECOMMENDATIONS—Continued

	Recommendation	Summary	Reason
3	Amend IRC sss 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients.	Amend IRC sss 3402(p)(3) to specifically authorize voluntary withholding between independent contactors and service-recipients (as defined in IRC sss 6041A(a)(1)), and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreements, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC sss 162(a).	Some independent contractors may wish to enter into withholding agreements with their payors. It is currently unclear, however, whether statutory authority exists to enter into such agreements. IRC sss 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent contractor would be permitted.
4	Amend IRC sss 6041A to require third-party information reporting for applicable payments to corporations. Amend IRC sss 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC sss 7701(2)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code).	Taxpayers report 96 percent of income from transactions subject to information reporting. The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape Form 1099-MISC information-reporting by incorporating. A taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC sss 6041A reporting requirements.	For Form 1099-MISC information-reporting purposes, there should be no distinction between taxpayers who are incorporated and those who are not.

VIII. EXHIBIT C: REQUIRING BROKERS TO TRACK AND REPORT COST BASIS—LEGISLATIVE RECOMMENDATION

	Recommendation	Summary	Reason
1	Amend IRC sss 6045(a) to authorize the Secretary of the Treasury to require brokers to track and report cost basis in connection with the sale of mutual funds and stocks. Amend IRC sss 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks. To facilitate accurate basis reporting, financial institutions that hold mutual funds or stocks for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.	When transactions are subject to information reporting to the government, tax compliance is generally very high—well over 90 percent. The opportunity for noncompliance upon sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government.	This proposal also helps taxpayers (and that was our primary reason for proposing it.) Today, more Americans own stocks or mutual funds than ever before. Most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not. With regard to stock investors, most brokers keep track of purchases their customers make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings. While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time.

ENDNOTES

[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Com-

missioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

[2] See IRS News Release 2006-28, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts). The National Research Program study estimated that the "gross tax gap" was about $345 billion and the "net tax gap" (i.e., the gross tax gap reduced by late payments and amounts collected as a result of IRS enforcement actions) was about $290 billion. The IRS's most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

[3] U.S. Census Bureau, Population Division (data as of March 2001).

[4] The IRS's most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

[5] Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes and found that two-thirds of taxpayers support additional funding for both IRS assistance and enforcement. See IRS Oversight Board, 2005 Taxpayer Attitude Survey.

[6] See IRS News Release 2006-28, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

[7] When IRS auditors conducted approximately 46,000 audits of individual taxpayers for purposes of the National Research Program, the auditors were asked, for each issue they identified, to characterize the reason for noncompliance. Among issues that IRS auditors examined that resulted in a change in tax liability, the auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only 3 percent of errors as intentional. Internal Revenue Service (unpublished data from National Research Program). The precision of these data may be open to question because it is impossible for an auditor to determine the intent of a taxpayer at the time the taxpayer prepared a return. In the absence of contrary data, however, these data at a minimum should persuade IRS to conduct significant new studies on the causes of noncompliance. A separate study by the Government Accountability Office analyzed the misreporting of capital gains transactions. The study concluded that 33 percent of taxpayers who misreported their income from securities transactions reported more capital gains than they actually realized. Where misreporting is inadvertent, from a statistical standpoint, one would expect that 50 percent of errors would be on the high side and 50 percent of errors would be on the low side. Thus, GAO's finding that 33 percent of all taxpayer errors tended to cause overpayments of tax (and thus were clearly inadvertent) implies that an equal percentage of inadvertent errors caused taxpayers to underpay their tax—or, put differently, that 66 percent of all errors in capital gains misreporting were inadvertent and only 34 percent were intentional. Government Accountability Office, Ref. No. GAO-06-603, Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed at 12 (June 2006).

[8] Internal Revenue Service, Fiscal Year 2006 Enforcement and Service Results (Nov. 20, 2006).

[9] Joseph M. Dodge & Jay A. Soled, Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question, 106 Tax Notes 453 (Jan. 24, 2005).

[10] See Department of the Treasury, General Explanation of the Administration's Fiscal Year 2008 Revenue Proposals 64 (February 2007). Treasury provides a 10-year revenue estimate of just $6.7 billion. We note, however, that Treasury's proposal would not take effect until 2009, and it would only require basis reporting with regard to securities purchased after that date. In the early years, many securities sold would have been purchased prior to the effective date of the proposal and thus would be exempt from reporting.

[11] John Cassidy, Going Long, The New Yorker, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

[12] See Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness 41 (Oct. 1996).

[13] IRS Wage & Investment Operating Division, Business Performance Review, Wage and Investment Operating Division, FY 2006; IRS Wage & Investment Operating Division, Business Performance Review, Wage and Investment Operating Division, FY 2005; IRS Wage & Investment Operating Division, Business Performance Review, Wage and Investment Operating Division, FY 2004; IRS Wage & Investment Operating Division, Business Performance Review, Wage and Investment Operating Division, FY 2003.

[14] IRS Small Business/Self Employed Operating Division, Response to Taxpayer Advocate Information Request (Sept. 5, 2006).

[15] This concern was raised by a taxpayer during a 2006 Town Hall meeting with the National Taxpayer Advocate in Fargo, North Dakota.

[16] Internal Revenue Service, Fiscal Year 2006 Enforcement and Service Results (Nov. 20, 2006).

[17] See IRS News Release IR-2006-42, IRS Selects Three Firms to Take Part In Delinquent Tax Collection Effort (March 9, 2006).

[18] Department of the Treasury, FY 2007 Budget in Brief at 59.

[19] Government Accountability Office, GAO-07-136, Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in FY 2006, but issued $277 billion in tax refunds.

[20] When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach ef-

forts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the marginal ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the average ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

[21] In the current Congress, the Appropriations subcommittees have been restructured, and the IRS will be funded through the Appropriations Subcommittee on Financial Services and General Government.

[22] Government Accountability Office, GAO-07-136, Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements 68 (Nov. 2006).

[23] Charles O. Rossotti, Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic underfunding of the IRS.

[24] The chairman and ranking member of the Senate Budget Committee supported additional funding for the IRS in the FY 2007 budget resolution. Senator Judd Gregg acknowledged that the existing budget procedures have the effect of shortchanging the IRS. He said: "We've got to talk to the [Congressional Budget Office] about scoring on [additional funding provided to IRS]. Clearly there's a return on that money." Dustin Stamper, Everson Pledges to Narrow Growing Tax Gap, 110 Tax Notes 807 (Feb. 20, 2006). Similarly, Senator Kent Conrad stated: "Rather than a tax increase, I think the first place we ought to look . . . is the tax gap. If we could collect this money, we'd virtually eliminate the deficit." Emily Dagostino, Senate Budget Resolution Would Increase IRS Enforcement Funding, 110 Tax Notes 1129 (Mar. 13, 2006).

[25] Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 16 (Sept. 2002).

[26] Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986, 43 Nat. Tax J. 395, 396, 405 (1990).

[27] Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 16 (Sept. 2002).

[28] Government Accountability Office, GAO-06-1000T, Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches, at 17 (July 26, 2006).

[29] Pub. L. No. 108-357, sss 881(a)(1) (enacting IRC sss 6306).

[30] For a detailed discussion of the private debt collection program, see National Taxpayer Advocate 2006 Annual Report to Congress at 34-61 (Most Serious Problem: True Costs and Benefits of Private Debt Collection).

[31] See, e.g., Dustin Stamper, Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs, 111 Tax Notes 11 (Apr. 3, 2006).

[32] Senator Max Baucus recently highlighted another example of the counterproductive impact of shortchanging IRS funding. In FY 2006, Congress imposed a one-percent across-the-board funding rescission on domestic discretionary spending, and the IRS absorbed a reduction of about $100 million as a consequence. Citing GAO data, Senator Baucus estimated that the $100 million in "savings" would ultimately cost the U.S. Treasury about $1 billion in lost tax collections. He stated: "[E]ven small reductions in collection and taxpayer services are penny-wise, pound-foolish. Sparing the IRS budget may be the best way to bring in more owed revenue and end deficit spending." News Release, Senator Max Baucus, $100 Million Budget Cut to IRS May Cost $1 Billion or More in 2006 Tax Collections (May 22, 2006).

[33] In the preface to the National Taxpayer Advocate 2006 Annual Report to Congress, I argue that compliance should be viewed as a third category or IRS emphasis rather than as the sum of service and enforcement. There are many compliance activities the IRS undertakes, such as document matching, that catch errors taxpayers make either inadvertently or negligently. In my view, these activities should be classified as "compliance" activities, and the "enforcement" label should be reserved for cases of willful violation of the laws. I argue that nomenclature matters in this area because if the IRS treats willful and inadvertent compliance the same way, IRS personnel will treat innocent taxpayers harshly and taxpayers will feel that the IRS has dealt with them unfairly, perhaps alienating them from the tax system and reducing their future compliance.

[34] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3 (Feb. 28, 2002).

[35] The DIF score is an estimate of the likelihood of non-compliance on a return. A higher score indicates a higher likelihood of non-compliance.

[36] IRS Compliance Data Warehouse, Individual Returns Transaction File data for tax years 2002-2004.

[37] IRS Compliance Data Warehouse, Audit Inventory Management System data for tax years 2002-2004.

[38] See Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 41 (Oct. 1996).

[39] See IRS News Release, IRS Updates Tax Gap Estimates, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[40] See Closing the Tax Gap and the Impact on Small Business, Hearing Before the House Comm. on Small Business, 109th Cong. (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, Small Business Legislative Council).

[41] IRS Small Business/Self Employed Division response to Taxpayer Advocate Service Information Request (Sept. 5, 2006).

[42] Two caps would have to be established for total appropriations—one for the IRS and one for all other discretionary spending.

[43] For FY 1995, the congressional budget resolution provided for an adjustment of budget resolution spending levels to allow additional funding for an "Internal Revenue Service Compliance Initiative." H. Con. Res. 218, 103rd Cong. sss 25 (1994). The provision authorized an adjustment to reflect amounts of additional new budget authority or additional outlays of up to $405 million per year provided certain conditions were met. Although there is no indication the initiative failed or generated strong opposition, control of Congress changed the next year and the provision was subsequently repealed. H. Con. Res. 67, 104th Cong. sss 209 (1995). The joint explanatory statement accompanying the conference report on the FY 1995 budget resolution provision (which originated as Section 54 of the Senate amendment to the House-passed budget resolution) provided additional information about the specifics of the approach:

Section 54 of the Senate amendment allows for additional appropriations for an Internal Revenue Service Compliance initiative. If the Congress appropriates the base amounts requested for the Internal Revenue Service in the President's budget for fiscal year 1995 and a variety of other conditions are met, then Congress can also appropriate additional amounts for a compliance initiative without triggering points of order that might otherwise lie against such legislation.

Under sections 54(a) and 54(b) of the Senate amendment, upon the reporting of an appropriation bill funding the compliance initiative and the satisfaction of the conditions listed, the Chairman of the appropriate Budget Committee must file revised appropriations caps, allocations to the Appropriations Committee, functional levels, and aggregates to clear the way for the incremental spending for the initiative. This procedure parallels that used in reserve funds . . . , which allow deficit-neutral legislation to proceed without points of order even if that legislation pays for direct spending with revenues. Similarly, section 54 of the Senate amendment allows appropriations legislation to proceed without points of order if it is demonstrated that the revenues raised by those appropriations would offset the costs of the appropriations.

The first parenthetical language in the matter after subsection (a)(3) establishes the first condition precedent, that the Congress appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995. Subsection (d) lists the other conditions: enactment of a Taxpayer Bill of Rights 2, initiation of an Internal Revenue Service educational program as mandated by the Taxpayer Bill of Rights 1 and 2, a finding by the Congressional Budget Office that by virtue of revenues raised, the appropriations will not increase the deficit, and a restriction of funds made available pursuant to this authority to carrying out Internal Revenue Service compliance initiative activities.

The House resolution contains no such provision.

The conference agreement contains as section 25 a provision similar to that in Section 54 of the Senate amendment. In particular, section 25(a)(2) of the conference agreement more explicitly spells out the condition precedent that Congress first appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995 before the provisions of this section apply. Similarly, the conference agreement revises subsection (d), which sets forth the other conditions precedent.

H.R. Conf. Rep. No. 103-490 at 58 (1994).

[44] In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of $48.7 billion. Internal Revenue Service, Fiscal Year 2006 Enforcement and Service Results (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was $2.24 trillion. Government Accountability Office, GAO-07-136, Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements 95 (Nov. 2006).

[45] Department of the Treasury, FY 2008 Budget-in-Brief at 56.

[46] Charles O. Rossotti, Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America 285 (2005).

[47] For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

[48] Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 18 (Sept. 2002).

[49] Internal Revenue Service Data Book: 2005, table 3 (showing that the total number of individual income tax returns filed in FY 2005 was 132,844,632) and table 4 (showing that the total number of individual income tax returns filed electronically in FY 2005 was 68,476,328). The total number of individual income tax returns filed on paper in FY 2005—64,368,304—is the difference between these numbers.

[50] Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board. Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 16 (Sept. 2002). However, we have not seen updated statistics published in this format since that time.

[51] The congressional budget rules currently prohibit the Congressional Budget Office or the Office of Management and Budget from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See H.R. Conf. Rep. No. 101-964 (1990). See also Office of Management and Budget, OMB Circular No. A-11, Part 8, Appendix A, Principle 14 (2006). Since changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the practical difficulty of devising accurate estimates. Yet accurate estimates obviously would be helpful to Congress, and we believe the IRS should make developing better estimates a priority objective.

Chairman SPRATT. Thank you very much for your excellent testimony. Mr. Brostek.

STATEMENT OF MICHAEL BROSTEK

Mr. BROSTEK. Chairman Spratt and members of the committee, I am pleased to participate in today's hearing on the tax gap. My statement focuses on the multiple approaches that are needed to successfully reduce the gap, including the importance of quality services to taxpayers. It then covers potential reductions in the tax gap that could ensue from simplifying and reforming the Tax Code, providing the IRS more tools to deal with noncompliance and dedicating more resources to tax enforcement.

The tax gap is a persistent problem. Although measurement methodologies have varied over time, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range between 81 and 84 percent over the past 3 decades. This suggest that materially reducing the tax gap is going to be challenging. Because the tax gap has multiple causes and spans different types of taxes and taxpayers, no one strategy is likely to be fully and cost-effectively efficient at reducing the gap. We need to try new approaches and to expand current effective approaches. In many cases, Congress will need to participate in the solution either through providing IRS new tools or additional resources.

Providing quality services to taxpayers is a necessary foundation for high levels of voluntary compliance. Quality services help taxpayers who wish to comply but who do not understand their obligations, and such services are needed even in pursuing other approaches to reduce the tax gap. For instance, even if tax laws are simplified, the IRS needs to educate taxpayers and to answer the questions they are likely to have. Regarding tax simplification or tax reform, there is no reliable estimate of how much simplification could actually reduce the tax gap. One indication of the potential is that the IRS has estimated a 2001 revenue shortfall of about $32 billion due to errors taxpayers made in claiming various credits and deductions. Over the decades, more and more special provisions have been added to the Tax Code with the number of credits, deductions and the like doubling in number between 1974 and 2005.

By making the rules across tax provisions more uniform, by merging multiple related provisions and deleting provisions that may not be accomplishing their intended purpose at an acceptable revenue cost, the Tax Code could be simplified. If so, both intentional and unintentional noncompliance should decline. Further, the IRS would be able to reallocate its resources to other more problematic compliance problems.

Tax reform also has the potential to reduce the tax gap, but it is most likely to do so if any reform system has few, if any, tax preferences or complex provisions and taxable transactions are transparent to the tax agency. These characteristics are difficult to achieve, and to my knowledge, all tax systems have tax gaps.

Tax withholding and information reporting are among the most powerful tools for promoting compliance. If we can spread these tools over more types of income that are major contributors to the tax gap, tax reductions might be achieved. Our recent work suggests that requiring information reporting on the basis for securities sales, like stock transactions, has the potential to improve compliance with capital gains reporting. Importantly, a key additional

benefit would be less taxpayer burden to understand and comply with the basis reporting rules.

Finally, devoting additional resources to enforcement has the potential to reduce the tax gap by billions of dollars. In part, devoting greater resources to enforcement could reduce the tax gap because, every year, the IRS identifies far more cases of probable noncompliance than it can address. How much the tax gap could be reduced by dedicating more resources to enforcement depends critically on how well the IRS can manage these resources. Here, information is key.

Which taxpayers are noncompliant? Why are they noncompliant? What amount of noncompliance can be corrected for an additional dollar of investment in IRS?

We and others have frequently called for improved information like this. In part, this is why we encouraged the IRS to undertake compliance studies like the most recent one of the tax gap. We are heartened that the President's 2008 budget calls for annual tax gap research.

As a caution, if additional resources are devoted to enforcement, returns on that investment are likely to lag as the IRS hires and trains new personnel, and we see that in the budget estimates for the President's new budget.

Also, several years can elapse between the time the IRS actually assesses a tax and when those taxes are collected. For instance, in a study we had done earlier, we had found that 5 years after taxes were assessed against individuals with business income only 48 percent of the assessed taxes had been collected.

This concludes my statement. I would be happy to answer questions.

[The prepared statement of Michael Brostek follows:]

United States Government Accountability Office

GAO

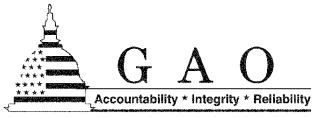
Testimony
Before the Committee on the Budget,
House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EST
Friday, February 16, 2007

TAX COMPLIANCE

Multiple Approaches Are Needed to Reduce the Tax Gap

Statement of Michael Brostek
Director, Tax Issues
Strategic Issues



GAO-07-488T

GAO
Accountability Integrity Reliability
Highlights

Highlights of GAO-07-488T, a testimony to the Committee on the Budget, House of Representatives

February 16, 2007

TAX COMPLIANCE

Multiple Approaches Are Needed to Reduce the Tax Gap

Why GAO Did This Study

The tax gap—the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law—has been a long-standing problem in spite of many efforts to reduce it. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap for tax year 2001 of $345 billion and estimated it would recover $55 billion of this gap, resulting in a net tax gap of $290 billion. When some taxpayers fail to comply, the burden of funding the nation's commitments falls more heavily on compliant taxpayers. Reducing the tax gap would help improve the nation's fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield $3 billion annually.

GAO was asked to discuss the tax gap, various approaches to reduce it, and what the proposed budget for fiscal year 2008 says about it. This testimony discusses the need for taking multiple approaches and to what extent the tax gap could be reduced through three overall approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement. This statement is based on prior GAO work.

What GAO Recommends

GAO is not making any new recommendations but highlights areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-07-488T

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches. Moreover, providing quality services to taxpayers is a necessary foundation for voluntary compliance. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.

Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by billions of dollars. IRS has estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Thus, considerable potential exists. However, these provisions serve purposes Congress has judged to be important and eliminating or consolidating them could be complicated. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve, and any tax system could be subject to noncompliance.

Withholding and information reporting are particularly powerful tools to reduce the tax gap. They could help reduce the tax gap by billions of dollars, especially if they make underreported income transparent to IRS. These tools have led to high, sustained levels of taxpayer compliance and improved IRS resource allocation by helping IRS identify and prioritize its contacts with noncompliant taxpayers. As GAO previously suggested, reporting the cost, or basis, of securities sales is one option to improve taxpayers' compliance. However, designing additional withholding and information reporting requirements may be challenging given that many types of income are already subject to reporting, underreporting exists in many forms, and withholding and reporting requirements impose costs on third parties.

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of IRS enforcement resources requires considering such factors as how well IRS uses its resources and the proper balance between taxpayer service and enforcement activities. If Congress provides IRS more enforcement resources, the amount of tax gap reduction would depend on factors such as the size of budget increases and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. The recent budget request for fiscal year 2008 proposes legislation and new initiatives to reduce the tax gap but expected dollar gains are modest. Further reductions likely would require many more such changes.

Chairman Spratt, Mr. Ryan, Members of the Committee:

I appreciate this opportunity to discuss the tax gap—the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law—and what is achievable in reducing the gap. Most recently, the Internal Revenue Service (IRS) estimated that for tax year 2001, taxpayers paid about 84 percent of the taxes that should have been paid on time under the law, resulting in an estimated gross tax gap of $345 billion. IRS estimated that it would eventually recover around $55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of $290 billion.[1] Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. Reducing the tax gap would help improve the nation's fiscal stability. For example, based on IRS's estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. Likewise, factors such as globalization and the ever-increasing complexity of the tax code challenge IRS's ability to administer the tax code.

My remarks focus on what is achievable in reducing the tax gap through a variety of approaches. First I will discuss the need for multiple approaches toward reducing the tax gap. Then I will discuss three specific tax gap reduction approaches: (1) simplifying or reforming the tax system; (2) providing IRS additional enforcement authority and tools, such as information reporting[2] and tax withholding,[3] through changes to the tax laws; and (3) devoting additional resources to enforcement under the existing tax laws. My remarks are based on our previous work on a variety of issues, in particular, recent testimonies and a report on reducing the tax

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[3]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

gap.[1] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since, for example, it has multiple causes and spans different types of taxes and taxpayers. Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major approaches discussed below, but providing quality services to taxpayers also is a necessary foundation for voluntary compliance. Quality services can help taxpayers who wish to comply but do not understand their obligations, whereas enforcement actions may be needed for those who intentionally evade their tax obligations. Such steps as periodically measuring noncompliance and its causes, setting tax gap reduction goals, considering the costs and benefits of initiatives to reduce the gap, evaluating the results of such initiatives undertaken, optimizing the allocation of IRS's resources, and leveraging technology to enhance IRS's efficiency would also contribute to tax gap reduction.

- Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by many billions of dollars. For example, IRS estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Reducing the number of such credits and deductions therefore has some direct potential to reduce the tax gap. However, these credits and deductions serve purposes Congress has judged to be important, and eliminating them likely would be complicated. Fundamental tax reform, such as shifting to a consumption tax system, would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few or no tax preferences) and taxable transactions

[1]GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-391T (Washington, D.C.: Jan. 23, 2007); *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C.: July 26, 2006); *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

are transparent to tax administrators. These characteristics are difficult to achieve in any system, and any tax system could be subject to noncompliance.

- Providing IRS with more enforcement tools, particularly withholding and information reporting, also has the potential to reduce the tax gap by billions of dollars, especially if those tools help IRS deal with the largest contributor to the tax gap—underreported income. Tax withholding and information reporting have been shown to lead to high, sustained levels of taxpayer compliance because the income taxpayers earn is transparent to them and IRS. Also, using these tools can help IRS better allocate its resources by improving its ability to identify and prioritize noncompliant taxpayers to be contacted. For example, we found that having third parties report to taxpayers and IRS the cost, or basis, of stocks and mutual funds that taxpayers sell could help taxpayers improve their voluntary compliance and help IRS allocate its enforcement efforts concerning these transactions. However, designing withholding or information reporting requirements to address underreporting may be challenging given that many types of income are already subject to such requirements, underreporting exists in many forms, and any requirements could impose costs and burdens on the third parties that withhold or report.

- Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount the tax gap could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but currently cannot contact given resource constraints.

The administration's budget request for fiscal year 2008 recognizes the need for multiple approaches to tax gap reduction. It offers 16 legislative proposals and hundreds of millions of dollars for new IRS initiatives to reduce the tax gap. Among other things, these proposals address taxpayer services as well as two other approaches—expanded information reporting and additional enforcement resources for IRS. Even with these efforts, however, the dollar amounts expected to be raised are quite small

compared to the size of the tax gap. This underscores the likelihood that more significant reductions in the tax gap will require many additional actions under a multiple approaches strategy given the variety of taxes, taxpayers, and types of noncompliance that contribute to the tax gap.

Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[5] IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. As shown in table 1, underreporting of tax liabilities accounted for most of the tax gap estimate for tax year 2001.

Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	**Individual income tax**	**Corporate income tax**	**Employment tax**	**Estate tax**	**Excise tax**	**Total**
Underreporting	$197	$30	$54	$4	No estimate	**$285**
Underpayment	23	2	5	2	$1	**$34**
Nonfiling	25	No estimate	No estimate	2	No estimate	**$27**
Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

Note: Figures may not sum to totals because of rounding.

IRS has estimated the tax gap on multiple occasions, beginning in 1979, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers. Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called

[5]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the estimate rely on old data, IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. IRS used data from NRP to estimate individual income tax underreporting and the portion of employment tax underreporting attributed to self-employed individuals. The underpayment segment of the tax gap is not an estimate, but rather represents the tax amounts that taxpayers reported on time but did not pay on time. Other areas of the estimate, such as corporate income tax and employer-withheld employment tax underreporting, rely on decades-old data. Also, IRS has no estimates for corporate income, employment, and excise tax nonfiling or for excise tax underreporting.[6] In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[7]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and tax form simplification. IRS uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns it receives from third parties. IRS reports that it collected over $48 billion in fiscal year 2006 from noncompliant taxpayers it identified through its various enforcement programs.

In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades. Any

[6]For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable.

[7]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance.[8]

Congress has been encouraging IRS to develop an overall tax gap reduction plan or strategy that could include a mix of approaches like simplifying code provisions, increased enforcement, and reconsidering the level of resources devoted to enforcement. Some progress has been made toward laying out the broad elements of a plan or strategy for reducing the tax gap. On September 26, 2006, the U.S. Department of the Treasury (Treasury), Office of Tax Policy, released "A Comprehensive Strategy for Reducing the Tax Gap." However, the document generally does not identify specific steps that Treasury and IRS will undertake to reduce the tax gap, the related time frames for such steps, or explanations of how much the tax gap would be reduced. Furthermore, the document mentioned the importance of establishing benchmarks against which progress on each step under the strategy could be measured. It said that after the fiscal year 2008 budget request was released, Treasury and IRS would issue more details in March or April 2007 about the steps they would take to reduce opportunities for evasion and address the tax gap.

The 2008 budget request issued on February 5, 2007, suggested 16 legislative changes to expand or improve information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. It also proposed additional funding for new initiatives aimed at reducing the tax gap.

Multiple Approaches Are Needed to Reduce the Tax Gap

No single approach is likely to fully and cost-effectively address noncompliance and therefore multiple approaches are likely to be needed. The tax gap has multiple causes; spans five types of taxes; and is spread over several types of taxpayers including individuals, corporations, and partnerships. Thus, for example, while simplifying laws should help when noncompliance is due to taxpayers' confusion, enforcement may be needed for taxpayers who understand their obligations but decline to fulfill them. Similarly, while devoting more resources to enforcement

[8]In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap even if the level of compliance remains unchanged because the amount of taxes that should be paid has been reduced. The tax gap would also tend to increase over time, even if the rate of taxpayer compliance remained unchanged, because of inflation.

should increase taxes assessed and collected, too great an enforcement presence likely would not be tolerated.

Simplifying or reforming the tax code, providing IRS more enforcement tools, and devoting additional resources to enforcement are three major tax gap reduction approaches discussed in more detail below, but providing quality services to taxpayers plays an important role in improving compliance and reducing the tax gap. IRS taxpayer services include education and outreach programs, simplifying the tax process, and revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. For example, if tax forms and instructions are unclear, taxpayers may be confused and make unintentional errors. Quality taxpayer services would also be a key consideration in implementing any of the approaches for tax gap reduction. For example, expanding enforcement efforts would increase interactions with taxpayers, requiring processes to efficiently communicate with taxpayers. Also, changing tax laws and regulations would require educating taxpayers about the new requirements in a clear, timely, and accessible manner. In 2006, we reported that IRS improved its two most commonly used services—telephone and Web site assistance—for the 2006 filing season.[9] Increased funding financed some of the improvements, but a significant portion has been financed internally by efficiencies gained from increased electronic filing of tax returns and other operational improvements.

Although quality service helps taxpayers comply, showing a direct relationship between quality service and compliance levels is very challenging. As required by Congress, IRS is in the midst of a study that is to result in a 5-year plan for taxpayer service activities, which is to include long-term quantitative goals and to balance service and enforcement. Part of the study focuses on the effect of taxpayer service on compliance. A Phase I report was issued in April 2006 and a Phase II report should be completed in fiscal year 2007, which is to include, among other things, a multiyear plan for taxpayer service activities and improvement initiatives.

However, in deciding on the appropriate mix of approaches to use in reducing the tax gap, many factors or issues could affect strategic

[9]GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-496T (Washington, D.C.: Apr. 27, 2006).

decisions. Among the broad factors to consider are the likely effectiveness of any approach, fairness, enforceability, and sustainability. Beyond these, our work points to the importance of the following:

- **Measuring compliance levels periodically and setting long-term goals.** A data-based plan is one key to closing the tax gap. To the extent that IRS can develop better compliance data, it can develop more effective approaches for reducing the gap. Regularly measuring the magnitude of, and the reasons for, noncompliance provides insights on how to reduce the gap through potential changes to tax laws and IRS programs. In July 2005, we recommended that IRS periodically measure tax compliance, identify reasons for noncompliance, and establish voluntary compliance goals.[10] IRS agreed with the recommendations and established a voluntary tax compliance goal of 85 percent by 2009. Furthermore, we have identified alternative ways to measure compliance, including conducting examinations of small samples of tax returns over multiple years, instead of conducting examinations for a larger sample of returns for 1 tax year, to allow IRS to track compliance trends annually. The administration's fiscal year 2008 budget proposal offers this idea by requesting funds to annually study compliance based on a smaller sample size than the 2001 NRP study.

- **Considering the costs and burdens.** Any action to reduce the tax gap will create costs and burdens for IRS; taxpayers; and third parties, such as those who file information returns. For example, withholding and information reporting requirements impose some costs and burdens on those who track and report information. These costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

- **Evaluating the results.** Evaluating the actions taken by IRS to reduce the tax gap would help maximize IRS's effectiveness. Evaluations can be challenging because it is difficult to isolate the effects of IRS's actions from other influences on taxpayers' compliance. Our work has discussed how to address these challenges, for example by using research to link actions with the outputs and desired effects.

- **Optimizing resource allocation.** Developing reliable measures of the return on investment for strategies to reduce the tax gap would help inform IRS resource allocation decisions. IRS has rough measures of return on investment based on the additional taxes it assesses. Developing

[10]GAO-05-753.

such measures is difficult because of incomplete data on the costs of enforcement and collected revenues. Beyond direct revenues, IRS's enforcement actions have indirect revenue effects, which are difficult to measure. However, indirect effects could far exceed direct revenue effects and would be important to consider in connection with continued development of return on investment measures. In general though, the effects of tax gap reduction by improving voluntary tax compliance can be quite large. For example, if the estimated 83.7 percent voluntary compliance rate that produced a gross tax gap of $345 billion in tax year 2001 had been 85 percent, this tax gap would have been about $28 billion less; if it had been 90 percent, the gap would have been about $133 billion less.

- **Leveraging technology.** Better use of technology could help IRS be more efficient in reducing the tax gap. IRS is modernizing its technology, which has paid off in terms of telephone service, resource allocation, electronic filing, and data analysis capability. However, this ongoing modernization will need strong management and prudent investments to maximize potential efficiencies. The administration's fiscal year 2008 budget proposal requests additional funds under its Business Systems Modernization initiatives.

Reducing the Tax Gap through Tax Simplification or Tax System Reform Depends on Their Design and May Have Effects Beyond Tax Compliance

Tax law simplification and reform both have the potential to reduce the tax gap by billions of dollars. The extent to which the tax gap would be reduced depends on which parts of the tax system would be simplified and in what manner, as well as how any reform of the tax system is designed and implemented. Neither approach, however, will eliminate the gap. Further, changes in the tax laws and system to improve tax compliance could have unintended effects on other tax system objectives, such as those involving economic behavior or equity.

Simplification has the potential to reduce the tax gap for at least three broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through tax shelters. Third, tax code complexity may erode taxpayers' willingness to comply voluntarily if they cannot understand its provisions or they see others taking advantage of complexity to intentionally underreport their taxes.

Simplification could take multiple forms. One form would be to retain existing laws but make them simpler. For example, in our July 2005 report[11] on postsecondary tax preferences, we noted that the definition of a qualifying postsecondary education expense differed somewhat among some tax code provisions, for instance with some including the cost to purchase books and others not. Making definitions consistent across code provisions may reduce taxpayer errors. Although we cannot say the errors were due to these differences in definitions, in a limited study of paid preparer services to taxpayers, we found some preparers claiming unallowable expenses for books.[12] Further, the Joint Committee on Taxation suggested that such dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.[13]

Another tax code provision in which complexity may have contributed to the individual tax gap involves the earned income tax credit, for which IRS estimated a tax loss of up to about $10 billion for tax year 1999.[14] Although some of this noncompliance may be intentional, we[15] and the National Taxpayer Advocate[16] have previously reported that confusion over the complex rules governing eligibility for claiming the credit could cause taxpayers to fail to comply inadvertently. The administration's fiscal year 2008 budget proposes legislative language to simplify eligibility requirements for the credit as well as to clarify the uniform definition of a qualifying child.

Another form of simplification could be to broaden the tax base while reducing tax rates, which could minimize incentives for not complying. This base-broadening could include a review of whether existing tax

[11]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[12]GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).

[13]U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II, 125-6 (April 2001).

[14]IRS measured the extent of noncompliance with the earned income tax credit in a study separate from NRP.

[15]GAO-06-208T.

[16]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

expenditures are achieving intended results at a reasonable cost in lost revenue and added burden and eliminating or consolidating those that are not. Among the many causes of tax code complexity is the growing number of preferential provisions in the code, defined in statute[17] as tax expenditures, such as tax exemptions, exclusions, deductions, credits, and deferrals.[18] The number of these tax expenditures has more than doubled from 67 in 1974 to 161 in 2006, and the sum of tax expenditure estimates rose to nearly $847 billion.[19] Tax expenditures can contribute to the tax gap if taxpayers claim them improperly. For example, IRS's recent tax gap estimate includes a $32 billion loss in individual income taxes for tax year 2001 because of noncompliance with these provisions. Simplifying these provisions of the tax code would not likely yield $32 billion in revenue because even simplified provisions likely would have some associated noncompliance. Nevertheless, the estimate suggests that simplification could have important tax gap consequences, particularly if simplification also accounted for any noncompliance that arises because of complexity on the income side of the tax gap for individuals.[20]

Despite the potential benefits that simplification may yield, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable

[17]The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. § 622(3)).

[18]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

[19]Summing tax expenditure estimates does not take into account interactions between individual provisions.

[20]The tax gap for underreported individual income taxes exceeded $150 billion for tax year 2001. However, IRS does not have data on how much of this noncompliance arose because of complexity.

transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system may not by itself eliminate any tax gap.[21] Any tax system could be subject to noncompliance, and its design and operation, including the types of tools made available to tax administrators, will affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform likely include factors beyond tax compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

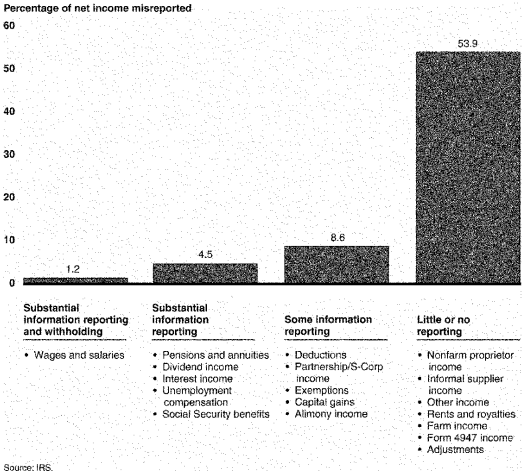
Providing IRS with Additional Enforcement Tools Potentially Could Improve Compliance Significantly, but Identifying and Designing Such Tools Can Be Challenging

Changing the tax laws to provide IRS with additional enforcement tools, such as expanded tax withholding and information reporting, could also reduce the tax gap by many billions of dollars, particularly with regard to underreporting—the largest segment of the tax gap. Tax withholding promotes compliance because employers or other parties subtract taxes owed from a taxpayer's income and remit them to IRS. Information reporting tends to lead to high levels of compliance because income taxpayers earn is transparent to them and IRS. In both cases, high levels of compliance tend to be maintained over time. Also, withholding and information reporting help IRS to better identify noncompliant taxpayers and prioritize contacting them, which enables IRS to better allocate its resources. However, designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, underreporting exists in varied forms, and the requirements could impose costs and burdens on third parties.

Figure 1 shows how much voluntary reporting compliance improves for income subject to withholding or information reporting. Once withholding or information reporting requirements are in place for particular types of income, compliance tends to remain high over time. For example, for wages and salaries, which are subject to tax withholding and substantial information reporting, the percentage of income that taxpayers misreport has consistently been measured at around 1 percent over time.

[21] For example, in a 2004 report, the National Audit Office in the United Kingdom reported on the 15.7 percent gap for the value added tax, which was introduced three decades earlier.

Figure 1: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001



Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:

- **Require more data on information returns dealing with capital gains income from securities sales.** Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, such as corporate stocks and mutual funds.[22] Further, around half of the taxpayers who misreported did so because

[22]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

they failed to report the securities' cost, or basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. When taxpayers sell securities like stock and mutual funds through brokers, the brokers are required to report information on the sale, including the amount of gross proceeds the taxpayer received; however, brokers are not required to report basis information for the sale of these securities. We found that requiring brokers to report basis information for securities sales could improve taxpayers' compliance in reporting their securities gains and losses and help IRS identify noncompliant taxpayers. However, we were unable to estimate the extent to which a basis reporting requirement would reduce the capital gains tax gap because of limitations with the compliance data on capital gains and because neither IRS nor we know the portion of the capital gains tax gap attributed to securities sales.

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to report separately on their tax returns the total amount of payments to independent contractors.[23]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO[24] have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[25] payments made by others to corporations are generally not covered by information returns.

[23]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

[24]GAO, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs*, GAO/GGD-91-118 (Washington, D.C.: Sept. 27, 1991).

[25]Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

Information reporting helps IRS to better allocate its resources to the extent that it helps IRS better identify noncompliant taxpayers and the potential for additional revenue that could be obtained by contacting these taxpayers. For example, IRS officials told us that receiving information on basis for taxpayers' securities sales would allow IRS to determine more precisely taxpayers' income for securities sales through its document matching programs and would allow it to identify which taxpayers who misreported securities income have the greatest potential for additional tax assessments. Similarly, IRS could use basis information to improve both aspects of its examination program—examinations of tax returns through correspondence and examinations of tax returns face to face with the taxpayer. Currently, capital gains issues are too complex and time consuming for IRS to examine through correspondence. However, IRS officials told us that receiving cost basis information might enable IRS to examine noncompliant taxpayers through correspondence because it could productively select tax returns to examine. Also, having cost basis information could help IRS identify the best cases to examine face to face, making the examinations more productive while simultaneously reducing the burden imposed on compliant taxpayers who otherwise would be selected for examination.

Withholding and information reporting lead to high levels of compliance. Designing new requirements to address underreporting would need to address the challenge that many types of income, including wages and salaries, dividend and interest income, and income from pensions and Social Security are already subject to withholding or substantial information reporting. Also, challenges arise in establishing new withholding or information reporting requirements for certain other types of income that are extensively underreported. Such underreporting may be difficult to determine because of complex tax laws or transactions or the lack of a practical and reliable third-party source to provide information on the taxable income.

For example, while withholding or information reporting mechanisms on nonfarm sole proprietor and informal supplier income[26] would likely improve their compliance, comprehensive mechanisms that are practical and effective are difficult to identify. As shown in figure 1, this income is not subject to information reporting, and these taxpayers misreported about half of the income they earned for tax year 2001. Informal suppliers by definition receive income in an informal manner through services they provide to a variety of individual citizens or small businesses. Whereas businesses may have the capacity to perform withholding and information reporting functions for their employees, it may be challenging to extend withholding or information reporting responsibilities to the individual citizens that receive services, who may not have the resources or knowledge to comply with such requirements.

Finally, implementing tax withholding and information reporting requirements generally imposes costs and burdens on the businesses that must implement them, and, in some cases, on taxpayers. For example, expanding information reporting on securities sales to include basis information will impose costs on the brokers who would track and report the information. Further, trying to close the entire tax gap with these enforcement tools could entail more intrusive recordkeeping or reporting than the public is willing to accept.

The administration's proposed budget for fiscal year 2008 has 16 legislative proposals on tax gap reduction of which 7 relate to expanded information reporting.[27] Two of these proposals involve information reporting on payments to corporations and on the cost basis of security sales, which we discussed earlier in this section of the testimony. The administration also proposes requiring a certified tax identification number from

[26]Nonfarm proprietors are self-employed individuals other than farmers who should file Schedule C with their individual tax returns to report profits and losses from their businesses. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers. Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an informal manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on Schedule C.

[27]In general, the other 9 proposals involve e-filing, clarifying employment tax liability for employee leasing companies and under collection due process procedures, sharing information related to the national directory of new hires and prison tax scams, making repeated and willful tax nonfiling a felony, and expanding IRS's penalty authority in certain areas.

nonemployee service providers (contractors), increased information reporting for certain government payments for property and services, and increased information return penalties. We have done past work related to these proposals and suggested them as options for reducing the tax gap.[28] The remaining 2 proposals would expand broker information reporting and require information reporting on merchant card payment reimbursements.

The 7 proposals relating to information reporting account for virtually all the revenue that the budget request's 16 tax gap legislative proposals are projected to raise. The 16 proposals are expected to raise about $29 billion over 10 years, or about 1 percent per year of the 2001 net tax gap amount of $290 billion. About 98 percent of the $29 billion would come from the information reporting proposals. About 85 percent would come from 3 of them—those relating to payments to corporations, basis reporting on security sales, and merchant payment card reimbursements.

Devoting Additional Resources to Enforcement Likely Could Reduce the Tax Gap, but to What Extent Is Difficult to Predict

Devoting more resources to enforcement has the potential to help reduce the tax gap by billions of dollars, as IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount of the tax gap that could be reduced depends in part on the size of any increase in IRS's budget, how IRS would manage any additional resources, and the indirect increase in taxpayers' voluntary compliance that would likely result from expanded IRS enforcement.

[28]GAO/GGD-92-108; *Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations*, GAO/GGD-92-130 (Washington, D.C.: Sept. 22, 1992), and *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

Given resource constraints, IRS is unable to contact millions of additional taxpayers for whom it has evidence of potential noncompliance.[29] With additional resources, IRS would be able to assess and collect additional taxes and further reduce the tax gap. In 2002, IRS estimated that a $2.2 billion funding increase would allow it to take enforcement actions against potentially noncompliant taxpayers it identifies but cannot contact and would yield an estimated $30 billion in revenue.[30] For example, IRS estimated that it contacted about 3 million of the over 13 million taxpayers it identified as potentially noncompliant through its matching of tax returns to information returns. IRS estimated that contacting the additional 10 million potentially noncompliant taxpayers it identified, at a cost of about $230 million, could yield nearly $7 billion in potentially collectible revenue. We did not evaluate the accuracy of the estimate, and as will be discussed below, many factors suggest that it is difficult to estimate reliably net revenue increases that might come from additional enforcement efforts.[31]

Although additional enforcement funding has the potential to reduce the tax gap, the extent to which it would help depends on several factors. First, and perhaps most obviously, the amount of tax gap reduction would depend in part on the amount of additional resources. The degree to which revenues would increase from expanded enforcement depends on many variables, such as how quickly IRS can ramp up efforts, how well IRS selects the best cases to be worked, and how taxpayers react to enforcement efforts. Estimating those revenue increases would require assumptions about these and other variables. Because actual experience is likely to diverge from those assumptions, the actual revenue increases are likely to differ from the estimates. The lack of reliable key data compounds the difficulty of estimating the likely revenues. To the extent possible, obtaining better data on key variables would provide a better

[29]For examples, see GAO, *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002); *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); and our tax gap products cited earlier in this statement, GAO-06-1000T, GAO-06-453T, GAO-06-208T, GAO-05-753, and GAO-05-527T.

[30]Commissioner of Internal Revenue Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of IRS and the Tax System*, October 2002.

[31]The overall tax gap has many components. Thus, if the tax gap in a specific area is reduced either through congressional actions like simplifying provisions or through IRS actions, the size of the overall gap may not be reduced if other portions of the gap increase.

understanding of the likely results with any increased enforcement resources.

With additional resources for enforcement, IRS would be able to assess and collect additional taxes, but the related tax gap reductions may not be immediate. If IRS uses the resources to hire more enforcement staff, the reductions may occur gradually as IRS is able to hire and train the staff. Also, several years can elapse after IRS assesses taxes before it actually collects these taxes.

Similarly, the amounts of taxes actually collected can vary substantially from the related tax amounts assessed through enforcement actions by the type of tax or taxpayer involved. In a 1998 report, we found that 5 years after taxes were assessed against individual taxpayers with business income, 48 percent of the assessed taxes had been collected, whereas for the largest corporate taxpayers, 97 percent of assessed taxes had been collected.[32]

These various factors need to be taken into account in estimating revenue to be obtained from increased funding. In doing such estimates for its fiscal year 2007 budget, IRS accounted for several factors, including opportunity costs because of training, which draws experienced enforcement personnel away from the field; differences in average enforcement revenue obtained per full-time employee by enforcement activity; and differences in the types and complexity of cases worked by new hires and experienced hires. IRS forecasted that in the first year after expanding enforcement activities, the additional revenue to be collected is less than half the amount to be collected in later years. This example underscores the logic that if IRS is to receive a relatively large funding increase, it likely would be better to provide it in small but steady amounts.

The amount of tax gap reduction likely to be achieved from any budget increase also depends on how well IRS can use information about noncompliance to manage the additional resources. Because IRS does not have compliance data for some segments of the tax gap and others are based on old data, IRS cannot easily track the extent to which compliance is improving or declining. IRS also has concerns with its information on

[32]GAO, *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

whether taxpayers unintentionally or intentionally fail to comply with the tax laws. Knowing the reasons for taxpayer noncompliance can help IRS decide whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement activities to pursue intentional noncompliance. To the extent that compliance data are outdated and IRS does not know the reason for taxpayer noncompliance, IRS may be less able to target resources efficiently to achieve the greatest tax gap reduction at the least taxpayer burden.

IRS has taken important steps to better ensure efficient allocation and use. For example, the NRP study has provided better data on which taxpayers are most likely to be noncompliant. IRS is using the data to improve its audit selection processes in hopes of reducing the number of audits that result in no change, which should reduce unnecessary burden on compliant taxpayers and increase enforcement staff productivity (as measured by direct enforcement revenue).

As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects $4 in revenue for every $1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1, versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns. In addition to returns on investment estimates being rough, IRS lacks information on the incremental returns on investment from pursuing the "next best case" for some enforcement programs. It is the marginal revenue gain from these cases that matters in estimating the direct revenue from expanded enforcement. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts. Because IRS's current estimates of the revenue effects of additional funding are imprecise, the actual revenue that might be gained from expanding different enforcement efforts is subject to uncertainty.

Given the variation in estimated returns on investment for different types of IRS compliance efforts, the amount of tax gap reduction that may be achieved from an increase in IRS's resources would depend on how IRS

allocates the increase. Although it might be tempting to allocate resources heavily toward areas with the highest estimated return, allocation decisions must take into account diverse and difficult issues. For instance, although one enforcement activity may have a high estimated return, that return may drop off quickly as IRS works its way through potential noncompliance cases. In addition, IRS dedicates examination resources across all types of taxpayers so that all taxpayers receive some signal that noncompliance is being addressed. Further, issues of fairness can arise if IRS focuses its efforts only on particular groups of taxpayers.

Beyond direct tax revenue collection, expanded enforcement efforts could reduce the tax gap even more, as widespread agreement exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[33] The precise magnitude of the indirect effects of enforcement is not known with a high level of confidence given challenges in measuring compliance; developing reasonable assumptions about taxpayer behavior; and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in tax law. However, several research studies have offered insights to help better understand the indirect effects of IRS enforcement on voluntary tax compliance and show that they could exceed the direct effect of revenue obtained.[34]

As table 2 shows, the administration's budget request for fiscal year 2008 proposes additional revenue-producing initiatives, legislative proposals, and non-revenue-producing initiatives. The revenue-producing initiatives generally would fund additional staff to enforce tax laws; the legislative proposals include, for example, new information return requirements that

[33]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

[34]Economists have estimated the indirect effect of an examination on voluntary compliance to range from 6 to 12 times the amount of proposed tax adjustments. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96) (Washington, D.C.: November 1996), 2, 35-36; Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde, "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986," *National Tax Journal*, vol. 43 (1990), 395, 396, 405; and Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance" (paper written for the IRS Research Conference, June 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (downloaded July 1, 2005).

would increase revenue; and the non-revenue-producing initiatives generally would fund infrastructure and Business Systems Modernization changes to support IRS operations.

Table 2: Cost and Estimated Revenue of IRS Tax Gap Proposals for Fiscal Years 2008 through 2010

Dollars in millions

	Cost of proposal			Estimated revenue from proposal		
Type of proposal	**Fiscal year 2008**	**Fiscal year 2009**	**Fiscal year 2010**	**Fiscal year 2008**	**Fiscal year 2009**	**Fiscal year 2010**
Revenue-producing initiatives	$198	$163	$163	$317	$526	$699
Legislative proposals	23	23	23	378	1,171	1,898
Non-revenue-producing initiatives	188	168	168	0	0	0
Total	**$410**	**$355**	**$355**	**$695**	**$1,697**	**$2,597**

Source: GAO (analysis); IRS and Department of the Treasury (data).

Note: Figures may not sum to totals because of rounding. Data are from IRS and from Treasury's February 2007 General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals.

Over the 3 years, the requested funding decreases while the estimated resulting revenue increases. About $410 million is requested for fiscal year 2008 to fund all of these initiatives, which are estimated to bring in about $695 million in increased revenue that year. The estimated cost for the initiatives declines to $355 million in fiscal years 2009 and 2010 and the projected revenues increase to about $2.6 billion in 2010. Costs decline due to start up costs applying only in fiscal year 2008. Revenues increase in part due to improved annual returns from the hiring, training, and deployment of additional staff, but more so due to the phase in of the legislative proposals, particularly the information reporting requirements. The legislative proposals alone are estimated to produce $1.9 billion of the $2.6 billion total additional revenues expected to come from the administration's budget proposals in fiscal year 2010. The revenue effects of the revenue-producing initiatives exclude the likely deterrent effect from IRS enforcement programs as well as any improvement in voluntary compliance due to improved taxpayer services.

The revenues expected from these initiatives are small compared to the estimated $290 billion net tax gap for tax year 2001. For instance, all of the revenue-producing initiatives coming largely from additional enforcement staffing are expected to yield about $699 million in fiscal year 2010, or about one-quarter of 1 percent of the tax year 2001 net tax gap. In 2010, the total estimated increased revenues from both the revenue-producing and

legislative initiatives, or about $2.6 billion, is about 0.9 percent of the 2001 net tax gap.

Concluding Observations

When taxpayers do not pay all of their taxes, honest taxpayers carry a greater burden to fund government programs and the nation is less able to address its long-term fiscal challenges. Thus, reducing the tax gap is important, even though closing the entire tax gap is neither feasible nor desirable because of costs and intrusiveness. All of the approaches I have discussed have the potential to reduce the tax gap alone or in combination, and no single approach is clearly and always superior to the others. As a result, IRS needs a strategy to attack the tax gap on multiple fronts with multiple approaches. The various proposals in the administration's budget request raise modest dollar amounts compared to the size of the tax gap. This underscores the likelihood that a wide variety of efforts will be needed to make significant progress in addressing the tax gap. We look forward to seeing the administration's expanded outline of steps it will be taking.

Mr. Chairman and Members of the Committee, this concludes my testimony. I would be happy to answer any question you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Thomas Short, Assistant Director; Jeffrey Arkin; Elizabeth Fan; Ronald Jones; Lawrence Korb; and Ellen Rominger.

Chairman SPRATT. Thank you very much.

Now Mr. Edwards.

STATEMENT OF CHRIS EDWARDS

Mr. EDWARDS. Thank you, Mr. Chairman and Mr. Cooper, for holding these important hearings today on the tax gap, and thanks to both of you over the years for your strong support of fiscal responsibility.

Compliance with our tax system, as we have heard, stands at about 86 percent. I think, to most people, that sounds like a pretty high number. We rarely get 100 percent compliance with any law. I looked up "compliance" yesterday on the Internet, on the Department of Transportation site, regarding automobile seatbelt laws,

and the nationwide compliance rate with automobile seatbelt laws is only 81 percent, and that is after many years of education on that issue.

International evidence also suggests that the U.S. tax compliant rate is very high. Frederick Snyder, who has completed detailed studies for the IMF on the size of underground or shadow economies in different countries, finds that the U.S. tax compliance rate, or the U.S. shadow economy is very low. He finds that the average size of the shadow economy in the OECD countries is 16 percent of GDP. The U.S. shadow economy, according to his studies, is only 8 percent of GDP, the lowest in the OECD. So Americans do seem to be highly law-abiding when it comes to reporting government taxes and complying with regulations.

As we have heard earlier, the size of the U.S. tax gap does not seem to have increased over time. The GAO says that the tax gap has been about the same rate over the last 3 decades.

For these reasons, the current intense focus in Congress over the tax gap is perplexing. Americans, of course, should pay the taxes that erode, but the tax gap, in my view, is far down the list of important tax system issues that we should be dealing with.

I think Congress should instead focus on issues such as America's high corporate tax rate and how uncompetitive it is, especially in the globalized economy we live in, and of course the enormous complexity of the Tax Code. The number of tax expenditures, as I think we had heard earlier, has doubled since 1975. This is a huge problem, and I think we need to deal with that before we get to the issue of the tax gap.

Interestingly, if you compare the FICA or payroll tax compliance, according to the IRS numbers we saw earlier, there is a very high compliance rate. Of course, we have got withholding there, but it is also a flat, simple tax with no deductions. Compare that to the very low compliance with the Federal estate tax. The Federal estate tax gap is about 28 percent of the amount of revenue collected by that tax because it is a grossly complex, inefficient tax.

Americans have a responsibility to pay their taxes, but Congress also has a responsibility to make tax laws that are simple and easy to comply with. I think Congress is failing in that responsibility. I say let us make the Tax Code coherent first before we put on more regulations to close the tax gap.

There are a few observations on the tax gap estimates from the IRS that I think are interesting. The IRS data shows that corporations create only 9 percent of the tax gap, and yet we constantly hear about supposed rampant corporate tax evasion. In recent remarks, Senator Kent Conrad talked about the hemorrhaging of tax revenues from cheating by corporations with offices in the Cayman Islands, but corporate tax cheating is not such a black-and-white affair as many think, and the complexity of the Tax Code makes it very difficult to determine how much companies should actually be paying.

Interestingly, the Joint Committee on Taxation's report on Enron a couple years ago, which was over 2,000 pages long, found hundreds of Enron subsidiaries in the Cayman Islands, but the Joint Committee had a very hard time showing that the firm's tax structures were actually illegal. They were abusive, but they had a very

hard time saying that they were actually illegal, and as I think was raised by Mr. Everson earlier, corporate tax revenues have soared in recent years. In 2007, corporate tax revenues will be $342 billion, up 65 percent from the peak reached in 2000. So corporate tax revenues are not hemorrhaging. It is the small business sector that would bear much of the brunt of the burden of new regulations to reduce the tax gap, but studies have found that small businesses already pay higher tax compliance costs, much higher compliance costs, compared to revenue collected than big businesses, and the IRS Taxpayer Advocate in the past has found that the heavy compliance burden on small businesses is one of the most serious problems with the Tax Code. So it seems to me that targeting small businesses with more tax gap regulations seems very unfair.

To conclude, the great attention being placed on the tax gap I think is out of place given that U.S. tax compliance is high compared to other countries and it has remained stable over time. Federal revenues are above historic norms at 18.5 percent of GDP this year, and as you may know, data for the first 4 months of fiscal 2007 show a 10 percent increase in Federal revenues over the same period last year. So the fiscal problem in Washington is not a lack of revenue.

In his famous book A Wealth of Nations, Adam Smith argued that, quote, "subjecting the people to the frequent visits and odious examination of tax gatherers exposes them to much unnecessary trouble, vexation and oppression," unquote.

So, rather than imposing more vexation on the taxpayers, I think we should reform the Tax Code to reduce marginal rates and special preferences, and I think a positive side effect would be to reduce the tax gap.

Again, thanks a lot for holding these hearings.

[The prepared statement of Chris Edwards follows:]

PREPARED STATEMENT OF CHRIS EDWARDS, DIRECTOR OF TAX POLICY STUDIES, CATO INSTITUTE

Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding the "tax gap," which is the difference between the amount of taxes owed and the amount of taxes actually paid.

The net tax gap, after enforcement, is $290 billion, or 14 percent of what is owed, according to the Internal Revenue Service.[1] Put another way, compliance with the federal tax system stands at 86 percent. I think to most people, that compliance rate would sound quite high. After all, we rarely get 100 percent compliance with any law. Consider automobile seatbelt laws. The national compliance rate with seatbelt laws was 81 percent in 2006, and that is despite large education campaigns on that issue.[2]

International evidence also suggests that the federal tax compliance rate is high. Friedrich Schneider, a professor of economics at Johannes Kepler University in Austria, completed a detailed study last year on the size of underground, or shadow, economies in 145 countries.[3] He is perhaps the world's top expert on underground economies and tax evasion. Schneider defines the shadow economy to include legal activities that are not reported to governments in order to avoid taxes and regulations. Reviewing the literature, he finds that "in almost all studies, it has been found that the tax and social security contributions are one of the main causes for the existence of the shadow economy."[4]

Schneider finds that the shadow economies of developing countries are much larger than those of the advanced nations of the Organization for Economic Cooperation and Development. Looking at 21 OECD nations in 2002, he found that the average size of shadow economies was 16 percent of gross domestic product. The United States had the smallest shadow economy at just 8 percent of GDP, according to Schneider's analysis.

In a study for the International Monetary Fund in 2000, Schneider similarly found that the United States had a smaller shadow economy than nearly all other countries.[5] In sum, Americans seem to be highly law-abiding when it comes to government taxes and regulations.

Another factor to consider is that the size of the federal tax gap does not seem to have increased over the years. The Government Accountability Office noted recently that "the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades."[6] Thus, to the extent that the tax gap is a problem, it is not getting any bigger.

For these reasons, the intense focus in Congress on the tax gap in recent months is perplexing. Americans should pay the amount of taxes that they owe, but the tax gap is far down on a long list of problems with the federal tax system. Congress should focus on the following items as more pressing problems needing attention:[7]

- America's high-rate and uncompetitive corporate income tax, which is a growing concern in our increasingly globalized economy.
- The excessive taxation of savings and investment under the income tax, which reduces the growth rate of the U.S. economy.
- High marginal tax rates on individuals and businesses, which are a hurdle to productive activities and encourage unproductive avoidance activities.
- The enormous complexity of the tax code. The number of pages of federal tax law and regulations increased from 40,500 in 1995 to 66,498 by 2006.[8]
- Increasing horizontal inequity in the tax code. The plethora of deductions and credits added in recent years creates unfairness by imposing different tax burdens on people with similar incomes.
- The alternative minimum tax, which threatens to hit 30 million taxpayers by the end of the decade if not reformed or repealed.

Americans have a responsibility to pay all the taxes that they owe. But Congress has a responsibility to make sure that laws are as simple as possible and easy to comply with.

With the tax code, Congress is utterly failing in its responsibility. James Madison noted that "it will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood ... or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow."[9]

Let's make the tax code coherent first before we consider any additional regulatory actions to close the tax gap. Focusing on the tax gap first puts the cart before the horse. Let's reform the code to increase economic efficiency and fairness, and an important byproduct will be to increase tax code compliance.

OBSERVATIONS ON THE TAX GAP ESTIMATES

Most of the tax gap regards individual taxes, not corporate taxes. IRS data shows that the corporate tax gap is only 9 percent of the overall gap.[10] Yet concerns are often expressed about supposed rampant corporate tax abuse. In recent remarks about the tax gap, Senator Kent Conrad (D-ND) talked about the "hemorrhaging" of federal tax revenues from cheating by large multinationals with offices in the Cayman Islands.[11]

However, the problem on the corporate side is legal tax avoidance by multinationals due to our high corporate tax rate, not illegal tax evasion. Interestingly, the Joint Committee on Taxation report on Enron found hundreds of Enron subsidiaries in the Caymans, but the JCT had a hard time showing that the firm's tax machinations were actually illegal.[12] The corporate tax code encourages the creation of very complex corporate tax structures that are usually legal, but they do make tax compliance much more difficult.

Note that corporate tax revenues have soared in recent years. Corporate tax revenues are expected to be $342 billion in fiscal 2007, which is up a remarkable 65 percent over the peak at the end of the last boom in fiscal 2000 of $207 billion.[13] Corporate tax revenues are clearly not "hemorrhaging."

The tax gap related to the estate tax is also worth looking at. At $8 billion, the tax gap for the estate tax is a huge 29 percent of the $28 billion in estate tax revenues in 2001. This large gap indicates the large inefficiency of the estate tax, which probably drives relatively more tax avoidance and evasion than any other federal tax. This is one reason why many tax experts support repeal of this tax.

The federal FICA payroll tax has a very low tax gap of just $14 billion. Experts note that the FICA tax has a low tax gap because of employer withholding. But another factor that promotes high compliance is that the payroll tax is the simplest federal tax. It has a low, flat rate and no deductions. It is a model to consider for

reforms of the federal income tax. Indeed, the Hall-Rabushka flat tax for individuals would consist simply of a flat-rate payroll tax, and thus would likely have a high compliance rate.

Major tax reforms would reduce the tax gap by reducing taxpayer confusion and aggressive tax planning. Many taxpayers pay the wrong tax amount because they are confused about what income is taxable and what tax breaks are allowed. And since complex tax rules are subject to multiple interpretations, they spur taxpayers to take risks on tax strategies in the hope that they are not caught by the IRS. The Joint Committee on Taxation noted that "taxpayers may consciously choose to 'play the audit lottery' by taking a questionable position on their tax returns, in the belief that complexity will shield them from discovery."[14] In its report on Enron, the JCT concluded that the company "excelled at making complexity an ally."[15]

The IRS estimate of the tax gap includes $32 billion related to claiming the wrong amounts of credits and deductions. The number of such "tax expenditures" has soared in recent years. Indeed, the GAO found that the number of tax expenditures has more than doubled since 1975.[16] Table 1 shows the number of tax expenditures relating to energy and education have more than doubled since 1995. The explosion of tax credits and deductions has added complexity and increased the system's unfairness by promoting horizontal inequities.

The largest source of the tax gap is the small business and self-employed sector of the economy. It is this sector that would bear the burden of many proposed actions to reduce the tax gap, as it would have to pay higher taxes and deal with greater paperwork. If Congress and the IRS increased reporting requirements and tax regulations to try and reduce the tax gap, most of the added compliance burden would fall on law-abiding businesses that are already paying their full load of taxes.

Note that individuals and businesses already spend more than 6 billion hours—or more than 3 million person-years—complying with federal taxes. Many members of Congress, usually around April 15, decry that large burden. Yet trying to reduce the tax gap by imposing added paperwork on businesses would increase the time spent on unproductive compliance activities.

Note that small businesses already have a higher ratio of tax compliance burdens to taxes collected than do large businesses. For small businesses, tax compliance costs can be larger than actual taxes paid.[17] The IRS Taxpayer Advocate has found that the heavy compliance burden on small businesses is one of the most serious problems with the tax system.[18] Thus, targeting small businesses with more regulations to try and close the tax gap seems especially unfair.

Senator Kent Conrad (D-ND) recently stated that "closing the tax gap is not about raising taxes on anyone."[19] But in fact, it is. Certainly, some individuals and businesses are currently not paying all they owe. But taking actions to increase taxes paid would create all the usual "deadweight losses," or inefficiency costs, that any tax increase would create. If a small business is required to pay more tax, it will have less cash flow available for capital investment and hiring workers. There is no free money sitting around for the federal government to simply grab without negative side-effects on the economy.

CONCLUSION

In conclusion, the great attention being placed on the tax gap seems out of place given that the problem is not excessive compared to other countries, nor is it getting worse over time. Federal revenues are up above historical norms at 18.5 percent of GDP in fiscal 2007. Indeed, data for the first four months of fiscal 2007 show a 10 percent increase over fiscal 2006.[20]

The fiscal problem in Washington is not a lack of revenue. Thus burdening small businesses and the economy with more tax regulations to try and close the tax gap is the wrong way to go. In his classic work, The Wealth of Nations, Adam Smith recognized that the total cost of taxation is "a great deal more" than just the amount of revenue collected. For one thing, he argued that "by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression."

Rather than increase odious tax-gathering activities, we should instead reform the tax code to reduce marginal rates and eliminate special preferences. That would be beneficial for families and the economy, and it would have the side effect of reducing the tax gap.

Thank you for holding these important hearings. I look forward to working with the committee on tax issues, particularly tax code simplification and reform.

ENDNOTES

[1] The IRS estimates are discussed in Government Accountability Office, "Tax Compliance," GAO-07-391T, January 23, 2007. See also U.S. Department of Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006.

[2] National Highway Traffic Safety Administration, "Seat Belt Use in 2006: Overall Results," November 2006, www-nrd.nhtsa.dot.gov/pdf/nrd-30/NCSA/RNotes/2006/810677.pdf.

[3] "Shadow Economies of 145 Countries all over the World: What do we really know?" May 2006, www.econ.jku.at/Schneider/ShadEconomyWorld145—2006.pdf.

[4] "Shadow Economies of 145 Countries all over the World: What do we really know?" May 2006, p. 5, www.econ.jku.at/Schneider/ShadEconomyWorld145—2006.pdf.

[5] Friedrich Schneider and Dominik Enste, "Shadow Economies Around the World: Size, Causes, and Consequences," International Monetary Fund, Working Paper 00/26, February 2000.

[6] Government Accountability Office, "Tax Compliance," GAO-06-1000T, July 26, 2006, p. 1.

[7] For a discussion of problems with the tax code, see Chris Edwards, "Options for Tax Reform," Cato Institute Policy Analysis no. 536, February 24, 2005, www.cato.org/pub—display.php?pub—id=3681.

[8] Based on the page count of the CCH Standard Federal Tax Reporter. See Chris Edwards, "Income Tax Rife with Complexity and Inefficiency," Cato Institute Tax & Budget Bulletin no. 33, April 2006, www.cato.org/pubs/tbb/tbb-0604-33.pdf.

[9] James Madison, The Federalist Papers, No. 62.

[10] For all tax gap figures, see Government Accountability Office, "Tax Compliance," GAO-07-391T, January 23, 2007. See also U.S. Department of Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006.

[11] Senator Kent Conrad (D-ND), Remarks at a Senate Budget Committee "Hearing on President Bush's FY2008 Budget Proposals on Tax Compliance," February 14, 2007.

[12] In testifying on the Enron activities, then JCT chief of staff, Lindy Paull, said, "I don't know if you could call it illegal." See Peter Behr, "Enron Skirted Taxes Via Executive Pay Plan," Washington Post, February 14, 2003, p. E1.

[13] Budget of the U.S. Government, FY2008, Historical Tables, p. 30.

[14] Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System," JCS-3-01, April 2001, volume 1, p. 102.

[15] Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," volume 1: Report, JCS-3-03, February 2003, p. 16.

[16] Government Accountability Office, "Tax Compliance," GAO-06-1000T, July 26, 2006. p. 7.

[17] Art Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation, March 1996.

[18] Internal Revenue Service, National Taxpayer Advocate, Annual Report to Congress, FY 1999.

[19] Senator Kent Conrad (D-ND), Remarks at Senate Budget Committee "Hearing on President Bush's FY2008 Budget Proposals on Tax Compliance," February 14, 2007.

[20] Congressional Budget Office, "Monthly Budget Review," February 6, 2007.

Chairman SPRATT. Did Adam Smith say all of those things? Was that a quote or was that a paraphrase?

Mr. EDWARDS. That was a quote, yes.

Chairman SPRATT. Let me ask each one of you, as a panel together, if you have an idea.

I was trying to probe the Commissioner earlier for how much the tax gap is today, 2006-2007, as opposed to 2001. We had a useful clarification in the GAO testimony that it is 345 gross, 55 late payments, so the net number is 290.

Considering the 290 in 2001, what do you think the gap is today in 2007? Mr. George.

Mr. GEORGE. Yes. Mr. Spratt, Mr. Chairman, we are not in a position to give a definitive answer there. They do not have——

Chairman SPRATT. Is the 2001 number scientific or is it just a stab itself?

Mr. GEORGE. No. No. No. They did a detailed study, the national review. They did a detailed review of this, but it is just incomplete. They only looked at one aspect of the overall picture.

Chairman SPRATT. If we were in earnest about closing this gap, wouldn't it be useful to have that number restated every year, have some kind of means for at least a summary update?

Ms. OLSON. Mr. Chairman, what I have advocated is—and the IRS is moving in this direction as fast as I think it actually can—to have a 5-year cycle of studying different components of the tax

gap so that—or the tax paying population. One year, you would be updating your corporate numbers. One year, you would be updating your pass-through numbers. In another year, you would be updating some components of the individual income tax, and as you went through those 5-year cycles, you would also be looking at what services those different populations needed since for so much of what we ask taxpayers to do they do need assistance from us or others in some way, and I think if you got on an ongoing 5-year cycle in that way, you would have reasonably good estimates so that if there were something that Congress had changed in the laws or had closed a loophole or something, you could back out or add to the effect of those changes to your bottom line estimate.

Right now, we have so many squishy numbers in the tax gap chart that the Commissioner uses—you know, there are whole colors that are in—these are squishy numbers. That is what I think the blue color represents on that tax gap chart.

Chairman SPRATT. Well, that is another whole problem for this committee because we need current and up-to-date numbers, and typically the definitive revenue collection for a given year may not be available for as much as 12 to 18 months after the close of the year, which is a problem for us in knowing if there is a revenue spurt or if there was a revenue decline, and we are not for sure looking at the numbers we all have.

Just one more question from me is a question I asked earlier. Mr. George, back in the 1990s when we were looking into the possibility or at least exploring this notion of having a lot more information filing, the small business community came down heavily on the side of saying, if you give us all these reams of information to the Internal Revenue Service, they do not have the wherewithal, the software or the hardware to begin to process it, correlate it and make good use of it. Do they now? Is the system there in such a state now that if they did indeed have information reporting that contractors would have to report certain payments to vendors, suppliers and subcontractors above a certain amount? Would the IRS have the capacity to process that meaningfully if they got the information?

Mr. GEORGE. They currently do not have the wherewithal to do this. There is much needed infrastructure improvements in order to adequately address that, Mr. Chairman.

Chairman SPRATT. And how long would it take to install that?

Mr. GEORGE. That is a great question. I do not have an answer to that.

Chairman SPRATT. Is there a software design?

Mr. GEORGE. It is still in the process. As you may recall, modernization was attempted over 12 years ago. Billions of dollars were expended on a program that failed to do anything that it was designed to do. It was a complete waste. They have learned from that lesson and are now engaged in a business systems modernization program which has had some success, is being rolled out slowly. It has not yet delivered everything promised. It is slightly—it is over budget, and it is not, again, delivering everything promised, but they are working at it.

Chairman SPRATT. Other witnesses?

Ms. OLSON. Mr. Chairman, you know, I have witnessed over the last 3 years the IRS ramp-up of the private collection agency initiative where they have spent millions and millions of dollars both in infrastructure and staff time to bring on a whole new program dealing with software, conveying data, data security, and what I have seen is that the IRS, when it puts its mind to things in a laser-like fashion, can accomplish some amazing things. So it seems to me that if the IRS were to be given the authority to do these things and the directive that it has to focus on it as it focused on the private collection agency, it should be able to accomplish that and is probably cheaper than the cost of the private collection agency.

Mr. BROSTEK. We have a separate team that looks at the business system modernization effort from the team that I am in. We have frequently found problems with the management of that modernization, and it certainly is behind the schedule it was intended to follow, and it has not had as much delivered as it was supposed to have delivered.

On the other hand, they do have greater capacity now than they certainly did back in the period you were talking about earlier to do this kind of matching. It would undoubtedly take them additional effort to implement any new requirements. They would have to do software development, and they may need additional——

Chairman SPRATT. There would be a lag time of several years in all probability between the enactment of legislation and appropriations and the effective implementation of this; is that right?

Mr. BROSTEK. That is certainly true, and it would depend a lot on the specific initiative that was implemented and how complex, for instance, the rule-making would be to determine exactly how the information reporting would be done.

Chairman SPRATT. Mr. Edwards, any observation?

Mr. EDWARDS. I am happy to make an observation on your prior question.

You asked about what compliance might be now in 2007. It does strike me—looking at the GAO, it shows the overall number being fairly stable and compliant over the decades, but there are many conflicting forces, of course, going into that that are probably balanced out. Tax or marginal tax rates are much lower than they were in the 1960s and 1970s and even to an extent in the 1980s. So that is good for compliance. The capital gains rate was cut from 20 to 15 percent in recent years, thus reducing the incentive to evade capital gains taxes by 25 percent.

On the other hand, you have got this huge increase in tax expenditures. Even in the last few years, more tax credits for energy and education and all kinds of other things consume the IRS' time. They make tax paying very confusing. The globalized economy is probably making tax compliance worse. So all of these things, it seems, sort of balanced out over time.

Chairman SPRATT. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

First, I would like to thank the tax advocate for the new IRS split refund regulations which enable taxpayers to not spend all of their refund at one time and hopefully save a portion of it. So

thank you for that on behalf of the Congressional Savings and Ownership Caucus. That was one of our priorities.

I would like to focus on tax expenditures again, and as Mr. Edwards just noted, Congress has legislated through the Tax Code to an amazing degree. If you add up all of the tax expenditures, as I mentioned in an earlier question, it is some $847 billion a year. That approaches the size of all Federal discretionary spending, including all defense spending and all domestic discretionary spending, so that is how much we have sacrificed in revenue just to serve a remarkably undefined constituency here, because as I quoted the other Ms. Olson earlier, "unmeasured and immeasurable, unverified and unverifiable."

So it seems to me, if you analyze it, what we have created here is a system in which the 17,000 Ways and Means and Finance Committees' lobbyists can get a tax break virtually for free for their clients, and as Commissioner Everson testified earlier, he admitted it takes the IRS some 20 years to catch up with law changes and who benefits and who does not and tax gap or tax cheating and things like that. That is a pretty scary prospect.

So I wanted to experiment with you the idea that perhaps we should make the tax expenditures more measurable and verifiable. For example, if you ask for and receive a tax break, wouldn't it be nice if, in succeeding years, you had to report who benefited from it and to what degree? That would improve accountability, I would think. Whereas, today, we do not really know where the money goes, and that is an astonishing amount of Federal money to lose.

Another approach would be, as Mr. Brostek reported, from GAO that there is a definite noncompliance rate associated with each tax expenditure. The more breaks you give, the more confusion you have in the Code and the more people do not pay their taxes. So these breaks create their own tax gap, and from Mr. Brostek's numbers, it looks like we lose $32 billion a year just in increased noncompliance as a result of these tax expenditures. That is about 4 percent of the total tax expenditures. So, if the government were really interested in collecting that money from the tax gap related to tax breaks, we would go ahead and have an upfront fee of about 4 percent, anticipating that there would be about 4 percent noncompliance, and I am already unpopular with the 17,000 lobbyists for the Ways and Means Committee.

But if the government, just as a theoretical question, were interested in simplifying the Code, improving verifiability and measurability, wouldn't it consider undertaking those steps of identifying who the beneficiaries are of these breaks and to what extent and also going ahead and anticipating a certain degree of noncompliance resulting therefrom? Those steps would come closer toward improving accountability of government. Comments?

Mr. BROSTEK. We did a report on tax expenditures a couple of years ago, and we have been updating the figures since. That is how we have the figure that is in my testimony today. We have felt that these provisions should have the same type of scrutiny as an outlay program. Now, there is a wide variety of tax expenditures. There are a lot of different purposes for the tax expenditures, but many of them are akin to a social program that is in the Internal Revenue Code. Yet, from our viewpoint, there is really not the

same ownership that you would have if you had it in a line agency that is responsible for overseeing outlays of Federal funds.

So we did, in fact, press for more visibility for these in the budget process, more research and more data collection so that we could determine whether or not the provisions are worthwhile, whether they are returning to the taxpayers a reasonable ROI for our revenue loss.

Mr. COOPER. If I could just interrupt you for a second, when you say "data collection," that makes me think that you are wanting to put the monkey on the government's back. These people are getting a special break. There is no constitutional right to a break. Shouldn't the monkey be on their back to report?

Mr. BROSTEK. That certainly is a reasonable proposition to me. I think that would generally be the case. There would be the need to collect data that we do not collect already, and one of the things that would be an issue here is we have talked some about the IRS having inadequate computer systems, in many cases, for administering the complex Tax Code. If they were also to collect the use information for these tax expenditures, there would be a lot more data that would come into the IRS, and so that would increase their need for computer systems, and someone would need to analyze that data if it were going to be worth collecting.

Mr. COOPER. I see that my time has expired.

Thank you, Mr. Chairman.

Chairman SPRATT. You could come back—hold on if you have got further questions, but let us recognize Mr. Boyd, and then you can come back for additional questions.

Mr. BOYD. Thank you, Mr. Chairman, and thank you, panel members.

Earlier, a number of people on the committee and the Commissioner expressed the notion that the complexity of the current code does two things. It complicates it for those who want to abide by the rules who eventually throw up their hands, and the complexity allows those who want to cheat that ability. Do any of you disagree with that? Do any of you on the panel disagree? I am not asking for an editorial here, but do any of you disagree with that theory?

Ms. OLSON. No.

Mr. BOYD. Okay. Thank you.

Mr. Edwards, I read a little bit about you, and I know you are listed as an expert on Federal tax and budget policy. I listened to your statement, and you said that everything seems to be going pretty well, that there is nothing wrong with our code. If you compare it to other nations, we have got an 86 percent compliance rate.

Mr. EDWARDS. There is nothing wrong with our compliance rate, I think, compared to other countries. There is a lot wrong with our code.

Mr. BOYD. Okay. There is nothing wrong with our compliance rate, but there is something wrong with the Code, but nothing that a lowering of the rates and a simplification would not fix.

Given that and your expertise in tax and budget policy, what do we do about the largest deficits in the history of the Nation in the last 3 years?

Mr. EDWARDS. Well, I mean I am very concerned about what has been going on on the spending side of the budget. I looked at the

numbers the other day under President Bush from 2001 to 2007. If you take out interest, which has been pretty stable over recent years, Federal outlays have gone up 54 percent just over those 6 years. So I think the problem is on the spending side of the budget.

Mr. BOYD. With the bulk of that coming on the national defense side and with the entitlement program?

Mr. EDWARDS. Yes, absolutely, and I think I have a big concern with both the defense and nondefense and entitlement sides of the budget. I mean all of that spending sucks money out of the private sector. Spending on defense is not good for the economy just like excess spending in the entitlement incentive program.

Mr. BOYD. But you would concede, until you attack the defense and entitlement sides, you really do not solve that problem?

Mr. EDWARDS. Absolutely. I agree with that entirely.

Mr. BOYD. Okay. Thank you.

Ms. Olson, earlier there was discussion about the Private Collection Initiative, and I understand that you have some issues with that.

Would you care to comment what those are and what you see those problems as?

Ms. OLSON. Well, I have been involved with the Private Collection Initiative since its inception for the last 5 years, before it even was legislation, when Treasury asked me to ensure that taxpayer rights were protected in this initiative, and my goal was to make sure that taxpayers were being treated in the same manner and under the same rules and under essentially the same procedures as they would be treated by the IRS employees, and I have had employees detailed to this initiative full time to watch it and report back to me, and this year——

Mr. BOYD. Could I ask you about that?

Ms. OLSON. Yes.

Mr. BOYD. You have 65 Federal employees monitoring 75 private sector employees? That is the number I have. Is that correct?

Ms. OLSON. That is the IRS' employees. It does not include the—I would say we have 3 employees looking at this pretty much full time.

Mr. BOYD. Okay. The IRS has 65 monitoring 75 private employees, and you have 3 monitoring the IRS guys?

Ms. OLSON. Right, and all of the information in our report, that we have reported on, has come from the IRS, so we are reliant on the IRS giving us that information. So I do not know whether there are more IRS employees, really. I do not know who is in that 65 number, except I know mine are not, and it was some of those numbers as we looked at the program as it went out, as it really started rolling out, and looking at the cases that were going on there that led me this year in my December 31st report to recommend that Congress repeal the authority to use the private collection agencies because I believe that the business case was not there. It was just costing taxpayers too much and that the IRS could do it much cheaper. I believe that there is a workforce that could be trained to do that inside the IRS that would be much more stable, would protect taxpayers better, and some of the very premises that the program was based on, such as that there were easy cases that we just were not getting to that we could just ship out

to the private collection agencies and they could just do like that do not exist. In fact, the IRS is now having to go to higher dollar accounts and small business accounts and accounts where taxpayers have not filed other tax returns in order to make up the number of cases that they are shipping out.

I guess the third concern that I had about it was that if you go online to the IRS Web site and you look up our Internal Revenue Manual, which is essentially our instructions to staff about how they are to treat taxpayers, you can find specific instructions to the collection employees about what they are supposed to do, and because we are contracting out to these employees, to these private parties as a matter of Federal procurement law we cannot disclose the instructions that they give to their employees. We cannot tell taxpayers how private collection agency employees are being told to treat taxpayers. That is a matter for the private collection agencies to agree because it is considered proprietary information, and I found that very disturbing.

Mr. BOYD. I do, too.

Chairman SPRATT. Would the gentleman yield?

Do the private contractors have the same authority, for example, the extraordinary authority, to administer, I guess, a search warrant, an administrative search warrant, to sequester the funds in a bank account, for example, without notifying the taxpayer?

Ms. OLSON. No, sir. They are limited under the Constitution. You know, it is the Federal Government that has the authority to assess and collect taxes, and so the way this——

Chairman SPRATT. And it is nondelegable?

Ms. OLSON. It is nondelegable, and so these individuals can only ask the taxpayer things that do not involve the exercise of discretion or judgment, so they can ask them "Do you owe the tax in full or can you pay this in 36 months?" one of the problems is if the taxpayer says, "Well, I need 60 months" or "I do not think that I should have to pay this penalty. I was in a coma during all of these years. I could not pay it while I was in a coma," then that case has to go back to the IRS to be worked. So then we have two people working a case at any given time.

Mr. GEORGE. Mr. Chairman, if I could just briefly address this issue, my office is very closely monitoring the implementation of this program given the sensitive nature of it, and we believe it is just much too early to make an assessment as to its success or failure, but we will be reporting on this within the year.

Chairman SPRATT. What about a lien?

Ms. OLSON. No, they cannot——

Chairman SPRATT. You have got the most powerful lien known to the law if they want to levy a lien against the taxpayer who is delinquent.

Ms. OLSON. It has to go back to the IRS, and the IRS does it.

Chairman SPRATT. Okay.

Excuse me, Mr. Boyd. Thank you for yielding.

Mr. Cooper.

Mr. COOPER. Thank you.

Ms. Olson, you mentioned in your testimony that due to the special accounts receivable function of the IRS that they should have greater budget leeway than some other agencies.

What should their current budget be? What would be the right amount of money for the IRS?

Ms. OLSON. Well, I would want to see—I am not subject to the same restraints as the Commissioner. You know, I get to speak freely in that respect, and my views do not represent the views of the administration nor the Commissioner nor the Secretary of the Treasury or pretty much anybody else, but I believe that the current budget is a good start, and I would want to see more funding for taxpayer service. We are ramping down some of the walk-in sites and some of the level of service on answering the phones, and I think I would take a good look at what more we need in the IT Department, and then on a going-forward basis, I think that we just need to think that the IRS needs for a period of years—and I am not quite sure what that period would be but for at least 10—increases, roughly, in the 2-percent to 3-percent range overall, both enforcement and taxpayer service and IT, to get caught up and stay abreast with some of the demands that we have.

I also think that we have to look at the way the IRS calculates return on investment, and one of the things that we suggested was that the IRS report annually to Congress about its return on investment calculations, both on the service side and the enforcement side, and what you are getting for your investments.

Mr. COOPER. A couple of other questions.

There are a number of small but nuisance areas; for example, household employee paperwork. It is a nightmare, a blizzard of ink and paper.

Is it your responsibility or whose is it to come up with simpler approaches for that that we can take that recommendation and perhaps pass it into law?

Ms. OLSON. Well, we have looked at that in the past, and we will continue to look at that. I agree with you that it is very, very complex. We have also looked at just the whole Federal employment tax arena because that is where so many small businesses get into problems. It is just the complexity of the rules, and we have tried to come up with some proposals.

Mr. COOPER. Well, since you are the Taxpayer Advocate, I look forward to hearing from you on those things.

Ms. OLSON. Thank you.

Mr. COOPER. Another set of questions.

So many people just run and hide when they hear the "T" word. They do not want to understand the complexity of the Code. Is there a simple breakdown? I thought I remembered from law school or someplace that a quarter or a half of the Tax Code is consumed with the capital gains distinction and income of some amazing portion. It would help if we kind of had some idea. I know that these retirement accounts are wonderful, but just with the complexity between the IRAs and Roth IRAs and all of the other varieties, that is a gigantic section of paperwork, and perhaps it is for a good purpose, but sometimes we do not realize the extent to which complexity is engendered by what seem like relatively simple ideas.

Mr. EDWARDS. Lots of tax experts will say that the capital gains is the single most complex part of the Tax Code, and it is not just individual capital gains; corporate capital gains is very, very com-

plex, and often when you read about the tax shelters in the newspaper about some corporation doing some sort of machination, it revolves around the treatment of corporate capital gains.

Mr. COOPER. Well, has some tax wizard made a map of the Code and just said, "Hey, half is here and half is there"? Because I think that might help us understand sometimes the complexity.

A final point. Mr. Brostek mentioned that many of these tax expenditures are in fact social programs, and I cannot help but note the irony that for discretionary spending here in Congress we have some 20 committees, including our friends on the Appropriations Committee, to oversee that $800 billion or $900 billion worth of spending, but on the tax expenditure side we barely have any committees looking at how that is understood. So perhaps we should double the Appropriations Committee. Perhaps we should have another set of committees here in Congress to look at how that money is, in fact, being spent because today we are largely clueless. It is almost a shadow government in place, and there is little or no accountability.

Mr. EDWARDS. Can I make a comment on the tax expenditure? There are two aspects of it. One is the complexity, which we have discussed. The other is the fairness issue. It seems to me, with this explosion in tax expenditures, you create greater horizontal inequities in the Code. People earning the same amount of money can pay substantially different amounts of tax, and even if you look at education tax expenditures they have increased from 7 to 16 just in the last 10 years.

So what we are doing is we are subsidizing, say, you know, young lawyers who are going to law school on the one hand, but we are burdening truck drivers and garbage men on the other hand because they do not get that sort of tax break. So there is a fairness thing here as well.

Mr. COOPER. Without data, though, we almost do not know how unfair or—you know, it is an amazing netherworld that we have entered into due to the multiplication of the size of these tax breaks.

Mr. BROSTEK. It is, if I can jump in.

There is a variety of levels of data that we have available. You know, for instance, on the earned income credit we have a pretty good understanding of who is receiving it and how much and where they live in the country and all kinds of things like that, but on some of the other provisions we have virtually nothing at all. If we have a special accelerated depreciation provision, that gets reported to the IRS with all other depreciation on one line on the tax form, and we do not know who is even using that benefit that is in the Tax Code.

Mr. COOPER. On the EITC, though, the major abuse there is claiming dependents that you are not entitled to claim or claiming too many dependents, isn't it? So I cannot understand why there is not a matching process there. Commissioner Everson mentioned earlier that suddenly 5 million dependents in America disappeared once there was better reporting. Surely, there is a nonintrusive way of getting at EITC fraud.

Ms. OLSON. I think that there is a lot actually that the IRS is doing on EITC, and we do have a very active matching program,

and that does stop a fair number of refunds going out. I think any time you have something that is in the realm of $4,000 on top of—that could be without any withholding and you could get a check back of $4,000, that is a great enticement for people to find ways to claim it, and with the human mind being what it is there are always new ways. Once we find the way that they are doing it, they invent a new one. It just requires ongoing watching, I think.

There is a large amount, though, when we were working on trying to quantify this, of taxpayers who are eligible for the EITC who are not claiming it. We think that might be with the childless worker where it is not involving the children, but it is there. I have worked with United Kingdom and studied their credit and made some recommendations about how to restructure all of our family provisions—the child credit, the dependency exemption, the head of household status, and the earned income credit—to sort of lessen some of the complexity. It is a very complex area of law, not just the EITC.

Chairman SPRATT. Gentlemen, we have got to be on the floor, especially on the floor, at around 1:00 o'clock.

Let me thank each one of you for excellent presentations, very forthright and forthcoming testimony. We appreciate your assistance in helping us better understand the tax gap and what we might hope to realize from it.

Thank you very much for coming.

Mr. BOYD. Mr. Chairman.

Chairman SPRATT. Mr. Boyd.

Mr. BOYD. May I ask one—I have one quick request of Mr. George on the Private Collection Initiative.

Chairman SPRATT. Sure.

Mr. BOYD. You said it is too early. How much time do you think you will need for your group to make an assessment, an evaluation, of whether it working or not?

Mr. GEORGE. We expect to issue a report in April, Congressman Boyd.

Mr. BOYD. Can you make sure that we get a copy of that report? I would be grateful.

Mr. GEORGE. Yes. Certainly, sir.

Mr. BOYD. Thank you very much.

Chairman SPRATT. I would, before adjourning, ask unanimous consent that members who did not have the opportunity to ask questions of the witnesses be given 7 days to submit questions for the record. Without objection, so ordered.

Thank you very much.

[Whereupon, at 12:57 p.m., the committee was adjourned.]

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