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UNCOLLECTED TAXES: CAN WE REDUCE THE $300 BILLION TAX GAP?

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

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UNCOLLECTED TAXES: CAN WE REDUCE THE $300 BILLION TAX GAP?

WEDNESDAY, OCTOBER 26, 2005

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:36 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn, Collins (ex officio), Carper, Levin, and Akaka.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. The Committee will come to order.

I want to thank our witnesses ahead of time for coming. I appreciate their attendance at our hearing. I want to give credit to Senator Carper. We are holding this hearing because of his pursuit of this issue, which is a very important issue for our country. This hearing is not about tax policy. That is a time for a different debate at a different time and a different subcommittee. What this hearing is about is the tax gap and whether or not the Federal Government is receiving its due, and how that impacts everybody else's paying their fair share when some of our citizens do not pay their fair share, whether they are corporate, personal, or payroll taxes.

So it is important, and the tone of this hearing is about the tax gap, the uncollected taxes that are owed that are now being shouldered not only by those people who are paying taxes appropriately in this country, but also going to be shouldered by our children and grandchildren because people who did not pay their fair share today, they are going to transfer it to our children and our grandchildren in the form of higher national debt. The actual national debt increased $564 billion last year. In our hearing yesterday, I quoted $600 billion. My staff corrected me. It was not quite $600 billion; it was just $564 billion. That is enough for $2,000 for every man, woman, and child in this country. It is something that cannot happen.

I pursue fiscal restraint, but the other thing is proper revenues under the law should be coming to the Federal Government, and it is important that they do so.

So I do want to give credit to Senator Carper. We are working as a bipartisan Subcommittee. Partisanship has no play on this

Subcommittee. We are not going to work that way. We have agreed not to work that way. We think that is what the American people expect of us. So we will do that.

The gap between revenues that should have been collected and those that actually were is known as the "tax gap." According to research by the IRS, on individual income tax returns, the tax gap falls somewhere between the range of $311 and $353 billion for the year 2001. Four-year-old data is the most recent data we have. Even worse, some argue that the tax gap is actually much larger than the $350 billion.

The tax gap is at least as big and probably much larger than our Enron accounting current deficit numbers. I find it troubling to think that if taxpayers were paying the amount they owe in taxes each year, the Nation could be running a positive balance at the end of the year rather than adding what we have added in terms of national debt.

The tax gap is a combination—underreporting, underpaying, and non-filing of required tax returns altogether or on time are the three areas where noncompliance occurs. The tax gap is also measured by type of tax in terms of income, employment, estate, or excise.

According to the IRS' most recent study completed in 2002, underreporting on individual income and self-employment taxes accounts for 80 percent of the tax gap. The IRS also reports that individual income and self-employment taxes on unreported income makes up between $134 to $155 billion, almost half of the gross tax gap.

As you might expect, underreporting can be either intentional or nonintentional, but nobody, including the IRS, is measuring which it is in most cases. The National Taxpayer Advocate reports that given the size of the current tax gap, the average returns includes a $2,000-per-year surtax to subsidize, noncompliance. That is a tax that everybody else is paying, on average, to subsidize those who are not paying. If the average American knew that $2,000 of his or her annual tax payment went to pay for intentional or unintentional tax evasion of others, I believe there would be an aggressive call for the IRS to do a better job of solving the problem. The tax gap deals with fundamental fairness and how each tax-abiding citizen of this country is paying or not paying the money they owe to the country.

This hearing is not to focus on what type of tax policy is fair to the most American people—as I said, that is for another hearing—or what type of tax system will boost the economy. That is for another hearing as well. I believe that increasing the tax burden on the American people while we are currently wasting their money through innumerable improper payments, fraud, and unaccountable programs is the wrong policy, but today's hearing is not about the size of the tax burden or what should be done to the Tax Code. Today, we are talking about the $350 billion problem and how it might be solved.

This hearing will allow us to take a better look at the sources of the tax gap, the reasons the income is lost, and what weaknesses exist within the current system to cause these billion-dollar deficiencies. The IRS balances its approach to tax gap reduction by fo-

cusing on both prevention—that is, improving taxpayer services—and enforcement after the fact. However, I have found no official long-term compliance goals are driving the IRS endeavor. If we really want to see noncompliant rates decrease, the IRS must develop a results-oriented approach, something that can measure progress made in reducing the tax gap. They must also have data that is more current than 2001 in order to get accurate results of how big the tax gap really is.

It is inherently unfair for one taxpayer's delinquency to be another taxpayer's burden. I look forward to hearing from our witnesses on what the tax gap is, its impact on the Federal deficit, and what it means for the future of our country. I want to thank the witnesses for their time and preparation and thank Senator Carper most especially for his help in securing this hearing.

[The prepared statement of Senator Coburn follows:]

PREPARED STATEMENT OF SENATOR COBURN

The Federal budget deficit hit $318 billion for the year just ended. The gap between revenues that should have been collected and those that actually were is known as the "tax gap." According to research by the Internal Revenue Service on individual income tax returns, the tax gap falls somewhere within the range of $311 and $353 billion for the 2001 tax year. Four-year-old data is the most recent we have. Even worse, some argue that the tax gap is actually much larger than $350 billion.

The tax gap is at least as big as—and probably much larger than—our current annual Federal deficit numbers. I find it troubling to think that if taxpayers were paying the amount they owe in taxes each year, the Nation could be running a positive balance at the end of each year, rather than adding $3 or $4 billion each year in the looming $4.3 trillion Federal deficit.

The tax gap is the combination of underreporting, underpaying, and non-filing of required tax returns altogether or on time, are the three areas where non-compliance occurs. The tax gap is also measured by type of tax: Income, employment, State, or excise.

According to the IRS' most recent study, underreporting on individual income and self-employment taxes accounts for 80 percent of the tax gap. The IRS also reports that individual income and self-employment taxes on unreported income makes up $134 to $155 billion, almost half of the gross tax gap. As you might expect, underreporting can be either intentional or non-intentional, but nobody, including the IRS, is measuring which it is in most cases.

The National Taxpayer's Advocate reports that given the size of the current tax gap, the average tax return includes a $2,000 per year "surtax" to subsidize noncompliance. If the average American knew that $2,000 of his or her annual tax payment went to pay for the intentional or unintentional tax evasion of others, I believe there would be an aggressive call for IRS to do a better job at solving the problem.

The tax gap deals with fundamental fairness in how each tax-abiding citizen of this country is paying—or not paying—the money they owe to the country.

This hearing is not to focus on what type of tax policy is most fair to the American people; or what type of tax system will boost the economy. I believe that increasing the tax burden on the American people while we are currently wasting their money through innumerable improper payments, fraud, and unaccountable programs is the wrong policy. Today's hearing is not about the size of the tax burden but what should be done to the tax code.

Today, we're talking about the $350 billion problem and how it might be solved. This hearing will allow us to take a better look at the sources of the tax gap, the reasons income is lost, and what weaknesses exist within the current system to cause these billion dollar inefficiencies.

The IRS balances its approach to tax gap reduction by focusing on both prevention—that is, improving taxpayer services—and enforcement after the fact. However, no official long-term compliance goals are driving IRS' endeavor. If we really want to see non-compliance rates decrease, the IRS must develop a results-oriented approach—something that can measure progress made in reducing the tax gap.

It is inherently unfair for one taxpayer's delinquency to be another taxpayer's burden. I look forward to hearing from our witnesses on what the tax gap and its impact on the Federal deficit means for the future of our country.

I want to thank our witnesses for their time and preparation.

I notice that our Chairman of the full Committee is here. I will recognize Senator Carper and then recognize Senator Collins thereafter.

Senator CARPER. Thank you very much, Mr. Chairman. I would be happy to yield to Senator Collins.

Chairman COLLINS. Please go right ahead.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Our Chairman has been very generous in giving me some credit, and my staff, some credit for calling attention to this issue and asking that we hold this hearing. I am grateful that we are. He and I have a passion for trying to reduce our budget deficit. I know it is a passion shared by Senator Collins and Senator Akaka as well. When you have a situation where we are running these huge budget deficits and we know there is money that is out there that is owed in taxes that are on the books and we have some idea who owes the money, we have an obligation, I think, to people who are paying their fair share of taxes to help you, Mr. Commissioner, and others whose responsibility it is to collect the revenues to collect them.

We have had some opportunity earlier this year, as the Chairman knows, and I think as our other colleagues know, to focus on the issue of improper payments. And this hearing today sort of reminds me of that. In fact, I think we have had two hearings now and identified that there is about $45 billion or so that are made in improper payments each year. For the most part, it is money that is overpaid and paid to vendors or payees that ought not be getting that money. We also learned that the number is just the tip of the iceberg, and there are a bunch of agencies that are not reporting at all on their improper payment problems. And as we learn more about what improper payments they are making, I think we are likely to see that $45 billion number grow further.

And the same can really be said about this so-called tax gap that the Chairman has alluded to. Officially I am told there are between $300 and $400 billion in taxes owed the Federal Government, and they go uncollected by the IRS or some agency of the Federal Government each year. This number does not include, I am told, cash payments made for legitimate business transactions that are made in the underground economy. I am also told that it does not include accurate, up-to-date data on taxes that are owed to underreported corporate tax income and other key factors.

Like with improper payments, then, we are probably pretty far from truly knowing everything that we should know about the extent of the tax gap in our country. Every dollar wasted on erroneous or fraudulent payments means that there is one fewer dollar that we can spend on worthy programs, so one more dollar we have to borrow around the world from China, Japan, South Korea, or somebody else as well. And that is not a good thing whether you happen to live in Delaware, Oklahoma, Maine, or even Hawaii.

Mr. Commissioner, I know that in your testimony today you are going to testify, I think, among other things, about efforts that are underway at the IRS to go after abusive tax shelters and to increase the audits of large corporations and high-income individuals. We welcome that and are anxious to hear what you have to report. We applaud you and those that you lead for those efforts.

What I also want to learn more about today, though, is the extent to which we have the information necessary to focus on compliance, focus on enforcement and customer service efforts at the IRS on the right things. We might be making progress, but I don't know if we are there yet. I always say, Mr. Commissioner, that everything I do I can do better. My guess is that the same is true of you and the folks that you lead.

In closing, Mr. Chairman, I would like to note for the record that we have some experience in our State, in Delaware, in dealing with these issues. At the beginning of my political career, I was State Treasurer of a State that had the worst credit rating of any State in America. We were the best in the Nation at overestimating revenues and underestimating spending. Nobody was as good as us. We ended up with a BAA credit rating, which tied us for dead last with Puerto Rico. We had all of our money in a bank owned by the State. We were closed out of credit markets. Nobody would lend us any money. We had no cash management system. And at the tender age of 29, I got to be State Treasurer.

So these are issues that are sort of near and dear to my heart. Later, as Governor of Delaware, my team and I worked with the legislature and others to turn around the State Division of Revenue, which is our State counterpart to the IRS, which was not getting the job done in a variety of areas, including customer service. And after a lot of years on behalf—by a lot of people and some hard work, we were actually able to bring the collections of delinquent taxes up to record highs. We also made it easier to file taxes online and save our State and our families and businesses, I think, a fair amount of time and money.

One of the things I am proudest of, we have an annual award, a Quality Award. And you probably have them in your States. We have one for the Nation. In my second term as governor, just before I came here to join some of my colleagues, our Division of Revenue was actually recognized for its customer service and the way they did their job by winning the Quality Award for Delaware, which a lot of times corporations win those, sometimes a nonprofit. But the idea of a State agency, essentially the tax-collecting State agency, would win the award for quality was something we were enormously proud of in our State.

And I say all this not to blow our horn in Delaware, but to point out that there are road maps out there for the IRS to follow, and I am sure you are aware of that. Our budget in Delaware is only a fraction of the Federal budget, but I am sure that some of what we have done there and much of what has been done in other States to identify problems, to fix them, and improve collections and customer satisfaction at the same time just might be replicated, at least in part, at the Federal level.

Again, Mr. Chairman, thanks for allowing us to have this hearing and for all our staff and the work that they have done to get

us to this day. And we are delighted to welcome the Commissioner and our other witnesses, including from as far as Georgia and from GAO. Thank you so much—and the Treasury employees as well I think are represented here. We thank you very much for coming and look forward to all your testimony. Thank you.

Senator COBURN. Thank you, Senator Carper.

I recognize our Chairman, the Senator from Maine, Senator Collins. Thank you very much.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. Thank you very much, Mr. Chairman.

Senator Coburn and Senator Carper, I would like to begin my remarks by thanking you for your leadership in examining the financial management and sometimes financial mismanagement in the Federal Government. I know that our partner, the Senator from Hawaii, also has a deep-felt commitment to improving the financial management of the U.S. Government.

We all have a responsibility to contribute to the running of our government, and a large measure of that responsibility involves paying our taxes fully and on time. In previous hearings before the full Committee and the Permanent Subcommittee on Investigations, I have taken a great interest in improper payments, but also focusing on the revenue side of the ledger. We have held hearings on Federal contractors who cheat on their taxes, and we have looked at improvements that can be made in the way that the IRS and other government agencies can cooperate to increase tax collection. And I am just delighted that this Subcommittee is building on that work because we have obviously not made much of a dent in what is a considerable problem.

I also am pleased to see the Treasury Employees Union here, and Colleen Kelley, whom I have worked with so closely, because I think we can get a lot of good ideas from the employees of IRS on how we can do a better job.

We ask a lot of our citizens—every year we ask that they write a check to the government or contribute through payroll taxes, contributing their hard-earned dollars to the public good. And most of our citizens do comply. But for every individual or every corporation that does not fully comply, honest Americans have to pay more than their fair share. This just isn't right and I hope that this hearing and the information we gather today will spur more progress on the part of the IRS and other agencies as we work to increase tax compliance.

So thank you for holding this important hearing.

Senator COBURN. Thank you, Madam Chairman.

To one of the nicest men in the Senate, I would like to recognize the Senator from Hawaii, Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you. Thank you very much, my good friend, Chairman Coburn, for calling this hearing today and focusing on the $300 billion in taxes owed to the Federal Government but not collected, as was pointed out by each of you.

I wish to compliment you and the Ranking Member, Mr. Chairman, for assembling such a distinguished witness group today, in-

cluding IRS Commissioner Everson. I remember that I last saw you in a hearing in May, and I look forward to your testimony today.

Also, I want to compliment the Chairman of our full Committee for her leadership of the Committee and feel that we really moved well in serving the Senate under her leadership.

I want you to know that I agree with the Chairman and Ranking Member that regularly measuring compliance with our Nation's tax laws and understanding why taxpayers fail to pay their taxes is needed now more than ever. Our witnesses today without question in my mind will give us many reasons for the noncompliance.

I would like to start by clearing up a common misconception, and that is, filing errors among low-income taxpayers are simply acts of fraud and contribute to the tax gap. The low quality of tax preparation services for the earned income tax credit earner contributes significantly to the errors found in the EITC-related returns. The EITC helps working families meet their food, clothing, housing, transportation, and educational needs. Do you know that 57 percent of EITC over-claims were made on returns prepared by paid tax preparers?

Steps must be taken to improve the quality of tax preparation services, which is why I worked with our colleagues Senators Bingaman, Smith, Baucus, Grassley, Schumer, and Pryor to develop S. 832, the Taxpayer Protection and Assistance Act.

Our bill will provide the Department of the Treasury with improved authority to regulate individuals preparing Federal income tax returns and other documents for submission to the Internal Revenue Service. The bill requires three things—examinations, one; education, two; and oversight of paid preparers, three—and urges citizens to utilize the services of an accredited or licensed tax preparer.

Enactment and implementation of this legislation would improve the quality of tax preparation services available to our citizens and reduce the error rate among returns filed by EITC recipients. Only through stronger regulation of the tax preparation industry and providing additional resources to help volunteer and community tax preparation programs will error rates among low-income filers be reduced, which will help close the tax gap.

Mr. Chairman, I am also concerned about a problem that likely contributes to the tax gap: Business-owned life insurance, which is insurance owned on the life of an employee that benefits the corporation or the business, and that is BOLI. They benefit from the earnings on the policy's cash value building up tax-free and are not taxed unless the policy is surrendered prior to the death of the insured. Because you are a proponent of fiscal responsibility, Mr. Chairman, I believe you may be interested in this problem as well.

In response to a request from Senator Bingaman and myself, the GAO released a study in May 2004 on BOLI that found limited data is available on the use and prevalence of BOLIs. We simply do not have good data on the number and use of BOLIs, many of which exist for no other purpose than to shelter income from taxes.

More needs to be done to understand the justification and costs of retaining the Federal tax advantages of BOLI. We are in a difficult fiscal environment which requires difficult choices, especially when there are calls for cutting essential health care programs

such as Medicaid or education programs. Imposing regulatory reporting requirements on BOLIs would provide needed information on the use and prevalence of these policies and would give Congress the data needed to evaluate whether or not these tax benefits are justified.

I look forward to a thorough discussion of these issues as part of today's hearing on the tax gap. Again, I want to say thank you to our witnesses and thank you to the Chairman and Ranking Member for having this hearing. Thank you.

[The prepared statement of Senator Akaka follows:]

PREPARED STATEMENT OF SENATOR AKAKA

Thank you, Mr. Chairman, for calling today's hearing which focuses on the $300 billion in taxes owed to the Federal Government but not collected. I wish to compliment you and Ranking Member Carper for assembling such distinguished witnesses, including IRS Commissioner Everson who I last saw at the Joint Taxation Committee's hearing in May.

I agree with the Chairman and Ranking Member that regularly measuring compliance with our Nation's tax laws and understanding why taxpayers fail to pay their taxes is needed now more than ever. Our witnesses today will touch on many reasons for noncompliance. I would like to start by clearing up a common misconception: That filing errors among low-income taxpayers are simply acts of fraud and contribute to the tax gap. The low quality of tax preparation services for the Earned Income Tax Credit (EITC) earner contributes significantly to the errors found in EITC-related returns.

The EITC helps working families meet their food, clothing, housing, transportation, and educational needs. Fifty-seven percent of EITC over-claims were made on returns prepared by paid tax preparers. Steps must be taken to improve the quality of tax preparation services, which is why I worked with our colleagues, Senators Bingaman, Smith, Baucus, Grassley, Schumer, and Pryor to develop S. 832, the Taxpayer Protection and Assistance Act. Our bill will provide the Department of the Treasury with improved authority to regulate individuals preparing Federal income tax returns and other documents for submission to the Internal Revenue Service (IRS). The bill requires: Examinations, education, and oversight of paid preparers, and urges citizens to utilize the services of an accredited or licensed tax preparer.

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In response to a request from Senator Bingaman and myself, the GAO released a study in May 2004 on BOLI that found limited data is available on the use and prevalence of BOLIs. We simply do not have good data on the number and use of BOLIs, many of which exist for no other purpose than to shelter income from taxes. More needs to be done to understand the justification and costs of retaining the Federal tax advantages of BOLI.

We are in a difficult fiscal environment which requires difficult choices, especially when there are calls for cutting essential health care programs, such as Medicaid or education programs. Imposing regulatory reporting requirements on BOLIs would provide needed information on the use and prevalence of these policies and would give Congress the data needed to evaluate whether or not these tax benefits are justified.

I look forward to a thorough discussion of these issues as part of today's hearing on the tax gap. I thank the witnesses for appearing this afternoon. Thank you, Mr. Chairman.

Senator COBURN. I thank the Senator.

Our first witness is Mark Everson. He is the Commissioner of the Internal Revenue Service. Prior to his time at IRS, he was Deputy Director for Management for the Office of Management and Budget, where he provided government-wide leadership to the Executive Branch agencies to strengthen Federal financial management and improve program performance, and this Subcommittee has seen some of the benefits of his work as we have seen how there are starting to be chief financial officers and some transparency starting to develop within the various agencies. And so I think you were incremental in helping get that done. We are very appreciative of that.

Your entire statement will be made a part of the record. You are recognized for 5 minutes.

TESTIMONY OF HON. MARK EVERSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. I want to start off correctly here. Do I say "Mr. Chairman" or "Madam Chair"? What is the right protocol here?

Senator COBURN. "Madam Chairman."

Mr. EVERSON. Madam Chairman, Mr. Chairman——

Senator CARPER. Actually, we use "Excellency" a lot. [Laughter.]

Mr. EVERSON. Senators Carper and Akaka, I am pleased to be here to discuss the important subject of the tax gap. This is the first time that I have testified as Commissioner before this Subcommittee. I did actually testify earlier on erroneous payments several years ago when at OMB. But it is certainly not the first time I have testified before the Homeland Security and Governmental Affairs Committee.

I want to thank the Members of the Subcommittee for your strong support for sound tax administration. In particular, I want to share with you my assessment that the work of the Permanent Subcommittee on Investigations has been instrumental to the government's efforts to combat abusive tax shelters, efforts which I believe have enjoyed considerable success.

Turning to today's subject, simply put, the tax gap is the difference between the tax that taxpayers should pay and what they actually pay on a timely basis. Our research confirms that the vast majority of Americans pay their taxes honestly and accurately, but the findings also show that even after IRS enforcement efforts and late payments, the government is being shortchanged by over a quarter trillion dollars each year because some pay less than their fair share. People who are not paying their taxes shift their burden to the rest of us. In this time of budget deficits, a dollar not received by the government becomes debt, the burden of which will be felt by future generations.

Moreover, as President Kennedy stated in 1961, "Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others." Beyond the effect on the government's revenue stream, persistent noncompliance erodes respect for the rule of law.

[1] The prepared statement of Mr. Everson appears in the Appendix on page 38.

Our research shows that the gross tax gap for 2001 was between $312 billion and $353 billion. The old tax gap estimate for 2001 was $311 billion, a figure based on studies conducted in 1988 and earlier. So there has been what I would term a modest deterioration in tax compliance among individuals since the last study was conducted in 1988.

IRS enforcement activities, coupled with late payments, recover about $55 billion of the total gross gap, leaving a new annual tax gap of between $257 billion and $298 billion. The new research for 2001 addresses the underreporting of income and self-employment taxes by individual taxpayers. It is based on the audits of 46,000 individual returns. The study did not address corporate compliance.

Preliminary findings include: Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more than 80 percent of the total tax gap with non-filing and underpayment at about 10 percent each.

Individual income tax is the single largest source of the annual tax gap, accounting for about two-thirds of the total.

For individual underreporting, more than 80 percent comes from understated income, not overstated deductions. Let me repeat that: understated income, not overstated deductions.

Most of the understated income comes from business activities, not wages or investment income. Compliance rates are highest where there is third-party reporting or withholding. Less than 1.5 percent of wages and salaries are misreported.

The next stage of our research will be to finish the data analysis and refine the tax gap estimates, which we will do by the end of this year. The IRS will use the data to update its statistical tools for selecting individual audits—or individual returns for audit. The tax gap study confirms a key point involving enforcement. The IRS needs to enforce the law so that when Americans pay their taxes, they are confident their neighbors and business competitors are doing the same.

Since 2001, we have taken a number of steps to bolster enforcement. We have increased total individual audits to more than 1 million. You can see that recovery after the sharp fall-off in the late 1990s. We have more than doubled high-income audits. We have brought up recommended criminal prosecutions, the same timing of the deterioration that took place in the late 1990s where we actually—we reduced our manning in revenue agents, revenue officers, and criminal investigators by over a quarter following 1996, as resources were just taken away from that in the environment with which I think we are all familiar.

Between fiscal year 2001 and 2004, the IRS increased its enforcement revenue from $33.8 billion to $43.1 billion, and when we release 2005, that is going to go up again. Enforcement revenues are the monies that result from IRS collection, audit, and document-matching activities. Enforcement revenues directly reduce the tax gap and the Nation's budget deficit. They exclude the positive impact on compliance that occurs when someone learns in a casual conversation that their neighbor has been audited and then thinks twice about fudging his or her own return.

The President has called for a nearly 8-percent increase for enforcement activities in the Administration's 2006 budget request.

These investments will pay for themselves several times over and help reduce the tax gap. This is a case where more spending will get more revenues.

I want to thank the Senate for fully funding the President's request in our 2006 appropriation bill which you passed last week. Please protect that funding.

I would like to point out that our system of tax administration is fundamentally one of self-assessment and enjoys a high compliance rate. The IRS is moving aggressively to reduce the tax gap. With proper funding over a number of years, we will be able to close a significant portion of the gap, but no one should think that we can totally eliminate the gap. That would take draconian measures and make the government too intrusive. We have to strike the right balance.

Finally, the tax gap challenge underscores the President's call for tax reform. Complexity obscures understanding. Complexity in the Tax Code compromises both the service and enforcement missions of the IRS. Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say, "Why bother?" Meanwhile, individuals who seek to pay less than what they owe often hide behind the Code's complexity in order to escape detection by the IRS and pay less. Thank you.

Senator COBURN. Thank you, Mr. Commissioner.

It looks like you are on the right track. There are some concerns we have as to how you measure it and the fact that you are working off of old data, and I am going to put up this chart over here.[1] It is a little bit wordy. But the problem with the data is we know actual amounts, we have got reasonable estimates, and then we have weaker estimates. In Oklahoma, we call a weaker estimate "just a guess." It is not a weaker estimate. It is that we do not really know, but this is our best shot at it.

Tell me what you have in plans to measure your performance within the IRS and how can you do that with such old data.

Mr. EVERSON. I do not want to defend the long gap it took to reinvigorate and do these studies. We stood down from doing research basically at the insistence of the Congress during the 1990s because it was considered too intrusive, some of the audits that were being done. And it was quite controversial before we moved forward to do this research in and of itself. But it has been done in a way that I think it generated very few complaints as we went through these 46,000 audits, and in some instances there was not even contact with the taxpayers, depending on the returns.

I think that the 2001 data—I wouldn't consider that out of date. Those returns are filed in 2002, and the work on the audits was done in 2003 and 2004. It is unrealistic to think that the timing will get too much more compressed than that because once the research is done, you need to adjust the numbers. If Bill Gates is in the sample, you have to sort of figure out whether that is representative, because it makes a difference if Bill Gates is there or myself. You get a different weighting, and you need to have the statisticians go through all this very carefully.

[1] Chart submitted by Senator Coburn appears on page 37.

So that piece, I wouldn't consider that old. What we have not done here, though, as you indicate, is the corporate side particularly, we are moving forward now to do flow-through entities. The flow-through entities have exploded, 1120 S-corps, they have increased by tenfold over the last period of years in terms of a vehicle of choice. We are concerned there may be problems there.

What we are doing right now is, as we finish up assessing this data—and by year-end we will have more precise numbers within the ranges—we are also developing a plan for updating that. As you know, GAO has said we ought to do this more periodically. I agree with this entirely. It is really, again, a question in part of cost, because doing 46,000 audits to the degree we did it, very resource-intensive. They are randomly selected. They are not following the same model of going through a risk assessment and then going after the audits that are going to generate probably a real picture of noncompliance. The other thing we did was we oversampled on the high-income audits so that took time.

What I have committed to doing to Finance, which is have this same discussion, and particularly Senator Baucus, is that as we finish this research, we will then come up with what we say are the long-term goals for compliance, because until you know really where you are, it is hard to set a goal for where you want to go. And, also, we will develop a plan for ongoing research. We have had conversations on that internally already.

Senator COBURN. When should we see the commitment on that?

Mr. EVERSON. I think that will happen early next year, and in my view, it also depends in part on the signal we get from the Congress on funding. If the monies are provided to enforce the law adequately and that sends a clear signal that—unlike in previous years, where the Congress has cut this President's request, and even before that, sometimes President Clinton's request, if the Congress is now supporting this and we can be assured that we will have the adequate resources, I think you can do a better job of projecting improvements.

Senator COBURN. So you do not think that we need to have better research than what we have or more timely research? We just need to take care of what we have got now and then develop a plan based on that?

Mr. EVERSON. No, I am not suggesting that. I think we do need to do that. We need to cover the other boxes in here that have not been covered, and we need to have a routine schedule for refreshing this. But we need to assess if we need to do a full-blown 46,000 or whatever the statistically valid piece is, or are there other ways to get after this? Because it is very expensive.

Senator COBURN. Is there not somebody out there that can design you a model that will allow you to statistically do this, computer-enhanced, where you can have better information on a faster turnaround, where you can make decisions where you can assess your progress? I have no doubt in my mind that the IRS wants to do a good job. We have got great IRS employees. And I have no doubt in my mind their commitment to it. What I am worried about is a management system that says how do we measure our performance. And I do not see that, and that is the thing that concerns me. You have identified what the problem is. Others estimate

it to be significantly higher than that. How do we develop the system where you have a management goal that rates the performance of IRS in terms of accomplishing this goal?

Mr. EVERSON. I think, as I said, that with this data and as we update our models, we are able to make better commitments.

Now, there are issues here that came up when we did the Finance testimony about setting goals, and I want to make sure you understand this. I am unable to measure employee performance based on enforcement results. My job is to deliver $2 trillion to the government every year. But I cannot measure an employee based on that.

Senator COBURN. Sure.

Mr. EVERSON. So it is a complicated question as to how you bring down performance, measure performance, when one of our jobs is clearly—it is not just to regulate charities and see that they are following the law or, as Senator Akaka was talking about, get out the earned income tax credit to over 20 million participants. It is also to bring in that money.

So there are a whole series of things that have to be done and have to be done carefully.

Senator COBURN. All right. Senator Carper.

Senator CARPER. I mentioned earlier, Mr. Commissioner, that there are lessons from—probably lessons from the States that we can take to heart, and I always call them experiments in—laboratories in democracy. And give us some ideas, some—do you have a mechanism that enables you to exchange ideas and information with the States—I am pretty sure you do—so that one hand can sort of wash the other? How does that work? So that is the first part of my question.

The second part of my question is: Can you cite some examples of things that States are doing that you think might be worthwhile for us to do at the Federal level?

Mr. EVERSON. I am glad you raise this question because there are several issues here that are of great importance. We do work with the States, and we have increased that coordination very significantly in just the last several years, particularly on the abusive shelters where now almost every State—I think it is 46 States. We have memorandums of understanding with them on sharing information about the abusive shelters. We are only going to get to so many cases. We may give them a list of participants in shelters that we have identified to the State of California, and then they will follow up on some, and then if they get the tax, they notify us, and then we go after it. So we are working—I am sure my colleague from Georgia will touch on this as well—particularly in this area of abusive transactions.

It leads me to another point, though, where there is a weakness where we can get the help from the Congress. Again, going back to charities, we regulate charities. The law precludes us from sharing information about charities with the State regulators of charities. That is to say, credit counseling, it is a mess. We have 50 percent of that industry under audit right now because of the abuses that are out there. We cannot talk to the State regulators of charities if an operation is in Delaware and in Oklahoma and we know

about something that is going on in Oklahoma, we cannot share it with a regulator from your State. So there are opportunities——

Senator CARPER. What is the rationale for that, Mr. Everson?

Mr. EVERSON. It is 6103. One of the absolute bedrock principles of the Tax Code is privacy of the return information, and that is an absolute prohibition, but then there are carve-outs. There are specific carve-outs, exceptions, if you will, that are provided. But as Senator Levin knows, because we have had this conversation in previous hearings, I cannot even share with the PCAOB.

Senator CARPER. With the what?

Mr. EVERSON. The PCAOB, that is the group that looks after the audit firms. I cannot even share with them the results of what we are doing in civil inquiries on accounting firms. So there are a lot of places where we can do more to share.

Senator CARPER. OK. Can you cite some examples that you are familiar with where you have actually done good work, helped one another?

Mr. EVERSON. These abusive shelters, we formed that agreement 2 years ago, and we have shared lots of information back and forth, and they are actively working cases out in the States now, and they are using our information. On an ongoing basis, when we do audits, we share information with the States, as you know. Over 40 of the States, their tax returns start with a line in the Federal return. So that is shared routinely.

Senator CARPER. I am told that the IRS tried to have private collections release a portion of the monies that were owed several years ago. The project was not very successful, and I do not know if you are going to try a new variation of that or a demonstration project or not. But can you tell us what may have gone wrong 10 years ago? If it was not successful, why not? And how might you structure something differently to try this time?

Mr. EVERSON. We do have authorization and are actively proceeding to have private collection agencies assist with a portion of our collections portfolio. So that was passed by the Congress sometime ago, and now we are moving to implement that.

The experience that you reference in the 1990s we all agree was not handled correctly. It was not planned for adequately, and I think the lessons learned in terms of the selection of the inventory, some of it was very old inventory, and other things that needed to be followed up on, we have taken that into account in the planning, which has been very careful in this area. We have a contract procurement out there right now that is going to identify the initial tranche of suppliers here.

I want to emphasize—I am sure you will hear from my friend Colleen, and occasionally she disagrees with some of the things I say—that this work should be done by government employees. You give me a blank check, we will have the government employees do that. But we never get the funding that we ask. And even if we get the full funding the President has asked for, it is not going to cover all of our employee needs because you passed a pay raise that is in excess of what is in the budget.

So very tough for us to get enough people to do the work that Colleen would want us to do. We are supplementing her members'

efforts, if you will, through this effort. We are going to do it responsibly.

Senator CARPER. Do you have a mechanism for getting ideas, deriving good ideas, encouraging your employees to provide good ideas to increase colleagues as a way to incentivize that?

Mr. EVERSON. We get ideas all the time from lots of people. I get e-mails every day from my folks. Colleen gives me ideas once a month, I would say, when she comes to see me. So I don't think there is a shortage of good ideas that come in to us. But we are a conservative organization. One of the things I have been trying to do is get it to be more speedy and more agile because by its nature and through experiences like the 1990s, it is very slow to change. I think it needs to change more rapidly and accept more ideas.

Senator CARPER. Thanks very much.

Senator COBURN. Let me clarify something. Your entire increase in budget this year will be consumed with payroll increases for present employees?

Mr. EVERSON. No, I did not suggest that, sir. What I am saying is when we get an increase, we have asked for an increase that will—it is almost $500 million. But even if we get all that, we will not deliver as many employees into the system because over 70 percent of our costs, our payroll costs, are benefits.

Senator COBURN. Thank you for clarifying that.

I am happy to recognize the Senator from Hawaii. We will go in order of appearance, and we note that Senator Levin has joined us, and we welcome him. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Commissioner, the earned income tax credit returns comprise 48 percent of audits while EITC over-claims make up only an estimated 4 percent of the overall tax gap. Do you believe low-income taxpayers are being targeted disproportionately in enforcement actions?

Mr. EVERSON. I do not share that view, Senator. I think you know that there is a long history, including separation appropriations for the earned income tax credit, not in effect now but that were set up because of the high error rate within that particular population.

As you probably know, under my tenure we have made the centerpiece of our work going after high-income and corporate problems, which this Subcommittee, and the Permanent Subcommittee, has been very aggressive in supporting. So I think that we are definitely working to increase the other areas.

Now, in terms of EITC, we are absolutely committed to both increasing participation in the program, which has a higher percentage participation of those who are eligible than food stamps and other benefit programs, we are still not satisfied with the 70 or 80 percent that it is. We want to get it up further than that. But we also want to make sure that the relatively high error rate—it is much higher than other benefit programs—comes down. It is higher because unlike food stamps or rental subsidies, there is no front end to that process. You take that on the return. You do not come in and apply and go through some screening process earlier.

So what we have done over the last couple of years, we have steered what I think is a sensible middle ground on this. We have worked with a lot of people to try and improve our notices. We have done a lot of testing and certification, and I think we are going to make some real progress in this area, but no, we do not target that group. I think that Senator Levin would agree that, if anything, in the last couple of years we have targeted people, and we have targeted the attorneys and the accountants who have been out there peddling abusive shelters.

Senator AKAKA. Well, I thank you for that. That was just for the record.

Mr. EVERSON. OK.

Senator AKAKA. Does the IRS need additional statutory authority or resources to improve the quality of tax preparation services that are available to low-income taxpayers?

Mr. EVERSON. The money is always an issue, as we have indicated. Now, what I have said, though, is I have not taken a position favoring this regulatory authority, expanding our reach, if you will, to include all tax preparers. Where there is fraud and where there is abuse of the taxpayers, I do not think by our registering them that that will get after that. People who want to help others prepare fraudulent returns, they are going to—they may not even register. They will not even show up. We have got so much to do. I am not in favor of expanding our duties at this time. I am not suggesting never, but I do not believe in that proposal right now.

Senator AKAKA. Well, I like your thoughts about eventually getting to a point where it is balanced, and it is something to seek, and I hope we can continue moving in that direction.

As I indicated in my statement, I believe the true size of the tax gap may be larger than we are currently aware of due to the unknown use and prevalence of corporate or business-owned life insurance. And I did mention it and use business and corporate companies, too.

What steps should be taken to increase the awareness of the number and use of these policies and to ensure that the tax advantages of life insurance are not being abused?

Mr. EVERSON. Senator, I am going to take the Fifth here based on the Chairman's quite clear statement that this is not a tax policy hearing. Our inquiries into this area have not indicated compliance problems. The corporate-owned life insurance, COLI, that the IRS dealt with and that Congress dealt with, that was a compliance issue, and then also statutory steps were taken.

As we have looked at what you have talked about and what GAO has spoken to, we have not, on the basis of our inquiries, concluded that what is happening is at variance with the Code. So it would not be in the tax gap. Sure enough, the Congress could take actions to generate that revenue if it wished. But from my point of view, I do not consider it a compliance issue.

Senator AKAKA. Finally, you mentioned privatization of collections. What safeguards will there be to ensure privacy? And how will the training of contractors differ from career employees?

Mr. EVERSON. Sir, we are taking our responsibilities in this regard very seriously. The scrutiny, first, of the firms that can actually be eligible to secure the work, they have to have been on a

GSA schedule for having done other appropriate government work, and we will be applying the same standards that our employees have to follow in regards to taxpayer privacy and the kinds of questions they can ask to the contractors. They will not be dealt with in a separate standard. It will be the same standard.

Senator AKAKA. Thank you very much, Mr. Chairman.

Senator COBURN. Thank you.

I would want both our panelists and our Members to know we have five stacked votes at 4:15. That will necessitate us changing the order of our witnesses, and the reason we will do that is we have witnesses from out of town. We will schedule a follow-up hearing for what was our second panel of witnesses for an individual hearing on their testimony—I have the concurrence of my Ranking Member in that—so that we do not keep you sitting here until 7 o'clock, because that is how long it is going to take us to do those five stacked votes. And I do not think any of you want to be here that long.

So I would recognize Madam Chairman of our full Committee, and I also would tell you that I have to be in the Chair in the Senate at 4 o'clock. So I will be leaving. Senator Carper will be taking over as Chairman of the hearing, and we will finish it up with our guest from Georgia and others, and then we will reschedule what was the second panel. And you have my apologies. We do not control the floor.

Madam Chairman.

Chairman COLLINS. Thank you, Mr. Chairman.

Commissioner, you have stated in your testimony today that the tax gap arises in part from noncompliance due to the complexity of our tax laws, and that can result not in cheating, which obviously is a huge issue, but in a lack of understanding that leads to noncompliance.

In recent years, the IRS has decreased by 50 percent the number of taxpayer assistance centers in my State from ten to five, and earlier this year, the IRS proposed the closure of a number of Senators across the Nation, including two more in Maine. And I want to commend you and thank you for responding to the concerns that a number of us expressed to you about what the impact would be.

But that is an area where spending money may well save you money. It seems to me that encouraging taxpayers with questions to come to these centers to seek help may, in fact, increase compliance.

Going forward, what are your plans as far as assisting taxpayers with compliance? I am talking about the honest but overwhelmed or confused taxpayers.

Mr. EVERSON. We are constantly assessing our services. If you look at what we have done in recent years, including under my tenure—some have suggested that I have been so pro-enforcement I have been out to decrease services. Not the case. As a whole, we have increased services, continued to do that. What we face, though, is difficult choices. When the President submitted the budget request for this year, he gave us, as we have discussed, a large augmentation on the enforcement side. But he looked at the services and said, We are going to ask you to take the same 1-per-

cent cut that other non-Homeland, non-DOD discretionary programs were taking.

I felt that was a reasonable thing to do, and that is the context in which we made the choices where we continued to invest on phone services, improving our tax law accuracy there, our services for electronic filing and other things. So it is not that we are against the walk-in centers. Hardly. But we are faced with choices as to within limitations, budgetary limitations what we think are the highest impact. The walk-in centers are the most costly. The footprint, if you will, was largely still associated with the Midwest and the East Coast, where you had the historic centers of the population. The country had moved. So if you went back and did a study of this right now and said if you wanted to stick with all these centers, where would you put them, you wouldn't put them in a lot of places where they are, some sort of relative ordering.

That having been said, I got the message. Both the appropriations bills said stand down on a tax. As you know, we have done that. Now, that is going to cause other issues on services as we go forward because we are constantly having to squeeze our money. So I don't want anybody to think that this is an issue that won't arise again as we continually try—and GAO, they were the ones who said you ought to be assessing your services against your finite resources and constantly upgrading the mix, if you will, or addressing the mix. So that is all we are trying to do.

Chairman COLLINS. I just think that, as you said earlier, sometimes when you spend money, you actually save money, and this may be one of them.

I was struck by the chart that you put up earlier that shows the exhibit and flow of audits, if you will.

Mr. EVERSON. Yes.

Chairman COLLINS. The huge drop in the 1990s, the increase now, which have brought in more revenues. It would be helpful to put it up.

I think that this probably reflects the pressures from Congress on the IRS. I suspect that this is our fault, not the IRS' fault. And the reason I believe this is when I look at the dates, it seems to me that they coincide with high-profile hearings that were held by the Congress looking at abuses—and there were undoubtedly some real ones, but also there were probably some that were exaggerated—in the audit process.

I remember many years ago when I was a staffer for this Subcommittee, Senator Levin and my old boss, Senator Cohen, having hearings berating the IRS—I will say Senator Cohen berated the IRS—for being too hard on small businesses that had run into tax difficulty.

How do we strike the right balance between ensuring that we have an aggressive, well-funded, but fair system of audits and how do we reach that and not have these peaks and valleys that are attributable to whether or not Members of Congress can find some horror stories, some legitimate abuses, but that undermines the overall effort to close this gap?

Mr. EVERSON. I think that is an excellent question. People often ask me—I have been on the job about 2½ years now, and they say, "What is the principal change or achievement?" or whatever. I

think that what we have done in the last couple years is there is a broad recognition up here now out in the taxpaying public that you have to do both, service—the formula, we say it is service plus enforcement equals compliance. And I think that what we have done is we have changed the dialogue here. It is a more intelligent dialogue. A lot of it, as the Chairman was saying, it has got to be data-driven to do better on making some of our decisions. But I think the philosophy is now relatively better set.

Let me just say to you one thing, if I can, about this balance. I think we are doing that job now. The oversight board just released its annual report, and let me just quote what the Chairman said: "The results we have seen over the past year demonstrate that it is possible to achieve balance between customer service and enforcement and be successful in both areas." We are doing that.

Now, we are having discussions, arguments about tax or some other areas, but I think, by and large, we have gotten on to this with the help of this Subcommittee. You mentioned the levies, the Federal levies that you and Senator Levin have been selective in. I talked about the shelters where what happened with KPMG would not have happened but for the congressional oversight, frankly, very instrumental.

I think the enforcement is not being short-changed. If we can augment that now with the money the President has asked for, look at some things—there may be a need for more reporting. As I indicated in my opening statement, we are not going to give up on the service side. I do not want you to think we are.

Chairman COLLINS. Thank you very much.

Senator COBURN. Senator Levin, welcome.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, and thank you, Mr. Chairman and Senator Carper, for these hearings. Thank you, Commissioner, for the good work of the IRS. You have been doing tremendous work in terms of enforcement. I applaud you on it. And you very properly give credit to an oversight Subcommittee which really, I think, led to a real important change in the environment and atmosphere when it comes to peddling tax shelters and going after those who have evaded and avoided the law with abusive shelters, such as KPMG. I want to thank you for that. These people who avoid paying taxes are insulting the men and women who serve our country in uniform. They are insulting taxpayers who pay their fair share. We all pay a price for that big figure you have got up there of the gap that exists between money that is owed to the IRS or the Treasury and that which is paid.

And now we have to continue to put the pressure on people who avoid taxes, who cheat on their taxes, who dodge paying their taxes. I do remember, as our Chairman does, the days when we went after the IRS for IRS abuses. There were some. We passed the Taxpayer Bill of Rights. We were proud to have participated in that. We think it made some important changes. But now we are focusing on this gap, and it is a huge gap. And one of the areas that we focused on on the oversight Subcommittee, which is called PSI, Permanent Subcommittee on Investigations, one of the areas of the tax gap are these abusive tax shelters, which we have gone

after. And the IRS is now really going after the people who peddle those tax shelters, and there are a lot outstanding. Eighteen hundred individuals bought the one tax shelter that we identified as BLIPs, which was one of the Sons of Boss. Apparently now a majority have agreed to pay the IRS what they owe. The IRS has collected over $3.5 billion so far this year, tracking down hundreds of taxpayers who have refused to settle. It shows just how big this tax shelter problem is, and I want to talk about a bill which has been introduced by Senator Coleman and myself.

It is a bill which would put some greater teeth into the collection effort relative to tax shelters and tax havens. One of the things it would do is require an economic substance for transactions in order to be eligible for tax benefits. This is something that Senator Baucus and Senator Grassley very strongly support. They have taken a lead on it in the Finance Committee to make sure there is economic substance in transactions before people can claim tax deductions for losses.

This chart we have up there is one of the Sons of Boss which showed the kind of convoluted efforts which were made, and that is a simplified chart.

Mr. EVERSON. I know.

Senator LEVIN. You have seen worse and I have seen worse, and we spent months and years going after KPMG and the others who perpetrated these kinds of convoluted, phony transactions in order to create tax losses.

But one of the things we have got to do is increase penalties on people who promote abusive tax shelters or who knowingly aid and abet taxpayers to use them. And right now, while we have taken some action to increase penalties relative to promoters of tax shelters, when it comes to people who aid and abet—and this can be the lawyers who write the tax shelters or it can be the banks who finance them—we still have a minute penalty so that people calculate what their exposure is. And if their exposure is a maximum of a $10,000 fine and you are making millions of dollars writing phony tax shelters—we have the e-mails where it says, "We can take this risk. We could be out a maximum of $10,000, but we are making millions writing these letters."

And so one of the things our bill does, in the Levin-Coleman bill, is we increase penalties for people who aid and abet taxpayers to understate their tax liability. Promoters now have to disgorge only half of their ill-gotten gains. So even a promoter who makes $10 million by promoting an abusive tax shelter, which the IRS goes after and collects on, the promoter only has to disgorge half the fees. The aider and abettor is maximally exposed to $10,000. And we have got to do better on both. There is no reason why someone who promotes an abusive tax shelter where the taxpayer has to come and pay the taxes plus a penalty, plus interest, while the promoter of that tax shelter should be able to keep half of his ill-gotten wealth or fee. And there is no reason in my book why the aider and abettor should be able to get by with a $10,000 fine.

So one of the things our bill does is we up those fines again. We succeeded in increasing the penalty for the promoter to 50 percent in the bill which was referred to by the Commissioner in his testimony. But we can do better than that, and we should do better

than that. He should disgorge all of the ill-gotten gain, not just half of it, and not just be exposed to a $10,000 fine in the case of aiders and abettors, which typically are lawyers and bankers.

I have 30 seconds left, and I will ask you to comment about one other point, and that is the tax havens. We have a huge problem with tax havens in this country, and our bill, the Levin-Coleman bill, goes after the uncooperative tax havens by authorizing the Treasury to publish the annual list of uncooperative tax havens and ending the tax benefits of using an uncooperative tax haven. We would end the tax benefits—if you use the tax haven, put your funds in a tax haven, we would not under our bill allow you to have any tax benefit from that if it is on the Treasury annual list of a country which does not cooperate with us in the transparency which—is this the Chairman's chart? Forgive me. I missed this. But it is No. 1 on the Chairman's chart of accountability. It may be the Ranking Member's chart, too. I do not mean to exclude either one of you.

So we have to crack down on the misuse of tax havens, and our bill does it, and we do it clean, too. Treasury, come up with your list, and you cannot take a tax benefit for putting your money on that tax haven if it is on the uncooperative tax haven list.

I am out of time, but I would hope if you could take perhaps a minute to indicate that, while you may not be able to support every provision of the bill, in general you are supportive of both the effort to go after and to help you go after even more so—and you have done a great job of going after tax shelter abuses, but even more so to give you the tools to go after both the tax shelter abuses and the tax havens which are abused.

Mr. EVERSON. Thank you, and thank you very much for your personal leadership on this issue, Senator. In the numerous conversations we have had, I think that we have enjoyed a very close relationship with the Subcommittee, and it has made a difference.

Let me say this: I think the JOBS Act has made very real improvements to the regulatory scheme here. We agree entirely with you that the penalties were too low. They needed adjustment. I am not sure yet where they need to head to or whether what has been put in place will fully dampen what has happened. I do know that the changes, like making the material adviser subject to much higher liabilities, I know—I was up in New York speaking to international bankers in June. This has their attention. Non-funding of a loan and just sending it around a paper mill for a couple of hours, you do that now, you are subject to some fines and some reputational risk and a bunch of other things. I think that, the strengthening of our Office of Professional Responsibility, which was provided all these things, combined with the criminal actions that the Southern District has taken, are having a very big impact.

I do support strong penalties. I cannot tell you with certainty how far they ought to go. I do know that there is a new world out there right now through the combination of our augmented activities, the fact that for the first time criminal prosecutions are being brought in areas of complex abuse, which we had not seen those happening before, and the changes that the Congress has made, largely through your efforts.

So we, of course, support those new tools.

Senator COBURN. We want to thank you again for being here.

Senator CARPER. We do not have time to ask this question and get your answer, but one of the questions that I should have asked before, I want to ask you for the record. It is sort of a laundry list of things that we can do to further strengthen your ability and that of the employees you lead to collect the monies that are owed.

Mr. EVERSON. Make sure that money that is in the Senate bill is protected, even from those spending cut hawks that might be on the Committee.

Senator COBURN. We have them, Commissioner. [Laughter.]

Mr. EVERSON. Thank you.

Senator COBURN. Our next panel, as we said—we will be going out of order—is Bart Graham, the Commissioner of the Georgia State Department of Revenue, where he has contributed greatly to Georgia's successful collection of nearly $173 million owed in tax dollars from 2003 to 2005, and Colleen Kelley, who is the President of the National Treasury Employees Union, the Nation's largest independent Federal sector union.

I would also want to apologize to our guests. I will be leaving in the next 5 minutes. I have read your testimony. We will be submitting questions to you, and Ranking Member Carper will take over the gavel, as I leave.

Thank you. And you are recognized, Mr. Graham.

TESTIMONY OF BART L. GRAHAM,[1] COMMISSIONER, GEORGIA DEPARTMENT OF REVENUE

Mr. GRAHAM. Thank you very much, Mr. Chairman and Members of the Subcommittee. Thank you for allowing me the opportunity to discuss the initiatives we have begun in Georgia to collect in excess of $1.6 billion in past-due taxes that have accumulated over the last 15 years in Georgia. Even at the State level, tax evasion, fraud, and aggressive practices of tax professionals have a substantial impact on State services and the request from the Federal Government for continued help. We see the same thing at the local county level as well.

In order to better understand how I came to this role, I want you to understand that I am not a career public servant. I did not work on Governor Perdue's campaign. I am an appointed official, and I did not give his campaign any money. And I think that has contributed to our perception of being nonpartisan in our approach to addressing this $1.6 billion pass-through initiative.

My background is in capital markets and corporate banking, and I also spent 7 years as a chief financial officer of various companies, which, again, aided my ability to see and address the problem in the department because we had substantial tax practice, but we did not have a great understanding in the department with how the banking system works and how people are laundering money into the Greek Islands and to the Caribbean, as you mentioned, and some of the other tax shelters and schemes that go on.

The way we came out identifying the problem, $1.6 billion, I asked early on, as a CFO would ask, What are our assets like? What are our past due's? And when it took them 3 weeks to accu-

[1] The prepared statement of Mr. Graham appears in the Appendix on page 49.

mulate that, I knew it was going to be a problem. And it took me a while to convince the Administration that it really was $1.6 billion, not just $1 million. It was a million accounts that had accumulated that.

In order to address the problem, we also felt like we had to have accountability within the department, dual accountability, dual authorizations. We instituted some of the provisions you find in the Sarbanes-Oxley Act where we have dual accountability, rotation of auditors within the department. Even things that I would sign have to be vetted through other people in the department so they understand what we are doing.

This also required a cultural shift within the department. The goal was to collect the correct amount of money from the correct obligated taxpayers, not how much money we could collect. We were not trying to solve a budget problem. Even though Georgia was faced with over a $700 million deficit, that was not the objective, because I determined over the process that there is plenty of money there to collect, and if we do so fairly and equitably, most of the budget problems that Georgia faced would be taken care of in the process. And we have been able to bear most of that out.

Part of the cultural shift that we had to identify and change was there was a strategy of help us get $5 million more in appropriated money and we will collect $50 million.

Well, to me I saw it as too easy given my background and knowing how to put pressure on people to do the right thing who have passed on their opportunities for customer service. I said we are going to go out and we are going to collect $100 million with what we have and then ask for help to enhance the system going forward from there. And, again, the accountability had to be there within the department so we did not get a reputation for being overzealous in our approach.

The other thing I heard from management on a repeated basis was we do not have enough time, money, or people to do our job. What happened was we were giving our best customer service to the worst delinquents in the State because we would meet with them four and five times or six times. Meanwhile, the people who were trying to be honest, trying to get help, were not getting any help from anybody. And the phone would ring constantly, and nobody would answer. So we made measures to change that.

We found ways to execute strategies that would make taxpayers accountable for themselves, and in some cases, we established strategies that actually pit industry groups against each other, that they have skin in the game in what we are doing so that if they deliver a product—say in the alcohol industry a distributor delivers product to an unlicensed retailer, then I am going to go after the distributor who is doing business illegally in Georgia. And that makes people highly cooperative when you start interfering with their cash flow stream.

As I believe you—and I know you have heard now from Commissioner Everson that penalties, fines, and prosecutions simply are not strong enough in Georgia and we are moving to improve that.

We are trying to change the curve of enforcement from the overzealousness of the past of doing something like this on the very front end of enforcement or just going negative, like you have seen

in the audit records you had here, is to start out with customer service, make sure we treated people fairly, make sure they have the opportunity to do the right thing. And then if they pass that opportunity, then we escalate the enforcement.

Part of that dual accountability is looking at revenue employees of yours, make sure they are filing. When I got to the department, employees were checked, but if they left the department and came back, they were not re-checked. We found an indicted felon on our staff who had embezzled $100,000 from two different banks, and one of our friends in the private sector called me and said, "Congratulations." Well, we took care of that, and we started re-screening everybody. Well, once we did that, other State agencies said we want to know if our employees are complying.

In that process, we found State legislators, judges, and others who were not complying, and, again, if you make it public, once it becomes a public record and you show people what you are doing about it, you get support for it. And people want that fairness and equity in the system as long as you hold yourselves accountable for it.

I know we are pressed for time, so I am going to move on to how we actually addressed dealing with the $1.6 billion.

We decided to implement a four-phase plan that would, first and foremost, address the individual taxpayer. We participate greatly in the Treasury Offset Program with the IRS, and it is a very successful venue for us, and we want to continue to see that grow. We are currently in the process of increasing the use of withholding tax offsets. And one of the things we do with our work in private collection agencies is we have shortened the length of time that it takes us to get paper to the agencies. They now get paper within 185 days. Before, it was nearly 500 days. Part of what they get in Georgia is only a tax lien, which is a public record. So we are protecting the confidentiality of the tax return. Collection agencies are not seeing a return. They are just seeing the delinquency that is a public filing.

We also have a 20-percent premium penalty that is added to that paper which is turned over to the agencies, and they are paid out of that 20 percent. We do not take a discount to what the tax obligation, penalty, or interest is in that process.

We meet with the collection agencies twice a year to re-emphasize the need and requirement to keep people from being overzealous. Any investigations are investigated, and any rampant abuse and the agency would be terminated. Since we ramped up this procedure approximately 20 months ago, I have gotten exactly four complaints. Two were people who never lived in Georgia, and the other two we resolved without having to terminate the agency that was involved. And we have 4.5 million taxpayers in Georgia, and, again, I personally meet with the collection agencies as a group in those two meetings to re-emphasize the way we are going to do business and protect that confidentiality and that we are not going to have abusive treatment of taxpayers.

Our second focus was on trust taxes, the sales and use and withholding taxes. That is one of the biggest abuses in Georgia. I firmly believe that 10 to 12 percent of trust taxes are misappropriated illegally in Georgia, and we have numerous cases that I can docu-

ment. My own father, who is not a tax professional, identified two Fortune 500 companies doing business in Georgia that had established nexus and were doing a mail order business and not paying sales tax appropriately. One of them recently settled for $600,000, plus an agreement to comply going forward, as did the other one. So, again, the issue of nonperformance is staggering.

Phase III of the plan was to accelerate delinquent income tax investigations, creation of an internal call center to give the customer service level there so people have the opportunity to bail out of a collection process and take care of their obligations. We also recently hired 15, first time ever, out-of-state auditors to go after aggressive tax planning strategies that arise out of State.

The results to date include over $173 million of collected money from the $1.6 billion that had accrued on the system. We have roughly worked 75 percent of that list, and due to death and bankruptcies and some overestimations of what we thought the delinquency was, we have now removed the rest of that obligation. So part of this was a management exercise that we also wanted to update our books and records so that we did not have that overhanging account receivable there if it was not legitimate for the long-term future.

Again, of that $173 million, one of the most successful ventures was private collection agencies, and the first most beneficial is the Treasury Offset Program that is phenomenal in our working relationships. One piece of legislation that I think would be helpful to all sides of the parties involved is the ability to exchange records on non-residents. People who formerly lived in Georgia, who have an obligation to Georgia, now relocated, we are not allowed to exchange that information with the IRS. And we are constantly looking for ways to enhance our relationships with not only other States but also with the IRS, because if people see that you will treat them fairly and give them an opportunity to solve their problem, and then if they pass on that, then they are going to put pressure on other people to comply because people do not want to get on our list.

We also in the past year started posting delinquencies on the Internet, and people have to work hard to get on that list. We do not put them all up there because it would be—the amount of data it would take would be staggering. But there are 400,000 individuals and roughly 15,000 businesses and corporate officers that are up there, and that, too, as you will see from our record, that has collected almost $19 million in the 18 months that it has been in process.

I will close with some of the essentials of success, and that is, the transparency that you have on your priority screen, that people see that people are being held accountable, but we are very careful to protect confidentiality. Our confidentiality laws in Georgia are some of the most stringent in the country, so that collection agencies only see records that are publicly filed liens. So the accountability is back on the department. If we give a bad lien to a collection agency that then is pursued and is in a courthouse, it is not the collection agency's fault. It is our fault. And I am happy to take that burden.

Again, we also have to treat everybody fairly and equitably, and we are quick to release any information where our employees have done something wrong or we have had to terminate employees or prosecute employees for tax evasion or tax problems. Our goal at the end of the day is to deal with taxpayers fewer numbers of times for less amount of times and have them going away feeling with the minimum belief that they have received a fair opportunity, received what they wanted.

One last thing on the collection effort that we have seen is one of the biggest abuses we see in Georgia is refund fraud, and those are folks claiming head of household and claiming ineligible dependents. That, unfortunately, often centers on low-income people claiming dependents that are not theirs. If they can find a single parent with children and the parent is not working—and we got on to this last year when someone called because somebody did not honor it, and it was an employee that was taking the head-of-household deduction and claiming that someone else had kids and they did not pay off as the deal was struck. So we looked throughout the department, and we terminated 15 people in our own department doing that. We stopped over $2 million in refund fraud just on head-of-household claims being filed with ineligible dependents. And it is not just the education of the taxpayer not knowing how to file a return. They are going to tax preparers who are saying, Here is your tax return, they do not review it or have the capacity to review it, and the preparer is making fake W–2s and claiming fake dependents. They are finding a real lot of people. In one case, we stopped in Columbus, Georgia, and the taxpayer's office, they had the entire school list in the public schools in Muscogee County with every parent's Social Security number and every student's Social Security number. And the guy was just sitting there hitting the "Send" button on a daily basis.

I want to thank you again for letting me appear today. For me personally this is a very special opportunity to share with you what we are doing in Georgia. Obviously, I can have all the vision and strategy and determination I want in doing this, but if it was not for the employees of the department pursuing what we are trying to accomplish, it would not happen. And I am pleased to take any questions and appear in the future if you can find any help from us.

Senator CARPER [presiding]. Great. What you have provided already has been a lot of help and, frankly, a source of inspiration. We commend the team that you lead, and we are delighted that you are here to present this testimony to us today.

And the same is true of Colleen Kelley. Welcome. We are delighted to see you, and thank you for joining us and being willing to move up to serve on the second panel here and present your testimony, and a little bit later, I want to foster a dialogue between the three of us, and whoever else might rejoin us, and talk about some of the things that we have been raising.

Ms. Kelley, you are welcome to submit your entire statement for the record or just proceed orally, however you prefer.

Ms. KELLEY. I would like to make some oral statement, Senator, if I could.

Senator CARPER. Welcome.

TESTIMONY OF COLLEEN M. KELLEY,[1] NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Ms. KELLEY. Thank you. I very much appreciate the opportunity to be here on behalf of the 150,000 Federal employees and 30 agencies represented by NTEU, and that includes the men and women of the IRS who do the work of the IRS every day.

The IRS needs more Federal employees on the front lines of tax compliance and enforcement in order to help close the tax gap. As Congress considers ways to cut the growing Federal deficit, I urge you to avoid any across-the-board cuts for the IRS.

While the IRS workload has increased by 16 percent based on increases in tax returns filed, the number of employees has decreased by 16 percent, and that is just between 1999 and 2002. The combined collection and exam employees, which do all the enforcement work of the IRS, has declined by 36 percent since 1996.

NTEU agrees with the IRS' goal of enhancing tax compliance and enforcement, but we do not agree with the approach of eliminating front-line customer service employees in order to pay for the additional complaint efforts. There needs to be funding for both.

Congress has agreed with NTEU that the IRS should not close the Taxpayer Assistance Centers, the TACs, as we heard in the prior conversation. And the IRS should not be allowed to slash customer service this year or next year, or in years after that, for the sake of bolstering enforcement. Again, the funding is needed for all of these efforts.

NTEU also supports GAO's recent tax gap report that a more regular compliance assessment is needed if the IRS wishes to obtain a clearer picture of the extent of the tax gap. But I would emphasize that the IRS must determine those factors which encourage and enable taxpayers to voluntarily comply, as well as determine reasons for noncompliance.

NTEU strongly opposes the Administration's plan to privatize the IRS tax debt collection, which was authorized by the American Jobs Creation Act of 2004, and we are going to continue to work towards its repeal. Under that statute, the IRS is permitted to hire, as we have heard, private sector debt collectors and to pay them a bounty of up to 25 percent of what they collect. The IRS' proposal would risk the loss of confidentiality of millions of taxpayers' private information, which provide incentives for the use of abusive tactics by private debt collectors, and it would cost U.S. citizens much more money than if IRS employees did this work. The 2-year pilot that was referred to earlier was so unsuccessful that it was canceled after 1 year. And while there were lessons learned from that, I think too often there is not enough of a focus on why that failed and why it does not make any sense to move forward with this.

The IRS does point to State tax revenue agencies that have contracted out collection work to demonstrate successful privatization of tax collection work, and surely we have just heard of some of that work from Mr. Graham in Georgia. However, States have also faced many problems with private collection agencies—or PCAs, as they are called. Just last year, the Ohio Attorney General's office

[1] The prepared statement of Ms. Kelley appears in the Appendix on page 69.

canceled the debt collection contract with a PCA due to its mishandling of Social Security numbers and private taxpayer information. A similar contract was canceled with a PCA in Montana this past summer due to numerous complaints of rudeness by the PCA employees that were filed by Montana residents.

According to GAO's May 2003 testimony before the House Transportation, Treasury Appropriations Subcommittee, one major concern the IRS must address prior to implementing any tax collection outsourcing is its ability to identify what they call delinquent debts with the highest probability of resolution through PCA contracts. However, as NTEU understands it, systems being developed are supposed to predict which cases are most appropriate to turn over to the PCAs, and those systems will not be available until 2011, long after when the cases are supposed to be put in the hands of these PCAs.

Furthermore, the IRS does not have the technology in place to ensure that taxpayer information is kept secure and confidential when it is handed over to the PCAs. In March 2004, TIGTA noted that the IRS is still unable to oversee its contractors and ensure that sensitive taxpayer data is secure, and I quote that TIGTA report. It says, "Contractor personnel assigned to an IRS modernization project committed numerous security violations that placed IRS equipment and taxpayer data at risk. In some cases, contractors blatantly circumvented IRS policies and procedures, even when security personnel identified inappropriate practices."

If those revenues that are collected by the PCAs could be dedicated directly to contract payments and IRS enforcement efforts, there is absolutely no reason that some small portion of other revenues collected by the IRS could not be dedicated to IRS enforcement efforts. This would allow for increased enforcement by IRS employees, which most in Congress indicate is the preferable route and would eliminate the large bounty payments to PCAs and significantly increase the net revenue to the general treasury. Front-line IRS employees are the best defense against an increasing U.S. tax gap, but front-line staffing has dropped dramatically, even while the number of managers within the IRS has grown, and this trend must be addressed.

I thank you very much for holding this important hearing today, and NTEU supports and offers assistance in your mission to shrink the U.S. tax gap. Thank you.

Senator CARPER. Ms. Kelley, thank you so much.

Go back, if you will, to the 1990s, the late 1990s, a period of time when there were fairly extensive hearings underway. I remember talking with employees of the IRS in my own State, in Delaware, who felt dispirited, almost demonized, because of the allegations and assertions that were sort of thrown at the IRS in general, and they felt, personally, at them. And I am going to ask you just to revisit with us what was going on then and how it affected the morale and maybe the productivity of Treasury employees and the IRS, and how in the roughly half-dozen or so years since then, are we seeing any recovery from that and return of spirit.

Ms. KELLEY. The impact on those hearings was really devastating to front-line IRS employees because they did feel as if they were being personally attacked, and they also knew that the allega-

tions that were being made were not true. In the end, of course, they were proven to be untrue. When the headlines hit and the allegations were made, it was on page 1 of newspapers across the country. When it was proven that the allegations were false in every case that was brought before the Congress——

Senator CARPER. It was every case, wasn't it?

Ms. KELLEY. It was every case.

Senator CARPER. Pretty amazing.

Ms. KELLEY. And when those allegations were proven to be untrue, that was not on page 1 of the newspapers. It was buried in page 37 somewhere, and no one saw it. But what everyone remembered——

Senator CARPER. I saw it.

Ms. KELLEY [continuing]. Were the accusations. I know you did, Senator Carper, but most did not see it.

But what they saw were the accusations, and what IRS employees then saw was a severe restriction on their ability to do their job. In some ways, it was a legitimate reaction by the IRS to the actions of Congress, and in other ways, it was really an overreaction. And employees then saw a lot of the tools that they needed to do their job, the authorities they had taken away from them, which then resulted in a decrease in taxes collected, a decrease in examinations conducted. And there is a very direct correlation between those hearings and many of the results that you saw on the charts that Commissioner Everson used.

Now, in addition to that, what happened after that was a reluctance on the part of Congress to fund the IRS because of those hearings, and there was a great decline in the funding that was provided to them, and that also resulted in——

Senator CARPER. Let me just ask you another question. Was it a reluctance on the part of Congress to appropriate funding, or was there also a reluctance on the part of the Administration to ask for it? Or was it both or was it one or the other?

Ms. KELLEY. I think it was a combination of both. It was a combination of both, definitely. But the numbers speak for themselves. The reality of what happened is that now there are, as I said in my testimony, 36 percent fewer employees doing enforcement work of the IRS when the number of tax returns have increased, depending on which time frame you look at, at least 10 percent, if not 16 percent. And yet the employees, the number of employees have decreased.

So employees feel that even today they still are not being given not only the authority but the support and the advice and the direction from the agency in order to be able to do their jobs. And they also know that they need more staffing because what they are experiencing today is—and I just met with leaders from across the country this morning, and we were talking about this. There is so much work that needs to be done in both collection and examination in the IRS, audits that need to be done and taxes that need to be collected. And because there are not enough employees, these employees have very large inventories that they are responsible for, and they are not making timely contacts to taxpayers, either for the examination or the collection end of it, because they have too much work assigned to them and there are too few employees.

So I would say it continues to have a devastating effect, and the environment in which they find themselves is not one that helps them to do the best work they can or that they feel like they are getting support they need from a funding standpoint as well as from an agency standpoint.

Senator CARPER. All right. Thank you.

Mr. Graham, you mentioned, I think, at one point in your testimony—I think I heard you say that you hired 15 out-of-state auditors. Is that correct?

Mr. GRAHAM. That is correct.

Senator CARPER. Are those State of Georgia employees, or are they folks who you hired from the private sector? How does that work?

Mr. GRAHAM. Well, they become State of Georgia employees. The State of Florida has 75 auditors in Atlanta alone to help do their work, and they have a different tax platform because they do not have an income tax there.

That is designed purely to target companies that are underreporting that are doing business in Georgia that are headquartered outside of the State. That is an area that has just been woefully absent. And what we were able to get the support from the General Assembly and the governor on is everybody sees the need for this greater enforcement, but we do not always just need to squeeze the last dollar out of somebody in Georgia, when these other out-of-state companies are doing business here.

Like I said before, we are not trying to get every dollar of penalty we can get out of everybody. It sounds like to me some of the union's concern with the IRS proposal is really a structure of the program. The structure of the Georgia program would deal with some of their concerns, I think.

Our approach in Georgia on the $1.6 billion is if we manage it correctly, it should be a one-time event, at least for a generation, before you have another anomaly that creates it. And we do not want to be in a position to have to terminate a lot of people. We do need people in examination and audit and other functions to make sure these programs run correctly and the call centers, in essence, so that taxpayers who do not want to go down the road of a collection agency have a chance to bail out and come back and do the right thing. So we are after behavioral change of people, having determined that the State of Georgia is their cheapest source of capital.

Senator CARPER. All right. Ms. Kelley mentioned several States. I think Montana was one.

Ms. KELLEY. Ohio.

Senator CARPER. Ohio was another, where the experience apparently with using private sector folks to do some of the debt collection has not been satisfactory. Let me just ask you to share with us your own experience in Georgia with private collections—I think you mentioned you have done some of that—and some safeguards that—if the IRS is going to do this, some safeguard that we ought to have in place so that we do not replicate at the Federal level what may have been done in Ohio and Montana, and maybe some other places as well.

Mr. GRAHAM. I am not specifically familiar with how their programs work, but part of how we get to the check and balance is nothing goes to a collection agency without there already having been a lien filed in a courthouse somewhere in the State. That is what they get to pursue. They do not get the tax return. They do not get it just being delinquent. And we add—once it goes, it gets an additional 20-percent cost of collection fee added to it, and the agencies are paid out of that fee. The State is not taking a reduction in the tax penalty and interest that was used to create the lien originally. So there is not a bounty. In the world of tax, if I were paid a commission for how much more I got, there is clearly a problem there, and there would be in this model as well. It is a fixed percentage of that 20 percent that each collection agency gets.

Also, again, since it is a public record that goes to the collection agencies, if we make a mistake and they pursue someone who does not owe the money, it is our fault, not theirs. What we have to manage them for is abusive behavior. Again, we meet with them twice a year, and it has to be with the senior management of each of the agencies that are under contract, and I meet with them personally in that joint session to talk about what is working, what is not working, and we also follow up on every complaint that we get.

I can document that in the 20 months since we ramped up this process, only four complaints have come to my office. All four have been investigated, and it did not necessitate removing an agency from the program.

It does require a lot of time. It takes a lot of time on our folks' staff to make sure we have it right when we give the paper to them. That is where I want to put resources, because that is part of giving the taxpayer better service, is making sure we can answer their questions. We have a product line that nobody wants to buy, but we have to engage people with it.

There was a study done in our department before I ever got there about closing all our field offices. Well, if you have a product line nobody wants to do business with you and you close the field offices, you are not going to find them again forever, and that is the end of it. You have to support that, at least some accessibility and openness in the process.

Senator CARPER. Thanks.

Ms. Kelley, can you give us some insights as to what went wrong in Ohio and what went wrong in Montana and how that might guide the IRS if they are going to do this demonstration project on this private collection? How might those experiences guide us?

Ms. KELLEY. Well, in both of those situations, I, of course, have the same information as anyone who read the newspaper accounts. I do not have any of the inside information. But it was about confidentiality and disclosure of private taxpayer information and misuse of that information. And this is a huge risk when you put the kinds of information in the hands of anyone that the IRS is talking about putting in the hands of these PCAs.

IRS employees are held accountable for enforcing the language in the legislation that Congress has passed on taxpayer rights, and they are held accountable and are at risk of losing their job if they do—and, of course, in addition to any kind of criminal proceedings.

But if they lose their job, you are talking about IRS employees who—many of them are career employees. In the private collection agencies, the workforce in most of these agencies has an average tenure of 10 months on the job. This is not a huge risk to tell someone that if they do something wrong, they are going to lose their job. It is a very different environment.

IRS employees take this responsibility seriously. They know that it is their responsibility as a Federal employee and as a protector of taxpayer rights to do this. And in the pilot that was done in the late 1990s, one of the things that we learned, we know from experience, is that there were very inappropriate actions taken by the PCAs. There were phone calls made at 4 o'clock in the morning to taxpayers, harassing them about the information that was given and the collectability of the taxes that they have. And I do not see anything in place that should put taxpayers at ease that these things will not occur again.

Senator CARPER. Mr. Graham, any comments or reflections you would have on what Ms. Kelley has just presented?

Mr. GRAHAM. This may already be obvious to you. if it is not, I just want to make sure it was. When we ramped ours up, it was not a mechanism to send employees home. Everybody is still doing everything they were. There is just that much evasion going on and noncompliance going on that we had that much more paper. If you look at Georgia's economic growth and population growth and new businesses registered, it went on that kind of curve for the last 20 years, and it is still going, whether we like it or not. But our department, too, shrank, as was described at the Federal level. At some point you have got to find a different way, what I call go to market or do business, in order to close that gap, and this is the same kind of gap you are talking about here. Everything we are doing with the agencies is designed to augment what our employees are already doing. We were not at all interested necessarily, as long as we had jobs and work to do, to send anybody home. That is just one nuance, I think, that is certainly relevant to the dialogue.

Ms. KELLEY. In the IRS, what they are currently doing is not eliminating current positions. They are not sending anyone home in the IRS. It is to supplement—the way they frame it is to supplement the current workforce.

One distinction I would make is when Mr. Graham talks about a one-time hit and you do not expect this work to reoccur, there are so many uncollectible accounts in what the IRS calls its queue that they just do not have employees to assign the work to. There are so many accounts in this queue that this is not about that work ever going away.

And so when Commissioner Everson said to you earlier, in response to a question that was asked, to write him a check and he will hire these employees so that the IRS employees can do the work, I mean, that is what this is about, is that the IRS needs appropriate funding; and if IRS employees were doing this work, it would put more money back in the general treasury than is going to come to the general treasury to attack these tax gap issues than is going to come to the general treasury through PCAs. It is not

a close call that more money will go to the treasury and that IRS employees can do this work less expensively than the PCAs can.

Senator CARPER. Mr. Graham.

Mr. GRAHAM. I, too, do not believe it is going to go away forever. You are always going to have some of it. But—I am trying to think of the best way to say this. In the spirit of time, I will come back to it maybe afterward.

Senator CARPER. OK. That happens to me all the time.

I asked the Commissioner a question earlier about how the IRS incentivizes employees to come forward with good ideas that are helpful. I remember when I was Governor in Delaware, we were trying to figure out how to structure a welfare system to try to reduce the likelihood that people stay on welfare for a long, extended period of time. What we did is just invite a lot of welfare families, welfare mothers in to talk to us about their experience. We were trying to figure out how to reduce teen pregnancy, and we decided to bring a lot of young people, a lot of teenagers in to talk about boys and girls from all kinds of walks of life.

We were trying to figure out how to reduce the runoff from our poultry industry from the—the environmental runoff from all the chicken houses and stuff, and we decided to bring in the poultry farmers themselves to help us figure it out.

Are you able to—are the employees called on or are there ways to incentivize employees to help—they probably know as well as anybody else, except maybe some of the perpetrators—what is going on here and how best to control it and to reduce it. How do we incentivized that?

Ms. KELLEY. Well, I actually made a note when you asked that question of Commissioner Everson's response because I am going to follow up with him on what should be done versus what is being done.

I do not doubt for a minute he gets e-mails from employees every day with their opinions or ideas. But there really is not any formal process that invites those kinds of suggestions from employees and gives them a procedure that lets them know that it will be acted on or responded to, at least, so that it is fully considered. And there is a sense of many in the IRS, just because of the size of the agency and the layers of management, that very often when ideas do get moved forward, they do not get very far. And I believe many of them never get to Commissioner Everson or to the executives who are responsible for those programs.

So I have made myself a note to initiate a new conversation with Commissioner Everson about how we can make this more formal, more responsive, and to assure that the ideas these employees have—and I absolutely agree with you. They have ideas that will help, that could help to solve the problem, at least to take us steps forward in solving it. And we need to have a better process to allow for that input and action on it.

Senator CARPER. Good. Let me change focus again a little bit and talk about technology and how we use technology, how the folks you represent are using technology, and, Mr. Graham, the people who work on your team, how you use technology to enable them to be more effective in their job and to close that tax gap.

Ms. Kelley, I do not know if you want to take the first stab at it, but I welcome your comments.

Ms. KELLEY. Technology and the money for the technology, again, is always an issue for the IRS. Their technology budget the last couple of years, probably the last 6 years, has been cut every year. And it is a huge problem because it is blocking tools that employees need to do their jobs most effectively from putting those tools in the hands of the employees.

And, again, you mentioned the hearings and the impact that had on employees. Well, there were also some past problems with the IRS many years ago, and when Congress reviewed how past technology money was spent, you were not very happy with it. So you put some pretty strict rules in place for them, and it has been a very tight budget since. Even though I think in many ways they have delivered and done a much better job with the technology money that they are given, it is not enough money to really give them the cutting-edge technology that they need to really be able to do the best jobs possible.

Senator CARPER. Mr. Graham, how have you all been using technology to help you close your own tax gap?

Mr. GRAHAM. When I got to the department, the mantra was we are trying to get $150 or $200 million to build a whole new technology platform, and faced with a $700 million previously undisclosed deficit, that just was not going to happen at all. And so what we sought to do was to give the taxpayer relief on the very front end, to improve the customer service and shorten that transaction time, the transaction time from the second they log on to the computer from the second they start to drive in the parking lot, not just when they get up to the counter to get help. Is the information there that they need?

Also, in our sales tax platform, we determined early on that out of 130,000 sales tax returns we sent out a month, 60 percent come back with errors, and we were doing the error resolution. So our process right now is to continue to enhance our online filing, and the error resolution has to be corrected before it is submitted to the department for acceptance so that we can take the resources in doing error resolution for years and dedicate it to compliance, enforcement, and customer service of helping educate taxpayers to do things the right way if they ask for help in that process. Again, it is one of the ways to find a different way to go to market and do our business.

We are in the early—not early stages but the middle stages of doing that, of fixing that front-end customer service. And that can be done—the part that we are doing there is going to impact every online filer. There are over 2 million online filers today, and that is being done at an expense of only $4 to $5 million.

Senator CARPER. OK. I wanted to ask a question of Mr. Everson, and the question that I wanted to ask him at the end but we just did not have time was for him just to kind of go through a list of things we ought to be doing to enable the IRS to do their job more effectively. And I will ask him that for the record.

I am going to ask you that question for the record, too, Ms. Kelley, but before I do that, let me just ask if you could just mention some of the most important things that we can be doing to en-

able your members, the IRS employees to do their jobs more effectively to reduce this tax gap.

Ms. KELLEY. Well, the short answer is to start with funding, but then also to support——

Senator CARPER. And Mr. Everson made that point.

Ms. KELLEY. Yes. One of the things he and I agree on is that the IRS needs more funding. And also to support the idea that both customer service and enforcement are needed in order to really increase the compliance, which is what everyone wants, is to increase the compliance rate.

The support for IRS employees does not often come publicly, and it is something that would be welcomed by them in support for the difficult work that they are trying to do. But I would welcome the opportunity to also give you a substantive list of things that would help them do their jobs better. I will submit that for the record.

Senator CARPER. Good. We would appreciate that.

We started our vote, the first of five votes, and we are trying to enforce a more timely arrival of Senators to cast their votes. And so I am going to have to close things down here today and to head over to the floor.

I really want to thank each of you for taking time. Mr. Graham, you have come a long way from Georgia, and we appreciate the work that you all are doing, and I always like to say States are laboratories for democracy and we can learn a lot from what is going on in the States.

I appreciate what I think is a fairly good, cooperative relationship between the States and the IRS to share information. We can always do better on that front, as we know.

We have had a whole panel of folks who have been good enough to prepare for today and to come here to join us, and they are not going to have the opportunity to testify today. And I apologize for all of us that that is the case and to the extent that we have inconvenienced those panel members, we apologize. We hope to have the opportunity within the next several weeks to reschedule that panel and to invite you to come back. I think that includes representatives from GAO, from Treasury Department Inspector General for Tax Administration, and I think the National Taxpayer Advocate.

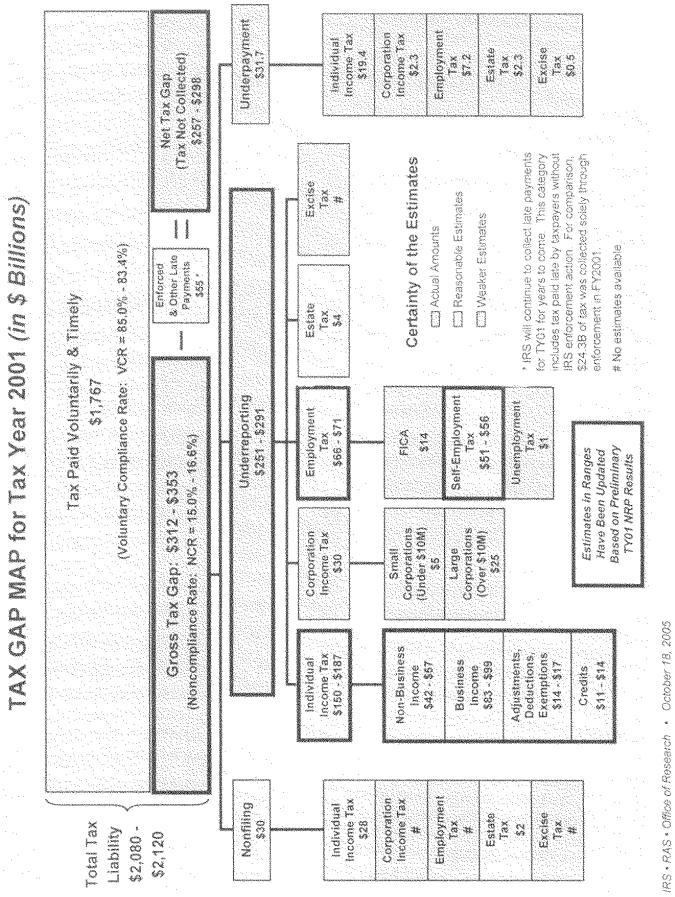
I was taught the Golden Rule to treat other people the way we want to be treated, and I do not like it when we treat folks like this. It is only because neither Senator Coburn nor I are the Majority Leader of the Senate, so we do not get to schedule these votes. But when we are, we will not schedule them to occur right in the middle of our panels for the Subcommittees that we chair. [Laughter.]

It has been a good hearing thus far, and we hope that the rest will be even more so.

Thank you very much for joining us today, and with that, this hearing stands adjourned.

[Whereupon, at 4:27 p.m., the Subcommittee was adjourned.]

APPENDIX


TAX GAP MAP for Tax Year 2001 (in $ Billions)
Total Tax Liability $2,080 - $2,120
Tax Paid Voluntarily & Timely $1,767
(Voluntary Compliance Rate: VCR = 85.0% - 83.4%)
Gross Tax Gap: $312 - $353
(Noncompliance Rate: NCR = 15.0% - 16.6%)
Enforced & Other Late Payments $55 *
Net Tax Gap (Tax Not Collected) $257 - $298
Nonfiling $30
Underreporting $251 - $291
Underpayment $31.7
Individual Income Tax $28
Corporation Income Tax #
Employment Tax #
Estate Tax $2
Excise Tax #
Individual Income Tax $160 - $187
Non-Business Income $42 - $67
Business Income $83 - $99
Adjustments, Deductions, Exemptions $14 - $17
Credits $11 - $14
Corporation Income Tax $30
Small Corporations (Under $10M) $5
Large Corporations (Over $10M) $25
Employment Tax $56 - $71
FICA $14
Self-Employment Tax $51 - $56
Unemployment Tax $1
Estate Tax $4
Excise Tax #
Estimates in Ranges Have Been Updated Based on Preliminary TY01 NRP Results
Certainty of the Estimates
Actual Amounts
Reasonable Estimates
Weaker Estimates
* IRS will continue to collect late payments for TY01 for years to come. This category includes tax paid late by taxpayers without IRS enforcement action. For comparison, $24.3B of tax was collected solely through enforcement in FY2001.
# No estimates available.
Individual Income Tax $19.4
Corporation Income Tax $2.3
Employment Tax $7.2
Estate Tax $2.3
Excise Tax $0.5
IRS • RAS • Office of Research • October 18, 2005

WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
MARK EVERSON
BEFORE
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ON THE TAX GAP
OCTOBER 26, 2005

Introduction

Mr. Chairman and members of the subcommittee, I am pleased to be here today to discuss the tax gap with you. Additionally, I would like to provide you with an overview of the steps we have been taking to reduce the tax gap and to provide you with a summary of efforts we have taken to deal with abuses of the tax system. The tax gap is the difference between the amount of tax imposed on taxpayers for a given tax 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.

This is the third time this year that I have testified on this subject. I appreciate the focus that Congress has given to this issue. The recent disaster recovery and restoration efforts taken in response to the devastating effects of Hurricanes Katrina and Rita serve to further highlight the importance of collecting the taxes that are lawfully owed. An efficient tax collection system is essential to the efficient operation of government, including appropriate Federal responses to natural disasters.

Early Estimates

Today, I will share with you results of our preliminary analysis of the compliance data recently compiled by our National Research Program (NRP). The bottom-line results are that although American taxpayers remain substantially compliant with the tax laws, the tax gap remains quite large in dollar terms. The results for Tax Year 2001 indicate that individual income tax reporting compliance may have gotten a little worse, but not alarmingly so, since 1988, the last time we performed a similar study.

Historically, there have been three types of income that are not well represented in compliance measurement audits (these are audits that are representative of the population and as thorough as possible): informal supplier income, tip income, and other unreported income that is not detected by auditors. Our detailed analysis of the NRP data will be supplemented with other data and special analyses to account more accurately for these three income types. These supplemental analyses in the past have taken several years to complete after the audit data have become available. We are applying new technologies this time, and we expect to have detailed, more reliable estimates of the tax gap available by the end of this year.

In the meantime, we have developed a set of preliminary updates to our tax gap estimates based on an initial analysis of the NRP data. We derived these estimates using a simple approach that reflects the historical magnitudes of adjustments made to the raw audit data to account for informal suppliers, tips, and other undetected noncompliance.

Our preliminary updates employ a range of estimates, reflecting different assumptions and levels of certainty. To give an idea of the magnitudes involved, our old projection of the overall Tax Year 2001 gross tax gap (i.e., for all types of tax, and all forms of noncompliance) was $311 billion, based on data from the 1980s and projected forward. Our updated estimates, incorporating data from the recently completed study, range from $312 billion to $353 billion. The range for the net tax gap (i.e., the amount of the tax gap left after enforcement efforts and collection of late payments) is from $257 billion to $298 billion. The corresponding noncompliance rate associated with our old projection was 14.9 percent, while the new estimates range from 15 percent to 16.6 percent. I want to emphasize at this stage in our analysis that these ranges are not upper and lower bounds; our final estimates could conceivably lie outside that range, and it is even more likely that our estimates for specific components of the tax gap (e.g., specific line items) will change significantly once we complete the detailed analysis. The range of estimates we are providing today also does not represent a statistically-based confidence interval, although we do plan to include such intervals with our comprehensive estimates at the end of the year.

Noncompliance takes three forms: not filing required returns on time (filing noncompliance); not reporting one's full tax liability even when the return is filed on time (reporting noncompliance); and not paying by the due date the full amount of tax reported on a timely return (payment noncompliance). We have separate tax gap estimates for each of these three types of noncompliance. Our preliminary estimates of underreporting by individuals appear to be consistent with previous studies, indicating that the underreporting portion is about 80 percent of the overall tax gap, with nonfiling and underpayment splitting the remaining 20 percent.

The National Research Program

Before providing more detail about these new estimates, I want to put them in context. I will start by summarizing the features of the new NRP data upon which the estimates are based, and then explain what the estimates do and do not include.

The NRP data that were ready for analysis in early January represent the first comprehensive reporting of compliance data since Tax Year 1988. We conducted several much narrower studies since 1988, but nothing that would allow us to update our estimates of the tax gap. All of our estimates of the tax gap in recent years have been rough projections that assume no change in compliance rates among the major tax gap components; the magnitude of these projections merely reflected growth in tax receipts in these major categories. 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. I will focus today on the first of these objectives.

Regular audits have two important shortcomings as a basis for compliance measurement. First, returns selected for regular audits are not intended to be representative. Second, the audits are not exhaustive, but instead focus on issues that appear to be most in need of checking. In the past, IRS overcame these shortcomings by conducting thorough, exhaustive audits on a representative sample of returns. From the early 1960s through 1988 we periodically conducted the Taxpayer Compliance Measurement Program (TCMP), consisting of line-by-line audits of random samples of returns, which provided us with information on compliance trends, and allowed us to update audit selection formulas. By the 1990s, however, it became apparent that we needed to find a less intrusive way to measure compliance with the tax laws. The National Research Program grew out of that need, and introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the "case building" data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, these data allowed us to focus our efforts where the return information could not otherwise be verified. This pioneering approach was so successful it is being expanded into our regular operational audit programs.

A second major NRP innovation was to introduce a "classification" process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors, referred to as classifiers, who identified the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (though sometimes with minor adjustments noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditors had to evaluate, though the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including, representatives of tax professional associations) in the design and implementation of the study. Moreover, a more focused selection process resulted in the NRP sample including around 46,000 returns—somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return. At the same time, we expect that the data collected through the NRP will be about the same quality as that collected under TCMP. A portion of the sample was designed to allow us to test the reliability of this methodology.

The new NRP data relate only to the accuracy of timely filed individual income tax returns. We are therefore able to use the data to update our estimates of just the individual income tax underreporting gap and the self-employment tax underreporting gap. All other components of our tax gap estimates remain the same projections to Tax Year 2001 that we have been using for the last few years. It is important to emphasize that the other components of the overall individual income tax gap remain unchanged. Specifically, we do not yet have new estimates for other taxes such as the corporate income tax or the estate tax. Moreover, we do not yet have a new estimate for the individual income tax nonfiling gap, though we anticipate having an update later this year. We are also not changing our Tax Year 2001 figures for the underpayment gap, because these are actual amounts tabulated from our Master File records rather than estimates or projections. (The underpayment gap is the one exception to the rule that the tax gap cannot be observed, and therefore must be estimated. That is because the underpayment gap is the amount that is reported on timely filed returns, but is not paid on time—information that is available on IRS records.)

Distinguishing the Tax Gap From Related Concepts

The tax gap is not the same as the so-called "underground economy," though there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap does not include the illegal sector of the economy, and the underground economy does not include tax noncompliance problems such as overstated deductions or improper filing status.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to complexity of the tax laws that results in ignorance, confusion, and carelessness. This distinction is important, though at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes.

The New Estimates

Our preliminary estimates of the individual income tax underreporting gap based on the new NRP data range from $150 to $187 billion, representing about half of our overall tax gap estimates of $312-$353 billion. This is consistent with the fact that the individual income tax accounts for about 46 percent of all tax receipts. Moreover, these figures are roughly in line with our earlier projections from compliance data compiled in the 1980s, though they suggest that reporting compliance among individuals has worsened slightly since Tax Year 1988. It is important to note, however, that the data represent a single point in time for Tax Year 2001 and so cannot tell us whether compliance trends today are improving or getting worse.

Preliminary NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**150-187**	**48-53%**
Understated non-business income	42-57	13-16%
Understated net business income	83-99	27-28%
Overstated adjustments, deductions, exemptions, and credits	25-30	8-9%
Self-Employment tax underreporting gap	**51-56**	**16%**
All other components of the tax gap (not updated yet)	111	
Total Tax Gap	**312-353**	
Note: Detail does not add to totals due to rounding		

As in previous compliance studies, the NRP data suggest that just over half ($83-99 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). About 30 percent ($42-$57 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $25-$30 billion came from overstated subtractions from income (i.e., statutory adjustments, deductions, and exemptions), and from overstated tax credits.

The corresponding NRP-based preliminary estimates of the self-employment tax underreporting gap range from $51 to $56 billion, and account for about one sixth 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, then, we see that individual underreporting contributes about two-thirds of the overall gross tax gap.

Early indications are that the sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study in 1988. 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). Amounts subject to third-party information reporting, but not to withholding (e.g., interest and dividend income), exhibit a somewhat higher misreporting percentage. Amounts subject to partial reporting by third parties (e.g., capital gains and mortgage interest payments) have a still higher misreporting percentage. And, as expected, amounts not subject to withholding or to third-party information reporting (e.g., sole proprietor income, and the "other income" line on the 1040) are the least "visible" and, therefore, are most likely to be misreported.

We expect to be able to provide good estimates of these misreporting rates for each line of the 1040 once we complete our detailed analysis of the NRP data by the end of this year. In the meantime, early indications are that reporting rates have remained fairly stable, with a few exceptions. First, the underreporting of net income from "flow-through" entities such as partnerships and S-corporations appears to be on the rise. This is consistent with what we have been finding in our regular audits, as taxpayers

use increasingly sophisticated abusive schemes to reduce or eliminate their tax liability. With this in mind, we are conducting our next NRP reporting compliance study on flow-through entities—not just to monitor compliance in this area, but also to help develop better audit selection methods and other creative interventions. Second, the reporting of sole proprietor income and expenses (e.g., gross receipts, bad debts, and vehicle expenses) appears to have worsened. With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may simply be swamped by the cost and complexity of meeting their tax obligations and other business requirements. Third, early indications are that taxpayers in 2001 tended to overstate their deductions somewhat more than in 1988, the last tax year for which we have comparable compliance data. Like most business income and expenses, many of these deductions are not subject to third-party information reporting.

What We Are Doing Today to Address the Tax Gap

Most Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken recently to bolster this confidence, turning briefly to each of our four Servicewide enforcement priorities.

Our first enforcement priority is to discourage and deter noncompliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap. The focus here will be Fiscal Year 2004 data because we are still compiling data for the just-completed Fiscal Year 2005.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year – double the number from 2000.
- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.
- In 2004, the number of audits of the largest businesses – those with assets of $10 million or more – finally increased after years of decline.

In addition to traditional audits, the IRS also uses computer matching of Forms W-2 and 1099s in its Information Returns Program, or document matching as it is often called. This technique is very effective for verifying income items reported on individual returns against that reported by third parties, including wages, interest, dividends and miscellaneous payments. During FY 04, the IRS closed more than 3.7 million document matching cases and collected about $2.7 billion as a result of these taxpayer contacts.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I want to discuss two important initiatives in this regard. These deal with the Son of Boss tax shelter and executive stock options.

We have continued a program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. In May of 2004, we made a settlement offer regarding the Son of Boss tax shelter, a particularly

abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed and, for most taxpayers, required a payment of penalties. I am pleased with the response to the offer. So far more than $3.7 billion in taxes, interest and penalties have been collected from the more than 1,200 taxpayers who are participating in the settlement initiative. The average taxpayer payment was about $2.9 million, with 22 taxpayers paying more than $20 million each. Processing of individual settlements continues.

Based on disclosures we have received from promoter investigations and from investor lists from Justice Department litigation, we have determined that over 1,800 investors participated in Son of Boss. We have begun our enforcement follow-up with the more than 600 investors who were ineligible or elected not to participate in the settlement initiative.

In February 2005, we announced a second important settlement initiative – this one relating to a transaction that involved executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with, and supported by, the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. Non-compliant taxpayers might have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like "how much am I going to have to pay the lawyers and expert witnesses to litigate this thing?" Moreover, going to court is a public matter. Damage to one's reputation is a potential factor. Many wealthy individuals, otherwise seen as community leaders, may not want to be identified as paying less than their fair share in taxes.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since Labor Day 2004, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the U.S. working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions which, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global world, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

We have also worked jointly with the Department of Justice to obtain civil injunctions against abusive tax scheme promoters and abusive return preparers. The Government stepped up use of civil power in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars or through other means. Currently the courts have issued permanent or preliminary injunctions against more than 130 abusive scheme promoters and abusive return preparers. An additional 50 suits have been filed by Justice seeking injunction action – 33 against scheme promoters and 17 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer's name while retaining control
- Misusing "corporation sole" laws to establish phony religious organizations
- Using frivolous "Section 861" arguments to evade employment taxes
- Claiming personal housing and living expenses as business expenses
- Filing tax returns reporting "zero income"
- Misusing the Disabled Access Credit

In addition, the IRS has over 1,100 promoter and return preparer investigations ongoing in the field; and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law.

Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners and return preparers. The vast majority of practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. The Treasury and IRS standards set forth rules governing what does and does not qualify as an independent opinion about a tax shelter.

Last year, the government won a series of court opinions on privilege. The cases confirm that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted and the President signed into law the American Jobs Creation Act of 2004. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement objective is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity.

In Fiscal Year 2004, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters – both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But, we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax-exempt and governmental entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, tax-exempt credit-counseling agencies. These organizations are granted tax-exempt status because they are supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations, instead, operate for the benefit of insiders or are improperly in league with profit-making companies. We are carefully scrutinizing these organizations. We currently have half the tax-exempt credit counseling industry -- in terms of asset size -- under examination.

Some shelter promoters join with tax-exempt organizations to create abusive shelters. The organization receives a fee from the taxpayer who is taking advantage of its tax-free status. That is an abuse of the tax exemption that our nation bestows upon charities.

It is heartening to see leading members of the non-profit community taking steps to address abuses. I particularly want to salute the Independent Sector – which earlier this year delivered a constructive report to the Senate Finance Committee. The report states that the "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be as enthusiastic about confronting abuses and the erosion of professional ethics as the non-profit community. An interesting point to note is that the report supports mandatory electronic filing of all tax returns for non-profits.

The threat to the integrity of our nation's charities is real and growing. At the IRS, we take it very seriously. We are augmenting our resources in the non-profit area. As of the end of last month, we have increased the number of our personnel who audit tax-exempt organizations by approximately 30 percent from two years earlier. If we do not act expeditiously, there is a risk that Americans will lose faith in our nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within our FY 2006 budget request.

President's FY 2006 Budget Seeks Increase in Enforcement to Address Growing Tax Gap

The President's fiscal year 2006 budget requests $10.679 billion for the IRS, a 4.3 percent increase over the fiscal year 2005 enacted level. This request represents a 1 percent decrease in Taxpayer Service and a 2 percent decrease in Business Systems Modernization, but an 8 percent increase in enforcement.

This budget includes $265 million for initiatives aimed at enhancing the enforcement of the tax laws. This request is above the increases to fund the pay raise and other cost adjustments ($182 million), for a total of $446 million for new enforcement investments and cost increases. It is important Congress fully fund these cost increases and new enforcement investments. The President's budget proposal to fund them as a program integrity cap adjustment reflects the importance of this investment to the Administration.

Currently, we do not know what our budget will be for fiscal year 2006. We are very pleased that the Senate has fully funded the President's request. The House bill provides a bit less funding, however, at the level of $10.56 billion.

We will use any additional funds for enforcement in several key ways to combat the tax gap. These investments will yield substantial results. IRS enforcement activities, coupled with late payments, recover about $55 billion of the tax gap, leaving a *net* tax gap of between $257 billion and $298 billion.

Since 2001, the tax year covered by the NRP, we have taken a number of steps to bolster enforcement. We increased our enforcement revenues by nearly 28 percent from $33.8 billion in 2001 to $43.1 billion in 2004. Audits of high-income taxpayers — those earning $100,000 or more — topped 195,000 in fiscal year 2004, which is more than double those conducted in 2001. Total audits of all taxpayers topped 1 million last year -- a 37 percent jump from 2001.

We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations. As discussed earlier, we have collected more than $3.7 billion so far in the settlement initiative for Son of Boss, a particularly abusive tax shelter.

The IRS yields more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget. In FY 2004, we brought in a record $43.1 billion in enforcement revenue – an increase of $5.5 billion from the year before, or 15 percent.

Beyond the direct revenues generated by increasing audits, collection, and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

The nearly 8 percent increase for enforcement activities in the Administration's 2006 IRS budget request, and Senate Appropriations Committee Report would increase audits of corporations and high-income individuals, as well as expand collection and criminal investigation efforts.

Program Performance

If we received the full funding provided in the President's fiscal year 2006 budget request and the Senate Appropriations Committee Report, we would anticipate the following results:

- Increase in field examinations for high-income individuals with complex returns; significant increase in collection cases processed; and closing of over 40 percent more delinquent balance-due accounts in FY 2008 than in FY 2004;
- Nearly double the audit coverage for individuals with income between $250,000 and $1 million, from 1.5 percent in FY 2004 to 2.8 percent in FY 2008;
- Auditing 15 percent more individuals earning above $1 million, from 3.4 percent projected for FY 2004 to 3.9 percent in FY 2008;
- Double the audit coverage for mid-size corporations, from 7.6 percent in FY 2004 to 16 percent in FY 2008; and
- Increased efforts to deter abusive tax shelters among corporations

Conclusion

On the whole, our system of self-assessment of tax liabilities appears to be working as well as it did in 1988. However, the new compliance data suggest that some types of income may be less accurately reported now than in the past. It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the excellent service that the taxpaying public deserves, and to maintain a strong and well-targeted enforcement presence are necessary to improve compliance rates.

While IRS enforcement efforts have lagged in recent years, that is now changing. We will continue to improve service and respect taxpayer rights. But we will also enforce the law. We won't relax until taxpayers who are unwilling to pay their fair share see that that is not a worthwhile course to follow.

Thank you very much for the opportunity to discuss the tax gap and our efforts to combat it. I am happy to take your questions.

Written Testimony of
Georgia Commissioner of Revenue
Bart Lanier Graham
Before
Subcommittee on Federal Financial Management, Government Information, and International Security
Committee on Homeland Security and Governmental Affairs
United States Senate
On the Tax Gap and Tax Compliance
October 26, 2005

Introduction

Mr. Chairman and members of the subcommittee, thank you very much for allowing me the opportunity to discuss with you the initiatives we have begun in Georgia to collect in excess of $1.6 billion in past due taxes and to insure that there is greater compliance with our laws annually. Even at the state level, tax evasion, fraud and aggressive practices have a substantial impact on state services and operations each year not to mention the perception and reality of an inequitable tax system on various taxpayers.

In order to best understand how Georgia resolved to address this issue it is important to have some background information. Governor Sonny Perdue's election in 2002 represented the first change in political party in 130 years. His commitment was, and continues to be, to bring professionalism and fairness to state government. One factor contributing to this was to appoint professionals with private sector experience who could share new practices and insight to the multitudes of intelligent, hard working legacy staff throughout state government. I was and continue to be one of the fortunate enough to be asked to serve. I truly believe that another very important aspect of our success to date is driven by my not having worked on the Governor's campaign.

My background prior to appointment includes twelve years of corporate banking and capital market services and seven years as a chief financial officer of a middle market business which included a small defense contractor, commercial bank and information technology firm. Each of the latter was being prepared for sell-off or raising private equity. After I joined the Governor's transition team, I served as Deputy Chief Financial Officer for the State of Georgia which gave me an initial six month opportunity to meet the legislative leadership. This too served me well when I was appointed Revenue Commissioner because we had established relationships such that I was believed to be a fair, reasonably intelligent and disciplined person.

Identifying the Problem

Upon my appointment in June of 2003 I began a review of the department much like I would have done with any business I financed or helped operate earlier in my career. This, I felt, was necessary for me to understand the operations of the department and the

culture. I also needed to better understand the culture and people many of whom have more than 20 years experience in public service. I found a wealth of very knowledgeable people working in a very decentralized platform of multiple divisions. Many had their own audit functions whose auditors had been working with the same taxpayers for years. This snapshot highlighted the applicability of applying some aspects of the Sarbanes-Oxley Act to a more robust system of dual accountability all the way to the commissioner's office and rotation of auditors. I also found the need to restructure the department to a functional-based platform from a tax-type platform to gain efficiencies. This allows for more cross training, retention of institutional knowledge and reduces the ability of taxpayers to "window shop" or keep asking the same question until they get the result they expect. Another way we attacked the ability of taxpayers to obtain overly aggressive tax planning was the formation of the Tax Law and Policy Division that reports to the Commissioner's Office.

Another task undertaken was to determine the quality of our assets – the known liabilities owed the State of Georgia. Upon inquiry no one could readily tell me what the known delinquencies were. After two weeks without an answer it was obvious there was a problem. After three weeks I was given a delinquency answer of $1.6 billion and greater than one million accounts. This so impressed the executive branch that many believed I was merely talking about $1.0 million or that the liabilities were not "real." Shortly after we began our initiative people became convinced.

I want to reiterate that even though Governor Perdue was managing through a significant deficit that he inherited from the prior administration there was never and continues to not be a goal to see how much money we can collect. The goal is to collect the correct amount of money from the correct obligated taxpayers. To treat everyone fairly and equitably while simultaneously insuring everyday that we do not get overzealous in our enforcement or even a perception of overzealousness is also critical. However, in order to succeed in this one must often be fairly aggressive.

A Cultural Shift

In June of 2003 many people, including career revenue employees, were pushing to rebuild the department's technology platform which goes on today. However, their approach was to seek up to $200 million and engage in a 3-4 year implementation exercise. This, to me, seemed rather illogical given the state budget deficit and priority needs. People tend to want results and relief as timely as possible. There is always time to continue to improve the new developments as long as you build with flexibility and with market based products and services rather than using legacy development.

There was also a previously unsuccessful strategy of "Help us get $5.0 million in increased appropriations and we'll collect $50.0 million in delinquencies". My perception has always been to show results with what you have and then ask for support. In this example my plan was to conservatively respond with "We're going to collect over $100 million with what we have and then ask for more assistance." I saw the significant past dues as an opportunity such that legislators facing a large deficit could not fail to

respond with support for our efforts with delinquencies exceeding $1.6 billion when they were also faced with cuts in healthcare and education.
Critical to our success in compliance is that no individual or organization would get preferential treatment over another one. Everyone is expected to get one opportunity to do the right thing after which our efforts escalate quickly. The equitable treatment applies to revenue employees who have tax checks done annually. Non-compliance regularly leads to terminations. We have also begun cross referencing W-2's for other state employees and found the need to apply fairness to non-compliant judges and legislators, as well as, other state administrators. This sends a strong message to the public which is in great support of our efforts. It is not us versus them. It is equivalent to getting dressed down by a college coach. It generally is quite humorous until the agenda turns to you.

The reorganization of the department also demonstrated that we were willing to squeeze out all non-essential functions which were differentiated by those things that were nice to have from things we had to have. This entire process was accomplished by using our own experience which not only saved the state consulting fees but also insured institutional buy-in from those who remain with the department today.

Repeatedly, I heard from managers and direct reports that "we don't have enough time, money or people to do our job". In some instances I began to understand why. We would discuss case resolution or habitual violators four to six times in the same tax year with no change in behavior because the financial gain to the taxpayer or tax professional was worth more than the repercussions. It was obvious that people couldn't get their work done because we gave our best customer service to our worst delinquents. That is, we spent the most time with our worst delinquents forcing resolution of their matters instead of focusing our attention on those taxpayers who are trying their best to fairly comply with their obligations.

My desire was to "execute ways to make taxpayers be accountable for themselves" or if not identify strategies that would engage one taxpayer against another or one industry level against the other to generate compliance. This was not intended to spur conflict but to, as I learned in capital markets, have everyone put skin in the game. For instance, if a liquor distributor knows he might have a business interruption for delivering to an unlicensed customer he will not likely engage in the activity. My desire was not to discourage consumption but to drive it across the street if need be to get compliance.

Further contributing to the delinquency was that without the previously mentioned system of dual accountability any tax examiner could place an account on hold without manager approval and without an adequate process in existence to resolve the cases in a timely manner. This too is a practice that is now managed.

It was, as I believe you have heard from Commissioner Everson, that the penalties, fines, and prosecutions simply were not strong enough to deter non-compliance. Also, relevant to Georgia's ability to get the job done is the economic and population growth that has continued to accelerate throughout my twenty year career. While Georgia's population

and registered business have at least doubled, in the last five years state funding and employees have declined well into the double digits. Further exacerbating the problem in Georgia is that no one could tell me when in the last 15 years anyone had been criminally prosecuted for tax evasion. I resolved with the attorney general that we would begin making our own cases with evidence and presenting the worst of the worst to the office of the attorney general for prosecution. This co-chairing would create the dual accountability for follow-up that is critical in all goals.

The culminating strategy had to be for the department to efficiently and timely execute a better way to go to market or, said in different way, find another way to do business. In any business, in any culture or any political ideology, if you put pressure on someone's money source, there is virtually nothing they will not do to cooperate. Our challenge has been to reduce the practice of chasing one taxpayer at a time consecutively but to motivate taxpayers to operate compliantly not only on their own tax returns and payments but at all levels of their business activity. As for the aggressiveness of tax professionals, we always make it a practice to learn who is representing who in which cases because in very short order we will see the same professionals seeking assistance for other clients. Our cooperation in each case is often influenced by the straightforwardness we obtain from taxpayers and their tax professionals.

I mentioned earlier the priority of not getting overzealous. This is particularly applicable to me as commissioner. Georgia is a very pro-business state proven recently by our corporate income tax reform of the 2005 legislative session. It is imperative that the department foster this climate. Additionally, I previously spent my entire career raising capital for companies. I have a one time opportunity for public service that I have resolved to do professionally and equitably. Anything less would earn a partisan reputation which would prohibit me from being able to associate with the kind of people I want to associate with the rest of my career, not to mention that I have a wife and young daughter and son which will require me working for many years to come.

Implementation of the Plan

Once we established the verifiable magnitude of the non-compliance problem two senior managers – Ed Many, Deputy Commissioner for Tax Administration and Bobby Lenihan, Deputy Commissioner – joined me in identifying what became a four phased collection initiative. The driving forces were to obtain results as timely as possible by transitioning the way we went about our business while enhancing customer service without infringing on anyone's due process.

Phase I centered on individual taxpayers whereby we reduced the length of time we would work with someone from 480 days to 165 days before we turned their tax lien case over to a private collection agency. This was accomplished with existing staff and existing funding. Also contributing greatly to this success was our extended participation in the Treasury Offset Program (TOPS) with the IRS.

Phase II focuses on trust taxes such as withholding and sales & use taxes. Common practices of account aging, likelihood of payment and large dollar obligations were prioritized. Again, we have shifted the collection cycle from 480 days to 245 days. Sales & Use tax in Georgia along with withholding tax abuse is significant to the point that I believe that as much as 10-12% is illegally used or uncollected annually. This extends from the level of small entrepreneurs to Fortune 1000 companies. My own father, Stewart M. Graham, who is not a tax professional, identified to me two Fortune 1000 companies with nexus in Georgia that were illegally avoiding the collection of sales tax while using mail order marketing. Upon investigation, both settlements resulted in the taxpayer remitting to the state in excess of $600,000 with agreements to comply without exception in the future.

Phase III focuses on accelerating delinquent income tax investigations, creation of an internal call center to work delinquencies, hiring of 15, first time ever, out of state auditors focused on corporate income taxes and trust taxes, and the formation of a special investigation and litigation group which focuses solely on fraudulent refund schemes of multiple returns and ineligible dependents. Other fraudulent practices are also the focus of this group. It is led by a former assistant district attorney. In the first tax season of their existence in 2005, fraudulent refunds in excess of $1.2 million were stopped. We also established a fraud hot line for people to report abuses that might warrant further inquiry. All contacts are recorded and follow-on updates are shared between divisions to build teamwork and a sense of accomplishment within the department.

Phase IV which is only in its infancy focuses on aggressive treatment of incentives and deductions. This is somewhat outside the scope of my understanding of what the federal tax gap is defined to be.

Results to Date

Total collections under these initiatives which are verifiable and outside the scope of business practices used previously total $172.5 million from November 2003 through September 2005.

The components of these efforts include but are not limited to:

Private Collection Agencies	- $40.1 million
Compliance Call Center	- $17.5 million
Alcohol License Hold	- $23.2 million
Internet Listing of Delinquents	- $18.6 million
Individual Income Tax	- $ 5.2 million
Tax Incentive Examination	- $ 3.2 million
Treasury (IRS) Offset Program	- $64.7 million

A number of the strategies employed during this initiative have included:

1. The cessation of renewing alcohol licenses to those with outstanding tax obligations. Out of 20,000 license holders in 2003, over 2,100 had outstanding obligations at the renewal date. Rather than taking 10 months to track each down and possibly get partial payment we withheld the alcohol license resulting in over 1,900 of them bringing over $11.5 million to the department within a twelve week window of renewal. The incentive is that, without licensing, the alcohol distributors in Georgia's three tier system stood to face substantial fines or suspensions if they delivered without a license being present.
2. Enhanced participation in the Treasury Offset Program (TOPS) has yielded substantial results. We are currently working on adding withholding tax compliance to this initiative.
3. Accelerated use of private collection agencies has been a significant success. While they were being used previously, the paper they received had generally been worked two or three times within the department prior to turning it over. To shift our approach to market we eliminated two non-required notice periods so that the agencies received the paper within 190 days with the paper only having been worked once, possibly twice, by the department. This increased the likelihood of greater collections by the agencies. To protect the state's interest, an additional collection fee of 20 percent is added onto the bill which is the funding source for the agencies. To protect taxpayers, all complaints of abuse are investigated and resolved. Any habitual problems with an agency will result in their removal from the program. To date, none have been removed for taxpayer treatment issues. The agencies are much happier, as well, given the growth in their collection potential.
4. Establishment of an internal call center in order to try to resolve tax obligations one final time prior to filing tax liens and referring to private collection agencies. To support 20 employees in the call center only required a $40,000 commitment.
5. In February 2004, we began posting the names of individual taxpayers with liens on the internet. No exceptions were made to protect people's identity. In May 2004, the list was expanded to include corporate officers. The list now includes 15,000 businesses and over 14,000 individuals. These are the largest of the large. The full list would be many hundreds of thousands.
6. Establishment of a special levying team to efficiently execute liquidations while minimally disrupting the operation of field offices throughout the state. This also allows for standardized treatment of taxpayers and better cross training. The focus of this activity is exclusively commercial.

Essentials for Success

Our continued expansion of these initiatives and their success necessitates the department being available to the media to explain the program's purpose and goals without compromising confidential taxpayer information. We continually have received positive feedback from the media and the public as we have been impartial and avoided any perception of being overzealous. Further success and support also requires our continual communication of our goals, practices and results to the executive branch, the legislative branch and the public.

Our long term success will continue to be driven by our resolve to initiate change. We must always treat everyone fairly, equitably and consistently with no exceptions. It is essential to continually demonstrate the magnitude of the problem and disclose certain outrageous practices that we encounter. An example of this is the recent $315 million settlement of tax claims by Georgia and 14 other states (Georgia received $39.7 million) in the MCI/WorldCom bankruptcy case in which MCI/WorldCom created huge royalty fees to an untaxed entity in exchange for "management foresight." This was a highly successful result from our perspective and the result of many hours of hard negotiations.

We also are quick to release to the public any internal abuses of non-compliance by departmental employees so that the public can see that we hold ourselves to a higher and consistent standard. Lastly, we continue to seek legislation and rewrite rules and regulations with progressive penalties so that we can deal with taxpayers "fewer numbers of times for less amount of time" and have them go away with a basic belief that they received a fair opportunity or received what they wanted.

Thank you

Thank you again for allowing me to appear before you today. We are pleased with our progress in Georgia and look forward to expanding our relationship with the IRS and other states. For me personally, this is special. Having grown up comfortably middle class with two parents of the depression era who gave me opportunities along the way, as well as numerous others who have given me opportunities such as Governor Perdue, it is especially rewarding to share some of our accomplishments – none of which would be present without the opportunities and the support and diligent work of the Georgia Department of Revenue employees who execute our mission everyday. Nothing happens without their commitment.

I will be pleased to take your questions and to appear again if I can be of further assistance.

State of Georgia
Commissioner Bart L. Graham

Compliance as the Highest Priority

State of Georgia
Commissioner Bart L. Graham

Perspective

- Became Commissioner in June 2003
- Initiated reorganization of DOR in July 2003
- Established magnitude of past due receivable problem in August-September 2003

As of September 2003, 420,693 taxpayers owed $1.6B in outstanding tax obligations dating to 1988.

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Recognition of the Problem

- Reductions in budget and staff in recent years compounded by the state's economic growth exacerbated delinquencies
- Priority was to find new ways to "do business", in essence motivating taxpayers to do the work
- Initiated strategies turning industry sectors against each other so their cash flow was at risk
- No preferential treatment
- Continuously reiterate priority to avoid reputation of being overzealous
- Resolve for fairness and accountability in tax system, made public, would have statewide support

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Cultural Change

- **Cultural redirection from "Help us get $5 million in additional appropriation and we'll collect $50 million" to "We're going to collect over $100 million with what we have and then ask for more assistance"**
  - Legislators could not fail to respond with past dues exceeding $1.6 billion
  - The reorganization showed we were willing to squeeze out all non-essential functions
- **Cultural shift from "We don't have enough time, money or people to do our job" to "Execute ways to make taxpayers be accountable for themselves"**
- **DOR gave its best customer service to the worst tax delinquents**
- **If you put pressure on someone's money source, there is nothing they won't do to cooperate**

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Developed 4-Phase Collection Initiative Program

- **Phase I**
  1. Individual taxpayers
  2. Reduce time from 480 days to 165 days to get delinquent accounts into the hands of private collection agencies
  3. Used existing staff and funding
- **Phase II**
  1. Trust accounts (withholding and sales & use tax)
  2. Emphasis on large dollar, newer delinquent accounts with high probability of collection
  3. Reduce collection cycle from 480 days to 245 days

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- **Phase III**
  1. Increase/accelerate delinquent income tax investigations
  2. Establish task force priorities to work delinquent accounts
  3. 15 additional out of state funded auditor positions in FY 2006 budget
  4. Formation of a special investigation and litigation group to aggressively scrutinize refund schemes of multiple returns and ineligible dependents

- **Phase IV**
  1. Establish greater enforcement presence in tax incentive area
  2. Comprehensive review of incentives taken by companies

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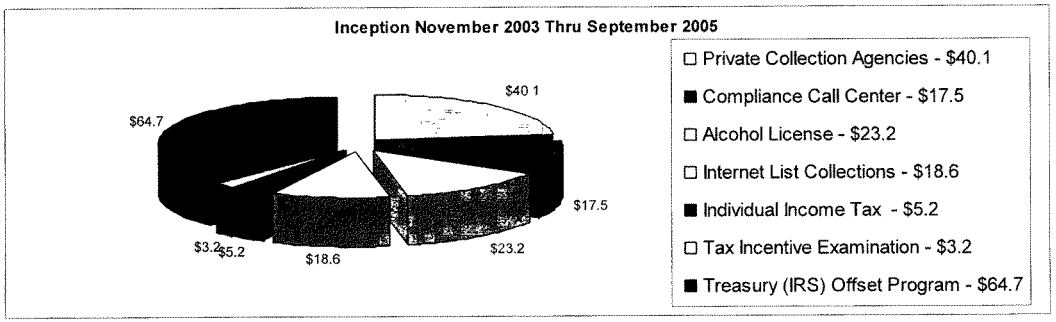

Total Collections from Initiative = $172.5 Million

Execution of Plan

- **Stopped Renewing Alcohol License of Those With Outstanding Tax Obligation**
  1. Initiated October – December 2003
  2. As of September 30, 2005 collected $23.2M
- **Treasury Offset Program**
  1. Increased participation in program in both 2003 and 2004
  2. As of September 30, 2005 collected $64.7M
- **Private Collections Agencies**
  1. Get accounts to PCAs faster
  2. As of September 30, 2005 collected $40.1M

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- **Call Center**

  1. New final effort to resolve debt prior to fifa and private collection agencies
  2. As of September 30, 2005 collected $17.5M
  3. Invested $37,800 to establish this group

- **Internet Posting of Tax Lien Filing**

  1. Began posting names of individuals in February 2004, no exceptions made
  2. May 2004, expanded list to include names of corporate officers
  3. List now contains 14,894 businesses and names of 14,106 individuals and corporate officers
  4. As of September 30, 2005 collected $18.6M

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Commissioner Bart L. Graham

New Organizations

- **Special Levying Team**
  1. Manage and resolve delinquent accounts
  2. Liquidation of unsolvable delinquent accounts, commercial only
  3. Five-member team
  4. Train other agents
  5. Allows field office staff to stay on mission

- **Litigation & Special Investigation Division**
  1. Initial interest in direct deposit income tax fraud
  2. Expand investigations to include all tax types – notably trust taxes
  3. Build cases for prosecution
  4. Maintain a good relationship with the Attorney General's office

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General Comments

- **Be available to media to explain program's purpose and goals**
- **Positive feedback from media and public**
- **Continually communicate goals, objectives and results to administration, public and legislative branch**

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Commissioner Bart L. Graham

Increasing Visibility of Compliance Efforts

"State going after tax deadbeats"
Atlanta Business Chronicle – 9/22/2003

"Official: Thousands of liquor license holders owe back taxes"
Associated Press – 10/8/2003

"State's delinquent tax list grows"
Calhoun Times – 3/24/2004

"Not Paying state taxes? You're on the web"
Camilla Enterprise – 5/25/2004

TV Coverage of Internet Listing of Tax Delinquents
CBS Evening News – 4/14/2004

"Let there be no refuge when state employees ignore their tax bills"
Athens Banner-Herald – 7/13/2004

"State attempts to collect unpaid use taxes"
Atlanta Business Chronicle – 8/20/2004

"Alcohol seized from site of 2 shootings"
Atlanta Journal & Constitution – 10/22/2004

Internet Listing of Tax Delinquents Featured on National TV
Fox Cable News – 7/6/2004

State of Georgia
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Essentials for Success

- Treat everyone fairly, equitably and consistently
- Be resolute in initiating change
- Demonstrate the problem to the executive branch, the legislative branch and the public to drive it home regularly
- Establish and maintain a clear mandate so the compliance priority cannot be publicly ignored
- Demonstrate you hold your own department to a higher standard and a consistent standard
- Rewrite rules, regulations and install progressive penalties

Statement of
Colleen M. Kelley
National President
National Treasury Employees Union

"Uncollected Taxes: Can We Reduce the $300 Billion Tax Gap?"

October 26, 2005

Senate Homeland Security and Governmental Affairs
Subcommittee on Federal Financial Management,
Government Information, and International Security

Chairman Coburn, Ranking Member Carper, and members of the Subcommitte, my name is Colleen Kelley and I am the National President of the National Treasury Employees Union (NTEU). As you know, NTEU represents 150,000 federal employees in 30 federal agencies and departments, including the men and women who work at the Internal Revenue Service. I appreciate you giving me the opportunity today to present NTEU's recommendations with regard to the tax gap and tax compliance.

My message today is simple: the IRS needs more federal employees on the frontlines of tax compliance and enforcement to help it close the $350 billion tax gap. Rather than move forward with its plans to drastically cut customer service in order to expand its enforcement role, the IRS needs to strike a balance between offering adequate opportunities for taxpayers to voluntarily comply and enforcing the tax code. NTEU agrees with GAO's recent tax gap report (GAO-05-753) that a more regular compliance assessment is needed if the IRS wishes to obtain a clearer picture of the extent of the tax gap. But I would emphasize that the IRS must determine those factors which encourage and enable taxpayers to voluntarily comply as well as determine reasons for noncompliance.

The IRS also ought to use its trained workforce to collect all delinquent taxes when voluntary compliance fails. These are two areas where the IRS can achieve greater compliance and enforcement by utilizing the knowledgeable and skilled workers currently employed by the IRS. But if Congress is serious about closing the tax gap, then more frontline employees are needed in order to achieve this goal.

Budget Cuts

While NTEU agrees with IRS' goal of enhancing tax compliance and enforcement, we don't agree with the approach of eliminating front-line customer service employees in order to pay for additional compliance efforts. As the number of tax returns continues to grow, the number of IRS employees continues to shrink. As the Oversight Board pointed out in its 2003 Annual Report, IRS workload has increased by 16 percent while at the same time the number of full time equivalent employees has decreased by 16 percent from 1999 to 2002. This is caused by a number of circumstances, including an increasingly complex tax code and an increasing number of tax returns—paper as well as electronic returns. This has led to a serious decline in the size of the IRS workforce as a way to cope with increasing budgetary demands. Combined Collection and Examination function enforcement staff declined from 25,000 at the beginning of FY 1996 to 16, 000 at the end of FY 2003, a 36 percent decline.

In its FY 2006 IRS Budget/Special Report, the IRS Oversight Board stated that it "agrees that investing in enforcement does pay for itself many times over, not only in increased revenues but by reinforcing the belief that all taxpayers are paying their fair share."

Also, the IRS should look at the management to bargaining unit employee ratio to find much needed resources for additional collection work. Although the number of frontline employees who do the work at the IRS has decreased by 5.1 percent since 2000, the number of managers who supervise these employees has *increased* by 1 percent over this same period. If the IRS decreased the number of managers and management officials at the same rate as it has decreased its rank and file employees, the Agency could put the savings toward bolstering Collections work.

As Congress considers ways to address the growing federal deficit, I urge you to avoid any across-the-board cuts to the IRS budget. The IRS is a revenue-generating federal agency. Any across-the-board funding cuts will hamstring the Agency from fulfilling its tax enforcement mission. IRS needs more resources if it is expected to seriously address noncompliance and the tax gap. By providing the IRS' full funding request, the IRS can ensure that other federal programs will have the necessary resources to keep the federal safety nets strong and solvent in times of crises.

Customer Service

Congress must continue to reject IRS' plans to implement draconian cuts to customer service. Customer service is one half of the compliance equation. The IRS' plan to close 67 Taxpayer Assistance Centers (TACs) across the country is counterproductive to the mission of the IRS. This plan will exacerbate—not shrink—the tax gap. IRS Taxpayer Assistance Centers are taxpayers' frontline source for personal, face-to-face tax help. Taxpayers who have complex issues, need to resolve a tax problem, or are more comfortable talking with someone in person can visit a local Taxpayer Assistance Center. IRS representatives in these offices can help with inquiries or adjustments to tax accounts, payment plans for those who owe tax and cannot pay the full amount, questions about IRS letters and notices, and levies on wages or bank accounts.

Seniors, who rely on face-to-face contact more than younger taxpayers, will be forced to travel farther distances in order to get the tax assistance they need if the IRS follows through with its cuts to customer service. This also means that minorities and low-income taxpayers, who rely on the Centers to help with language barriers, the earned-income tax credit and general tax preparation, will also see the tax services they rely on cut.

As Janet Spragens, law professor and director of American University College of Law's Federal Tax Clinic, notes in her testimony before the IRS Oversight Board (February 1, 2005):

> *"...these taxpayers, many of whom have limited or no proficiency in English, are generally not part of the information age. They are not Internet connected...They tend to be helped better through local walk-in offices and opportunities for face-to-face meetings than with an organizational structure based on specialization of function, remote offices, mailed documents, telephone trees with automated selections and electronic transfers."*

Earlier this year, the Treasury Inspector General for Tax Administration Russell George stated before the Senate Transportation, Treasury, HUD Appropriations Subcommittee (April 7, 2005), "TIGTA believes this information is insufficient to draw conclusions on the capability and likelihood that taxpayers who have used these centers in the past will be willing to use alternative methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing TACs."

The 2004 IRS Oversight Board Tax Compliance Study found that "the most heavily relied upon source of tax information and advice are IRS representatives" (82 percent see them as very/somewhat valuable). The study further shows that more than 90 percent of those surveyed said that IRS customer service is either very or somewhat important to them.

The statements from these reliable sources point to one conclusion: maintain customer service options for taxpayers. Both chambers of Congress have also come to the same conclusion with the language passed in H.R. 3058, the Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006 which temporarily prevents cuts to customer service. Customer service is a critical part of the compliance equation and the IRS must not be allowed to slash customer service this year, or next year, for the sake of bolstering enforcement.

Private Tax Collection

NTEU strongly opposes the Administration's plan to privatize IRS debt collection, as authorized by Congress last year in H.R. 4520, the American Jobs Creation Act of 2004. Under the statute, the IRS would be permitted to hire private sector debt collectors and pay them a bounty of up to 25 percent of the money they collect. NTEU opposes this short-sighted proposal, anticipates its complete failure as witnessed in a similar 1996 pilot program and will continue to work towards its repeal.

Last year, the House signaled its bipartisan disapproval of privatizing tax collections by passing legislation that would prevent the program from being authorized; however, under pressure from the administration, the language was removed in conference committee.

Representatives Rob Simmons (R-CT) and Chris Van Hollen (D-MD) introduced H.R. 1621, The Taxpayer Protection Act of 2005. The legislation would repeal the IRS' recently enacted authority to hire private debt collectors to collect tax debt. The bill currently has sixty-five bipartisan cosponsors. The Taxpayer Protection Act would undo a serious mistake and NTEU strongly supports this legislation.

Proposals to allow private collection agencies to collect taxes on a commission basis have been around for a long time. As far back as 1986, the Reagan administration

opposed the concept of privatizing tax collections. The Treasury Department warned then of considerable adverse public reaction to such a plan, and emphasized the importance of not compromising the integrity of the tax system, which is a longstanding inherently governmental function. President Reagan's Administration said this about such a proposal:

> *"The Department strongly opposes contracting out the collection of taxes because it is likely to result in considerable adverse public reaction. The public must be assured at all times that the person collecting taxes derives no personal benefits from that activity and that the integrity of the tax system will not be compromised." (Treasury Department Statement to the House Judiciary Committee, August 8, 1986).*

The IRS' proposal would risk the loss of confidentiality of millions of taxpayers' private information, would provide incentives for the use of abusive tactics by private debt collectors, and would cost U.S. citizens much more money than if IRS employees did the job. A two-year pilot project in 1996 was so unsuccessful it was cancelled after one year. The pilot project lost money, did not provide adequate protection of sensitive taxpayer data and allowed hundreds of taxpayers to be called outside of the times set by the Fair Debt Collection Practices Act—including calls at 4:19 a.m. (IRS Internal Audit Report No. 080805, December 19, 1997).

IRS Employees

IRS Collections employees have made considerable progress over this past year. In fact, Collections has already closed 100,000 more Taxpayer Delinquent Accounts (TDAs) than expected this year. The IRS has reported to NTEU that the successes of the Collection work increases is attributable to the employees approaching cases strategically, and taking multiple, parallel actions where available. NTEU is confident that the quantity and quality of work performed by the Collections employees will only continue to improve if more resources are devoted to Collections work. However, taking work away from IRS Collections and handing it over to private collection agencies (PCAs) could hinder the momentum and continuity of the Collections team.

The National Taxpayer Advocate Nina Olson has also expressed her concerns about handing this work over to PCAs in lieu of keeping it in-house. In her "Fiscal year 2006 Objectives Report to Congress" Ms. Olson stated, "the National Taxpayer Advocate has significant concerns about supplanting the trained professionals at the IRS with private debt collectors. A primary concern is the quality and quantity of training received by IRS employees versus the training received by private collection representatives." Although the IRS has attempted to convince skeptics that the PCAs will receive adequate training, you simply cannot compare the years of dedicated service and successful performance of IRS employees to the temporary jobs of private collection agency employees. No amount of training can replace the institutional knowledge and respect for tax compliance and enforcement exhibited by IRS employees.

Problems with PCAs

The IRS will point to state tax revenue agencies that have contracted out state tax collection work to demonstrate successful privatization of tax collection work. However, what the IRS fails to mention is all of the problems that states have faced with private collection agencies. Just last year, an Ohio news station uncovered hundreds of documents that revealed the names, addresses and Social Security numbers of Ohio taxpayers and consumers in twenty-one other states. A private collection agency (PCA) reportedly left hundreds of pieces of confidential taxpayer information in a dumpster in the back of its office in Columbus, Ohio despite the agency's claims that it takes precautions to shred such information. The Ohio Attorney General's office canceled its contract with the PCA.

This past summer, the state of Montana also canceled its contract to collect state tax revenue because of numerous complaints from Montana residents of rude behavior from the contractor's employees. But the contract wasn't cancelled before the company walked away an18.9 percent bounty—courtesy of Montana taxpayers. This should sound familiar as it is the exact same payment plan the IRS has proposed to its PCA contractors.

A Federal Trade Commission (FTC) report to Congress confirming skyrocketing consumer complaints against debt collectors should make the Internal Revenue Service (IRS) abandon its plan to turn over the personal and sensitive information of taxpayers to this most complained-about industry in America. According to the FTC annual report to Congress on the Fair Debt Collection Practices Act, third-party debt collectors generated 58,687 consumer complaints to the FTC last year—fully 17 percent of all complaints filed with the FTC last year, and a sharp increase from the 12.6 percent the year. This represents a 34.9 percent level of growth in complains about third-party collectors in 1994. Even more striking though, is FTC's own belief "that the more than 58,000 consumers who complained last year is only a relatively small percentage of people who have problems with debt collectors. Most people simply do not tell the FTC." Certainly, this problem will only worsen once third-party debt collectors are allowed to go after delinquent U.S. taxpayers.

Case Selection and Security Technology

According to GAO's May 2003 testimony before the House Transportation-Treasury Appropriations Subcommittee (GAO-03-732T), one major concern the IRS must address prior to implementing tax collection outsourcing is the ability to identify "delinquent debts with the highest probability of resolution through PCA contacts. Earlier pilot efforts to study the use of PCAs in 1996 and 1997 were hindered, in part, because the IRS was unable to do this...While IRS proposes using the "case selection analytics" to identify appropriate cases, the analytical model has not been developed."

It appears as though the IRS has yet to address case selection even though contracts are scheduled to be awarded next year. According to the IRS' February 15,

2005 "Filing and Payment Compliance Modernization Briefing: The Use of Private Collection Agencies," there are five major issue areas that still need to be addressed before handing work over to the PCAs . One of the issue areas is selecting the workload for PCAs (called Filing and Payment Compliance), which will be part of the Business Systems Modernization Program (BSM). The IRS has experienced cost-overruns and major delays with the BSM contractor. Given its track record with technological innovation, the IRS cannot reasonably expect to provide case selection technology anytime soon. And as NTEU understands, systems being developed that are supposed to predict which cases are most appropriate to turn over to PCAs will not be available until 2011—long after the cases are handed over to the PCAs. Since case selection was a major obstacle for the IRS in its 1996 pilot program, the IRS should guarantee Congress and U.S. taxpayers that case selection technology is in place prior to handing over any work to the PCAs.

Furthermore, the IRS does not have the technology in place to ensure that taxpayer information is kept secure and confidential when it is handed over to the PCAs. The IRS expects to hand over taxpayer information, including Social Security numbers, to the private collection companies.

A serious lack of contractor oversight at the IRS will jeopardize the confidentiality of sensitive taxpayer information. In March 2004, the Treasury Inspector General for Tax Administration (TIGTA) noted that the IRS is still unable to oversee its contractors and ensure that sensitive taxpayer data is secure. TIGTA reports, "Contractor personnel assigned to an IRS modernization project committed numerous security violations that placed IRS equipment and taxpayer data at risk. In some cases, contractors blatantly circumvented IRS policies and procedures even when security personnel identified inappropriate practices. IRS employees did not carry out their responsibilities for ensuring adequate security on contractor workstations and servers and for overseeing contractor activities." (TIGTA Audit #200320010).

In GAO's report, "Internal Revenue Service Needs to Remedy Serious Weakness over Taxpayer and Bank Secrecy Act Data," (GAO-05-482), GAO discovered that the IRS has failed to implement 21 of 53 previously reported security weaknesses found in GAO's 2002 IRS security review. Furthermore, GAO found an additional 39 new information security control weaknesses that would impair the IRS' ability to ensure the confidentiality and integrity of sensitive taxpayer data. The primary reason for these security weaknesses is due to IRS' failure to implement an agency-wide information security program to effectively protect the taxpayer data. The Agency has failed to provide specialized security training to employees with significant security responsibilities—including government contractors! The IRS has also failed to establish a process to periodically test and evaluate its systems.

If the IRS does not have the systems in place to protect sensitive taxpayer and financial data currently, the flaws in security will only be made worse by hiring private contractors to handle IRS collections work.

Funding Source

One of the most often heard arguments in favor of the use of private collection agencies is that if they are paid out of the proceeds of what they collect, it increases the IRS' enforcement capabilities without having to increase appropriations. Numerous Congressional supporters said they would prefer to have tax collection done by federal employees, but would go along with the use of private collection agencies solely because it avoids the difficult issue of getting Congress to approve additional appropriations for the IRS.

The statute that gives the IRS the authority to use PCAs allows 25 percent of collected revenue to be returned to the collection companies as payment and 25 percent to be retained by the IRS for enforcement efforts, thereby circumventing the appropriations process altogether.

There is nothing magical about revenues collected by private collection companies. If those revenues could be dedicated directly to contract payments and IRS enforcement efforts, there is no reason some small portion of other revenues collected by IRS employees couldn't be dedicated to IRS enforcement efforts. This would allow for increased enforcement by IRS employees, which most people indicate is the preferable route and eliminate large payments (up to 25% of collections) to private collection companies, significantly increasing net revenue to the General Treasury. While legislation would be required to allow for this kind of dedication of revenue, I believe the precedent has now been set with the private collection agency funding provisions. Congress should consider supporting this approach as a common sense way to make real progress in closing the tax gap, lowering our deficits and making more funding available for our Nation's critical needs.

Privatizing tax collection is the wrong approach for the IRS and is not the most efficient or effective way to decrease the tax gap or increase taxpayer satisfaction. This plan will merely make confidential taxpayer information vulnerable to fraud and abuse, anger U.S. taxpayers who are approached by the PCAs, and cost the U.S. government more money than if the work were left in the capable hands of IRS employees.

Conclusion

Frontline IRS employees are the best defense against an increasing U.S. tax gap. But it is up to Congress to provide the funding necessary for these employees to do their job. Then, it is up to the IRS to utilize these employees to their fullest potential. Without a doubt, rank and file employees are committed to working with management to increase efficiency and customer satisfaction while decreasing the U.S. tax gap. NTEU is undoubtedly committed to striking a balance between taxpayer satisfaction, business results and employee satisfaction. I invite urge Congress to join us in this endeavor.

I thank you for holding this important hearing today. NTEU supports and offers assistance in your mission to shrink the U.S. tax gap.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U. S. Senate

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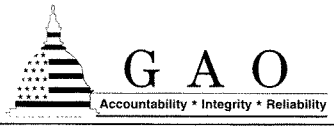
TAX GAP

Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance

Statement of Michael Brostek, Director
Strategic Issues



GAO-06-208T

October 26, 2005

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-06-208T, a testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

TAX GAP

Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance

Why GAO Did This Study

Long-term budget simulations by GAO and others show that we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. Reducing the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—could help the nation cope with these long-term fiscal challenges. The tax gap arises through the underreporting of tax liabilities, underpayment of taxes due or "nonfiling" of required tax returns.

This testimony discusses the findings of GAO's recent tax gap report. It addresses the significance of reducing the tax gap, measuring the extent of the tax gap, collecting data on reasons why noncompliance occurs, and the Internal Revenue Service's (IRS) strategies for reducing the tax gap.

What GAO Recommends

GAO's July 2005 report recommended that IRS develop plans to periodically measure tax compliance; take steps to improve its data on the reasons why taxpayers do not comply; and establish long-term quantitative goals on voluntary compliance levels, starting with individual income tax underreporting and total tax underpayment.

In commenting on a draft of the report, IRS agreed with GAO's recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-208T.

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

IRS's recent estimate of the tax gap in 2001 ranged from $312 billion to $353 billion. IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap of $257 billion to $298 billion. Reducing the tax gap will be challenging given persistent levels of noncompliance. Still, given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from $25 billion to $50 billion or more in additional revenue annually.

The tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. These strategies could include simplifying the tax code, providing quality service to taxpayers, and enhancing enforcement of tax laws by using tools such as tax withholding and information reporting.

Regularly measuring compliance is also critical to IRS's ability to reduce the tax gap. A significant part of IRS's tax gap estimate is based on recently collected data on individual income tax reporting compliance. However, other areas of the tax gap rely on old data and outdated methodologies. IRS does not have approved plans, with one exception, to collect more current compliance data covering the various components of the tax gap.

Although it can be challenging to develop, data on the reasons why taxpayers do not comply with the tax laws could help IRS more effectively tailor its efforts to reduce noncompliance. IRS has begun to capture data on the reasons for noncompliance, but it has concerns with the data. Although IRS is developing a system intended to capture better examination data, it does not have specific plans to develop better data on the reasons for noncompliance.

IRS's strategies for reducing the tax gap involve improving taxpayer service and enforcing tax laws, but do not have a clear focus on quantitative long-term goals or results measurement. Establishing clear goals and measuring progress toward them would be consistent with results-oriented management principles and would provide IRS with a solid base upon which to develop a more strategic approach to reducing the tax gap.

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to discuss the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—and how reducing that gap can help the nation cope with its large and growing long-term fiscal challenges. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap from $312 billion to $353 billion for tax year 2001.[1] IRS estimated that it would eventually recover some of this amount through late payments and IRS enforcement actions, resulting in an estimated "net" tax gap for 2001 from $257 billion to $298 billion.[2] The tax gap arises when taxpayers intentionally or unintentionally fail to comply with the tax laws. Their failure to pay taxes increases the burden of funding the nation's commitments on those taxpayers who voluntarily pay their taxes.

Mr. Chairman, as I know you and the Comptroller General have discussed in the past, confronting the nation's long-term fiscal challenge will require nothing less than a fundamental review, reexamination, and reprioritization of all major spending and tax policies and programs that may take a generation or more to resolve. Simply put, our nation's fiscal policy is on an imprudent and unsustainable course. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that over the long term we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations. While our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap should be one part of a broader effort to repair the nation's fiscal health.

My remarks are based on our previous work on a variety of issues, in particular the Comptroller General's recent testimony and our report on

[1]IRS's most recent estimates of the tax gap are preliminary, and as such, IRS presents them as ranges.

[2]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

reducing the tax gap.[3] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Reducing the current tax gap would contribute to our fiscal sustainability while simultaneously improving fairness for those citizens who fully and timely meet their tax obligations but must be done with multiple strategies over a sustained period.
- Regularly measuring the extent and nature of noncompliance is critical to effective efforts to reduce the tax gap given changes in the economy and tax law, but IRS does not have approved plans, with one exception, for obtaining and maintaining more current compliance data covering the various components of the tax gap beyond tax year 2001.
- Collecting data on the reasons why noncompliance occurs can help IRS more effectively tailor its efforts to improve compliance. However, IRS has no specific plans to gather better data than it already collects.
- Finally, IRS's strategies for improving compliance do not have the clear focus on quantitative long-term goals and results measurement that are associated with high-performing organizations and that are incorporated into the statutory management framework Congress has adopted.

In our July 2005 report on reducing the tax gap, we made recommendations that IRS develop plans to periodically measure tax compliance, take steps to improve its data on the reasons why taxpayers do not comply, and establish long-term, quantitative goals for voluntary compliance levels with an initial focus on individual income tax underreporting and total tax underpayment. Taken together, these steps can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance, improve the efforts, and make progress on reducing the tax gap. The Commissioner of Internal Revenue agreed with our recommendations, highlighted challenges associated with

[3]GAO, *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), and *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).

them, and commented on various steps IRS would take to implement each recommendation.

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 timely and accurately paid 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 timely.[4] Estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers.

IRS develops its tax gap estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely complied with their tax obligations. That rate is then used, along with other data and assumptions, to estimate the dollar amount of taxes not timely and accurately paid. For instance, IRS recently estimated that for tax year 2001, from 83.4 percent to 85 percent of owed taxes were paid voluntarily and timely, which translated into an estimate gross tax gap ranging from $312 billion to $353 billion.

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.[5] Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.[6]

IRS has a strategic planning process through which it supports decisions about strategic goals, program development, and resource allocation.

[4]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 timely.

[5]GAO, *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001).

[6]GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002).

Under the Government Performance and Results Act of 1993 (GPRA),[7] agencies are to develop strategic plans as the foundation for results-oriented management.

Reducing the Tax Gap Could Improve the Nation's Fiscal Position but Will Require Multiple Strategies

Given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from $25 billion to $50 billion or more in additional revenue annually.[8]

However, reducing the tax gap will be challenging given persistent levels of noncompliance.[9] The tax gap must be attacked on multiple fronts and with multiple strategies on a sustained basis. For example, efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations.[10] For instance, the multiple tax preferences for education assistance might increase taxpayers' burden in understanding and complying with the rules associated with these options. In our July 2005 report on postsecondary tax preferences, we found that hundreds of thousands of taxpayers do not appear to make optimal decisions when selecting education-related tax

[7]Pub. L. No. 103-62 (1993).

[8]Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance. 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 simply because the amount of tax that should be paid has been reduced, even if the level of compliance remains unchanged.

[9]Recognizing these challenges, we have long been concerned about tax noncompliance and IRS's efforts to address it. Since 1990, we have had various aspects of tax noncompliance on our high-risk list, and this year we have affirmed our broad concern by consolidating two prior high-risk areas into one—Enforcement of Tax Laws. See GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: Jan. 2005).

[10]GAO's report, *Understanding the Tax Reform Debate*, discusses a number of topics, such as the growing complexity of the current tax system, that tax experts have identified as those that should be considered when evaluating tax policy. See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: Sept. 2005).

preferences.[11] One explanation of these taxpayers' choices may be the complexity of postsecondary tax preferences, which experts have commonly identified as difficult for tax filers to use. Also, simplification may reduce opportunities for tax evasion through vehicles such as abusive tax shelters. However, for any given set of tax policies, IRS's efforts to reduce the tax gap and ensure appropriate levels of compliance will need to be based on a balanced approach of providing service to taxpayers and enforcing the tax laws.

Providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. One method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements.[12] For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[13]

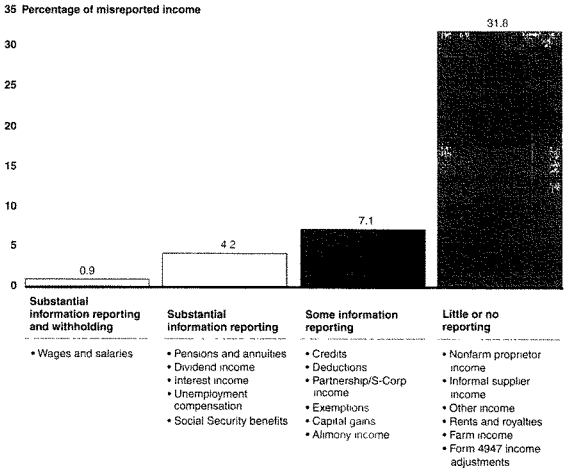
In terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. In particular, as figure 1 shows, a pair of tools have been shown to lower levels of noncompliance: withholding tax from payments to taxpayers and having third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Preliminary findings from NRP indicate that more than 98.5 percent of these types of income are accurately reported on individual returns.

[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/T-GGD-97-35.

[13]GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

Figure 1: Taxpayer Noncompliance Categorized by Amount of Withholding and Information Reporting, 1992



Source: IRS

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:[14]

- Requiring tax withholding and more or better information return reporting by organizations that make payments to independent contractors for services provided.[15]

[14]GAO, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

[15]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

- Requiring information return reporting on payments made to corporations for services provided.

- Require that information returns dealing with capital gain income report the purchase price, or other cost basis data, as well as the sales price for stocks and bonds.

Although withholding and information returns are highly effective in encouraging compliance, such additional requirements generally impose costs and burdens on the businesses that must implement them. However, continued examination of opportunities to expand information reporting and tax withholding has the potential to increase the transparency of the tax system and the level of compliance.

Finally, making progress on closing the tax gap requires that the tools and techniques being used to promote compliance are evaluated to ensure that they actually are effective. IRS evaluates some of its efforts to assess how well they work—perhaps most notably, its current effort to test new procedures designed to reduce noncompliance with the Earned Income Tax Credit[16]—but misses other opportunities. For example, we reported in 2002 that the effectiveness of the Federal Tax Deposit Alert program—a program that since 1972 has been intended to reduce delinquencies in paying employment taxes—could not be evaluated because IRS had no system to track contacts IRS made with delinquent employers.[17]

[16]GAO, *Earned Income Credit: Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete*, GAO-03-794 (Washington, D.C.: Sept. 30, 2003), and *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, But Tests and Evaluation Plans Were Not Fully Documented*, GAO-05-92 (Washington, D.C.: Dec. 30, 2004).

[17]GAO, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

Regular Compliance Measurement Can Support Informed Decisions to Reduce the Tax Gap, but IRS Lacks Approved Plans for Such Measurement

Regularly measuring compliance can offer many benefits, including helping IRS identify new or growing types of noncompliance, identify changes in tax laws and regulations that may improve compliance, more effectively target examinations of tax returns, understand the effectiveness of its programs to promote and enforce compliance, and determine its resource needs and allocations.[18] For example, by analyzing 1979 and 1982 TCMP data, IRS identified significant noncompliance with the number of dependents claimed on tax returns and justified a legislative change to address the noncompliance. As a result, for tax year 1987, taxpayers claimed about 5 million fewer dependents on their returns than would have been expected without the change in law.

Tax compliance data are also useful outside of IRS. Other federal agencies and offices use compliance data for tax policy analysis, revenue estimating, and research. Further, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[19] Without current compliance data, IRS has limited capability to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources.

Underreporting Accounted for Most of the Tax Gap Estimate

Using its recently collected compliance data, IRS has estimated that underreporting of individual income taxes represented about half of the tax gap for 2001 (the estimate ranges from $150 billion to $187 billion out of a gross tax gap estimate that ranges from $312 billion to $353 billion), as indicated in table 1.

[18]GAO, *Tax Administration: IRS' Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993).

[19]GAO/GGD-93-52.

Table 1: IRS's Preliminary 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	$150-$187	$30	$66-$71	$4	No estimate	$250-$292
Underpayment	19	2	7	2	1	$32
Nonfiling	28	No estimate	No estimate	2	No estimate	$30
Total	$198-$234	$32	$73-$78	$8	$1	$312-$353

Source: IRS.

Note: Figures may not sum to totals due to rounding

Within the underreporting estimate, IRS attributed about $150 billion to $187 billion, or about 50 percent of the total tax gap, to individual income tax underreporting, including underreporting of business income, such as sole proprietor,[20] informal supplier,[21] and farm income (about $83 billion to $99 billion); nonbusiness income, such as wages, interest and capital gains (about $42 billion to $57 billion); overstated income adjustments, deductions, and exemptions (about $14 billion to $16 billion); and overstated credits (about $11 billion to $14 billion). Underreporting of corporate income tax contributed an estimated $30 billion, or about 10 percent, to the 2001 tax gap, which included both small corporations (those reporting assets of $10 million or less) and large corporations (those reporting assets of over $10 million).[22]

Employment tax underreporting accounted for an estimated $66 billion to $71 billion, or about 20 percent, of the 2001 tax gap and included several taxes that must be paid by self-employed individuals and employers. Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. Employers

[20]Sole proprietors are self-employed individuals who should file a Schedule C with their individual tax return to report profits and losses from their business. 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.

[21]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 a Schedule C.

[22]GAO-05-753.

are required to withhold these taxes from their employees' wages, match these amounts, and remit withholdings to Treasury at least quarterly. Underreported self-employment[23] and employer-withheld employment taxes respectively contributed an estimated $51 billion to $56 billion and $14 billion to IRS's tax gap estimate. The employment tax underreporting estimate also includes underreporting of federal unemployment taxes (about $1 billion).

IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and outdated methodologies. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes. IRS has no estimates for other areas of the tax gap, such as for corporate income, employment, and excise tax nonfiling or for excise tax underreporting. For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable. 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.[24]

IRS Plans to Issue a Revised Tax Gap Estimate, but Has No Approved Plans to Regularly Collect Compliance Data

IRS is taking several steps that could improve the tax gap estimate for tax year 2001. IRS plans to further analyze the preliminary results from NRP and expects to publish a revised estimate by the end of 2005. The revised estimate will incorporate new methodologies, including those for estimating overall individual income tax underreporting as well as for the portion attributable to self-employed individuals who operate businesses informally, and for estimating individual income tax nonfiling. In addition, IRS has begun a compliance measurement study that will allow IRS to

[23]As employment taxes and income taxes for self-employed taxpayers are largely assessed on the same income, self-employed individuals who underreport their income consequently underreport the employment tax due on that income.

[24]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

update underreporting estimates involving S corporations.[25] This study, which IRS began in July 2005, is scheduled to take 2 to 3 years to complete. Because individual taxpayers may be recipients of income (or losses) from S corporations, this study could affect IRS's estimates for the underreporting gap for individual income tax.

Beyond this study of S corporations, IRS has no approved plans to periodically collect more or better compliance data over the long term. Also, IRS has indicated that given its current research priorities, it would not begin another NRP study of individual income tax returns before 2008, and would not complete such a study until at least 2010. When IRS initially proposed the tax year 2001 NRP study, it had planned to study individual income tax underreporting on a 3-year cycle.

According to IRS officials, IRS has not committed to regularly collecting compliance data because of the associated costs and burdens. Taxpayers whose returns are examined through compliance studies such as NRP bear costs in terms of time and money. Also, IRS incurs both direct costs and opportunity costs—revenue that IRS potentially forgoes by using its resources to examine randomly selected returns, which are more likely to include returns from compliant taxpayers and less likely to produce additional tax assessments compared to traditional examinations. One IRS official also emphasized that IRS has fewer resources than in the past to conduct examinations as well as compliance studies.

Although the costs and burdens of compliance measurement are legitimate concerns, we believe compliance studies to be good investments.[26] The lack of firm plans to continually obtain fresh compliance data is troubling because the frequency of data collection can have a large impact on the quality and utility of compliance data. Any plans for obtaining and maintaining reasonably current information on compliance levels for all portions of the tax gap would need to take into account costs, burdens, and compliance risks in determining which areas of compliance to measure and the scope and frequency of such measurement.

[25]S corporations, as well as partnerships, are businesses commonly referred to as flow-through entities as they do not generally pay taxes on income. Instead, they distribute net income and losses to partners, shareholders, and beneficiaries, who are subsequently required to report net income or losses on their individual tax returns and pay any applicable taxes. According to an IRS research official, IRS expects to conduct a compliance measurement study of partnerships at a later date.

[26]GAO/GGD-93-52.

Knowing the Reasons for Noncompliance Could Help Guide Compliance Efforts, but IRS Has Concerns with Its Data on These Reasons

Data on whether taxpayers are unintentionally or intentionally noncompliant with specific tax provisions are critical to IRS for deciding 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. For example, taxpayers may unintentionally claim the Earned Income Tax Credit (EITC) because they do not understand the child residency requirements for this credit (i.e., a qualifying child must live with the taxpayer for more than half of the year). This type of unintentional noncompliance may require IRS to more clearly explain the EITC requirements within related forms and publications. However, other taxpayers may file false EITC claims with the intent of evading tax liability, which may suggest a strategy that relies on IRS's enforcement programs and tools. Similar situations could exist for other tax code provisions. Recognizing the benefits of better compliance data, we, as well as the National Taxpayer Advocate, have urged IRS to consider performing additional research into causes of noncompliance.[27]

IRS collects data on the reasons for noncompliance for specific tax issues during its operational examinations of tax returns. In many of these cases, it is difficult for examiners to determine a taxpayer's intent—whether the noncompliance is unintentional or intentional. Unless the evidence clearly points to the reason, the examiner would have to make subjective judgments about why the noncompliance occurred. IRS has a number of other concerns with the data:

- The database is incomplete because not all examination results, including data on reasons for noncompliance, were being entered into the database.
- IRS has not tested the adequacy of the controls for data entry or the reliability of the data being collected. IRS has found instances where examiners close examinations without assigning a reason for noncompliance or by assigning the same reason to all instances of noncompliance, regardless of the situation.

[27]Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance, July 21, 2004, and Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004); and GAO, *Tax Research: IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109 (Washington, D.C.: June 5, 1996).

- IRS has not trained all examiners to ensure consistent understanding and use of the various codes to indicate the reason for noncompliance.
- The data do not represent the population of noncompliant taxpayers but rather only those who had their tax returns examined.

According to IRS officials, the agency does not have firm or specific plans to develop better data on the reasons for noncompliance. One official explained that IRS decided not to improve the consistency of its current reason data because it is devoting its limited resources to other efforts, such as developing the Examination Desktop Support System. Although this system is intended to allow examiners to capture better examination data, specific system features have not yet been identified to improve examiners' selection of reason codes. IRS officials said that the system could be enhanced in the future to improve the data on reasons for noncompliance and that they plan to consider such enhancements. If IRS enhances the data on reasons for noncompliance, it will be important to consider factors such as how complete and reliable such data need to be, and whether to collect the data for all types of noncompliance or for all examinations (as opposed to a targeted random sample).

Long-term, Quantitative Goals for Improving Taxpayers' Compliance Would Be Consistent with Results-Oriented Management

Focusing on outcome-oriented goals and establishing measures to assess the actual results of a program compared to its intended purpose can help agencies improve performance and stakeholders determine whether programs have produced desired results. Furthermore, setting long-term, quantitative goals would be consistent with results-oriented management principles that are associated with high-performing organizations and incorporated into the statutory management framework Congress has adopted through GPRA. As such, establishing long-term, quantitative compliance goals coupled with periodic measurements of compliance levels offers several benefits for IRS. These benefits include providing a better basis for determining to what extent its various service and enforcement efforts contribute to compliance, considering new strategies to improve compliance over time,[28] and promoting strategic and

[28]For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007 has required enhancement of its technology, development of software to support electronic filing, education of taxpayers and practitioners, and other steps that could not be completed in a short time frame. Congress established this electronic filing goal in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998).

disciplined management decisions that target areas most in need of improvement.

IRS's strategies for improving compliance, which involve improving taxpayer service and enhancing enforcement of the tax laws, generally lack a clear focus on long-term, quantitative goals and results measurement. In response to a President's Management Agenda[29] initiative to better integrate budget and performance information, IRS officials said that they are considering various long-term goals for the agency. However, IRS has not yet set a time frame for publicly releasing the goals or indicated how many goals will be related to improving taxpayer compliance or whether they will be quantitative and results-oriented. According to IRS officials, developing long-term, results-oriented goals is a complex process that requires sustained management commitment. These factors contribute to IRS's uncertainty about when it will publicly release its goals.

Like other agencies,[30] IRS faces challenges in implementing a results-oriented management approach. For example, collecting reliable compliance data, 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, make it difficult to estimate the effect of IRS's enforcement and service activities.[31] However, even if IRS is unable to show that its actions directly affected compliance rates, periodic measurements of compliance levels can indicate the extent to which compliance is improving or declining and provide a basis for reexamining existing programs and triggering corrective actions if necessary. Moreover, having completed the NRP review of individual

[29]The President's Management Agenda is intended to help the federal government become more results-oriented and encourage federal managers to ask whether their programs are working as intended and, if not, what can be done to achieve greater results.

[30]GAO, *The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven*, GAO/GGD-97-109 (Washington, D.C.: June 2, 1997), and *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, GAO-04-38 (Washington, D.C.: Mar. 10, 2004).

[31]As discussed in our July 2005 tax gap report, several research studies have offered insights to better understand the direct and indirect effects of IRS's activities on tax revenue and voluntary compliance. Indirect effects arise when voluntary compliance increases in the larger population or in subsequent years due to examinations, or other enforcement and service actions, on targeted taxpayers. Although these studies generally indicate that IRS activities have positive tax effects, the magnitude of these effects is not yet known with a high level of confidence given compliance measurement challenges.

income tax underreporting, IRS now has an improved foundation for setting a goal or goals for improving taxpayers' compliance.

Concluding Observations

Reducing the tax gap is one approach that would help address the looming fiscal challenges facing the nation. While our long term-fiscal imbalance is too large to be eliminated by one strategy, reducing the tax gap can ease the difficult decisions that are needed. Toward that end, in our July 2005 report on reducing the tax gap, we made recommendations to IRS to develop plans to periodically measure tax compliance, take steps to improve its data on the reasons why taxpayers do not comply, and establish long-term, quantitative goals for voluntary compliance levels with an initial focus on individual income tax underreporting and total tax underpayment. Taken together, these steps can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance, improve the efforts, and make progress on reducing the tax gap. The Commissioner of Internal Revenue agreed with our recommendations, highlighted challenges associated with them, and commented on various steps IRS would take to implement each recommendation.

Mr. Chairman and Members of the Subcommittee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

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Testimony of

J. Russell George
Treasury Inspector General for Tax Administration

before the

Subcommittee on Federal Financial Management,
Government Information, and International Security

Committee on Homeland Security and Governmental Affairs
United States Senate

"Uncollected Taxes: Can We Reduce the $300 Billion Tax Gap?"

October 26, 2005

Chairman Coburn, Ranking Member Carper, and Members of the Subcommittee, as the Treasury Inspector General for Tax Administration (TIGTA), I appreciate the opportunity to appear before you today to discuss the scope, size, and nature of the tax gap problem, as well as some opportunities for closing the tax gap. My testimony will also address issues relating to the cash economy.

The importance of these issues cannot be overstated. The nation's ability to provide for the general welfare and protect its citizens is based on the ability to raise revenue through taxes. For our government to perform effectively, it must ensure that the taxes owed are timely paid. It also cannot go unnoticed that the estimated annual tax gap figures closely correspond to the reported fiscal year 2005 budget deficit of $319 billion.

Because the tax gap poses such a significant threat to the integrity of our voluntary tax system, one of my top priorities for TIGTA is to identify opportunities for improvements to the Internal Revenue Service's (IRS') tax compliance initiatives. My staff is in the preliminary stages of preparing an audit report to assess whether the IRS is positioned to significantly improve voluntary compliance. I expect this report to be issued in 2006.

The Tax Gap: Its Scope, Size, and Nature

The IRS defines the tax gap as "the difference between what taxpayers are supposed to pay and what is actually paid."[1] The IRS further 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.[2] Within the underreported income component, the IRS has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes. However, the IRS is not confident in the reliability of certain components of its tax gap estimate. Areas of uncertainty include portions of the underreported employment tax segment and the underreported corporate tax segment, because the underlying data is 15 years old or more, and the IRS has low confidence in its original estimates. Thus, these figures are simply rough estimates of the tax gap problem.

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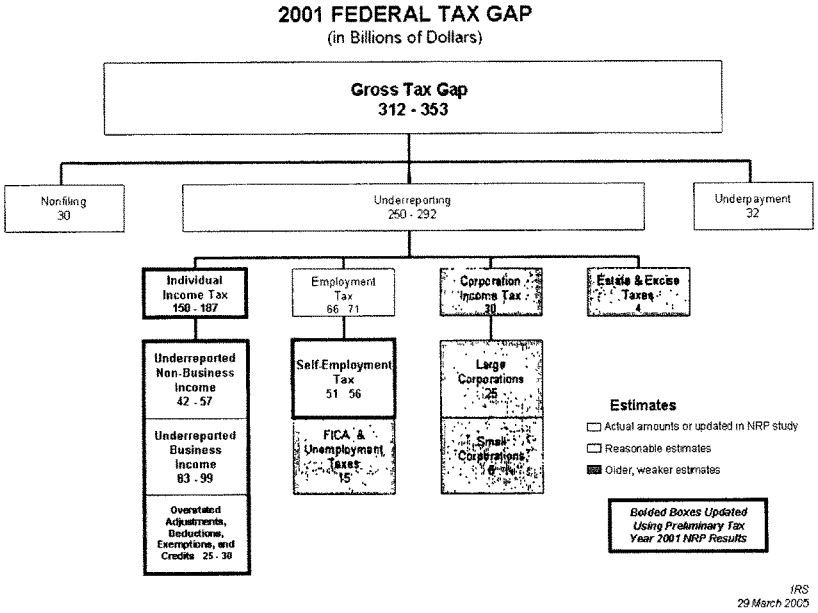
[1] *Hearings on Bridging the Tax Gap Before the Senate Committee on Finance*, 108th Cong. (2004) (statement of Mark Everson, Commissioner of Internal Revenue).

[2] 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 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.

The following chart, which the IRS developed, provides a good visual reference for the various components of the tax gap. Additionally, it indicates which segments of the tax gap estimate were updated based on new data.

Figure 1: Tax Gap



Source: IRS Tax Gap Facts and Figures

The updated estimates of the tax gap released March 29, 2005, and developed for tax year 2001, estimated that the annual gross tax gap[3] is between $312 billion and $353 billion. The net tax gap, which is the portion of this amount that will not be collected after all IRS and taxpayer actions have been completed for a given tax year, is estimated to be between $257 billion and $298 billion.[4] To provide some perspective on the size of this estimate, if collected, these dollars could fund much, if not all of the estimated costs for hurricane relief efforts in the Gulf Coast region.

The largest estimated component of the tax gap is the underreporting component, which for tax year 2001 was estimated to be between

[3] The amount of tax that is imposed for a given tax year but is not paid voluntarily and timely.
[4] INTERNAL REVENUE SERVICE, TAX GAP FACTS AND FIGURES 3, *available at* http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf (last visited Oct. 20, 2005).

$250 billion and $292 billion. Within that component, underreporting of individual income taxes was estimated to be between $150 billion and $187 billion, with business income estimated to be $83 billion to $99 billion of that total (about 27 percent of the total gross tax gap). The second largest segment of underreporting, estimated at $66 billion to $71 billion, is the employment tax, which includes social security, medicare, and unemployment taxes. The self-employment tax, which is self-reported, is the largest component of that category at $51 billion to $56 billion (16 percent of the gross tax gap).

Thus, individuals with business income, including the self-employed, are estimated to have an underreporting tax gap of $134 billion to $155 billion in tax year 2001. This figure is more than 40 percent of the estimated gross tax gap, and more than half of the estimated total underreported portion of the tax gap. The cash economy is a subsection of this segment and is discussed later in my testimony.

Better Data Are Needed to Measure the Tax Gap and the Effectiveness of Enforcement Actions

From 1963 to 1988, the IRS conducted studies to measure tax compliance approximately every three years.[5] Estimates of the tax gap were first developed from these studies in 1973.[6] However, the program used to conduct these studies, called the Taxpayer Compliance Measurement Program (TCMP), was shelved in 1991 due to concerns about its burden on compliant taxpayers.[7] When the IRS unveiled an expanded approach to measure compliance in 1994, Congress eliminated all funding for this project because of concerns about its intrusiveness. More recently, the IRS initiated a new program to measure compliance, and its results were used to produce the update of the individual tax gap figures.[8]

Although better data will help the IRS identify noncompliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing noncompliance. The Taxpayer Advocate's 2004 *Annual Report to Congress* effectively laid out some of the complexities involved in structuring an enforcement program to address the tax gap. The report also addressed the efforts IRS still needs to make to analyze the

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[5] KIM M BLOOMQUIST ET AL., INTERNAL REVENUE SERVICE, TAX NONCOMPLIANCE IN THE UNITED STATES: MEASUREMENT AND RECENT ENFORCEMENT INITIATIVES (2004).
[6] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-95-157, REDUCING THE TAX GAP: RESULTS OF A GAO-SPONSORED SYMPOSIUM (1995).
[7] The TCMP was considered by the IRS and by external stakeholders to be burdensome to taxpayers because of the intensive "line-by-line" nature of its audits. *See* KIM M. BLOOMQUIST ET AL., *supra* note 5; GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-95-59, TAX ADMINISTRATION: ESTIMATES OF THE TAX GAP FOR SERVICE PROVIDERS (1994).
[8] *See* discussion *infra* p. 9.

effectiveness of various compliance techniques.[9] Similarly, TIGTA has identified examination programs that the IRS had implemented nationwide before determining their possible effectiveness or before implementing an effective strategy to measure the results of the programs.[10]

The IRS must continue to seek accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. This information is critical to the IRS for strategic direction, budgeting and staff allocation. The Department of the Treasury also needs these measures for tax policy purposes. Additionally, Congress needs this information to develop legislation that improves the effectiveness of the tax system.

The Cash Economy: A Growing Problem

The cash economy and the resulting underreporting of income for tax purposes have been a significant portion of the tax gap for many years.[11] The cash economy, also known as the underground economy, consists of activities that may be both productive and legal but are deliberately concealed from public authorities for a variety of reasons, such as to avoid the payment of taxes or to avoid meeting certain standards or administrative requirements.[12] As described earlier, underreporting of individual business income and self-employment taxes on filed returns comprises nearly half of the 2001 estimated tax gap. Taking action to improve compliance in this area is critical to making strides in addressing the tax gap.

The difference in compliance rates between individual wage-earning taxpayers and those operating businesses is striking. The IRS has estimated that individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes.[13] In contrast, self-employed individuals who formally

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[9] NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, 2004 ANNUAL REPORT TO CONGRESS (2004).

[10] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-012, THE HIGH INCOME TAXPAYER STRATEGY WAS EFFECTIVELY IMPLEMENTED, ALTHOUGH ITS SUCCESS STILL NEEDS TO BE DETERMINED (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-029, THE LIMITED ISSUE FOCUSED EXAMINATION PROCESS HAS MERIT, BUT ITS USE AND PRODUCTIVITY ARE CONCERNS (2005).

[11] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-82-34, FURTHER RESEARCH INTO NONCOMPLIANCE IS NEEDED TO REDUCE GROWING TAX LOSSES (1982); GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-79-69, WHO'S NOT FILING INCOME TAX RETURNS? THE IRS NEEDS BETTER WAYS TO FIND THEM AND COLLECT THEIR TAXES (1979).

[12] From the 1993 System of National Accounts (SNA93), published jointly by the United Nations, the Commission of the European Communities, the International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), and the World Bank These principles comprise a conceptual framework that sets the international statistical standard for the measurement of the market economy. SNA93 uses the term "underground economy."

[13] *See* GENERAL ACCOUNTING OFFICE, *supra* note 7; INTERNAL REVENUE SERVICE, PUB. 1415, FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992, (Rev. 1996).

operate non-farm businesses[14] are estimated to report only about 68 percent of their income for tax purposes. Even more alarming, self-employed individuals operating businesses on a cash basis[15] report just 19 percent of their income to the IRS.

Estimates indicate that the cash economy is growing.[16] An article earlier this year in *Barron's* on the underground economy in this country estimated that the income in this segment of the population is currently about 9 percent of the gross domestic product and will soon surpass $1 trillion.[17] The article indicated that growth in this segment of the economy has been spurred by corporate downsizing, which has forced many employees to become independent contractors, and by the increasing size of the nation's population of undocumented immigrants.

An April 2002 Economic Roundtable briefing paper entitled "Workers Without Rights" explored the informal economy in Los Angeles.[18] Even using conservative estimates, the study stated that unpaid payroll taxes and insurance benefits exceeded $1.1 billion. The briefing paper estimated the size of the informal economy to be between 9 percent and 29 percent of the employment in Los Angeles County. The informal economy included employment in a variety of manufacturing industries, agriculture, construction and others. Thus, the informal economy operates in many aspects of the economy and obtains a competitive advantage by paying low wages and not paying employment taxes.

Although the noncompliance rate in the cash economy is high, the percentage of examinations of self-employed taxpayers is still low. The figure below indicates that in the past nine years, this percentage dropped from 3.60 percent in 1996 to a low of 1.55 percent in 2000. In the last four years, however, the percentage has risen to 2.13 percent.

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[14] Formal, non-farm businesses are considered to be those that are typically not operated on a cash basis and that pay expenses such as taxes, rent, or insurance.

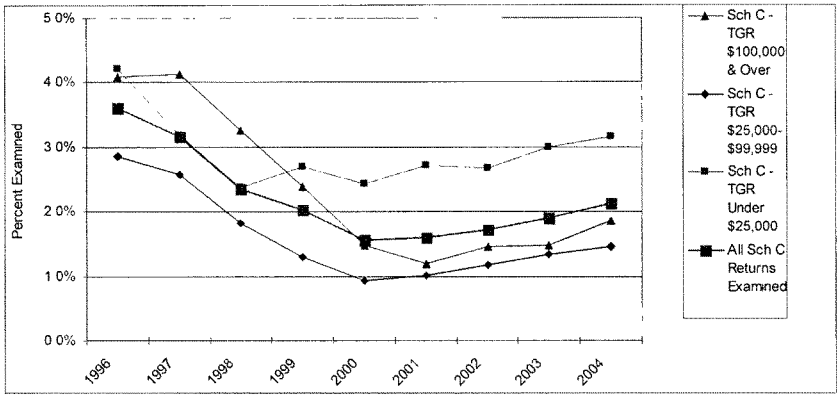
[15] These individuals provide products or services through informal arrangements that typically involve cash transactions or "off-the-books" accounting practices. This group includes child care providers, street vendors, and moonlighting professionals.

[16] KIM BLOOMQUIST, INTERNAL REVENUE SERVICE, TRENDS AS CHANGES IN VARIANCE. THE CASE OF TAX NONCOMPLIANCE (2003).

[17] Jim McTague, *Underground Economy,* BARRON'S, Jan. 3, 2005.

[18] The paper defined the informal economy as that which produces legal goods and services that are not effectively regulated Such activities can give rise to abuses by employers who fail to respect basic labor, safety, immigration, and tax laws, leaving workers without rights

Figure 2. Examination Coverage of Forms 1040 With Business Income[19]



Source: TIGTA Analysis of IRS Data Book Information.

Although examinations of these returns should increase compliance, the visibility of the income received by these self-employed individuals needs to be raised.

Opportunities for Closing the Tax Gap

Recommendations on how to address closing the tax gap have been circulating for years. Some of those recommendations made 10 to 15 years ago are still relevant today. In this section of my testimony, I will focus on the following opportunities that TIGTA, other oversight groups, and interested stakeholders have identified to address the tax gap:

- Reduce the Complexity of the Tax Code;
- Gather Better Compliance Data;
- Institute Withholding on Non-employee Compensation;
- Use Document Matching to Enhance Compliance;
- Address Increasing Levels of Late Filed Returns; and,
- Increase Resources in the IRS Enforcement Functions.

Reduce the Complexity of the Tax Code

According to the President's Advisory Panel on Federal Tax Reform, tax code complexity is a significant problem.[20] Among others, sources of complexity include duplicative and overlapping provisions, phase-outs, and expiring

[19] "TGR" is Total Gross Receipts, and "Sch C" is Schedule C, the tax return schedule used by the self-employed to report a profit or loss from business

[20] THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, COMPLEXITY AND INSTABILITY STAFF PRESENTATION (JULY 20, 2005)

provisions. In addition to those sources, the Panel cited the instability of the tax code as another source of complexity. Since 1986, there have been more than 14,400 changes to the code. Furthermore, complexity is costing the U.S. economy $140 billion each year, with over 3.5 billion hours spent preparing tax returns. More than 60 percent of Americans rely on a tax practitioner to prepare their tax returns.

In 2001, the Joint Committee on Taxation conducted a study on the complexity of the tax law. The Committee found that, at that time, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments. At that time, a taxpayer filing an individual income tax return (Form 1040) could be confronted with a 79 line return, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of having to file numerous other forms.[21] For the 2005 tax filing season,[22] the IRS estimates it should take, on average, over 19 hours to complete and file a 2004 Form 1040 and the associated Schedule A.

Tax law complexity creates a number of problems. It reduces the transparency of the tax system, rewards those with the means and inclinations to find all of the "angles" and then to exploit them, and it undermines trust in the fairness of the system, which may in turn undermine voluntary compliance. The complexities of the tax law also affect the ability of the IRS to administer the nation's tax system. The IRS' efforts to provide assistance to taxpayers are hampered because of these complexities.

In December 2003, in compliance with Section 2004 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98),[23] the Department of the Treasury reported to Congress that there are several changes that would make the tax system less complex and reduce compliance costs while meeting its other goal. The United States has attempted to reduce taxpayer burden by primarily simplifying the tax law and tax forms when feasible, and by improving customer service and encouraging electronic filing and the use of tax preparation software. Another approach taken by over 30 countries is a return-free filing system.[24] In most of these countries, taxpayers meet their obligations entirely through tax withholding payments made throughout the year. A few of these countries rely on tax-agency reconciliation. These are systems in which tax authorities prepare

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[21] STAFF OF THE JOINT COMMITTEE ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Comm. Print 2001).

[22] The period from January through mid-April when most individual income tax returns are filed.

[23] Pub. L. No. 105-206, 112 Stat. 685 (1998) (codified as amended in scattered sections of 2 U.S.C , 5 U.S.C. app., 16 U.S C., 19 U.S C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U S.C., 38 U.S.C , and 49 U.S.C.).

[24] Countries that have some sort of return-free filing as part of their tax systems include the United Kingdom, Denmark, Sweden, Germany, Japan, Ireland, and Mexico.

tax returns for individuals based on information submitted by employers and others, and then send taxpayers a completed tax form for their review.[25]

Providing accurate responses to tax law inquiries remains a challenge. Our most recent audit to determine the accuracy of responses provided to tax law questions at IRS' Taxpayer Assistance Centers (TAC) reported that taxpayers are continuing to receive inaccurate answers.[26] Assistors correctly answered 66 percent of the 196 tax law questions auditors posed during the 2005 filing season. Although this is comparable to our results obtained for the 2004 filing season, the IRS continues to experience nominal improvement in decreasing the number of incorrect responses given. In addition, the IRS did not achieve its fiscal year 2005 accuracy rate goal of 81 percent.

We believe this happens because assistors are not using the required tools. Other contributing factors include the complexity of the tax law and the number of potential questions assistors must be prepared to answer. For example, assistors are trained and expected to be knowledgeable in 318 tax law topics and 395 subtopics. They are expected to be able to respond to taxpayer issues for the current and prior tax years.

Complexity exists for many taxpayers regardless of the intricacies of their financial situations. The Earned Income Tax Credit (EITC), for example, is a program that is so complicated, it is difficult for both taxpayers and the IRS to consistently and accurately determine eligibility. TIGTA recently completed an audit of the EITC program and reported that, according to the Office of Management and Budget, EITC accounted for $9.7 billion (21 percent) of the $45.1 billion in improper government payments.[27]

At the other end of the economic spectrum, white collar professionals and executives have used the complexities of the tax code to devise intricate schemes to illegally shelter income from taxation. Widely publicized corporate scandals over the last several years indicate that abusive tax shelters may be more common than once thought. The IRS has increased its oversight of tax shelters with some significant success. For example, the IRS recently reported that it has collected approximately $3.7 billion from the Son of Boss settlement initiative.[28]

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[25] DEPARTMENT OF THE TREASURY, REPORT TO THE CONGRESS ON RETURN-FREE TAX SYSTEMS: TAX SIMPLIFICATION IS A PREREQUISITE (DECEMBER 2003).
[26] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-133, CUSTOMER ACCURACY AT TAXPAYER ASSISTANCE CENTERS SHOWED LITTLE IMPROVEMENT DURING THE 2005 FILING SEASON (2005).
[27] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-133, ADMINISTRATION OF THE EARNED INCOME TAX CREDIT PROGRAM HAS IMPROVED, BUT CHALLENGES CONTINUE (2005).
[28] INTERNAL REVENUE SERVICE, *ROBUST RESPONSE FOR EXECUTIVE STOCK OPTION INITIATIVE; SON OF BOSS SETTLEMENT HEADING FOR $4 BILLION*, IR-1005-72, AVAILABLE AT HTTP://WWW.IRS.GOV/NEWSROOM/ARTICLE/0,,ID=141014,00.HTML (LAST VISITED OCTOBER 21, 2005).

However, the complexities of the tax law make the job of pursuing these abusive tax avoidance schemes even more challenging and costly. Recent IRS statistics for revenue agents indicate that time spent per tax return on examinations has increased in the last two years.[29] For example, in fiscal year 2004, hours spent per return on examinations were up 23 percent for individual tax returns and 19 percent for corporate tax returns over 2003 figures. The increase in time spent on examinations could be partially attributed to the types of cases that were being worked. The Small Business/Self-Employed Division has designated several categories as high-priority, including:

- High-risk, high-income taxpayers and nonfilers;
- Abusive schemes; and,
- Unreported income.

These types of cases require in-depth probing to identify unreported income and to determine reporting compliance.

Various proposals have been made to dramatically alter America's tax system. Others have made recommendations for less sweeping, but more targeted changes. In the near future, the President's bipartisan Advisory Panel on Federal Tax Reform will issue its report advising the Secretary of the Treasury on options to reform the tax code. Whatever proposal is chosen, simplifying the tax code could make it easier for taxpayers to voluntarily comply.

Gather Better Compliance Data

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 addresses 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 next phase of the NRP, which has begun, focuses on Subchapter S corporations (Forms 1120S). These initiatives allow the IRS to update return-selection models for more effective return selection for its compliance efforts. A recent TIGTA audit 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 fiscal year 2004.[30] Updated selection models should contribute to more effective use of the IRS' compliance resources.

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[29] TIGTA analysis of IRS Data Book Information.

[30] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION., REF. NO. 2005-30-130, THE SMALL BUSINESS/SELF-EMPLOYED DIVISION IS BEGINNING TO ADDRESS CHALLENGES THAT AFFECT CORPORATE RETURN EXAMINATION COVERAGE (2005).

Institute Withholding on Non-employee Compensation

Each year, over 40 percent ($130 billion) of the total tax gap is attributable to underreporting among individuals with business income. More than 20 years ago, GAO recommended that Congress consider requiring withholding and improving information returns reporting for independent contractors. More recently, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments, such as those provided to independent contractors.[31] TIGTA maintains that implementing such a provision could reduce the tax gap by billions of dollars. The IRS has agreed to consider such a proposal. The Taxpayer Advocate's 2003 *Annual Report to Congress* also made this recommendation.[32]

In a recent Joint Committee on Taxation report, the proposal was made to implement withholding on payments from government entities.[33] The proposal recommended withholding 3 percent of payments to businesses and individuals (other than employees) providing goods and services to government entities. TIGTA agrees that this proposal may be a good first step as it provides an opportunity to test the feasibility and burden associated with such withholding.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors.[34] For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TINs) for independent contractors. For tax years 1995 through 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately $204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records. Legislation could address this problem by mandating that the payer and payee verify the TIN at the beginning of their relationship. Additionally, withholding could be mandated for independent contractors who fail to furnish a TIN. Implementing mandated withholding for this segment of independent contractors would result in an estimated $2.2 billion in increased revenue to the IRS each year.

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[31] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-040, WHILE PROGRESS TOWARD EARLIER INTERVENTION WITH DELINQUENT TAXPAYERS HAS BEEN MADE, ACTION IS NEEDED TO PREVENT NONCOMPLIANCE WITH ESTIMATED TAX PAYMENT REQUIREMENTS (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2001-30-132, SIGNIFICANT TAX REVENUE MAY BE LOST DUE TO INACCURATE REPORTING OF TAXPAYER IDENTIFICATION NUMBERS FOR INDEPENDENT CONTRACTORS (2001).

[32] NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, 2003 ANNUAL REPORT TO CONGRESS (2003).

[33] STAFF OF THE JOINT COMMITTEE ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005).

[34] *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 31.

Use Document Matching to Enhance Compliance

TIGTA has also identified improvements that should be made to improve compliance in business tax filing. [35] The GAO 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. [36] 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.

An IRS study, based on TIGTA recommendations, found that in fiscal year 2000, business information documents[37] reported $697 billion of potential taxable income.[38] Furthermore, business information documents identified 1.2 million unresolved business nonfiler tax modules. A 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.[39]

Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes,

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[35] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2002-30-185, THE IRS SHOULD EVALUATE THE FEASIBILITY OF USING AVAILABLE DOCUMENTS TO VERIFY INFORMATION REPORTED ON BUSINESS TAX RETURNS (2002).

[36] 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).

[37] 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).

[38] INTERNAL REVENUE SERVICE, REPORT OF BMF IRP NONFILERS FOR TAX YEAR 2000 (CORPORATIONS, PARTNERSHIPS, AND TRUSTS), RESEARCH PROJECT 02.08.003.03, SB/SE RESEARCH (JULY 2004).

[39] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2001-30-084, STRONGER ACTIONS ARE NEEDED TO ENSURE PARTNERSHIPS WITHHOLD AND PAY MILLIONS OF DOLLARS IN TAXES ON CERTAIN INCOME OF FOREIGN PARTNERS (2001); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-101, COMPLIANCE OPPORTUNITIES EXIST FOR THE INTERNAL REVENUE SERVICE TO USE FOREIGN SOURCE INCOME DATA (2005).

but it could identify significant pockets of noncompliance among business taxpayers.

Address Increasing Levels of Late Filed Returns

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[40] 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 15th were attributable to extended-due-date taxpayers.[41] 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 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 calendar year 2008, of which approximately $29.8 billion would not be paid until after the end of fiscal year 2008. Due to the more complex nature of corporate taxes, similar figures were not available for corporations, although TIGTA estimated that by tax year 2008, approximately $768 million in additional corporate taxes would be timely paid if TIGTA's recommendations were adopted. The IRS is currently studying TIGTA's recommendations.

Increase Resources in the IRS Enforcement Functions

Staffing in the IRS enforcement areas has decreased significantly in the last few years.[42] However, in 2004, the IRS received additional funding and was able to

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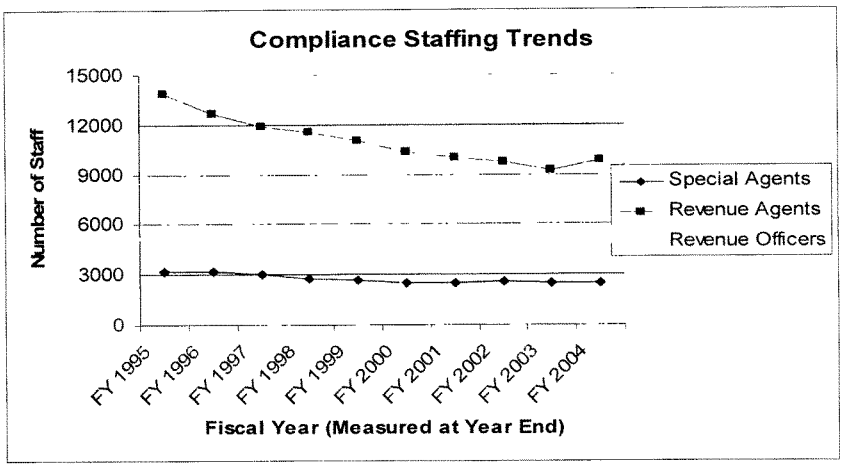
[40] The Delinquency Penalty is also known as the Failure-to-File Penalty, although it only applies to taxpayers who both file late and fail to pay all taxes by the tax payment deadline.
[41] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2003-30-132, THE REGULATIONS FOR GRANTING EXTENSIONS OF TIME TO FILE ARE DELAYING THE RECEIPT OF BILLIONS OF TAX DOLLARS AND CREATING SUBSTANTIAL BURDEN FOR COMPLIANT TAXPAYERS (2003) AND TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-106, CHANGES TO THE REGULATIONS FOR GRANTING EXTENSIONS OF TIME TO FILE CORPORATE RETURNS ARE NEEDED TO ALLEVIATE SIGNIFICANT PROBLEMS WITH ADMINISTERING THE TAX LAWS (2004).
[42] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-055,TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2004 (2005).

increase its enforcement staffing slightly over the prior year. In the Examination function, the number of Revenue Agents decreased from 13,857 in fiscal year 1995 to 9,787 in fiscal year 2004. In the Collection function, the number of Revenue Officers decreased from 5,908 in fiscal year 1995 to 3,789 in fiscal year 2004. These decreases in staffing occurred during a period in which the number of tax returns filed increased by more than 10 percent.

Figure 3. Compliance Staffing—Field Special Agents, and Revenue Agents and Revenue Officers Working Compliance Cases — Fiscal Year (FY) 1995-2004



Sources: Criminal Investigation Business Performance Review, Examination Table 37, Collection Report 5000-23.

One effect of the lack of resources in the Collection function is that the Queue,[43] has increased significantly since fiscal year 1996. In fiscal year 1996, there were 317,865 balance due accounts worth $2.96 billion in the Queue. In fiscal year 2004, these figures had increased to 623,477 balance-due accounts worth $21 billion. Additionally, the number of unfiled tax-return accounts in the Queue increased from 326,118 in fiscal year 1996 to 838,090 in fiscal year 2004.

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

[43] 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.

Collection function inventory and shelved. Additionally, in fiscal year 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 contractors should allow the IRS to collect more outstanding taxes. The IRS will have 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 to reduce the likelihood of similar issues occurring when contracting out collection of tax debt.[44]

There are many areas in which increased enforcement and/or legislative remedies could address noncompliance. For example, a recent TIGTA audit found a significant number of single shareholder owners of Subchapter S corporations avoided paying themselves salaries to avoid paying employment taxes.[45] 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 on this growing problem.[46] 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).[47] During that same period, all fraudulent returns identified grew by just 45 percent.

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[44] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2002-30-055, FEDERAL REQUIREMENTS NEED STRENGTHENING AT LOCKBOX BANKS TO BETTER PROTECT TAXPAYER PAYMENTS AND SAFEGUARD TAXPAYER INFORMATION (2002); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, INSUFFICIENT CONTRACTOR OVERSIGHT PUT DATA AND EQUIPMENT AT RISK (2004).

[45] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-080, ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS (2005).

[46] *Hearing to Examine Tax Fraud Committed by Prison Inmates*, 109th Cong. (2005) (statement of J. Russell George, Inspector General) AND TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-10-164, THE INTERNAL REVENUE SERVICE NEEDS TO DO MORE TO STOP THE MILLIONS OF DOLLARS IN FRAUDULENT REFUNDS PAID TO PRISONERS (2005).

[47] 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.

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 in EITC. For those unscreened returns, over 18,000 prisoners incarcerated during all of calendar year 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.

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. I believe that steps to reduce the current level of customer service should be taken only with the utmost thought and consideration of their impact, and only with all the necessary data to support these actions. 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 of providing America's taxpayers quality service by helping them understand and meet their tax responsibilities.

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.

Written Statement of Nina E. Olson
National Taxpayer Advocate

Before the
Subcommittee on Federal Financial Management, Government Information, and International Security

Committee on
Homeland Security and Governmental Affairs

United States Senate

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Mr. Chairman and distinguished members of the Subcommittee:

Thank you for inviting me to testify before your subcommittee today about the tax gap. My testimony will focus on one particular aspect of the tax gap -- the cash economy -- and what the IRS is doing and can do about increasing compliance in that area. I will also discuss the important contributions that taxpayer service and the protection of taxpayer rights can make to closing the tax gap.[1]

The Tax Gap

The IRS develops estimates of both the "gross tax gap" and the "net tax gap." The gross tax gap is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely. The net tax gap is the portion of the gross tax gap that is not collected after all IRS and taxpayer actions have been completed for a given tax year.

The IRS' most recent estimates, based upon 2001 tax year returns, indicate that the gross tax gap is between $312 and $353 billion annually.[2] After accounting for amounts that the IRS receives as late voluntary payments or as a result of collection activity, the IRS estimates the net tax gap is between $257 and $298 billion.[3]

The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year.[4] Given the size of the net tax gap, the average tax return includes a "surtax" of about $2,000 to make up for tax revenues lost to noncompliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax "savings" to customers by charging lower prices.

Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.

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[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 Commissioner of Internal Revenue. The statute authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary 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] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

[3] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

[4] IRS, *Statistics of Income Bulletin, Spring 2005,* Publication 1136 (Rev. 2-2004) (Table 22).

Composition of the Tax Gap

The tax gap can be looked at through several lenses. For example, we can view the tax gap by the type of noncompliance – nonfiling, underreporting, and underpayment – or by the type of tax – income, employment, estate or excise. The IRS's 2001 National Research Program (NRP) study updates its current tax gap estimates for underreported individual income and self-employment taxes, which together are by far the largest component of the tax gap. In fact, the IRS estimates that underreporting accounts for more than 80 percent of the tax gap.[5]

The IRS estimates that individual income and self-employment taxes on unreported business income range from $134 to $155 billion, almost one-half of the gross tax gap. Based on earlier 2001 estimates, fully 67 percent of the gross tax gap is attributable to nonpayment of income taxes and employment taxes by self-employed individuals.[6]

The self-employed community always reacts a little defensively to these statistics, and understandably so. So let me emphasize one point here: No one – certainly not I – is suggesting that self-employed persons are any less honest than wage earners employed by businesses. However, there are certain aspects about the way the tax system treats self-employed persons that provide what I call "opportunities for noncompliance." I use this term because it encompasses both inadvertent and deliberate noncompliance.

While all wages paid to employees are subject to withholding and third-party reporting, payments to self-employed persons are rarely subject to withholding and are often not subject to third-party reporting. Tax withholding and third-party reporting are important tools in the IRS's effort to increase compliance. For example:

- Where payments are subject to withholding, IRS estimates that compliance is almost 100 percent.[7]
- Where payments are reported to the IRS, IRS estimates that compliance is about 96 percent.[8]

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[5] Individual income and self-employment tax underreporting can arise from a number of sources, including understated income and overstated deductions, expenses, and claims. The preliminary 2001 NRP data estimates that underreporting ranges from $250 to $292 billion. IRS National Headquarters Office of Research, *Tax Gap Facts and Figures*, March 29, 2005

[6] This estimate includes underreporting, non-filing and non-payment of income and employment taxes by all self-employed taxpayers. IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001).

[7] IRS National Headquarters Office of Research, (July 2004).

[8] IRS National Headquarters Office of Research, (July 2004).

- Where payments are not reported to the IRS at all, overall compliance is substantially lower.[9]

The above data tell us what most people intuitively expect: Where a taxpayer knows the IRS is aware of a payment, the taxpayer generally will report it on his or her return. Where a taxpayer thinks the IRS has no clue about the payment, the likelihood that the taxpayer will report the payment is substantially lower. The large majority of the tax gap attributable to self-employed persons does not result from payments reported to the IRS on a Form 1099. Most of that tax gap results from payments not reported to the IRS. In other words, the bulk of the tax gap is attributable to the "cash economy."[10]

The Cash Economy

Although the IRS has no direct estimate of the portion of the tax gap attributable to the so called "cash economy," unreported income from the cash economy is probably the single largest component of the tax gap.[11] Self-employed individuals often receive income from cash economy transactions.[12] As noted earlier, approximately 67 percent of the tax gap is attributable to self-employed individuals.[13] Underreporting by self-employed individuals represents $134 to

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[9] The IRS estimates that compliance among informal suppliers is about 20% and one IRS study estimates the compliance rate among self-employed persons overall at about 68%. IRS National Headquarters Office of Research, (July 2004).

[10] The term "cash economy" generally refers to legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting. *See Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate,* 108th Cong., 21 (July 21, 2004) (statement of Professor Bankman defining the cash economy as "your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting").

[11] It is important to note that some noncompliance in the self-employed sector may be attributable to inadvertent noncompliance, including noncompliance due to the complexity of the tax law. Self-employed businesses are small and often marginal businesses; cash is very dear to them. Thus, some self-employed underpayments are attributable to a lack of a withholding – or forced saving – mechanism.

[12] According to Professor Bankman:

> [O]nce an enterprise gets large, even if it is family-owned, the rate of noncompliance falls. That is because it is thought that either the owners, or their trusted employees, or their families have to cheat, and you cannot if you have nine outlets. You can really only cheat at the one controlled by the family. *Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate,* 108th Cong., 23 (July 21, 2004).

[13] IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001) (indicating that self-employed taxpayers are responsible for about 67 % of the tax gap). This estimate includes underreporting, non-filing and non-payment of income and employment taxes by self-employed taxpayers. It is consistent with prior estimates. *See* Small Business/Self-Employed, *Strategic Assessment Report FY 2004-2005,* 5 (March 11, 2003) (stating that SB/SE taxpayers are responsible for 68 % of the tax gap and that sole proprietors are responsible for 94 % of SB/SE's share of the tax gap); SB/SE Research, *Small Business/Self-Employed Compliance*

$155 billion, or about 43 percent, of the gross tax gap.[14] Over 80 percent of this underreporting is attributable to understated income rather than overstated deductions.[15] These estimates suggest that underreporting by self-employed taxpayers represents the single largest component of the tax gap, accounting for more than a third of the gap and over $100 billion per year.

Self-employed individuals and other cash economy participants understate their income primarily because it is not subject to withholding or information reporting. As noted above, IRS research indicates that taxpayers whose wages are subject to withholding report 99 percent of their wage income.[16] Similarly, taxpayers report about 96 percent of their income that is subject to information reporting.[17] In contrast, taxpayers whose income is not subject to withholding or information reporting, report only about 68 percent of their income.[18] This percentage drops to 20 percent for certain sole proprietors (called "informal suppliers") who operate "off the books" on a cash basis in areas such as street vending, door-to-door sales, child care, or moonlighting in a trade or profession.[19]

Research suggests that the cash economy is growing. According to one estimate the "underground economy," which includes both the cash economy and illegal activities, increased from four percent of the U.S. Gross National Product in 1970 to nine percent in 2000.[20] A recent study finds that up to 29

Risk Assessment, FY 04-05 Strategic Planning Cycle, 28 (Jan. 31, 2003) (stating that Schedule C filers are responsible for 59.2 % of the tax gap).

[14] IRS estimates indicate that taxpayers who underreport business income on individual returns account for $83 to $99 billion of the tax gap and taxpayers who underreport self-employment taxes accounts for $51 to $56 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005). The IRS' tax gap estimates may understate the portions of the tax gap attributable to cash economy transactions because such transactions are inherently difficult to detect. *See* IRS Office of Research, Analysis, and Statistics (RAS), *Preliminary Update of the TY 2001 Individual Income Tax Underreporting Tax Gap Estimates,* 8-16 (June 7, 2005); James Alm & Brian Erard, *Estimating the Informal Supplier Tax Gap,* 2005 IRS Research Conference (June 7, 2005) available at http://aysps.gsu.edu/people/working/IRS2005ResearchConference-Alm_Erard-Abridged.doc. *See also,* Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap,* GAO-05-753, 12 (July 2005).

[15] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001,* (June 7, 2005).

[16] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[17] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[18] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[19] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[20] *See* Friedrich Schneider & Dominik Enste, Economic Issues No. 30 -- *Hiding in the Shadows: The Growth of the Underground Economy,* IMF, (March 2002) available at http://www.imf.org/external/pubs/ft/issues/issues30/index.htm.

percent of the workers in Los Angeles County California are paid in cash and do not have federal or state payroll taxes withheld.[21]

IRS Enforcement Priorities

The IRS is currently placing priority emphasis on combating corporate tax shelters and abusive schemes used by high-income individual taxpayers. This approach is justifiable for two reasons. First, corporate tax shelters and abusive schemes have received extensive press coverage, and it is essential that the public not perceive these taxpayers as "getting away with anything." Second, the direct revenue gains from a single audit are much higher for high-income taxpayers.

In light of the updated tax gap data, however, the IRS needs to develop a broader long-term focus, particularly with respect to the cash economy. Clearly, the Treasury's and IRS's emphasis on combating corporate tax shelters and abusive schemes by individuals has had an effect on such activity. The good news, based on our conversations with tax professionals in law and accounting firms, is that the truly abusive deals have largely stopped. The bad news is that the tax revenues to be gained from focusing so heavily on these schemes predictably will dry up in the next few years.

There will always be yet another scheme or shelter that someone is hatching somewhere, and the IRS needs to have a strategic plan for identifying and addressing these products before they gain much ground. At the same time, the IRS must turn its focus to the largest portions of the tax gap, including the self-employed. There is simply no way to make significant progress in reducing the tax gap if we fail to aggressively go after the segment responsible for two-thirds of that gap. Indeed, the perception that the IRS is focusing so heavily on corporate tax shelters and abusive schemes could widen the tax gap if it continues for too long. In particular, if taxpayers operating in the cash economy believe that the IRS is devoting most of its attention to going after others, they may be emboldened to cheat even more.

Notwithstanding that the cash economy is responsible for the largest share of the tax gap, the IRS is currently directing only 14 percent of its examination resources to Schedule C returns,[22] and these examinations predominantly focus on high income taxpayers. The IRS's current examination work plan does not do nearly enough to address the cash economy.

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[21] Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights: The Informal Economy in Los Angeles,* Economic Roundtable Briefing Paper, 2002. Interestingly, the authors of this study conclude that since unions help to formalize the employment conditions of informal workers they may help to reduce the number of workers in the cash economy.

[22] IRS, Report to Congress: *IRS Tax Compliance Activities*, July 2003; AIMS Database (closed cases), IRS Examination Table 37 – An Examination activity management report and Automated Financial System (AFS) Database

The Tax Gap Presents a Challenge to IRS Enforcement

Except for costly field examinations, the IRS' traditional enforcement tools are unlikely to be effective in detecting unreported income from the cash economy because these tools rely on information reporting, and income from the cash economy is not subject to information reporting. IRS focus group discussions by practitioners illustrate how difficult it will be for the IRS to address underreporting by cash economy participants.[23] For example, it suggests that (1) some workers pass along most of their tax "savings" to customers or employers when paid "under the table," (2) underreporting may be rampant, at least in certain areas, (3) underreporting income from cash transactions may expand even faster as those transactions move to the Internet, and (4) the IRS is frequently unable to deter or detect underreporting among cash economy participants.

Traditional Enforcement Tools Are Not Effective in Targeting Cash Economy

Most traditional tools that the IRS uses to address unreported income or unfiled returns are not effective when applied to the cash economy. The IRS typically uses its Examination, Automated Underreporter (AUR, also called Document Matching), and Automated Substitute for Return (ASFR) programs to contact taxpayers to resolve unreported income and nonfiling issues. The AUR Program automatically matches the items reported on a tax return with information reported by payers on information returns.[24] Similarly, the ASFR Program relies on data from information returns or prior year returns to prepare substitute returns and assessments for individuals who fail to file after the IRS sends them a notice.[25]

Correspondence examinations also rely heavily on information reporting. While Correspondence Examiners may request certain documents to identify unreported income, Revenue Agents and Tax Compliance Officers who conduct field and office examinations, respectively, use more sophisticated indirect methods.[26] Unlike Correspondence Examiners, Revenue Agents also use a "dynamic" examination strategy and will change the focus of their examination in

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[23] SB/SE Research – Brooklyn/Hartford, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups*, Project 01.08.003 04, 12 (Dec. 2004).

[24] *See,* Department of the Treasury, Internal Revenue Service, Report to Congress: *IRS Tax Compliance Activities,* July 15, 2003, 5.

[25] *See* IRM § 5.1.11.6.5 (May 27, 2003).

[26] IRM § 4.10.4 (June 1, 2004); IRM § 4.19.1.2.3.1(12) (Oct. 1, 2004); IRM § 4.10.4.3.5 (June 1, 2004). Similarly, when a Revenue Officer (*i.e.*, IRS collection personnel working in the field) files a substitute for return for a high income nonfiler, he or she is required to observe the taxpayer to determine if sufficient income is reflected on the information reporting documents before filing the substitute for return *See* IRM § 5.1 11.6.3.1 (May 5, 2003).

response to new information.[27] This dynamic approach allows agents to find unreported income that would not be possible in the context of a limited scope correspondence examination.

Field examinations also differ from correspondence examinations because Revenue Agents are required to conduct certain "filing checks" to ensure that taxpayers have filed all of their returns, including information returns. These filing checks often lead to an expansion of the audit to include additional years or other taxpayers, which can uncover unreported income.[28] Thus, although correspondence examinations could be slightly more effective than ASFR and AUR in identifying unreported income from the cash economy, field examinations (and possibly office examinations) are likely to be the IRS' most effective tools for identifying such income.

Unfortunately, field examinations are more expensive than AUR, ASFR and other examinations.[29] As a result, the IRS uses them sparingly. In FY 2004, the IRS made AUR adjustments to 1,948,363 individual returns, filed 198,362 individual returns using its ASFR program, and examined 1,007,874 individual returns.[30] However, it only examined 195,054 individual returns using either field or office examinations.[31]

The IRS's Current Efforts to Address the Cash Economy

The IRS is presently pursuing a number of initiatives that could be more effective in addressing noncompliance in the cash economy if it pursued them more aggressively. These efforts include:

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[27] IRM § 4.10.4.1(2) (June 1, 2004).

[28] *See* IRM § 4.10.5 (May 14, 1999).

[29] Typically, Revenue Agents who conduct field examinations are more highly paid than Tax Compliance Officers who conduct office examinations and Correspondence Examiners who conduct correspondence examinations, as well as the IRS employees working ASFR and AUR processes. United States Office of Personnel Management, Operating Manual, Qualification Standards for General Schedule Positions (March 22, 1999); AWSS Human Resources Systems Office (HRSO), Workforce Information by Organization (June 11, 2005).

[30] IRS Data Book, Publication 55B, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004; IRS Data Book, Publication 55B, Table 26 - Taxpayer Contact Information, by Type of Math Error and Selected Program, FY 2004 (ASFR and AUR statistics).

[31] IRS Data Book, Publication 55B, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004.

Refining the Unreported Income Discriminant Function (UI-DIF)

UI-DIF is a tool for identifying returns that are most likely to have unreported income.[32] The IRS has begun using and refining this tool.[33]

Examining More Sole Proprietors in the Field

Although the likelihood that the IRS will audit a sole proprietor has not changed significantly, the IRS has increased the likelihood that when sole proprietors are examined the examinations will be conducted in the field. The percentage of the non-EITC Schedule C examinations conducted in the field (rather than in an office or by correspondence) increased from 35 percent of the total number of non-EITC Schedule C examinations in FY 2003 to 47.5 percent in FY 2004.[34] As discussed above, field examinations are the most effective types of examination for detecting unreported income generated by cash economy transactions.

Obtaining State and Local Tax Information

The IRS is working with state and local governments, with a primary focus on using state information to identify business non-filers and tax shelter investors.[35] As of February 2004, the IRS had 1,925 agreements and initiatives in place to share data with federal, state and local government agencies, including the following:[36]

- The State Revenue Agent Report Initiative. The IRS receives examination reports from some states on a monthly basis. These reports provide state tax examination results that the IRS can and sometimes does use as leads to make federal tax adjustments.

- The State Sales Tax Matching Project. Some states provide the IRS with sales tax records that it can and sometimes does use to match against income tax records to identify potential unreported income.

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[32] *See generally,* Treasury Inspector General for Tax Administration, Ref. No. 2003-30-146, *Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program,* (July 2003).

[33] *See* Publication 3744, *IRS Strategic Plan 2005-2009,* 19 (June 2004); SB/SE Strategy and Program Plan FY 2004 – FY 2005, (Sept. 25, 2003); SB/SE Strategy and Program Plan FY 2004–FY 2005, 28 (Sept. 25, 2003). IRS research recently concluded that a high UI-DIF score is a good predictor of unreported income by certain types of sole proprietorships. Denver SB/SE Research, *Research Report: Utilize Exam Results to Further Evaluate UI DIF Scores,* Project 03.08.002.03, iii (March 2005).

[34] SB/SE, AIMS Database (Closed Cases), IRS Examination Table 37 (Apr. 2005).

[35] *See* Publication 3744, *IRS Strategic Plan 2005-2009,* 20 (June 2004); *Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate,* 108th Cong., 50 (July 21, 2004) (statement of Commissioner Everson) *See also* IR-2004-77 (June 7, 2004).

[36] IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005).

- Ad Hoc Initiatives. The IRS has a variety of ad hoc information sharing initiatives with various states and localities. For example, IRS obtains some lists of business license applicants to identify nonfilers.

Obtaining Information on Cash Transactions in Excess of $10,000

Any person engaged in a trade or business and who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) is required to inform the IRS by filing Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business.*[37] The IRS uses information from Form 8300 to identify returns that may have unreported income.[38]

Entering Into Voluntary Compliance Agreements

The IRS sometimes enters into voluntary compliance agreements, including TIP agreements, to improve reporting compliance.[39] Instead of auditing the tax returns of employers and tipped employees, which burdens the employees and employers as well as IRS, the IRS negotiates two basic types of agreements with employers (who are generally in the food and beverage, cosmetology or gaming industries) to improve compliance by their individual employees in reporting tip income: Tip Rate Determination Agreements (TRDAs) and Tip Reporting Alternative Commitments (TRACs).[40]

Under a TRDA, the IRS and the business agree upon a tip rate for various occupations in the business and at least 75 percent of the business' employees agree to report at that rate on their income tax return. Under a TRAC, the business educates all of its employees about their obligation to report tip income and establishes procedures to promote reporting. These agreements are attractive to businesses because the IRS generally will not audit them while the TIP agreement is in effect.[41] In FY 2005, the IRS expected to secure over 180 new agreements.[42] The TIP agreements generally increase the amount of tip

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[37] *See* IRC § 6050I.

[38] *See* IRM § 4.26.15.4 (Jan. 1, 2003).

[39] SB/SE Strategy and Program Plan FY 2004 – FY 2005, 21 (Sept. 25, 2003).

[40] For useful background information about TIP agreements, *see* IRM § 4.23.7.3 (Mar. 1, 2003); Publication 1875, *Tips on Tips* (Apr. 2004); SB/SE Research, Brooklyn/Hartford, Project No. 01.08.004.03, *Update the Report on 'The Effect of Tip Compliance Efforts on Tip Reporting,'* (July 2003); General Accounting Office, GAO-03-378, *IRS Should Continue to Expand Reporting on Its Enforcement Efforts,* 49 (Jan. 2003); Treasury Inspector General for Tax Administration, Ref. No. 2001-30-076, *Opportunities Exist to Improve the Tip Rate Determination and Education Program* (May 2001). One variation of a TRAC, called an Employer-designed Tip Reporting Alternative Commitment Agreement (EmTRAC) allows employers to modify the TRAC agreement.

[41] IRM § 4.23.7.3(4) (Mar. 1, 2003).

[42] SB/SE Strategy and Program Plan FY 2004 – FY 2005, 21 (Sept. 25, 2003).

income reported by employees who receive tips and the amount of FICA taxes paid by employers on employee wages received as tips.[43]

Making it Easier to Pay Taxes Electronically or by Phone

Taxpayers may use an Electronic Funds Transfer Payments System (EFTPS) to make estimated tax payments or deposits electronically or by telephone.[44] EFTPS makes it easier for all taxpayers, including cash economy participants, to pay their taxes. For new enrollees the IRS will even waive one prior failure to deposit penalty.[45] However, IRS efforts focus on encouraging taxpayers to use EFTPS for depository taxes such as employment taxes rather than for estimated tax payments. In FY 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS, but in TY 2004 it received less than one percent of all estimated individual income tax payments (and less than one percent of all individual estimated tax payment dollars) through EFTPS.[46] The IRS may be focusing its efforts on depository receipts because the IRS is required by law to use an electronic system to collect 94 percent of all depository taxes.[47] No such requirements exist for estimated tax payments.

What Else Can We Do to Address the Cash Economy?

At a Senate Finance Committee hearing on the tax gap in July 2004, Senator Baucus asked the Commissioner to develop a list of options to address the tax gap and asked that they be characterized as "most stringent," "most lenient," and "moderate."[48] In my 2004 Annual Report to Congress, I listed 24 steps that could

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[43] *See* IRC § 3121(q); Treas. Reg. § 31.3102-3. Employers have an incentive to enter into TIP agreements because when employees fail to report tip income, which is considered a wage, the employer also fails to pay its share of the FICA taxes due on employee wages. In the absence of a TIP agreement, the IRS could assess additional FICA taxes against the business on audit. In contrast, businesses that properly classify their service providers as independent contractors have less incentive to enter into TIP agreements because they are not required to pay FICA taxes on amounts paid to independent contractors. Furthermore, since service providers often pass along some of their tax "savings" from underreporting to their "employer" by charging less for their services, the benefit of paying service providers "under the table" may, in many cases, exceed the cost of complying with information reporting requirements.

[44] EFTPS is the Treasury's electronic remittance processing system for making federal tax deposits and payments. Once enrolled in EFTPS, a taxpayer may initiate electronic payments with a telephone call or by using a computer. *See* IRM Exhibit 3.0.273-2 (Jan. 1, 2005) and http://www.EFTPS.gov

[45] Publication 4048, *EFTPS: Special IRS Penalty Refund Offer for Businesses* (Feb. 2004).

[46] Senior Tax Analyst – IRS, Wage & Investment Division, Customer Account Services, Submission Processing, Response to TAS Information Request (Oct. 5, 2005).

[47] *See* IRC § 6302(h)

[48] U.S. Senate Committee on Finance, Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (Release Date: July 8, 2004) (Doc 2004-15394), (Q&A of Commissioner Mark W. Everson), 56.

address the tax gap, and without expressing an opinion about the wisdom of any particular item, I identified key benefits and burdens associated with each.

One principle underlying many of these options is that their goal should be to *reduce opportunities for noncompliance*. This principle is important for two reasons. First, by reducing opportunities for noncompliance, we will bring in more revenue with a minimal direct expenditure of IRS resources. Second, fewer taxpayers will get caught up in audits, requests for substantiation, and claims for interest and penalties. Audits are burdensome and frustrating for taxpayers, so everyone benefits if we can make the liability clear on the front end and avoid the need for compliance actions on the back end.

With this concept in mind, I attach a full list of these options at the end of my written statement, and I will highlight a few of the key proposals here.[49]

IRS Must Conduct or Sponsor Much More and Better Research

The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities.[50] IRS activities have indirect revenue effects, which in most cases are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers any unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct revenue gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and as each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS economists have estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.[51]

However, not all audits have the same effect on compliance. One dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing a corporate tax shelter. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, one dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax

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[49] The table included with this written statement includes references to text contained in the *National Taxpayer Advocate's 2004 Annual Report to Congress.* The report, in its entirety, is available at http://www.irs.gov/advocate/article/0,,id=133967,00.html

[50] *See generally,* Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap,* GAO-05-753 (July 2005).

[51] 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), 35-36; 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).

law questions, has a positive indirect effect on compliance.[52] 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 best spent on enforcement or for taxpayer service.[53] Thus, in the absence of better research, it is important to emphasize that current decisions about how much to increase or decrease certain activities represent merely a policy call based on educated guessing.

Each taxpayer is compliant or noncompliant for a different reason, and a comprehensive approach to reducing the tax gap must recognize these differences.[54] Because unreported income from the cash economy is so difficult and costly for the IRS to detect and deter through traditional enforcement methods, the indirect effect of the IRS' activities is even more important in fostering compliance among these taxpayers than for the general population.

Revise Tax Forms

The IRS should revise Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, to include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099. IRS research shows that taxpayers are more likely to report income if it was reported to the IRS on information-reporting documents, such as Form 1099.[55] 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.[56] Breaking out gross receipts on the income tax form would likely improve compliance by emphasizing that income not reported on information reporting documents is still subject to tax. It may also suggest to taxpayers 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.

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[52] IRS researchers previously estimated that every dollar the IRS spent on return preparation generated $396 dollars of additional tax revenue. *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), 41.

[53] *See* Government Accountability Office, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (April 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (April 7, 2005).

[54] For a discussion of the categories of taxpayer noncompliance, *see* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All,* 51 U. Kan. L. Rev. 1145 (2003).

[55] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[56] *See* SB/SE Research – Brooklyn/Hartford, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups,* Project 01.08.003.04, 9 (Dec. 2004).

The IRS should also require all businesses (*i.e.*, sole proprietors, corporations and partnerships) to answer two questions on their income tax returns:

- Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business?
- If yes, did you file all required Forms 1099?

These two questions would alert uninformed taxpayers of their reporting obligations and encourage them to comply. The questions would also alert taxpayers that the IRS is looking at information reporting compliance and that there is some additional risk to avoiding the information reporting requirements by paying contractors "under the table." Since taxpayers must sign tax returns under penalty of perjury, they may be hesitant to answer such direct questions inaccurately.

Use Available Information

The IRS should aggressively use information available from state and local governments, from Forms 8300, and its UI-DIF tools to effectively audit taxpayers operating in the cash economy who are underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions and computer-based tools to identify underreporting, it uses very little of these resources. Moreover, use of TIP agreements could be extended beyond food, beverage, and gambling establishments to other industries such as barbers and hair and nail salons, adult entertainment, and parking attendants.

Use Filings with State and Local Governments to Identify Gross Receipts Not Reported on Federal Income Tax Returns.

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.[57] The IRS should obtain access to business license tax filings and compare a taxpayer's gross receipts, as reported on state and local filings, with a taxpayer's gross income reported on his or her federal income tax return. This comparison could help the IRS identify businesses that may be underreporting income.

Compare State and Local Property Tax Records to Income Reported on Federal Income Tax Returns.

Many states and localities impose property taxes based on the value of real and personal property. The IRS should obtain access to property tax records and

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[57] *See, e.g*, Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005) *See also* 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), available at http://www state.va.us/dpor/Contractors%20Web.pdf (requiring contractors to obtain different contractor's license classes based on the value of the contractor's jobs).

compare taxpayer property holdings with income reported on federal income tax returns. The IRS should use such information in conjunction with other factors to select returns for examination.[58]

Educate Cash Economy Participants about the Benefits of Reporting

The IRS should educate certain cash economy participants about the benefits of reporting their income. 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 credit, and
- ability to gain admission to the U.S. or a visa status adjustment for family members or employees.[59]

The IRS could test this concept by educating taxpayers through outreach and various media targeting cash economy participants in local communities where compliance is low. Publicizing such benefits, which may not be well known among cash economy participants, when combined with other enforcement initiatives in a given community, may significantly improve local reporting compliance.[60] The IRS should study the effect of such efforts to determine if they are cost effective.

Reestablish Local Compliance Planning Councils

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 so that it can adjust its local strategy accordingly. The IRS previously recognized this when it created

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[58] *See Bridging the Tax Gap: Hearing before the Committee on Finance, United States Senate,* 108th Cong., 23 (July 21, 2004) (making a similar suggestion).

[59] *See, e.g.,* Social Security, Survivors Benefits, Publication No. 05-10084, 5 (Jan. 2005) (indicating that survivors benefits are based on average lifetime earnings); Social Security, What Every Woman Should Know, Publication No. 05-10127, 1, 6 (Apr. 2003) (indicating that Medicare, death and disability benefits are based on earnings); IRC § 32 (earned income tax credit); 8 USC § 1182(a)(4) (requiring a sponsor to provide an affidavit of support for persons seeking admission to the U.S. or a visa status adjustment); 8 USC § 1183a (defining affidavit of support); Form 1-864, *Affidavit of Support Under Section 213A of the Act,* (Oct. 5, 2001) available at http://uscis gov/graphics/formsfee/forms/files/I-864.pdf (requiring sponsors to attach three tax returns to the Affidavit of Support).

[60] *Accord* Joshua D Rosenberg, *The Psychology Of Taxes: Why They Drive Us Crazy, And How We Can Make Them Sane*, 16 Va. Tax Rev 155, 227-232 (Fall 1996).

local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.[61]

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.[62] However, if the IRS could convince a critical number of market participants to report their income to obtain the benefits described above and avoid the risk of detection by the IRS, then the market price for their goods or services would increase so that taxpayers could both compete and pay their taxes. Just a few market participants usually cannot change the market price by themselves. Such a change generally requires collective action, which is difficult to achieve without some form of organization or a credible threat that the IRS will enforce the law.[63] If the IRS could focus its enforcement and educational efforts on a particular local market, however, it may be able to shift market prices and improve tax compliance among large numbers of market participants. Compliant taxpayers might also be more likely to inform the IRS of noncompliance by their competitors. As the IRS's activity starts to affect market prices, it could produce a dramatic increase in voluntary tax compliance in the local cash economy as it changes local norms.[64] Local Planning Councils could work to identify local compliance challenges, direct the IRS' local response and measure whether its response has been effective.

Make It Easy to Pay Estimated Taxes

The IRS should make it just as easy for taxpayers to make their estimated tax payments as to pay other bills.[65] Most other creditors send customers a bill to

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[61] *See* General Accounting Office, *Tax Research: IRS Has Made Progress but Major Challenges Remain,* GAO/GGD-96-109, 30 (June 1996); IRS, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8.

[62] *See, e.g., Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs,* 2004 TNT 134-43, 189 (July 12, 2004). IRS focus group discussions suggest that workers sometimes pass along much, if not all, of their tax "savings" from underreporting to their customers or employers. *See* SB/SE Research – Brooklyn/Hartford, TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups, Project 01.08.003 04, 12 (Dec. 2004) (noting that workers will work for "half wages" if they are paid in cash)

[63] Interestingly, the author of a study on the cash economy concludes that unions may help to reduce the number of workers in the cash economy by formalizing the employment conditions of informal workers. *See* Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights The Informal Economy in Los Angeles,* Economic Roundtable Briefing Paper, 2002.

[64] *Accord* Jon S. Davis et. al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics,* 78 THE ACCOUNTING REVIEW 39 (2003) (finding that noncompliant populations respond to increasing enforcement by gradually increasing compliance until enforcement reaches a threshold level and then suddenly shifting to very high levels of compliance).

[65] The IRS should also make it possible for taxpayers to sign up for EFTPS and make a payment on the same day. Under its current process, taxpayers must wait at least seven to 10 days to use EFTPS, even if they are in the "Express Enrollment" program. *See* Publication 4276, *Express Enrollment Q & A's* (Jan. 2004). Taxpayers must wait two weeks if they do not participate in the "Express Enrollment" program.

remind them when a payment is due and offer them the option to make automatic monthly withdrawals from the customer's bank account free of charge.[66] Similarly, the IRS should send letters to self-employed taxpayers on a quarterly basis to remind them to make their estimated tax payments. These reminders should point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule them in advance, just like automatic payments to a mortgage or utility.[67] The letters should also offer to accept estimated payments on a monthly or even bi-weekly basis just like most other recurring bills.[68]

Taxpayers may fall behind on their estimated tax payments inadvertently because the payment process is cumbersome. Estimated tax payments are due on the following oddly-spaced dates: April 15, June 15, September 15 and January 15.[69] These dates do not consistently coincide with calendar quarters, and some taxpayers do not believe the dates make sense.[70] It may also be difficult for taxpayers to save enough to pay their taxes on a quarterly basis. One study for TY 1999 showed that 31 percent of the taxpayers who made (or were required to make) estimated tax payments were assessed estimated tax penalties.[71] A year 2000 telephone survey found that approximately two-thirds of taxpayers with a balance due prior to filing their return did not plan to owe a balance upon filing.[72] Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering odd payment dates, and saving enough on a quarterly basis is cumbersome, especially for self-employed taxpayers who are juggling many different duties.

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[66] TIGTA previously recommended that IRS clearly communicate to taxpayers that EFTPS is free. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

[67] Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly property tax payments or spend the funds elsewhere.

[68] Some mortgage companies offer programs to electronically deduct mortgage payments bi-weekly rather than monthly.

[69] Publication 505, T*ax Withholding and Estimated Tax Payments* 24 (Dec. 2004).

[70] *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

[71] *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

[72] *See* Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004), citing W&I Customer Research Group 5, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments*, (2000).

Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.[73] A recent IRS study found that "investors" receiving reminder letters increased both estimated tax payments and withholding by a statistically significant amount.[74] The study recommended that the IRS consider a large-scale "soft notice" program (*i.e.*, send reminder letters).[75] According to IRS research, taxpayers who owe a balance upon filing their return are **more likely to understate their tax liability** than other taxpayers.[76] Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.[77] Self-employed taxpayers are often participants in the cash economy and need to make estimated tax payments. Thus, if the IRS could reduce estimated tax payment shortfalls it could increase both reporting and payment compliance by cash economy participants.

Utilize Reporting and Withholding to Develop a Comprehensive Approach to Helping Taxpayers Become Compliant and Remain Compliant

Since we know that the compliance rate is approximately 96 percent when payments are reported to the IRS, we should explore ways to ensure that a broader array of payments is subject to 1099 reporting. Moreover, since we know that compliance is nearly 100 percent when payments are subject to withholding, we should require withholding in limited circumstances. Withholding

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[73] Signing taxpayers up for EFTPS could make estimated tax payments almost as automatic as withholding. As previously noted, taxpayers subject to withholding report 99 % of their income. IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

[74] *See* Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 6-7 (Jan. 16, 2004). The study defined "investors" as taxpayers with a balance due of between $100 and $1000 with non-wage income in excess of $4,000 and wages less than $500,000 *Id.* at 8.

[75] Both GAO and TIGTA had previously recommended that the IRS test a soft notice program to improve estimated tax payment compliance. *See* General Accounting Office, GAO/GGD-99-18, *Billions In Self-Employment Tax Are Owed,* 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements,* 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO's soft notice recommendation, it delayed and then canceled the planned implementation based on a June 2000 initiative that tested the effect of a pre-filing notice on repeat high-income nonfilers).

[76] Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan 16, 2004).

[77] Wage & Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters,* 7 (Jan. 16, 2004).

imposes significant burdens on the payor, so I am not advocating universal withholding. However, we should at least consider the feasibility of the following:

- Enter into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms, *e.g.,* travel agencies and travel agents, or hair salons and stylists. The IRS, on a case-by-case basis, could agree to provide a safe harbor worker classification where the payor enters into a voluntary withholding agreement.[78]

- Actively encourage self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the Electronic Funds Transfer System (EFTS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene when the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, impose a back-up withholding requirement, as described below.

- Amend IRC § 3406 to require a form of "backup withholding" by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

Balancing Tax Law Enforcement with Taxpayer Service and Taxpayer Rights

In developing a long-term strategic approach toward noncompliance, the IRS must remember that the "stick" is not the only effective tool for addressing the tax gap; the "carrot" has a critical role to play, too. For taxpayers who will make reasonable but not Herculean efforts to comply with the tax laws, taxpayer service makes all the difference. If we make it easy for taxpayers to get forms, get answers to tax law questions, file returns, and get assistance if they run into problems, the vast majority of taxpayers will meet their tax obligations. If, instead, we increase the burdens of compliance too much, we will lose some of these taxpayers. Just as with indirect revenues on the enforcement side, the indirect revenue gains on the taxpayer service side are not easily measurable. But these gains exist, and they are significant. If we start emphasizing enforcement at the

[78] For over thirty years in the United Kingdom, contractors in the construction industry have been required to withhold on payments to independent contractors unless Her Majesty's Revenue and Customs (HMRC, formerly Inland Revenue) declares the independent contractor to be exempt from withholding. Independent contractors can obtain exemption certificates from HMRC by demonstrating compliance. This approach has the advantage of making it in the contractor's best interest to employ compliant subcontractors, since most contractors want to minimize their paperwork burden and avoid withholding requirements.

expense of taxpayer service, we ultimately will not achieve the overall revenue gains that we are seeking.

Taxpayer service and enforcement activities work hand-in-hand to promote high levels of compliance. Both are responsible for the estimated 84 percent compliance rate we have today, and both must be strengthened if we are to increase the compliance rate meaningfully. Importantly, in attempting to reduce noncompliance on the part of taxpayers responsible for the 16 percent noncompliance rate, we must be careful to avoid steps that could reduce compliance among taxpayers who are currently responsible for our 84 percent compliance rate.

Recently, the IRS's approach to combating the tax gap has focused almost exclusively on enforcement. Noncompliant taxpayers are often characterized as "cheaters." In my view, this is a mistake. The carrot and the stick are inextricably intertwined.

We can categorize taxpayers – somewhat simplistically – into three groups. They are either currently complying with the tax laws, or trying to comply, or not trying to comply at all. The taxpayers who aren't trying to comply may respond only to enforcement, but taxpayers who are seeking to comply will do so if we make compliance easy to achieve. These taxpayers will be much less likely to comply if we make it difficult. Thus, there should be minimal barriers for these taxpayers to get forms and answers to tax law questions, file returns, and obtain assistance if they run into problems. Even enforcement problems.

Today, all we know about noncompliant taxpayers is the nature of their noncompliance, not the underlying reasons for it. We know whether taxpayers are nonfilers, or underreporters, or non-payors. If we don't understand the reasons for noncompliance, we run the risk of a shotgun approach. We may hit someone with serious enforcement actions when a less drastic approach might work and might have better long-term compliance effects.

Conclusion

The IRS faces significant challenges in the next few years as it attempts to increase taxpayer compliance. I believe the IRS is doing the right thing in targeting corporate tax shelters and high-end cheating in the short-term, but I believe that with two-thirds of the tax gap attributable to the self-employed, the IRS needs to develop a thoughtful and comprehensive strategy to address noncompliance in the cash economy. The strategy should consider not only direct revenue benefits but the indirect effects (*i.e.,* the multiplier) generated by IRS activity.

Among areas for consideration, IRS and Congress should reduce opportunities for noncompliance through increased information reporting and limited non-wage

withholding, increase information sharing with state and local governments, develop targeted local initiatives, revise tax forms, and put more IRS agents "on the street" to focus on industries that are particularly noncompliant. At the same time, the IRS should keep in mind that taxpayer service is central to maintaining and improving the compliance rate and it should do more to study taxpayer needs, particularly with respect to face-to-face service, and to meet them.

To achieve these objectives, the IRS needs to do a better job of identifying and balancing both taxpayer needs and enforcement efforts. Rather than making resource-driven decisions that are based on inadequate research and that fail to identify equivalent alternatives, the IRS must develop a world-class research function that is the foundation for all of its customer service and enforcement activities. Research – and truly strategic planning – should inform the IRS's allocation of resources so that we achieve the maximum compliance possible by obtaining the optimal balance between service and enforcement.

Tax Gap Reductions Options

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Form 1099-MISC	Increase the Penalty for failing to issue a required Form 1099-MISC (currently the penalty is $50 per return).[79]	SI MI	Increased Form 1099-MISC reporting would reduce some income that currently escapes information reporting (sometimes referred to as the "cash economy".) Increased information reporting results in higher compliance.[80]	Increased 1099-MISC reporting would impose additional burdens on service-recipients that would be required to process and file more paperwork to comply with any additional compliance. Eliminating the "trade or business" requirement for issuing a Form 1099MISC would impose a new burden on non-business service-recipients, requiring individuals to file information returns on payments for such items as home repairs and yard care.
	Reduce or eliminate the $600 per year threshold for requiring a service recipient to issue a Form 1099-MISC.[81]	MI		
	Reduce or eliminate the $5,000 per year threshold for requiring a Form 1099-MISC to be filed in the case of a direct seller.[82]	LI		
	Require Forms 1099-MISC to be issued to incorporated service providers.[83]	SI		
	Eliminate the "trade or business" requirement for issuing a Form 1099-MISC, but also introduce a high dollar threshold for requiring a service recipient to issue a Form 1099 for non trade or business payments.[84]	MI		

[79] Up to a maximum of $250,000 per year. IRC § 6721(a).
[80] *See* Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. *See also*, Most Serious Problem, IRS Examination Strategy, *supra*.
[81] *See* IRC § 6041A(a)(2).
[82] *See* IRC § 6041A(b).
[83] Incorporated service providers are currently exempt from Form 1099-MISC reporting in most cases. *See* Treas. Reg. § 1.6041-3(p)(1).
[84] *See* IRC § 6041A(a)(1).

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Non-Wage With-holding	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting.[85]	MI	Nearly 100 percent of income subject to with-holding is reported.[86]	Withholding on current Form 1099-MISC payments would effectively impose employment tax compliance requirements on service recipients for payments to non-employees. Withholding on current Form 1099 MISC payments would require both independent contractors and service recipients to calculate profit margins to estimate the applicable withholding rate. This could impose significant administrative burdens on service
	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting, and specify that service providers that fail to withhold under this requirement are subject to the Federal Trust Fund Recovery Penalty.[88]	MI		

[85] *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 256-269, where this proposal is explained in detail. Several other Federal agencies have also recommended non-wage withholding: see Hearings on H.R. 3245, The Independent Contractor Tax Status Clarification Act of 1979, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 96th Cong. 11 (1979) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy); Hearing on Compliance Problems of Independent Contractors, GAO-109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Federal Contractor Compliance*, GAO/GGD-92-108, 4 (July 1992), General Accounting Office, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, 37 (May 11, 1994); GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, 12 (August 1996); Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference No. 2001-30-132, ii (Aug. 2001) *see also, Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration), and Q&A of Mike Brostek, Director Strategic Issues, Government Accountability Office.

[86] *See* Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. *See also*, Most Serious Problem, IRS Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Encourage service recipients and independent contractors to enter into voluntary withholding agreements.	LI		recipients that use independent contractors for various kinds of work. It could also impose significant burdens on independent contractors that operate at narrow profit margins.[87]
	Provide tax or reduced compliance incentives for service recipients that enter into voluntary withholding agreements with independent contractors.	LI		

[87] *See* generally, Russell A. Hollrah, Home Care Representative Opposes NTA's Plan to Target Underreporting by Self-Employed, 2004 T.N.T. 73-37, March 22, 2004.
[88] *See* IRC § 6672. See also Key Legislative Recommendation, Small Business Burden Reduction, Protection from Payroll Service Misappropriation, *supra.*

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Backup Withholding	Institute "real time" Taxpayer Identification Number (TIN) verification for service recipients and institute immediate backup withholding on those with invalid TINs.	SI	Expanding the current backup withholding provisions[89] to target specific noncompliance would be less burdensome then general non-wage withholding. Nearly 100 percent of income subject to withholding is reported.	"Real time" TIN verification presents taxpayer information confidentiality concerns.[90] Withholding targeted at noncompliant service providers would still place compliance burdens on the service-recipients that use these service providers. Establishing standards for "demonstrated noncompliance" for both individuals and specific industries could be difficult.
	Require immediate backup withholding on individual service providers who have demonstrated a history on noncompliance.	SI		
	Require immediate backup withholding in specific service industries that have demonstrated a history of noncompli-ance.	SI		

[89] *See* IRC § 3406.
[90] *See* IRC § 6103.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Frequency of Estimated Tax Payments	Mandatory Increase	SI	More frequent payments would reduce the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.[91]	More frequent payments would increase self-employed paperwork and compliance burdens. More frequent payments could impose cash flow constraints on self-employed taxpayers that operate at narrow profit margins.
	Voluntary Increase.	LI		
Voluntary Electronic Estimated Tax Payments	Provide system to allow self-employed taxpayers to electronically submit estimated taxes.	LI	Reduces paperwork and compliance burdens associated with nonelectronic payments. Provides a simple means for on-time estimated tax payments, reducing the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.	Minimal, if any, taxpayer burden.
	Provide system that would allow the IRS to automatically withdraw estimated taxes from a self-employed taxpayer's business checking account. Self-employed taxpayers could participate in this system voluntarily.[92]	LI		

[91] Valerie Chambers, Evidence of Significant Excess Intangible Utility of Increased Intertemporal Payments over Financial Investment Gain Opportunity in a Tax Budgeting Situation (unpublished paper, on file with the National Taxpayer Advocate), see also, Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration).

[92] This system could be expanded to impose mandatory withholding through a self-employed taxpayer's business checking account if that taxpayer had demonstrated a history of noncompliance.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Audit and Exam Initiatives	Increase "Required Filing Checks" (a.k.a., package audits). Required Filing Checks are part of an IRS field audit and require the IRS agent(s) to examine the records of a business taxpayer to determine such things as whether the taxpayer has filed all required returns – including information returns, if it has submitted questionable Forms W-4, and if it is a "cash business" that may be subject to additional scrutiny.[93]	SI	Increased enforcement increases both direct and indirect compliance.[94] Increased IRS and taxpayer focus on gross receipt sources and Form 1099-MISC reporting. Compliance would increase directly for those taxpayers selected for audits, both for the tax years at issue and for future years.	Taxpayers selected for audits would need to go through IRS examination procedures. Concerns that taxpayers affected by local and national compliance initiatives and receiving disparate treatment compared to non-affected taxpayers.
	Implement local audit initiatives that are focused on income reporting for specific groups of taxpayers with demonstrated histories of noncompli-ance (for example, contractors in a particular city).[95]	SI		

[93] *See* IRM 4.10.5 (July 13, 2001). On June 27, 2003, the Deputy Director of Compliance Policy for the IRS SB/SE division issued a memorandum limiting the scope of Required Filing Checks by eliminating information return and employment tax return reconciliations and mandatory inspections for questionable Forms W-4. The procedures set forth in this memorandum were to expire on April 15, 2004, but no memorandum to that effect has been issued. Memorandum from SB/SE Deputy Directory, Compliance Policy re Required Filing Checks (package audit) – IRM 4.10.5, June 27, 2003.

[94] *See* Most Serious Problem, Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Implement industry segment compliance initiatives (including, audits, research, education and outreach, and other compliance initiatives) aimed at increasing voluntary compliance within specific market and industry segments nationwide.[96]	SI	Compliance would increase indirectly as word of these audits spread throughout the respective industries and communities.	
	Fully utilize IRS Financial Status Analysis and Financial Status Audit techniques to the extent permitted by IRC §7602(e). These techniques seek to identify unreported income by analyzing a taxpayer's cash flows to estimate whether there are sufficient funds to cover the taxpayer's expenses.[97]	SI	Outreach, education and research efforts would increase voluntary compliance in selected local areas and market and industry segments.	

[95] *See also* discussion in Most Serious Problem, Examination Strategy, *supra*.
[96] These initiatives could be structured to fit within the IRS' Compliance Initiative Projects program. See IRM 4.17.1 (Feb. 1, 2004).
[97] IRM 4.10.4.3.3.1 and IRM 4.10.4.6.1 (June 1, 2004). IRC § 7602(e) limits financial status or economic reality examination techniques to cases where the IRS has a reasonable indication that there is a likelihood of unreported income. The IRM Financial Status Analysis procedures are designed to determine whether such a reasonable indication exists to permit the IRS to implement its Financial Status Audit procedures.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Forms Revisions	Revise Form 1040, Schedule C, to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC.	LI	Receiving specific Form 1099-MISC income information would allow the IRS to better track self-employment income sources and develop measures to reduce the cash economy. Specifically requiring Form 1099-MISC income to be separately reported would increase the likelihood that taxpayers would report such income and also increase tax-payer aware-ness of income sources that should be re-ported on Forms 1099-MISC. A "penalties of perjury" statement would make issuers aware of the significance of the Form 1099-MISC requirements and increase awareness that the IRS is actively monitoring accurate Form 1099-MISC compliance and reporting.	Minimal recordkeeping burden.
	Supplement Form 1099-MISC with a required statement that the issuer must sign, under penalties of perjury, declaring that all required Forms 1099-MISC have been issued for the tax year.[98]	LI		

[98] Only one statement would be required per issuer per year. In other words, a Form 1099-MISC issuer would not be required to sign a statement for each Form issued.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Information Sharing Initiatives	Establish local Compliance Planning Councils, involving the IRS (including both compliance and noncompliance division chiefs and local research offices) and state and local taxing authorities, that would focus on improving self-employed and cash economy compliance in their respective areas.[99]	LI	Self-employed noncompliance and the cash economy affect all levels of government. Information sharing and partnering efforts will allow all government participants to enhance compliance in these areas.[100]	Minimal, if any, taxpayer burden.
	Information sharing between the IRS and state and local taxing, compliance and licensing authorities. These sharing efforts could involve such information as business licenses and property tax records.[101]	LI		

[99] *See also* Most Serious Problem, IRS Examination Strategy, *supra*.
[100] *See Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).
[101] *See* Testimony of Nina E. Olson, National Taxpayer Advocate, Hearing on Bridging the Tax Gap before the Senate Committee on Finance, July 21, 2004, 10.

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