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EXAMINING THE ADMINISTRATION'S PLAN FOR REDUCING THE TAX GAP: WHAT ARE THE GOALS, BENCHMARKS, AND TIMETABLES?

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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EXAMINING THE ADMINISTRATION'S PLAN FOR REDUCING THE TAX GAP: WHAT ARE THE GOALS, BENCHMARKS, AND TIMETABLES?

WEDNESDAY, APRIL 18, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:27 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Lincoln, Wyden, Schumer, Stabenow, Salazar, Grassley, Thomas, Bunning, and Crapo.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Forty-five years ago, President Kennedy challenged the Nation. He said, "I believe that this Nation should commit itself to achieving the goal, before this decade is out, of landing a man on the moon and returning him safely to the earth."

President Kennedy acknowledged the difficulty of the task, but he also saw the risks of failing to act. He said, "While we cannot guarantee that we will one day be first, we can guarantee that any failure to make this effort will make us last."

Today we discuss goals for improving compliance with the tax law. Improving tax compliance might also be a difficult task, but it is not rocket science. In 2005, the rate of voluntary tax compliance was 85 percent. In 2006, it dropped to 83.7 percent. That is a drop of more than a full percentage point in 1 year. Each percentage point drop in the rate amounts to a $25-billion increase in the annual tax gap.

Since 2001, the government has failed to collect more than $2 trillion in legally owed taxes. The American people have a right to expect that their government will have a goal and that a credible plan to reduce this tax gap exists. It is the Treasury's job to fix it, yet the administration does not appear to take this job seriously.

In February of 2006, I asked Secretary Snow for a tax gap plan within 30 days. When he left office 5 months later, we still had not received one. He left behind a few proposals that would raise $3.5 billion over 10 years, barely a dent in the tax gap, that would lose $3.5 trillion—trillion—over 10 years.

On June 13, 2006, I asked IRS Commissioner Everson for a "reasonable, but aggressive" plan to reduce the tax gap. He agreed to provide a plan, but he has not delivered one.

On June 27, 2006, I asked Mr. Paulson for a plan. He did not commit to provide one. On July 13, 2006, I asked Mr. Solomon for a plan. He, too, did not commit to provide a plan. Only after I held up Mr. Solomon's nomination did Treasury agree to come up with something. Good faith. That was the agreement.

What we received, however, was an outline for a strategy. That outline was utterly inadequate. It merely rehashed ideas that were already floating around Washington. It contained no specific goals.

The Treasury promised to provide a more detailed outline following the release of the administration's fiscal year 2008 budget plan. In February, however, the administration's budget included 16 tax-compliant proposals that would raise just $29 billion over 10 years.

The Finance Committee staff is working closely with Treasury officials to develop these proposals. But a few worthy ideas do not rise to the level of a plan, and a penny on every dollar of the tax gap is simply not enough. That is what those 16 amounted to, one penny on the dollar of the tax gap.

The budget says that the Treasury and the IRS "continue to consider additional approaches to reducing the tax gap." But for 2½ months, this committee has been waiting to hear what they are.

Some complain that improving the tax compliance will burden taxpayers and decrease their rights. But what about the rights of honest, hardworking taxpayers who do pay taxes that they owe? What about the additional tax burden on honest taxpayers when the dishonest are allowed to skate by?

I know there is no magic solution to the tax gap, but that does not mean that there is no solution to the tax gap. Increasing our Nation's rate of voluntary tax compliance is going to take some ingenuity. It will take some elbow grease. It is going to require a multi-faceted approach and require addressing services, enforcement, and technology. But the administration still needs a plan. It needs a concrete plan, a plan with goals, with benchmarks, with time tables.

Secretary Paulson was a successful investment banker. Any banker would ask for a comprehensive business plan before approving a loan. Every time the Secretary of Treasury travels overseas, the Department has a destination, an itinerary, and a precise time table. It has a plan, a very detailed plan.

That is why it astounds me that the Treasury does not have a comprehensive, credible plan for the tax gap. I will not wait any longer. I am going to set the goal for you today. I am setting the goal of 90 percent voluntary compliance by the year 2017. Ninety percent over the next 10 years. That is 6 percentage points higher than today's rate.

I think this is realistic. It is achievable within 10 years, and when it is reached, collections of taxes legally owed will increase by at least $150 billion annually. It is up to the Treasury Department to develop and present to this committee a plan that will achieve this 90-percent compliance goal. I would invite you back, Mr. Secretary, to appear before this committee in 90 days, July 18,

2007, to deliver a more credible plan, complete with benchmarks and time tables.

The dropping voluntary compliance rate threatens the integrity of our tax system. It undermines fairness, it weakens confidence in government, and it breeds disrespect for the law.

This Nation should commit itself to achieving the goal before a decade is out of having at least 9 out of 10 taxpayers comply with the tax law. While we cannot guarantee that we will achieve this goal, we can guarantee the consequences of failure to make the effort.

Let us challenge more taxpayers to comply with the law. Let us challenge the Treasury Department to find ways to make it so. Let us, together, work to restore the integrity of our tax system.

I see Senator Grassley is not here, so I will begin with you, Mr. Secretary. Why don't you begin with your opening statement?

Secretary PAULSON. Thank you, Mr. Chairman.

The CHAIRMAN. But when he returns, at the appropriate time I will ask Senator Grassley if he wishes to make a statement. I apologize for the late delay in this hearing; we had two votes. I do not think there are any more votes to interfere with the hearing the rest of the day.

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC; ACCOMPANIED BY HON. ERIC SOLOMON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC AND HON. MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Secretary PAULSON. I will begin with an opening statement, and then hopefully we will have a chance to talk about some of the points you made, including the man on the moon and the business trip analogy, because I would like a chance to talk about them.

Chairman Baucus, members of the committee, thank you for considering this important topic and for inviting me to speak about it. It is very appropriate that we have this conversation the day after tax day.

Over the last few months, millions of Americans have collected their W–2s, their 1090s, their home mortgage interest statements, and countless other pieces of paper to fill out their tax returns. This is an annual ritual for Americans, completed without great enthusiasm, but with remarkable honesty and effort.

The vast majority of Americans pay their taxes, without additional prodding by the IRS, out of a sense of fairness and civic duty. They understand the importance of paying what they owe, and they know that when they fail to pay their taxes, when other people fail to pay their taxes, it serves as a de facto increase on everyone else.

While the current compliance rate is high, it can, and should, be improved. Our objective must be to increase tax compliance without over-burdening the tens of millions of taxpayers who already pay their taxes honestly and on time.

The amount of taxes that are owed but not paid is commonly referred to as the tax gap. An important part of addressing the tax gap is to understand not only the types of taxpayers—individuals,

small businesses, corporations—that do not comply, but also why these taxpayers fail to comply. Answering these questions will help us improve taxpayer service and better target our enforcement efforts.

In September of last year, we released a comprehensive 7-point strategy to address the tax gap. The budget we put forward for 2008 is critical to implementing that strategy. It requests new funding for taxpayer services, research, improved technology, and targeted enforcement. We ask for your help in working with the Appropriations Committee to make sure the IRS has the resources it needs to improve compliance, while maintaining its commitment to taxpayer service.

The budget also includes 16 legislative proposals that, if enacted, will help to narrow the tax gap without imposing excessive burdens on compliant taxpayers. Since I appeared before this committee, my staff has been meeting with your staff on a regular basis to review the 16 legislative proposals.

Treasury's Assistant Secretary for Tax Policy Eric Solomon and IRS Commissioner Mark Everson are here with me today to provide more detail about these proposals and the IRS's budget request.

Our legislative proposals attempt to balance the burden they impose on taxpayers against the impact they will have on improving compliance. Even so, some of the proposals have generated concern from those who could be affected by them.

We must consider the impact of any new rules on the vast majority of Americans who already pay what they owe and better target our enforcement efforts to minimize additional burdens.

Since I last testified before you, Treasury has explored ways to improve compliance. We held a public discussion a few weeks ago and heard from a broad cross section of stakeholders, including a former IRS Commissioner, tax preparers, and business representatives.

Several insights emerged: first, we need to know more about specific sources and causes of the tax gap so we can focus our efforts more precisely; second, great care must be given to ensure that those efforts do not impose unreasonable burdens on already compliant taxpayers; third, simplification of the tax code, as well as taxpayer education and services, would help improve compliance; fourth, we need to manage expectations, recognizing that every potential solution carries consequences.

I know you spent a great deal of time exploring this issue, and since I came to Washington I have taken a hard look as well. The most recent data we have on the tax gap comes from 2001. It indicates that the vast majority of the tax gap was attributable to under-reporting of income.

Most of the under-reporting is attributable to individuals with business income and corresponding self-employment tax liabilities. This includes small businesses, farms, and ranches. It is unclear whether this under-reporting is a result of deliberate deception or simple misunderstanding of what needs to be reported and how to do it.

To substantially improve compliance in this regard, Congress would have to mandate additional requirements that would affect

not only those who do not report all other income, but also those who already do. I have come to the conclusion that there is a big part of the tax gap we simply will not be able to reach without adding draconian and painful requirements on all taxpayers. I do not believe any of us really want to do that.

We must remember that the tax gap is simply not a pot of gold that we can dip into every time we want to pay for a new or expanded program, nor should it be viewed as an easy solution to existing challenges, such as the Alternative Minimum Tax.

As you know, narrowing the tax gap is about improving compliance. It is not about changing the baseline to raise more revenue. The budget resolution passed by the Senate assumes revenue collections are raised by hundreds of billions of dollars.

Some believe this level can be achieved largely through measures to reduce the tax gap. I believe it is unrealistic to assume that reducing the tax gap will yield that level of additional revenue.

In developing our 16 proposals, we focused on changes that would narrow the tax gap with minimal additional burdens. Some have suggested that far more expansive proposals should be put forward. Many of these proposals would require steps that I would not recommend because they are bad tax policy and would be unnecessarily painful, expensive, and time-consuming for taxpayers. For example, requiring individuals to file 1099s reporting their transactions with service providers such as their doctor, auto mechanic, dry cleaner; eliminating cash transactions in favor of electronic transactions with card issuers and banks providing statements to the IRS so that payments can be matched with the business's reported income; or doubling or tripling the number of IRS agents and audits.

In theory, each of these measures could bring in some additional revenue, but the cost of compliance for individuals and businesses, most of whom already pay what they owe, would far outweigh the gains. In many cases, such measures would also raise privacy concerns due to the government's heavier focus on the daily transactions in each of our lives.

I hope we can all agree that such extreme measures are not the approach we should take. Instead, as a strong first step toward narrowing the tax gap, I hope you will work with us to approve the additional IRS funding and enact the legislative proposals the President has requested.

I am pleased that Congress has recently taken up a number of these proposals by capitalizing on the direct and indirect effects of IRS enforcement, and, by making focused legislative changes, I am confident we can make measurable progress toward reducing the tax gap without adversely affecting compliant taxpayers.

We should also look for ways to reduce the complexity of the U.S. tax code. Making the tax code simpler and fairer for the average American could help to improve compliance by reducing the number of honest mistakes, removing incentives for cheating, and providing fewer places for tax cheats to hide.

It is critical that we manage expectations and view efforts to reduce the tax gap over the long term, with a clear understanding of both the costs and the benefits of taking any action. Making significant progress will require a sustained, focused effort by the ad-

ministration, Congress, and the American people. Honest American taxpayers are allies in this effort, and we must always put their interests first.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared statement of Secretary Paulson appears in the appendix.]

The CHAIRMAN. As I listened to you, basically I heard you say not much could be done. You are basically accepting it. That is basically what I heard.

Secretary PAULSON. Well, let us address that a minute. I believe that we can make, and are making, progress. I believe that if you have an 85-percent compliance rate, that is a level that people all over the world look at with great admiration. So to go beyond that, we know it is a matter of balance, weighing the burden you are putting on the compliant taxpayers. Now, what I would like to do, if I could just take a minute and address——

The CHAIRMAN. Very briefly, because I do not want to take up the time on one question.

Secretary PAULSON. What I want to do is address your goal.

The CHAIRMAN. Sure. Sure.

Secretary PAULSON. Because this is a very, very important topic, and we all agree we need to make progress. We all agree that no one likes people who are free-riding on our system. We need to figure out how to deal with this.

Now, your question of the goal. I would love to get to 90 percent. I would like to get there as much as you would. So, as I have thought about the goal, there are two problems I have with it. Now, I will use your man-on-the-moon analogy. When we got the man on the moon, it was clear to everybody. The man was on the moon, and it was very, very measurable.

The first question I have about this—which I think is not the overriding question but I just really need to point it out—is that, with your goal, in 10 years of 90-percent voluntary compliance, what we would need to do to ascertain whether we reached the goal would be to do a study in 2017, and we would get the results several years later. And, it would only be an estimate. Because it is very hard, no matter what kind of study you do, to figure out or prove how much money was not paid in taxes. Most of the tax gap, 80 percent of it, is from under-reporting.

But again, I do believe that is not a reason, in and of itself, not to set a goal. I believe the part that troubles me the most is, if we set a goal for 90 percent, then you are rightfully going to say—and what we did at Goldman Sachs and what we do at Treasury when we have business plans is—how are we going to get there? I am sure, when we said, how are we going to get a man on the moon, there was a series of steps that needed to be taken, and there were clear steps to get there.

When I look at it, if I say 80 percent of this tax gap is about under-reporting of income and the vast majority of that is individual income, the steps that need to be taken are very, very onerous steps if people were going to get there.

The CHAIRMAN. So basically you are agreeing that not much can be done because the steps, in your judgment, are too onerous.

Secretary PAULSON. No. I think we can talk a lot about what has been done and what is being done. The administration put forward a goal before I was here to get up to 85 percent. I think Commissioner Everson is quite optimistic that if we pass the legislative proposals, pass the funding request in the budget, and keep working on the things we are doing, we will make progress.

I want to make progress, but what I do not want to do is put forward a plan that is an aspiration when we cannot measure the success and I cannot tell you what we are going to do to get there.

The CHAIRMAN. Right. I hear you. I do not have a lot of time here, but two points I want to make. One, I would just like your very brief comment. I have before me a release by the Republican party, the Senate Republican Policy Committee. It is talking about the tax gap.

The executive summary says there is no pot of gold here. That is because any attempts to reduce the tax gap on a large scale necessarily must increase the burden on taxpayers and decrease taxpayer rights.

The policy paper goes on to say—this is the main point—that the practical impact of implementing it could be devastating to the individual taxpayer. That is the Republican Senate Campaign Committee.

What is your response to that?

Secretary PAULSON. On this, we have a very credible plan, and we want to keep working on it to make progress on reducing the tax gap. So I would like to talk about what we can do to reduce the tax gap.

The CHAIRMAN. Here are five potential areas that I think are not draconian. One, is improved service.

Secretary PAULSON. Yes.

The CHAIRMAN. That is, do not shut down face-to-face taxpayer assistance centers for the elderly and poor.

Secretary PAULSON. We would agree with that.

The CHAIRMAN. That is one way. Second, more electronic filing. Free, direct IRS portals so everyone can file.

Secretary PAULSON. I missed your second. What was your second?

The CHAIRMAN. More electronic filing.

Secretary PAULSON. Yes.

The CHAIRMAN. A free, direct IRS portal so everyone can file for free and get faster refunds, less errors, and so forth. More electronic filing.

Third, improve regulation of preparers. We all know the gross disservice that a lot of preparers are performing and how many mistakes preparers are making. The GAO did a study on that, and it was just devastating, how badly the preparers are trained. That is not a big burden on taxpayers. That is not draconian, I would not think.

Better technology. You know, work smarter. Better filters. Catch identity thieves, like Mr. Soukas the other day, who had false identification, for example. I was stunned at that hearing to learn, I might say, and I do not mean to step on the toes of Mark Everson, basically saying not much could be done about that.

Here is this guy who defrauded honest taxpayers with refund loans of $43,000. The answer I got was, nothing can be done about that, which I find just totally stunning, outrageous, and unacceptable. We have to find ways to find those persons who file false identifications.

Another is, use the tools you have. What about tax shelters? So far there have been no disclosure penalties for 2½ years after stronger penalties were enacted in the JOBS bill. There are a lot of things that can be done, and I am just surprised and disappointed that I am not hearing suggestions from you, Mr. Secretary. You can tell us what needs to be done to reach that 90 percent.

You can put a caveat next to it, when we meet 3 months from now, as to whether you would recommend them or do not recommend them, but your best judgment of what it takes to reach 90 percent compliance over 10 years.

Secretary PAULSON. I would say this, Mr. Chairman. First of all, I think every statement you made, I agree with. We are working on better service and more electronic filing, and the Commissioner will tell you everything he is doing with regard to the individual and corporate side concerning tax shelters and better technology.

So this is something we are working on very, very hard. We have seven principles, and the ones you named are included in those. So, these are the things we are working on. All I am saying to you is that I do not see a clear path, pursuing all of these, where I would be able to say we are going to get to 90 percent. Again, as I said, the elephant in the room right here is under-reporting and what it takes to get at non-reported income.

The CHAIRMAN. Well, my time has expired. I appreciate that. We will have further opportunity to talk about this.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thank you, first of all, for holding this hearing. Thank you for being aggressive on this effort, because I think this is one of the significant challenges facing us from a fiscal standpoint, and in terms of equity to all taxpayers.

They are now telling us the tax gap, the difference between what is owed and what is paid, back in 2001, was $345 billion for that 1 year alone. The difference between what is owed and what is paid, $345 billion for back in 2001.

I have studied the numbers from what has been done in terms of assessing taxpayers for money not paid over, and it looks to me like we have gone through a very deep valley where compliance was dramatically reduced. It has been recovering now under the leadership of Mr. Everson. But we went through a very deep valley there. I believe this number—I have spent some time studying this number—is a conservative number.

Let us go to the next slide, if we could. What this means, according to the National Taxpayer Advocate—this is a person who is given responsibility to stand up for all the honest taxpayers.

She said this in a report this year: "Compliant taxpayers pay a great deal of money each year to subsidize non-compliance by others. Each household was effectively assessed an average surtax of about $2,680 to subsidize non-compliance in 2001. That is not a

burden we should expect our Nation's taxpayers to bear lightly." So if it was $2,680 for all of us who are honest taxpayers to subsidize those who are not, that really is utterly unacceptable.

Let us go to the next. I must say, Mr. Secretary, I am an admirer of yours. You know that. I have said so publicly, I have said it to you privately. On this issue, I do not think you are meeting the test. I do not think, in your previous position—you had a sterling reputation—that if you saw a hole in the budget of this significance, that you would accept a lack of a plan. And what I hear you saying today is, we are supposed to accept a lack of a plan.

Secretary PAULSON. We have a plan.

Senator CONRAD. Please. Not a serious plan. Look, we have a hole here of $2 trillion, I believe, over the next 5 years. Two trillion. And this administration is telling us, about the best they can do is $20 billion a year. Now, come on. You can do better than that.

Now, we have not discussed tax havens. That is a whole other element, but one that also deserves attention. I have shown this building on the floor of the Senate. This is a building in the Cayman Islands. It is a 5-story building that claims to be the home to 12,700 companies. They all say they are doing business out of this building. Now, they are not doing business out of this building. They are engaged in an enormous tax dodge.

Let us go to the next. We have another committee of Congress, the Senate Homeland Security and Governmental Affairs Committee on Investigations, and here is what they have told us: "Experts have estimated the total loss to the Treasury from offshore tax evasion alone approaches $100 billion a year, including $40 to $70 billion from individuals, another $30 billion from corporations engaging in offshore tax evasion."

Now, if anybody doubts that there is a massive movement on tax evasion, I would just urge you to go to the website. Go punch in "tax haven" and see what you find. Here is what we found. Put in "offshore tax planning." We got 1,260,000 hits. One million, two hundred and sixty thousand.

Read what they are saying. It is appalling, what they are saying. Go on the Web. Here is my favorite: "Live tax-free and worldwide on a luxury yacht. Moving offshore and living tax-free just got easier."

Now, Mr. Secretary, I could go on and on with this stuff. This is the Subcommittee on Investigations of Homeland Security that says we are losing $100 billion a year to this.

We are losing, over the next 5 years, I believe, $400 billion a year to the tax gap. That is a combined effect of $500 billion a year, and all I hear from this administration is, the best they can do is to recover maybe $20 billion of that. Is that really the best you can do?

Secretary PAULSON. Senator, let me say that I believe the 16 legislative proposals we have put forward are the most comprehensive set of proposals that have been put forward in 20 years. I really do believe a first step of this plan, a very, very important first step, is enacting those proposals, enacting our budget request, and we are working very hard.

Senator CONRAD. Mr. Secretary, I am out of time. Let me just say this to you sir, and I say this with absolute sincerity.

Secretary PAULSON. Right.

Senator CONRAD. I calculate, between the tax gap and this tax haven abuse, over the next 5 years, $2.5 trillion of lost revenue to the U.S. Treasury. In the testimony before the Budget Committee by this administration, the best they could say was that they would capture maybe $20 billion of that, and not until the end of the year. We are talking about capturing 2 or 3 percent. Is that really the best you can do?

Secretary PAULSON. Well, first of all, in terms of those numbers and in terms of estimates, there is no doubt there is a lot of abuse, and there is a big focus on that. There is also a fair amount, in this global world, of very legitimate activity offshore.

Senator CONRAD. But I am not talking about legitimate activity. I am talking about illegitimate activity.

The CHAIRMAN. Senator, you are going to have to——

Secretary PAULSON. And I would say a lot of what you were talking about there was, again, individual unreported income. That is what we are talking about.

But Mark, would you comment a little bit about what you are doing in this area?

The CHAIRMAN. Very briefly, Mark. The time is way over. Maybe a few seconds.

Commissioner EVERSON. Senator Conrad, as you know——

The CHAIRMAN. About 15, 30 seconds. No more, please.

Commissioner EVERSON. Particularly when you get into the offshore area, that is the hardest area for us, one, because those are seeking to obscure information that is more readily available, and also because, as the Secretary is indicating, there are many legitimate business activities that take place and this gets beyond what is in the tax gap to what may not be really policy that the Congress intended, but is legal in some instances.

The CHAIRMAN. Thank you, Senator.

Senator Thomas?

Senator THOMAS. Thank you. This is enthusiastic conversation here today.

How many of the 16 proposals that you had were included in the budget resolution?

Secretary PAULSON. How many of them? We put forward all of them.

Senator THOMAS. But are they in the budget resolution?

Secretary PAULSON. No.

Senator THOMAS. Well, then where are we on them?

Secretary PAULSON. We need to get them done.

Senator THOMAS. I know. But that is why we are here. They are not getting done that way then, is that it?

Secretary PAULSON. Yes.

The CHAIRMAN. I might say, nine are in the supplemental. Nine. We are working on seven. There is no problem with working through the other seven. We are working on it.

Secretary PAULSON. Senator, I have spent a lot of time with people at Treasury, people at IRS, the man on my right, the man on my left, asking how do we go after this and thinking it through.

I will tell you, the 16 proposals we put up there we thought were the best. There are issues with a number of them. It is a matter

of balancing. Overall, we thought these were the right steps to take, and we think they are aggressive. I think the fact that they are difficult to get passed quickly and that there is a fair amount of comment on them just shows you how challenging this is.

Senator THOMAS. Yes.

One of the kind of puzzling things, just looking at this from the standpoint of not being an expert in it, you seem to be able to know what the gap is but you do not know what to do about it. How do you determine what the gap is? If you know what is not there, why can't you go after it?

Secretary PAULSON. First of all, that is a very good question. The gap, which I tried to get to earlier, is an estimate that in some cases is bordering on an educated guess, because we did the study in 2001 and we got the results 4 years later.

Now, Senator, think about this a minute. If 80 percent of it is as a result of unreported income, if you have individuals, small businesses, and others not reporting cash income or not reporting income in other ways, it is hard when you send an IRS agent in to audit them to know whether you have found all the unreported income.

So this is, at best, an educated guess. It is a number of years out of date. But we are learning about this. Just because it is difficult does not mean we should not be working on it. We are working very, very hard on it.

I was just trying to make the point that there is some level, when you have a tax system like ours, that is less than 100-percent compliance, which is as far as you can reasonably go without overburdening everyone else.

When I first came here, I was given some memos to read on the tax gap, and people said, well, the solution to the tax gap is to simplify the tax system. I think that will be useful in dealing with honest taxpayers who want to do the right things. But it will not be helpful with compliance issues.

Frankly, the more I looked at it, the more I said, if you really were going to seriously make a very big dent in closing that tax gap, you would have to go in the opposite way. You would have to impose more burdens. You would be going toward complexity, which I think would be a big burden on all the honest taxpayers.

Senator THOMAS. Closing the tax gap is a kind of an interesting term. But is it not true that the activities that Mr. Conrad referred to there on the website are already illegal, right? We do not need to pass any more laws. They are already illegal. We are just simply not enforcing the law.

Secretary PAULSON. Well, I would say he was, I am sure, referring to the point that there are plenty of illegal activities. So there it is a matter of compliance and being able to hunt them down, having enough trained auditors and investigators. Mark can talk about that. So, that is part of it.

But again, when you get to the corporate side, that is the smallest part of the issue. When you are looking at individuals, a lot of these activities are illegal. It is illegal to not report income, but plenty of people do not.

Senator THOMAS. All right. I guess that is the challenge. I have used up my time. Thank you.

The CHAIRMAN. Thank you very much, Senator.

Senator Grassley?

Senator GRASSLEY. Yes. Thank you.

Mr. Chairman, I am going to put my statement in the record. I would love to hear myself say it, but I think we had better go on to other things.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator GRASSLEY. So I am going to go to the Secretary and ask some questions, and it is going to be about enforcement. I think my staff hopefully gave you an idea of what I was going to ask, because I am not playing a "gotcha" game with you.

First of all, for everybody to understand, enforcement activities by the IRS are, of course, just one method of attacking the tax gap. We cannot use enforcement proposals for the benefit of this committee as bringing in revenue, because CBO is not going to score them. It is going to bring in more revenue, yes, and that is going to help us with the budget deficit. That is a very important consideration.

It seems to me that the largest portion of the tax gap is underreporting by small business. When it comes to small business, I guess I am a little concerned about our being too intrusive, yet we have to do everything we can to collect every dollar.

Last year we had Commissioner Everson testifying before the Budget Committee that the tax gap could be reduced $50 to $100 billion without changing the way the government interacts with taxpayers, and then earlier this year Commissioner Everson clarified for the Budget Committee that the IRS is already picking up the lower end of that range, and that it could get to the middle of that range or another $20 to $30 billion in 5 years if Congress would meet the President's funding request for the IRS.

Mr. Secretary, five questions. The IRS's $345 billion tax gap estimate represents a voluntary compliance rate of about 84 percent. That is pre-enforcement. After collecting $55 billion through late payments and enforcement, the compliance rate would be about 86 percent. How do IRS enforcement practices affect that voluntary compliance rate?

Secretary PAULSON. They obviously increase it. Obviously, it has a significant impact.

Senator GRASSLEY. All right.

How would IRS have to change its enforcement practices to reach a voluntary compliance rate of, let us say, 90 percent? There is nothing magic about the 90 percent; 89, 90, 91. If it were 90 percent, it would bring in about $130 billion.

Secretary PAULSON. I will make a general comment, and then I will let the expert speak. But I believe that this is a very, very important balance, to have the IRS be vigilant and proactive and not be abusive.

I can remember, back when I was in the private sector in the late 1990s, reading press reports about hearings about abusive tactics that were too aggressive by the IRS. I think the Commissioner has been very aggressive without crossing the line.

I think part of the reason is that he has invested heavily in getting new IRS agents, but recognizing that you can only assimilate

them, train them, control them, and bring them on at a measured level.

I commend this committee for helping to fund that build-up, because I think we have made, and I think he can make, the case in terms of the improvements that have been put in place and the progress we have made in this area. But again, it is a balance.

I think it would be a mistake for me to say, although it would make us all feel good if I said, well, let us keep investing in the IRS and we will get to 90 percent in 2017. Then maybe in 2020, 3 years later, someone could call me, wherever I am, and say, did we get there? Although we have to keep working on it and we want to invest very heavily in compliance and enforcement, I do not think that will be the path that will get us to 90 percent.

I think we would have to do some very burdensome things. It is a mirage to say that that 90 percent is out there without some pain. I think that is something we should just work on together.

Senator GRASSLEY. How would the IRS need to change its enforcement practices to reach the post-enforcement compliance rate of 90 percent, which would mean collecting about an additional $80 billion a year through enforcement? Specifically, how many more revenue agents, how many more audits, how much more money would Congress have to give the IRS? Then that will have to be my last question.

Secretary PAULSON. I will let Mark answer specifically. He is the expert.

Senator GRASSLEY. All right.

Secretary PAULSON. But I would just say to you, as someone who has spent a lot of time talking with him about this, if he thought you could appropriate more money and that would solve it, he would be asking for it. He is asking for what he needs. He is picking a number and saying, these are the number of IRS agents we can hire, we can train, we can assimilate.

So, if you keep funding us the way we are, and he can keep hiring and training people the way he is, he is going to get to that 85-percent goal that is laid out there and maybe do a little better. But that is, I think, the simple answer.

The CHAIRMAN. I am sorry. We can come up later and follow up in the second round, but I want to keep things moving here.

Senator Schumer, you are next.

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank the Chairman and Ranking Member for scheduling the hearing. This, to me, is the second most important tax issue we face after dealing with the Alternative Minimum Tax, the tax gap is.

But before I begin on the tax gap, I have one question, not related, but time is of the essence. This is to you, Mr. Secretary, or to Mr. Everson. We have had big floods in New York State. They occurred Sunday and Monday. Heavily populated areas had 7 inches of rain; the previous record was less than 2.

Now, I know the IRS gave a 2-day extension for those families severely affected by the flooding to file their taxes. I would like to ask, I have heard from some of the families. Can that be extended for maybe an additional week?

Commissioner EVERSON. We will certainly take a look at it. That sounds like a reasonable request to me, Senator. We did want to

act promptly, because some people do wait till the end. I had not heard that additional request, but we will certainly take it under consideration and act one way or another today.

Senator SCHUMER. All right. If you could get me an answer this afternoon, I would appreciate it.

Commissioner EVERSON. Yes. I can certainly do that.

Senator SCHUMER. It does not have to be too long, but they are just getting settled.

Commissioner EVERSON. Yes. I understand entirely. I talked to a friend about this whose basement had flooded. He had already filed, though.

Senator SCHUMER. All right. Great. Well, your friends are the early birds, but people who call me are not, shall we say. [Laughter.]

All right. Let us get to the tax gap. The net tax gap, as Senator Baucus said, is estimated at about $300 billion a year. It is inexcusable that we have let tax avoidance and evasion reach this point.

I found it almost immoral that, until the last couple of years, we were auditing working families earning $25,000 a year at a higher rate than families making more than $1 million a year. This idea, before your term began, and yours, that somehow it was the EITC where all the money was, I have to believe was ideologically, and almost nastily, driven. But that is not my question.

I also, though, was surprised to read in the *New York Times* that things are being cut back in certain areas, that IRS auditors are being forced to close corporate examination cases prematurely, that of corporations, only 1.2 percent faced real audits in 2006, and that was stunning to me.

We need to do more audits on corporations and high-income Americans, simply because, as Willie Sutton said, that is where the money is. So, I have known both of you. I have great respect. I do not mean this with disrespect. The Chairman sort of alluded to it. I will say it in a little more New York way. The idea that we cannot do better is a little bit insulting, with no disrespect intended to either of you. To close the tax gap only by 1 percent without your "draconian and painful requirements on all taxpayers" defies belief.

Are you telling us there is no middle ground between 1 percent and 100 percent? Could we not close the gap by 10 percent, maybe 20 percent without the kind of draconian measures that you are talking about? It is a huge amount of money.

Secretary PAULSON. Yes. I would say, of course there is. We have, Senator, quite an aggressive program. In terms of compliance and enforcement, we have a 7-point plan we have gone through. We have the legislative proposals. We are making real progress. But all I was saying is that I just do not want to mislead the American people here with the idea that we could set out a goal and say 90 percent.

Senator SCHUMER. I do not want you to mislead or overstate. But isn't 1 percent minimal, low? You scratch your head and believe that that should not be the goal of the IRS or of Treasury in tax collection.

Secretary PAULSON. It is one thing to have a goal. I have a goal. All of us have a goal. We have an aspirational goal to get to 90 percent or higher. But I believe it is incumbent upon me to make sure we have an aggressive plan, an aggressive plan that is balanced and is based upon tangible steps we are taking.

Senator SCHUMER. Right.

Secretary PAULSON. And my point is, it would be, I think, irresponsible of me, sitting in this seat. It would be quite easy for me to put forward some plan and, years after I have left—hopefully I will still be alive and can read about it in the newspaper sometime—someone will comment on that plan.

Senator SCHUMER. I understand. But you do not think 1 percent is too low?

Secretary PAULSON. What I have said is that I would like to fund our budget, pass the 16 legislative proposals, and I know we will get to 1 percent or better. We are hiring as many IRS agents as we can reasonably hire and train. This man can tell you all the things he is doing. So we are clearly going to push forward.

The other thing is that we are pleased to work on this jointly. I appreciate what Chairman Baucus has said, but we have had people up every week, talking with his staff. We are looking for more steps to take, and we are pleased to work with you on it.

The CHAIRMAN. Thank you. I might just remind everybody here that those proposals total about one cent on the dollar. They total about one cent on the dollar. Some are already in the supplemental. We are working through the others, but the total is only one cent on the dollar.

Secretary PAULSON. I understand. But even those——

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you.

Mr. Secretary, I have before me—I believe these are your charts.

Commissioner EVERSON. Yes.

Senator BUNNING. Are they your charts?

Commissioner EVERSON. Yes, sir.

Senator BUNNING. All right.

Commissioner EVERSON. We have that chart here. This is the point I wanted to make, just to respond.

Senator BUNNING. Well, I am going to make the point, if you do not mind.

Commissioner EVERSON. All right.

Senator BUNNING. Thank you.

According to the chart that you have set forth, since 2001—and I am sorry Senator Schumer is leaving—the EITC increases since 2001 are minimal, the audits. Those who make under $100,000 are accelerated. For those making over $100,000, they are very accelerated, to the point of almost 3 times the amount of audits that you did in 2001. Is that correct?

Commissioner EVERSON. That is absolutely correct, sir. At that point, 2001 was the Clinton-Bush transition year. EITC audits were something like half of all of our audits each year. I took a conscious decision to flat-line them in 2005, after they had grown up some more.

We have been clearly emphasizing the high income, because you are right, Senator. That is also a sense of fairness that resonates

in our system in that red line. That has gone up much more sharply. That is the area of emphasis.

Senator Bunning. All right.

Mr. Commissioner, it looks like, with that type of auditing, if we are going where the money is, we are going to the right people. In the next chart, the growth in corporate tax receipts since 2003 has been kind of dramatic. Can you give me the numbers on that, the actual numbers, or is this just a trend line?

Commissioner EVERSON. There are two lines here. There is the actual increase in corporate tax receipts between 2003 and 2006. The total receipts to the government increased by over $600 billion. The big contributors to that were high-income individuals and corporations.

These two lines show that that increase, and also as a percentage of GDP—Senator, when I got in this job I was getting a lot of questions about why our corporate tax receipts were so down as a percentage of GDP. They have come up because income is up. Corporations have done well. But the tax has gone up, too. I would be very concerned——

Senator BUNNING. That is collection of taxes.

Commissioner EVERSON. Correct, sir. Correct.

Senator BUNNING. All right. That is what I wanted to make sure of.

So the actual facts do not bear out what my good friend from New York was trying to point out since 2001. Is that accurate?

Commissioner EVERSON. I never contradict a Senator.

Senator BUNNING. Well, your charts are contradicting him. Are your charts accurate?

Commissioner EVERSON. I would say to you, Senator, that we have emphasized, in my tenure, high-income individuals and corporations, and I think those efforts have paid off.

Senator BUNNING. All right.

In the President's fiscal budget request, the President outlined 16 different ways to close the tax gap that would raise about $30 billion in 10 years. That seems minute to the amount of uncollected taxes.

We have been arguing back and forth here—at least the questions have been arguing—your ability as Secretary of Treasury to do more in respect to collecting without draconian, as you call it, means to do it. If there is a ball out there full of money, give me how we can get more of it it without burdening.

Secretary PAULSON. Well, I would make this point. The 16 proposals were legislative proposals, largely to deal with under-reporting. I think they are one part of a plan. One is ramping up enforcement properly, as we have laid out.

Senator BUNNING. That is the money you have requested in your budget. All right.

Secretary PAULSON. If you are going to do this in a responsible way, it has to——

Senator BUNNING. There is a diminishing return here somewhere along the way.

Secretary PAULSON. Well, it is not only a diminishing return, but there are only so many agents you can hire and train in a given

period of time if you are going to control this process. So that is important.

But Chairman Baucus mentioned other things: more electronic filing, more education, taxpayer service. We have to do a better job of modernizing our technology at the IRS. There is a fair number of more research. This is quite a comprehensive program, so this is something we have to work on and work on over time, and we can make progress.

Senator BUNNING. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman. Thank you very much for this meeting. Thank you to all of you for coming.

I have had an opportunity, in a number of committee settings and watching debate on the floor, to see Senator Conrad's charts. I have a simple question to start with. We know or were told that this building has 12,748 companies in it. Has anybody checked out that building? Do you believe, Mr. Secretary or Commissioner Everson, that there really are 12,748 companies? It is a very efficient building if there are that many companies in that building.

Secretary PAULSON. Let me turn it over to the man who has responsibility for that.

Senator STABENOW. We have seen this picture numerous times. Has anybody checked it out?

Commissioner EVERSON. I think that one of the problems is, when you are dealing with a tax haven country, depending on whether there are exchange of information provisions and what is public or not, getting behind some of the information is very difficult. This is not a situation of dealing with Great Britain or a country like that.

Senator STABENOW. I appreciate that. But have you tried? This building. Not just in general. Here is a building. We have a picture of it.

Commissioner EVERSON. We would not try——

Senator STABENOW. We have an address.

Commissioner EVERSON. No, we would not try a building. What we would do is, we would work based on what we would see for an individual or a corporation that would lead us to make an inquiry or do an audit of that individual or that corporation.

Senator STABENOW. So on the face of it, just knowing there are 12,000-plus corporations that say they do business out of a building that is 5 stories high, obviously common sense would dictate they are not there. So that, on the face of it, would not be——

Commissioner EVERSON. I think it might be a factor, but you are asking a question that I would want to ask our people about. But typically the way it works, again, is you look at the returns of the individual, what you know about the individual. Does it seem out of line? Is there anything that leads you to it? That could be a factor. I am not saying it is not a factor, but we do not start, typically, with something like that, is my understanding.

Senator STABENOW. So even though, right now, we know—I mean, I really sincerely mean this as a question.

Commissioner EVERSON. Yes.

Senator STABENOW. I do not understand.

Commissioner EVERSON. Yes.

Senator STABENOW. I would have thought, after the first time we had this building shown, that somebody would have started checking it out. So just on the face of it——

Commissioner EVERSON. Well, I guess, then, the problem here is you are dealing with—some of the nations just will not give you all the details that you want to get. That is the nature of tax havens.

Senator STABENOW. So Cayman Islands are not cooperating, then? Is that it?

Commissioner EVERSON. I would say to you that it is more difficult to get information from the Cayman Islands and certain other tax haven nations than in other places, traditional partners, treaty partners.

Senator STABENOW. I would very much appreciate, as a member of this committee—and I am sure all the members would appreciate—knowing specifically the difficulties in finding out information about what appears to be, on its face, something that is not accurate.

Commissioner EVERSON. Sure. Absolutely.

Senator STABENOW. And I guess the next question I would have is, on the websites that Senator Conrad talked about, do any of your investigators look at the website, in the age of the Internet, and attempt to pursue anything through these broad advertisements now about ways for folks to skip——

Commissioner EVERSON. We do. We do, Senator. We have active programs and we try to stay on top of this, particularly on the phishing schemes. You may have seen, we put out a notice on Friday or Saturday where we saw a new scheme that was trying to rip off the Free File Alliance. An organization was posing as a Free File member.

We got on that quite promptly. It actually goes back—it is interesting—it goes back to the conversation we were having last week, where a taxpayer called in to check what was going on. That is what led us to unraveling this. So, we absolutely do do what you are saying there.

Senator STABENOW. I would appreciate very much knowing—earlier, Commissioner Everson, you mentioned that there are things that Congress would need to do. There are some things that may be causing something like this that are, in fact, legal.

Commissioner EVERSON. Yes.

Senator STABENOW. We talked about tax incentives, tax policies that actually encourage businesses to go offshore, jobs to go offshore rather than being here in America. We need to know from you what your recommendations are to stop things like this from happening.

Commissioner EVERSON. Yes

Senator STABENOW. Not the broad question.

Commissioner EVERSON. Yes.

Senator STABENOW. I am not talking about the broad issue of out-sourcing and so on. But these kinds of things that we are talking about that, on the face of it, I think, make us as the Federal Government look pretty foolish.

Commissioner EVERSON. Yes. Thank you.

Senator STABENOW. Thank you.

The CHAIRMAN. Senator Lincoln? Thank you, Senator Stabenow. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

I am so pleased that we are here today with this discussion, and you brought us so enthusiastically into looking for the solutions to this. You and Senator Grassley have really both put forth some phenomenal effort to address this in the Finance Committee, and I am very grateful to you.

I, along with most Americans, continue to be astounded, I think, with the amount of taxes that are owed and not paid. We are not talking about a small amount here, and I think it is overwhelming, particularly to most of the constituency I serve, who try hard every day to live by the rules and do what they are supposed to do.

So I think we are looking at the progress that we can make in closing this gap. It should be significant. It should be more than one cent on the dollar. Our hope is that we can all come to the table and look for the solutions that will make that happen.

We know, here in the Finance Committee, that our hands are tied to some degree. We cannot do it by ourselves. With 16 legislative proposals, that only gets us one cent on the dollar. We need to work with you. We need your help and your dedication to solve this issue and certainly hope that we can do that. We can put our heads together and our ideas together to really make that happen.

And I would just say to the three of you all, the reason why we want to make that happen. I have a constituent, an 80-year-old constituent in northwest Arkansas, who has dedicated the rest of his life to ensuring that a 4-story building that houses his senior colleagues in that community stays open, because we are not seeing the resources put into housing for seniors in this country.

I spoke with the Humanities Council yesterday—which has been under-funded for the last 4 years—which provides tremendous resources in very small amounts to some of the poorest children in our country to experience field trips and exposures to things like the Civil Rights Movement and other things that really make the fabric of our country stronger.

I look at a group of 25 junior and senior high school students I spoke with yesterday who were concerned about the number of children in this country who are going hungry. Out of 2.6 million people in Arkansas, approximately 500,000 people live in food insecurity. I mean, we need those revenues, and it is worth working for, to make this a reality in terms of the things that we can do.

So we are looking for your help and we are looking for your passion in doing what is right in making our country whole and reinvigorating the fabric of this country.

Just two quick questions I have. Commissioner Everson, the decline in corporate audits was touched a little bit by Senator Schumer. There was an article also in the *Washington Post*—I do not know if anybody else brought it up—that caught my attention last week. It outlines policy changes that you made in 2003 and those shifts in auditing.

Commissioner EVERSON. Yes.

Senator LINCOLN. We are seeing now, and I guess I would argue as a direct result, decreased revenues from audits of our largest

companies; money raised from audits of the biggest companies fell 15 percent—that was indicated.

But perhaps maybe the directives that agents are getting would be a concern that I have, that the *Washington Post* article indicated that they were walking away from unassessed taxes in the audits because the policy does not allow them to pursue it.

In other words, when they start that audit, they are targeted towards a specific problem. If they come across another issue, they are basically instructed to go over the issue they found, to focus on the issue in the audit that they started with. It just seems like a big problem to me in terms of what we are leaving on the table.

Commissioner EVERSON. Sure.

Senator LINCOLN. Maybe you might comment on the article and why we do not allow more flexibility in allowing agents to follow that audit where it takes them, so to speak.

Commissioner EVERSON. Of course. Well, Senator, the first point I would make is, I was distraught about the decreasing coverages in the corporate. Maybe I will just show you this chart here, and speak loudly.

These are the total corporate audits for over $10 million in assets. They were going down just like individual audits went down. You could see, we brought them back up from $7,000 to almost $11,000. We had very low coverage, 5 or 6 percent, in the category between $10 and $250 million. I was very concerned about that, because these companies are growing. The bigger companies were doing 1 in 3, or 44 percent, each year, the ones that are bigger here.

As we brought this back, the total dollars that we have assessed, you can see dollars recommended, an increase from $13 billion and it went up to $32 billion. It came back down a little bit last year. We are not concerned about that. But it is way up.

What we have done is, we have pressed to get things done sooner. And I would be concerned about that if we did not see the numbers coming up. But what we have done is, we have gotten more coverage and we have gotten more money being set up.

Senator LINCOLN. But would your numbers not be even better if you gave them more flexibility to focus on everything they are auditing?

Commissioner EVERSON. Senator, my understanding is pretty clear on this. If an agent feels there is more to do, they have to take that upline to their supervisor and that will be dealt with. If the supervisor agrees, then they will proceed. I do not think people are being stopped.

But there is an issue here where sometimes it takes longer to do some of these corporate audits, if you will, than it takes to get a death penalty decision all the way through the system in America. That is not a good thing.

Senator LINCOLN. But all the more reason they should have flexibility as they go because, if it is going to take them that long, you do not want to get to the end and have to go back.

Commissioner EVERSON. I agree with you. I think they have a fair amount of flexibility. But I think what we are doing is working here. We are doing more, but we are pressing to go faster.

The CHAIRMAN. All right. Thank you. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Welcome to all of you.

My question to start with is for you, Secretary Paulson. My view is that real tax reform is a very good way to close the tax gap because, with real reform, you simplify the system and it makes it tougher for people to cheat and to rip the system off.

We have had one witness after another come before the Senate Finance Committee. In fact, Mr. Everson—I asked him this question, and he said he agreed. Do you believe that real tax reform that simplifies the tax code would be a good way to close the tax gap?

Secretary PAULSON. Yes. First of all, I think it would be great to have tax simplification and real tax reform that simplifies. So, number one, I think that is good. I think, second, "close" is one thing, but to make progress on the tax gap is another.

I think closing the tax gap is something that may be unrealistic, but making progress on it is possible. I think the best kind of progress will come from your suggestion. But I do believe that the most progress will be made in dealing with those who are making honest errors as a result of complexity. I do not think simplification deals with the under-reporting of income and people who intentionally do not report income or do not report cash income.

So I think, frankly, if we set our sights too high, the only way you can get at a part of the problem is by putting a burden on all the honest taxpayers that Senator Lincoln talked about who are already paying their taxes, and then to have them be more burdened with more reporting.

So I think what you are suggesting is the most effective way of dealing with this in a balanced, non-burdensome way. But I do believe, again, that to get at a big part of the problem, the only way you could get it, would be through steps I would not want to recommend, which would be more onerous reporting.

Senator WYDEN. I am not suggesting that tax simplification will close the entire tax gap. But we have had one witness after another, including Mr. Everson, say that it would make a real difference.

Secretary PAULSON. Absolutely, Senator.

Senator WYDEN. I appreciate that.

Secretary PAULSON. Absolutely.

Senator WYDEN. So why is it that tax reform has been buried by the administration? Now, I am very troubled about the fact that it has now been something like 18 months since the President's commission came in with their reform proposal. I was one of the Democrats who said I think there are some darned good things in it.

I think it is too bad that, at a time when the country thinks the tax code is broken and we have had people just in the last few weeks go through bureaucratic water torture trying to fill out schedule this and form that, I still do not understand why the administration is stalling on tax reform. It has been 18 months. Now, you have not been there for 18 months, and we have had a number of good conversations on it.

But when can we expect the administration to come forward with a concrete proposal where we can go at this in a bipartisan way,

the way the Congress did in 1986? We have had 15,000 changes in the tax code. It comes to three for every working day.

Practitioners are telling me that the system is so broken and so complicated, that it does give the green light to people to try to rip it off, to take advantage, to exploit it. You all have an opportunity, in a bipartisan way, with people like myself working with you, to change this. When can we expect that the administration will come forward with a tax reform proposal?

Secretary PAULSON. Senator Wyden, let me say, first of all, I appreciate your enthusiasm for this area, as I said, and your creative thought and the amount of effort and passion you put into that. I would say, frankly, I think a lot of people find it inspiring.

But to get to your specific question, the judgment was made that we have now had significant tax relief and that there are priorities, very, very major priorities in terms of entitlement reform, that we have deemed to be very pressing.

So with regard to simplification, we have emphasized this in more incremental ways. Eric Solomon, who is sitting on my right, can give you some of the things that we are doing incrementally. But in answer to your question, there is not a major tax reform proposal being put forward now, and I do not see that on the dockets in the near future.

Senator WYDEN. My time is up. I would only ask, Mr. Secretary, that you all reconsider it. I think that is a bad judgment. Certainly all of the things that you have cited, the administration's assertion about the value of their tax program, that was true before the commission was named.

What was the point of having this commission? That commission, now, is basically being labeled a sham, that there really was not any point in having it, and we are not going to do anything with it because we think everything else is working.

I think the tax code is broken. I think simplifying it will make a real dent, if not deal with the entire problem, with the tax gap. I hope, Mr. Secretary, you will reconsider this. This is an area where you can have bipartisanship, and I hope you will look at it again.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Secretary, I think there is a little confusion over the propriety of a U.S. business having, say, a shell subsidiary in a tax haven, so my real question is, is there a legitimate purpose for a U.S. business to have a shell subsidiary located in a tax haven country like the Cayman Islands? Is there a legitimate purpose?

Secretary PAULSON. There may be no legitimate purpose in that particular instance. I think the comment that was made by the Commissioner and was made by me was that there is a lot of very legitimate business in today's global marketplace that is done offshore, so we need to distinguish. I think what the Commissioner said is to distinguish between tax policy and law on the one hand, and compliance on the other.

The CHAIRMAN. That is correct. But I am asking, still, whether there is a legitimate business purpose. I think it was Senator Stabenow who held up the photograph of that building in the Cay-

man Islands. I am asking, again, is there a legitimate business purpose for U.S. companies?

Secretary PAULSON. In terms of that particular thing, I'm not familiar with the legitimacy. I do not know the details.

The CHAIRMAN. What is the Treasury doing to attack noncompliance involving offshore activities?

Secretary PAULSON. Mark, would you like to go through what you are doing? It is really quite a comprehensive effort.

Commissioner EVERSON. I would say, Mr. Chairman, that this is one of the most difficult areas. That is the first point I would make. It is in part because, when you get into the more sophisticated products and schemes that are developed by tax intermediaries, investment banks, law firms, accounting firms, they can start as something that is totally legitimate and then morph into something that pushes the lines ever outward. If you will recall the testimony I gave last June, you get into troubling areas like the foreign tax credit generators. You have issues on sales of intangibles. Transfer pricing is always tough.

Now, what we do is, we are doing more on our corporate side. But I would say the principal change we are making is the way we are interacting with other countries. We have formed the Joint International Tax Shelter Information Center—you may be familiar with that—here in Washington, with partners from the U.K., Australia, and Canada.

We are about to expand that to London, with other partners. That is an area where we exchange information, again, within the context of treaties, and then follow up on that. I chair a group at the OECD, the Forum on Tax Administration, which is tax administrators from all over the world who met in Seoul last September and commissioned a study which is being led by the United Kingdom on tax intermediaries, and it gets to this issue. I do not want to promise any easy solutions here. This is the toughest area, I think, the international.

The CHAIRMAN. Right. It is a very tough question.

Commissioner EVERSON. Very tough.

The CHAIRMAN. I urge you to keep this committee very informed of your joint international efforts, because I am quite certain other countries are facing some of the same problems.

Commissioner EVERSON. Sir, they have the same concerns. That is why they endorsed what was a pretty tough statement, the Seoul Declaration, last September that expressed concern about just these issues.

The CHAIRMAN. I appreciate that.

Mr. SOLOMON. Mr. Chairman, could I just add?

The CHAIRMAN. Keep this committee informed. Frankly, there is a lot of angst in the Congress about what is going on here.

Commissioner EVERSON. I understand.

Mr. SOLOMON. Mr. Chairman, could I add a point with regard to these international issues? On the regulatory side, we have many important projects. For example, in the transfer pricing area, which is section 482, we have very important projects there about services and cost sharing. Also, three recent projects on foreign tax credit. The Commissioner referenced recent regulations with regard to structured transactions.

Also, in the treaty and the tax information exchange area, information exchange is very important. In fact, recently a tax information exchange was entered into with the Cayman Islands.

The CHAIRMAN. All right. I appreciate that.

I want to get back a little bit to sort of the overall theme of this hearing, and that is the degree to which a lot of this tax gap can be addressed without causing undue pain.

I am quite concerned, frankly, because I still hear from the administration that the sundry honest taxpayers are being singled out and they are going to have to share a greater burden for the sake of trying to find those who are not the honest taxpayers.

Let me get at this a little bit differently. You, Mr. Secretary, earlier said that there comes a point where additional efforts here tend to over-burden taxpayers. Can you agree with me that achieving 90 percent compliance does not over-burden taxpayers?

Secretary PAULSON. Here is the way I would approach it.

The CHAIRMAN. What is the level?

Secretary PAULSON. You see, I think speaking in terms of broad goals are helpful, but I think the only way we can really make meaningful progress is to approach these things from the bottom up.

I cannot speculate in terms of what level we can achieve without over-burdening. The only way I know how to do it is to work with you—we are not going to be able to do anything important together here without doing it jointly—from the bottom up on a plan and say what is doable.

The CHAIRMAN. I am sorry, Mr. Secretary. We have been down that road, and it did not work. I am changing gears here, as I mentioned in my opening statement.

Secretary PAULSON. Right.

The CHAIRMAN. I am asking you to come up with a plan. You are the Treasury. You are the IRS. You have the facts. You are the agency, the departments in charge here. We are asking you to come up with a plan to reach 90-percent compliance over 10 years. I think that is a fair statement.

You come back to us in 3 months and tell us what you can or cannot do, any changes in the law that you think may or may not be necessary, and we will deal with those. We are just asking you for the plan so we can get to 90-percent compliance.

Secretary PAULSON. Right. We have come up with a plan. We think our plan is a serious, credible plan. I am happy to come back and talk with you about it.

The CHAIRMAN. Mr. Secretary, if it is what you have given us, it is not credible. It is only 1 percent.

Secretary PAULSON. I would just say to you, and just say it with great respect, because I know how much you care about this, that I care about it also. I would like to be able to say with some credibility, without fooling people or misleading people, that there is a clear path to 90 percent. But to show a plan, to have a goal, we would have to say what steps we are going to take to get there.

The CHAIRMAN. Exactly. Exactly.

Secretary PAULSON. And I would say to you that I do not see the steps that we can take. I cannot see a clear path.

The CHAIRMAN. You are saying we cannot get there.

Secretary PAULSON. I am not saying we cannot get there, but I am saying I do not have, and I have not heard from you or anyone else, a set of steps that could be taken to get at this under-reporting and to close that gap all the way to 90 percent. We will keep working. We will keep working with you.

I have worked on a lot of business plans. I have worked with multiple clients. I have done it at Goldman Sachs; I have done it in the not-for-profit area. There are some plans where you can set a very specific goal because you see the steps to get there. We need to build this from the bottom up.

The CHAIRMAN. I am asking you to do that. When we meet 3 months from now, I would like to see it.

Secretary PAULSON. We have a plan that says, here are our enforcement legislative proposals, and other areas on which we are focusing. I will be pleased to come back and talk to you about it again and keep working on it.

The CHAIRMAN. But, Mr. Secretary, I am not going to leave this issue. I am going to be focused on this until we reach our goal.

Secretary PAULSON. I am not either. I am not either.

The CHAIRMAN. Like a lot of things in life, if we are going to do something, we might as well do it now. We are not just going to be dragging our heels and so on and so forth. Let us get the job done.

Secretary PAULSON. I would leave it this way. You and I are in total agreement on one thing. The tax gap is a serious issue. We should be very vigilant about addressing it. I am not going to rest until we keep making progress.

I think this administration is doing as much as anyone has done about it. I want to do more and want to work on it. But what I do not want to do is put forward something that is going to mislead the American people. I really do not want to do that.

We are going to have to work together, and this is going to have to be a joint effort. If you have ideas, you have been working on this for a long time yourself, you have a big staff, if there are things you think we are not considering——

The CHAIRMAN. You have got a heck of a lot bigger staff than we do. [Laughter.]

Secretary PAULSON. I know.

The CHAIRMAN. By far.

Secretary PAULSON. Anything you want us to evaluate, we will evaluate. We will work together on this.

The CHAIRMAN. I appreciate that. Three months from now I want a plan.

Secretary PAULSON. You have a plan now.

The CHAIRMAN. No. I want a plan that is a real plan, that gets us to 90 percent. This is not a plan that gets us to 90 percent.

Secretary PAULSON. The other thing that would be great is if 3 months from now—and I really say this with great respect—we had the 16 legislative proposals enacted, if our budget——

The CHAIRMAN. Nine of them are in the supplemental. They amount to about $2.3 billion over 10 years. There are five or six others that total about $27 billion over 10 years. If you add them all up, it's the 1 percent in your plan. That is not a plan.

Secretary PAULSON. I tell you, where I come from, every $30 billion is real money, and we want to go after it a billion dollars at a time.

The CHAIRMAN. That is what we are asking. You come up with a plan.

Secretary PAULSON. And we are doing a lot of other things.

The CHAIRMAN. You come up with a plan. Every year we have another $30 billion. Then we get to the 90 percent.

Secretary PAULSON. Thank you.

The CHAIRMAN. All right.

Senator Salazar?

Senator SALAZAR. Thank you. Thank you very much, Chairman Baucus.

I do have a statement for the record, and I will just submit that for the record.

[The prepared statement of Senator Salazar appears in the appendix.]

Senator SALAZAR. But I have a question for you, Secretary Paulson.

The CHAIRMAN. I might say, I am sorry, Senator. I am going to have to leave here. But, Mr. Secretary, again, you have not heard the last from me on this.

Secretary PAULSON. I rest assured. We are going to keep working on it. You have not heard the last from me. We will get back to you.

The CHAIRMAN. And we are also going to solve it.

Secretary PAULSON. Well, we have to determine what the "it" is we are going to solve, and what is the realistic objective. I will tell you, we are going to be working very hard. We owe it to the American taxpayer and we owe it to you, so we are going to keep working hard on this. But I value my credibility too much to promise something where I do not see a clear path to get there.

The CHAIRMAN. But we have very high regard for your talents, Mr. Secretary.

Secretary PAULSON. Thank you.

The CHAIRMAN. See you in 3 months, Mr. Secretary.

Senator SALAZAR. Thank you, Mr. Chairman.

Secretary Paulson, I looked at the same figures that my Chairman and others have looked at. The plan that has been set forth by the administration, at least the figures I have here, would produce $19.5 billion over 10 years as we try to close the tax gap.

I hear you, in the dialogue with the Chairman, essentially saying this is what we think we can do in a realistic way, so we are not just aiming at something that is pie in the sky.

Secretary PAULSON. Senator, you missed the first part. Those are the legislative proposals, which are really as comprehensive as anything that has been suggested in 20 years. That is part of an overall plan that has to do with enforcement, research, investment and technology, and taxpayer service.

So, we have a comprehensive plan. We are not doing it all through the legislative proposals. But we believe, if you are going to get at some of the unreported income, you are going to need to do it through legislative proposals, some of which are not easy, I know, for Congress to pass, but they are an important part.

Senator SALAZAR. Then the additional statutory enactments that you requested us to enact, plus additional executive authority that you will exercise, which you already have, that gets you to that $19.2 billion figure?

Secretary PAULSON. Well, I think what you are talking about—is that with the Joint Committee score?

Mr. SOLOMON. Yes. That may be the Joint Committee score. The $19.2 billion is the Joint Committee score. Our score was $29 billion.

Senator SALAZAR. Your score was $29 billion?

Secretary PAULSON. Right.

Senator SALAZAR. All right. I think that is where Chairman Baucus or others came up with this. That would be a 10 percent, 1 percent solution, whatever. But it is not dealing with the whole tax gap.

Now, I hear you saying that what you want to do, and what you have done here, is you have set forth what you consider to be a plan that is comprehensive and realistic on how you get there. The dialogue with the Chairman is that you do not know how to get where we want you to go.

So my question to you is, and I am sure you have done this already within Treasury. We know what the tax gap is, and you probably have identified the different sectors that are out there in terms of what contributes to the tax gap.

I am not an expert like you are, but I can imagine that, when I go to the Mile High Flea Market in Denver, CO, several hundred thousand people congregate there every weekend, and there are probably not a lot of taxes being collected there. There are probably lots of places that you have identified as gaps.

For me, I will support the Chairman in terms of the request here that you come up with a plan that we can examine again in 3 months. But it would be useful information to know what you think the major opportunities are for us to close the tax gap.

Secretary PAULSON. Right. I think that is really the key question. Just to be very brief, the last comprehensive research was based on tax year 2001. We did research on tax year 2001, and we got the results in 2004. We are doing new research right now.

What you see, Senator, is that about 80 percent of the tax gap is a result of under-reporting. Some people just do not file. But the biggest part is under-reporting, and a lot of that is going to be individuals. A lot of that is going to be small businesses, farms, and so on.

Senator SALAZAR. Let me ask you this, just to push you a little bit on that. So, if it is under-reporting then from individuals and small businesses, I know a lot of restaurants—my wife was an owner of a Dairy Queen restaurant for some time.

Secretary PAULSON. Yes.

Senator SALAZAR. At least, when you are part of a franchise, everything gets calculated because it has to go to your franchisor, so you know exactly what your sales are. I know a lot of other owners of restaurants who probably do not have that same kind of accountability. So if you just take that one sector, just the restaurant sector, what is it that you would do to try to get accurate reporting?

Commissioner EVERSON. Let me throw in one of the 16 proposals we have made that I personally believe is the most important, and it is being roundly criticized in the small business community.

That is to get, once a year, the gross receipts from credit card processors so that we would know—if it is the Everson dry cleaning business—every year, from 8 or 10 credit card processors, the IRS would get a number that would say, here are the total receipts that that business generated via credit cards.

If you follow the example for a second, if Everson—I probably would not do this, given my day job—had only reported $500,000 of cash income and $500,000 of credit card income, but then the banks reported to the IRS that there was actually $1 million of credit card income, well, obviously that could trigger an audit, but it would actually trigger more compliance, because word gets around and they would do that. They would file correctly.

But they would not only file correctly on credit card receipts, they would file correctly about the cash receipts, because they know that we know—and this is a hypothetical—that dry cleaners are half cash and half credit cards.

That is the most important way that we think we can get at this without having a lot of extra burden for those small businesses, because the banks who process this already have all that information in their databases.

Senator SALAZAR. Now, are you supportive of that proposal then?

Commissioner EVERSON. We have made that proposal. We made it last year and the Congress has not acted. We want them to act. We ask you to act.

Senator SALAZAR. My time is up, and I see my wonderful colleague from Arkansas. She has, obviously, questions. She is the chairperson of the committee, so I will turn it back to her.

Thank you, Blanche. Thank you, Secretary Paulson and the rest of you.

Secretary PAULSON. Thank you.

Commissioner EVERSON. Thank you.

Senator LINCOLN. Well, thanks, Senator Salazar.

Commissioner, just going back to that last question I had where the agents in the *Washington Post* article were quoted as saying that they were walking away from unassessed taxes in those audits because the policy does not allow them, I think you take that one step further, your answer was simply that you are giving them the ability to appeal to their superiors. I would certainly like to know how many, and how often, are those superiors allowing them to continue?

Commissioner EVERSON. Sure.

Senator LINCOLN. So if you could get that back to me.

Commissioner EVERSON. We can do that. Can I make one point?

Senator LINCOLN. Apparently they are not, it sounds like. I mean, when you go further into the quotes from those agents, they are being told, no, stay focused on what we have given you and do not deviate.

Secretary PAULSON. Let me say one thing. I know nothing about the particulars here, but as someone who has managed a business with multiple people, sometimes the people in the field do not have the best judgment, and sometimes they are spending time and re-

sources where someone actually above them may know a bit more than they do about where their time could be better spent.

Senator LINCOLN. I am sure they do. But I would just simply like to know how many times they are being allowed to go ahead.

Commissioner EVERSON. Certainly. Certainly, Senator.

Senator LINCOLN. Thank you.

Mr. Commissioner, the difference between the tax gap and what you all refer to at the IRS—I do not think you use the words "accounts receivable." Maybe you use "accounts financial." Do you use "accounts receivable?"

Commissioner EVERSON. Yes. Yes.

Senator LINCOLN. Are accounts receivable considered as a part of the tax gap?

Commissioner EVERSON. No, ma'am. That is the difference between, say, an income statement and a balance sheet. The accounts receivable, which runs around $260 to $280 billion, that is the amount that is actually owed. The government carries on its books debt for 10 years. In a business, you would write off a lot of that amount.

Senator LINCOLN. But you cannot write that off.

Commissioner EVERSON. We cannot write it off, so we carry that until 10 years have elapsed.

Senator LINCOLN. Right. So how much of it is considered collectible?

Commissioner EVERSON. We look at that, and I think our potentially collectible inventory that we look at is somewhere around $70 or $80 billion. Is that a fair number? My colleagues are——

Senator LINCOLN. Of that $200 billion?

Commissioner EVERSON. The $280 billion.

Senator LINCOLN. Two hundred and eighty.

Commissioner EVERSON. That is what we count.

Senator LINCOLN. Seventy is collectible?

Commissioner EVERSON. Seventy or so. Seventy or eighty, we would categorize. As you know, Senator, the longer the debt stays out there, the harder it is to get.

Senator LINCOLN. So your idea on the dollar amounts of the receivables not currently in the queue to be collected is $210 billion?

Commissioner EVERSON. Well, we would not be actively working that.

Senator LINCOLN. And that is just over a 10-year period, right?

Commissioner EVERSON. It is not a 10-year period. That is the amount on the balance sheet today.

Senator LINCOLN. Right. But it is going to sunset. I mean, it has a statute of limitations of 10 years. Correct?

Commissioner EVERSON. It stays on the balance sheet. That is correct. Yes.

Senator LINCOLN. So how much revenue owed in accounts receivable is lost every year through the 10-year statute of limitations? How much do you lose there?

Commissioner EVERSON. I do not think the 10 years really prompts any additional loss.

Senator LINCOLN. It goes off your books.

Commissioner EVERSON. Well, it goes off the books, but the older it gets the harder it would be to get, frankly.

Senator LINCOLN. It is still there and it still goes off your books.

Commissioner EVERSON. No, I agree. I understand. But the way to get after this is to get after it promptly. That is why part of our enforcement build is to do more in the collections area. It also gets into this controversial area of private debt collectors that Senator Grassley is so strongly supportive of. We use that tool to get after the money sooner.

Senator LINCOLN. So you are saying you only collect, of those receivables, about $70 billion out of the $280 billion?

Commissioner EVERSON. That is not what I suggested.

Senator LINCOLN. All right. I am sorry.

Commissioner EVERSON. What I am saying is, when we look at that amount now at a point in time that is on the government's balance sheet——

Senator LINCOLN. Receivables.

Commissioner EVERSON [continuing]. We say we can potentially get only around a quarter of that. A lot of it is already old or, for a variety of reasons, you are not going to get to.

Senator LINCOLN. Well, maybe you could expand on that some more to me in terms of an answer of why it is so difficult to get.

Commissioner EVERSON. Absolutely. Happy to.

Senator LINCOLN. And why you give up on it, I guess.

Commissioner EVERSON. I have learned that collections is a complex area, and we are happy to take you through it.

Senator LINCOLN. The other thing that I would just like to briefly mention, because Senator Grassley is back and I will hand it over to him, some of you all commented on the impact on small businesses. I certainly want to be cognizant of that. There is much there to be concerned about, I think.

But the other was an issue that Senator Grassley himself brought up. Just repeating today, for what it is worth, I do not believe we are going to see the kind of significant progress on this issue if we do not recognize that voluntary compliance is certainly a huge key.

We are never going to be able to police all of the non-compliant taxpayers, but we catch more flies with honey. We say that in the South. I guess they say it everywhere. Taxpayer service, through outreach and education on the front end, I think, has to be an essential tool.

It was amazing to me. I did a tax Free File seminar in my State and an outreach of trying to encourage more people to use the Free File opportunities that exist, and more importantly to file online and hopefully do a better job, particularly in terms of bringing down error rates. I was amazed at the number of people, one, who came, two, who did not know about it, and three, who were interested in being able to take that message back to other people in their communities.

Education is going to be a critical part of what we do in terms of both minimizing error rates and making sure that we are doing everything we can. I hope that that will be a huge part of what we do.

Commissioner EVERSON. Senator, just two quick comments. One, I agree with you. The volunteer sites, that program, year over year, is up 15 percent through last Friday in terms of how many returns

we processed. It is a key area of emphasis, as we discussed last week. I absolutely think it is essential.

Senator LINCOLN. Well, as Senator Grassley will remember, I voted for the prescription drug component to Medicare and am glad I did. It was not perfect, but it was a good thing. But a huge part of what I think helped make it successful for us in Arkansas was, we went back home and I spent weeks working with seniors across our State, educating them on how to engage with the program.

If we do not do that here, we are never going to reach the goals that Senator Baucus has set for us. I think those are laudable goals, and I think they are achievable. Thank you.

Senator GRASSLEY. I am cognizant of the fact that you have to go very soon, Mr. Secretary. I have to as well, so we are not going to be here a long time.

Mr. Secretary, I asked about the number of agents, additional audits, and how much more money it would take to provide the IRS the additional resources they need to get $80 billion a year. You provided a general answer. I would only ask you now if you would follow up with an answer more in detail in writing.

Then I want to go on to an issue that I brought up a couple times. This is kind of a general question, but it deals with the tax gap and the efficient use of employees within the Treasury Department.

Several hundred thousand hours of IRS employee time are spent on union activities. That is taxpayer time that could be used for the tax gap work. Would that time be better spent on enforcement and taxpayer service, at least part of it? Go ahead.

Secretary PAULSON. Mr. Chairman, that is an important question. Let me turn it over to the guy who is closest to it.

Commissioner EVERSON. Senator, we do have an overall agreement with the union which has now lapsed. We are in the process of trying to renegotiate that master agreement. It would get at issues like this.

I believe you are correct, that if you look at the agency relative to other departments and agencies within government, that the amount of time devoted to union activities is proportionately higher at the IRS than it is elsewhere. Obviously we would like to get every incremental productive resource that we can, as management.

Senator GRASSLEY. All right. Well, I am glad you are negotiating that. You will have an opportunity to get more of that put into collecting taxes than union activity.

Commissioner EVERSON. Well, I am sure your interest in it is not unseen.

Senator GRASSLEY. Mr. Secretary, I think that there is a lot going on in the hedge fund industry that might help us with the tax gap as well. You recently had the opportunity to study the hedge fund industry in relation to the President's Working Group on Financial Markets.

I would like to know if you studied any tax policy issues related to the financial markets, and specifically hedge funds or alternative investments, in that context. If not, I would like to know why that was not a part of the issue.

Secretary PAULSON. Yes, Senator. Two things. First of all, we did not study tax policy. I would just give you a simple answer there. When we think about tax policy, it is not by business activity, it is by taxpayer type. So we have individuals, corporations, partnerships, and so on.

But Eric, do you have anything else?

Mr. SOLOMON. Yes. Independently, we are looking at issues regarding hedge funds.

Senator GRASSLEY. All right. So you are dealing with this problem as a possible tax problem, just not as part of the President's Working Group on Financial Markets.

Mr. SOLOMON. That is correct. Yes, we are looking at these issues, and I know the IRS is also looking at these issues.

Senator GRASSLEY. All right.

Mr. Secretary, Chairman Baucus correctly zeroed in on a relationship between the tax gap and international issues. I would like to follow up. Mr. Solomon noted in his written testimony that the Treasury Department and the IRS have done, and continue to do, considerable work to go after the international tax gap, particularly in the areas of transfer pricing and information exchange.

Mr. Solomon, please briefly describe Treasury's work in these areas and the role of our tax information exchange network in combatting offshore tax evasion.

Mr. SOLOMON. We are doing a lot in the international area. For example, in transfer pricing we have very important projects in regard to services among related parties, and also cost sharing. In the foreign tax credit area, we have issued three sets of guidance dealing with cross-border transactions and most recently proposed regulations about certain highly structured transactions.

Information exchange is a very important issue. We have a very vigorous treaty program, trying to enter into new treaties. Also, tax information exchange agreements are very important. In just the very recent past, we have entered into a number of tax information exchange agreements, as I mentioned, including one with the Cayman Islands, but also with other countries such as the Netherlands Antilles, and the British Virgin Islands.

Senator GRASSLEY. All right.

Mr. Secretary, the administration proposed, and I strongly supported, an effort to provide for private debt collection contracts at the IRS. This was a way for the IRS to collect tax due and owing that otherwise would not be collected because of a low priority.

The Commissioner stated at an earlier hearing that the private debt collection effort was an important part of fighting the tax gap. Actually, it has not gotten the support from members of Congress the way it should. It seems like fighting the tax gap is stopping at the union boss's door.

However, despite the naysayers, the Treasury Inspector General for Tax Administration recently came out with a report that gave the private debt collection program and IRS management a gold star.

I would like your comments on the importance of the private debt collection effort as it relates to the tax gap, and more importantly, to understand and get your commitment to already established plans to expand this successful program.

Secretary PAULSON. Senator, first of all, clearly we understand the direction from Congress. I think this program is being run, as the Inspector General said, in a very positive and balanced way.

The second point I would make, which the Commissioner could point out to you, is that a lot of the activity being conducted by the private debt collectors, if they were not doing it, would not be done.

As he is hiring new IRS agents and training them, there is a higher value-added use for them. So the cases assigned to the private collection agencies are the simplest cases, and he has more productive uses for new IRS agents. So, again, we understand the importance of that program.

Senator GRASSLEY. I have one more question I will submit for the record.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman.

First, I saw that the chart that the Commissioner put up showed that enforcement dollars are on the rise. I have a question related to it.

Commissioner EVERSON. Certainly.

Senator SCHUMER. The private debt collection program is controversial, but maybe there is one aspect that could be expanded. My understanding is that a certain percentage of the money collected by debt collectors has to be used to boost IRS enforcement. That sounds good to me.

Commissioner EVERSON. Can be used. Yes. That is correct.

Senator SCHUMER. Yes. All right.

Well, why do we not set up an enforcement trust fund within the IRS, where the IRS gets to dedicate, say, 1 percent of the money that it raises through new enforcement to the following year's enforcement budget without Congress's interference?

Commissioner EVERSON. I am a former OMB official, and I think Mitch Daniels would reach across several States and wring my neck if I agreed to a proposal like that.

Senator SCHUMER. He is Governor of Indiana now.

Commissioner EVERSON. I know. I know.

Secretary PAULSON. Senator, I can say this. We have been very fortunate because, over the last several years, Congress has improved our enforcement budget.

Commissioner EVERSON. That is not correct. We did not get everything we wanted in enforcement. That is the starting point.

Secretary PAULSON. All right.

Senator SCHUMER. I saw on the Commissioner's——

Commissioner EVERSON. But I want to say this, since I have contradicted my boss. This Secretary fought for, and got, the biggest budget increase that we have had in years. What we have now is a very good budget before the Congress that does address enforcement.

Secretary PAULSON. And I am assuming, and no one on this committee has here indicated that that would not be approved. I would find it ironic beyond belief if, after this hearing on the tax gap, it were not approved.

Senator SCHUMER. Right. But this trust fund would be an incentive. It would be automatic. You could count on it from year to year. When I asked the Commissioner the question, I saw the smile

on his face. It sort of reminded me when Sid Caesar, the old comedian, would get all the applause in the audience. He would say, "No, no more applause."

Commissioner EVERSON. Let me say one thing. One of the biggest problems we have, Senator, is this scoring question, because we can demonstrate for you that, if you invest in the IRS—and it runs to services, enforcement, our infrastructure, everything else too—you get a very good return. But that does not count. You score a legislative proposal, but you do not score the baseline IRS activity.

Senator SCHUMER. Right. Right.

Commissioner EVERSON. That is a real problem.

Senator SCHUMER. Yes. Well, this would help that, I think. It would sort of give you some money automatically.

Commissioner EVERSON. You might throw money at us.

Senator SCHUMER. Yes. All right. Well, I do not want to do that.

Commissioner EVERSON. Can I come back to your earlier question? This will surprise you that you get an answer this promptly.

Senator SCHUMER. Yes.

Commissioner EVERSON. But we are going to grant that extra week.

Senator SCHUMER. Oh. Thank you. That is great. I very much appreciate it, and so do the people in Westchester and the Hudson Valley who had all that flooding, and I am sure the people in New Jersey, and other States as well, although they have not contacted me. Great. All right.

The next question relates to something that has been a pet peeve of mine that relates to the corporate side of things. It is book versus tax income. Since I am last here, I think I can take a little more time, so I will elaborate a bit.

Obviously one of the issues that is intriguing to me is the difference between the profits businesses report to their shareholders versus the profits they report to the IRS. Some of this is due to deductions, like depreciation, but a good part of it is also gamesmanship. They want to report as high a profit to the shareholder and as low a profit to the IRS as possible, so I think the numbers should bear some relationship. I think, as Justice Brandeis once said—I think it was Brandeis—"sunlight is the greatest disinfectant."

Now, the IRS—correctly, in my opinion—has made an effort to get companies to explain these differences on what is called Schedule M–3. It is supposed to explain the discrepancies between book and tax income.

From what I am told, many companies do not take it seriously, that the M–3 is not seriously filled out. Sunlight would be a great disinfectant. Why could we not make either the M–3 form public, or if not public, because there might be certain things that companies do not want to make public, an abbreviated M–3 that would show the main bottom lines and compare them? I think it would be an incentive on corporations to narrow the difference between what they say publicly and what they report to you.

Secretary PAULSON. Senator, I am going to make a point. Most of the points you bring up, I agree with. On this one, I would have a significant question. The reason is the accounting rules. I spent a lot of time in accounting.

Senator SCHUMER. Right.

Secretary PAULSON. Accounting rules are very different from tax rules.

Senator SCHUMER. Right.

Secretary PAULSON. The accounting rules are changing all the time. Most companies, very, very honest, honorable companies who are not trying to explain anything, have book income that is driven by accounting rules, which is very different for their tax income, which is based on tax rules.

So, I have always believed that we are doing this right. That is one thing the IRS should look at, and it is one thing the IRS does look at. I think putting it in sunlight and publicizing it could be misleading and could be misused by people who just simply say, because there is a difference, there is something wrong there.

Senator SCHUMER. Right. Now, everyone will admit there is a difference.

Secretary PAULSON. That would be my concern.

Senator SCHUMER. All right. Well, I am not going to ask the Commissioner to overrule you here. [Laughter.]

Commissioner EVERSON. Thank you. Thank you very much.

Senator SCHUMER. Do you have time for one more?

Secretary PAULSON. Yes.

Senator SCHUMER. All right. Great. I will be as quick as I can. This one relates to the Free File program. It is really to the Commissioner.

Commissioner EVERSON. Yes.

Senator SCHUMER. I wrote a letter last week to you. I do not know if you have gotten to look at it yet. In my view, it is simply wrong to ask taxpayers to pay an additional fee for the privilege of filing their returns electronically when it saves the government money and we are trying to reach a goal of 80 percent e-filing.

So I do not think it would infringe on tax preparers and software companies for the IRS to offer free filing to everybody, as long as the IRS forms did not provide tax advice or actually do the math.

I would like you to explain to the committee why taxpayers who mail in their forms get to do so for free, while those who file electronically have to pay an additional $15 fee, we will call it, not a tax.

It seems backwards to me that millions of Americans who are actually doing their own taxes at home—with a software program maybe; these days, a lot of people do that—printing the forms out, should avoid the fee. Taxpayer Advocate Olson, Nina Olson, does the same thing. She recently testified that navigating the Free File portal on the IRS website was like being in the wild west.

So should the IRS not act within its rights and end the Free File agreement by next year so everyone can file electronically for free? So if you are over $50,000 you do not have to pay a tax preparer if you do not want to because it is not just $15, but the tax preparer fee. It would help you reach your goal of 80 percent. It seems to me like a no-lose.

Commissioner EVERSON. The Free File agreement is in there to help taxpayers, largely middle- or lower-income taxpayers. Really, it helps them avoid going to a practitioner or buying the software. If you are in the Free File, you do not get charged to file with the

government. But what you are getting at is, if you have used Turbo Tax at home or something else, then you might be getting a fee depending on the product that you bought.

Senator SCHUMER. You are.

Commissioner EVERSON. Yes. So what you are raising, Senator, is a question of increasing concern, I think, in the industry. There are sort of two levels. One is this ability to get whatever return it is you have—and 80 percent of the returns now are done by the software—into the system without an additional charge. We do not make the charge, they make the charge, the practitioner or the software company.

Senator SCHUMER. Right. We want to let them go right to you without the practitioner.

Commissioner EVERSON. That is right. But to do this would take quite a bit of investment on the part of this service. It would be some years out. I think that this is a question that the industry needs to look at. We need to look at it, and we need to size how big a deliverable this would be.

Senator SCHUMER. Well, could it not be just, finally, your interests and the industry's interests are somewhat different here?

Commissioner EVERSON. I am not sure, in that instance, they are if that fee reflects the true incremental costs. But I do not know the——

Senator SCHUMER. All right. Well, I would ask you to give that a serious look.

Commissioner EVERSON. Certainly, sir.

Senator SCHUMER. I think we should be able to do that.

I did have one more. I will be quick. Withholding. What about withholding on capital gains and dividends of large amounts? Not of somebody who pays a small amount, but above a certain amount of dividend, or a certain amount? We get 99-percent compliance when there is withholding of wages. We might be able to increase compliance if you think it is a problem. I am not sure it is the right thing to do. I want to ask you.

Secretary PAULSON. Well, that is one thing. We have a list of things we look at and think about.

Senator SCHUMER. Yes.

Secretary PAULSON. It is one thing we look at. Actually, we look at income, dividends, pensions, and withholding on a lot of things. I remember back, and I think it was in the days of Dan Rostenkowski, when Congress took a step to do that, and there was just such an outpouring of sentiment that it was quickly withdrawn. We have looked at that. To date, we have felt that it would be a mistake to propose that, but that is something that——

Senator SCHUMER. As I recall, Rostenkowski proposed it on all. I mean, a small little person who gets $100 in dividends should not be withheld, but a big one—where the money is—again, might work. And Rostenkowski, dearly I love him, was in the pre-computer days.

Mr. SOLOMON. In this area, 1099s are issued. There is a very high reporting rate for 1099s. So the question is how much extra benefit you would get from that. My understanding is that the compliance rate with respect to 1099s is somewhere in the 95 percent

area. So you would have to take that into account, whether or not this particular idea, how much it would get for you.

Commissioner EVERSON. Could I add one thing? I agree with everything that has just been said. We have a proposal—one of the 16—to get basis reporting for stock transactions. That, so far, has not been picked up even though it is a very bipartisan proposal. I have heard from Senators and Congressmen on both sides of the aisle. This would further get at it. We put that forward and strongly advocate it.

Senator SCHUMER. Yes. I am a co-sponsor of that. I would support that.

Secretary PAULSON. Good.

Senator SCHUMER. Thank you all for staying an extra 7 minutes.

Secretary PAULSON. Thank you.

Senator SCHUMER. And for the rest of the time as well.

Can I do this? The hearing is adjourned. [Laughter.]

[Whereupon, at 12:22 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE SERVICE
MARK EVERSON
BEFORE
SENATE FINANCE COMMITTEE
ON
EXAMINING THE ADMINISRATION'S PLAN FOR REDUCING THE TAX GAP: WHAT ARE THE GOALS, BENCHMARKS AND TIMETABLES?

APRIL 18, 2007

Introduction

Chairman Baucus, Ranking Member Grassley, and members of the Committee, thank you for the opportunity to appear this morning to discuss our strategy to reduce the tax gap and to improve voluntary compliance. I am honored to be here with Secretary Paulson and my good friend Eric Solomon, Treasury's Assistant Secretary for Tax Policy.

Put simply, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. Based on the results of a National Research Program (NRP) analysis of approximately 46,000 individual income tax returns for Tax Year 2001, the gross tax gap was $345 billion. After collections and late payments the net tax gap for that year is estimated to be $290 billion.

Last July, the Director of Research and Statistics for the IRS appeared before this Committee to discuss the NRP study and how the tax gap estimates were developed. As a result, I will not repeat that discussion in my statement this morning. Rather, I would like to discuss the efforts we have made since 2001, the last year for which we have solid numbers, to reduce the tax gap as well as the efforts we plan to pursue in the future, specifically in regards to the FY 2008 IRS Budget.

Progress Made

After passage of the IRS Restructuring and Reform Act (RRA) of 1998, enforcement efforts on the part of the IRS waned significantly. For example, enforcement revenue collected in Fiscal Year (FY) 2001 was approximately $3.5 billion less than it was in FY 1997. There were similar declines in other enforcement statistics from FY 1997 to FY 2001. There were 5,000 fewer enforcement personnel working at the IRS; the Service did less than half the number of examinations of individual returns; and business examinations in 2001 were only 40 percent of what they were in 1997.

Restoring Credibility to Enforcement Programs

My goal when I became Commissioner of Internal Revenue in 2003 was to restore the credibility of IRS enforcement programs without infringing on taxpayer rights. To that extent, I think we have been successful.

One of the most obvious measures of success is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 43 percent.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 75 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in this category rose by almost 78 percent compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million.

Growth in audit totals and coverage rates extend to other taxpayer categories. IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, and the coverage rate increased from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax-exempt organizations have risen from 5,342 in FY 2001 to 7,079 in FY 2006. While examinations in the tax-exempt community generally do not provide the tax collection "return on investment" that audits in other areas might, it is important that we keep a "cop on the beat" in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes-- and in the most egregious cases, revocation of exempt status.

Maintaining Strong Taxpayer Service

Perhaps the thing that I am most proud of is that our growth on the enforcement side has not come at the expense of taxpayer service. According to a survey commissioned by the IRS Oversight Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as its Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005, to 54 percent of all individual returns.
- The level of service for toll-free assistance was 82 percent, about the same level as FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.
- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.
- Visits to the IRS Web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

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

- *Improve and expand education and awareness activities*: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- *Optimize the use of partner services*: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- *Enhance self-service options to meet taxpayer expectations*: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- *Improve and expand training and support tools to enhance assisted services*: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- *Develop short-term performance and long-term outcome goals and metrics*: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint was delivered to Congress last week. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing

commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

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

As a first step in incorporating Blueprint results into the IRS budgeting process, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help. All of this will be done with the utmost concern for the protection of taxpayer information.

The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the FY 2008 budget includes funding for research to better understand the effect of service on compliance.

Enhancing Outreach and Education

Another customer service effort involves our improved outreach and education efforts over the past two years. It is much more cost effective to educate taxpayers to voluntarily comply with their tax responsibilities than it is to use enforcement programs to address noncompliance.

We have relationships with at least 1,500 small business industry and tax professional organizations. Last year we coordinated or participated in over 2,000 events across the country with more than 122,000 direct participants, sharing education and outreach messages. In the first quarter of FY07, we already coordinated or participated in over 1,100 events with approximately 81,000 participants.

One specific area of focus has been tax law topics where data indicates the highest areas of noncompliance including: business income, cost of goods sold, home office deduction, car and truck expenses, depreciation, supplies, and others.

Other educational products we provide include:

- Virtual Small Business Tax Workshop DVD – 10-lesson interactive video
- Small Business Resource Guide CD-ROM

- Tax Calendar for Small Businesses and Self-Employed
- Tax Talk Today – A monthly webcast for tax professionals.
- E-News for Small Businesses and E-News for Tax Professionals – Weekly electronic newsletters with approximately 200,000 combined subscribers.

Leveraged Partnerships with Other Government Agencies

The IRS is also partnering and leveraging resources with local, state, and federal agencies across the country. Examples of accomplishments include the following:

- Utilizing data sharing with approximately 90 agencies to leverage resources and avoid duplicate audits by multiple agencies.
- Implementing a Questionable Employment Tax Practices (QETP) Initiative to develop a federal and state interagency approach to combat employment tax schemes and increase voluntary compliance. To date, 17 states have agreed to partner with IRS.
- Obtaining 88 agreements in 27 states with stakeholders such as state professional licensing agencies and local business licensing agencies to distribute educational information to small business applicants.
- Partnering with foreign tax agencies as part of the Organization for Economic Cooperation and Development's (OCED) Forum on Tax Administration.
- Piloting a State Reverse Filing Match Initiative (SRFMI) to identify taxpayers filing state but not federal returns
- Developing a Joint Operations Center (JOC) for National Fuel Tax Compliance in partnership with the Federal Highway Administration (FHWA) and participating states to act as one seamless organization leveraging resources at the state and federal level to develop fuel tax compliance strategies, including joint examinations and investigations based on JOC data analysis.

The President's FY 2008 IRS Budget Request

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

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total FY 2008 Budget request for these three operating accounts is $10.8 billion, supplemented by the $180 million from user fee revenue, for a total operating level of $10.9 billion --- a 5.5 percent

increase over the FY 2007 JR level. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. I am pleased that both the House and Senate passed Budget resolutions for 2008 include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

This is the strongest budget for the IRS that I have seen during my term as Commissioner. It provides funding to help us attack the tax gap in several critical ways. I look forward to working with the Committee to ensure that the appropriations for the next fiscal year meet the President's budget request.

Enhancing Taxpayer Service

The FY 2008 Budget contains three significant taxpayer service initiatives. First, we are requesting $5 million to expand the VITA program, a significant component of our effort to support taxpayers eligible to claim the Earned Income Tax Credit. This taxpayer service initiative will help expand our volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

The budget also requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

Finally, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB) Strategic Plan for taxpayer service. As part of the Blueprint effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

- *Contact Analytics* provides an analytical tool for evaluating contact center recordings for the purpose of improving business processes and lowering business costs, as well as improving customer service.
- *Estimated Wait Time* provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.
- *Expanded Portfolio of Tax Law Decision Support Tools* enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Web site enhancements are designed to

maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

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

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

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

- **$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance.**
  This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.
- **$26.2 million for increasing compliance for large, multinational businesses.**
  This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.
- **$28 million for expanded document matching in existing sites.**
  This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this

new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

- **$6.5 million to increase individual filing compliance.**
  This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.
- **$15 million to increase tax-exempt entity compliance.**
  This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (6 percent) and employee plan/exempt organization determinations closures by over 9,000 (8 percent) by FY 2010.
- **$10 million for increased criminal tax investigations.**
  This will help us aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud-referral program. Our robust pursuit of tax violators and the resulting publicity is designed to foster deterrence and enhance voluntary compliance.
- **$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.**
  The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

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

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

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. The Treasury Inspector General for Tax Administration (TIGTA) agreed with

that assessment. Earlier this month, TIGTA issued a report which noted that "IRS has taken proactive measures to effectively develop and implement the (PCA) Program."

The report said that we had taken the appropriate steps to ensure contractor employees received sufficient and adequate training on applicable laws and regulations before allowing them access to Federal tax information. This included providing contractors with an orientation and overview of the training required and conducting an onsite assessment of the contractor training.

TIGTA also recognized that we had required all contractor employees assigned to the Program contract, or who have access to Federal tax information, to undergo background investigations. We granted either interim or final approval of background investigations for each employee working on the contract at the time of our review.

We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years. From September 7, 2006, when cases were first assigned to PCAs, through March 22, 2007 PCAs collected $17.8 million in gross revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of $1.4 billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector, but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate the potential of this initiative to help improve compliance and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

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

In the FY 2008 Budget request, the Administration proposes 16 legislative changes that will expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. Assistant Secretary Solomon will discuss these proposals in some detail in his statement, so I will not repeat them here except to say they are a critical element to our overall effort to improve voluntary compliance and reduce the tax gap.

Enhancing Research

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The FY 2008 Budget requests funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers, which is needed to update existing estimates of reporting compliance. Through this initiative, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

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

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

Continuing Improvements in Information Technology

Tax administration in the 21st century requires improved IRS information technology (IT). Improved technology has led to improved efficiencies in terms of taxpayer service and enforcement and will be a critical factor in out ability to increase the rate of voluntary compliance. We are committed to continuing to make improvements in technology and the FY 2008 Budget reflects that commitment.

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

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1

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

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

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

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

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

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

Observations on the Tax Gap

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

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

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

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

Fourth, to reduce the tax gap dramatically would take some draconian steps, ones that would fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers. Nevertheless, there are reasonable steps – first and foremost the funding request and legislative proposals in the FY 2008 Budget – which I have outlined in this statement that can be taken to improve compliance.

Finally, while I urge Congress to appropriate every cent that is in the FY 2008 Budget request for the IRS, I want to stress that our budget request is the right amount of enforcement dollars. We have a limited capacity to hire and train new enforcement personnel. What is more important than additional dollars is consistency in the budget process, which will allow us to build each year on the previous year's growth in enforcement resources.

Summary

While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated an average direct return of approximately $4 in increased revenue to the Federal Treasury. This is not to suggest that we expect a 4-to-1 return on the marginal enforcement dollar. As mentioned above, we have a limited capacity to hire and train new enforcement personnel and would expect marginal revenue to decline on each enforcement dollar above our budget request..

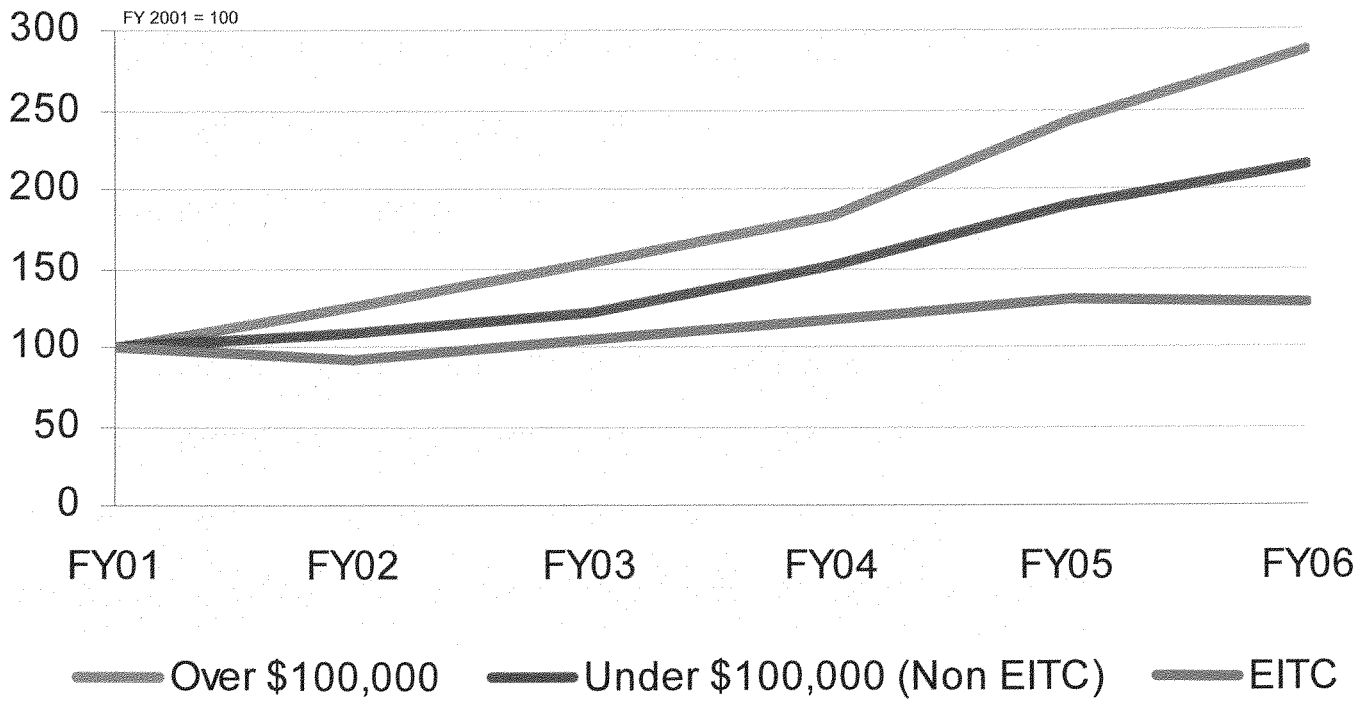
This 4:1 historical return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities.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

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

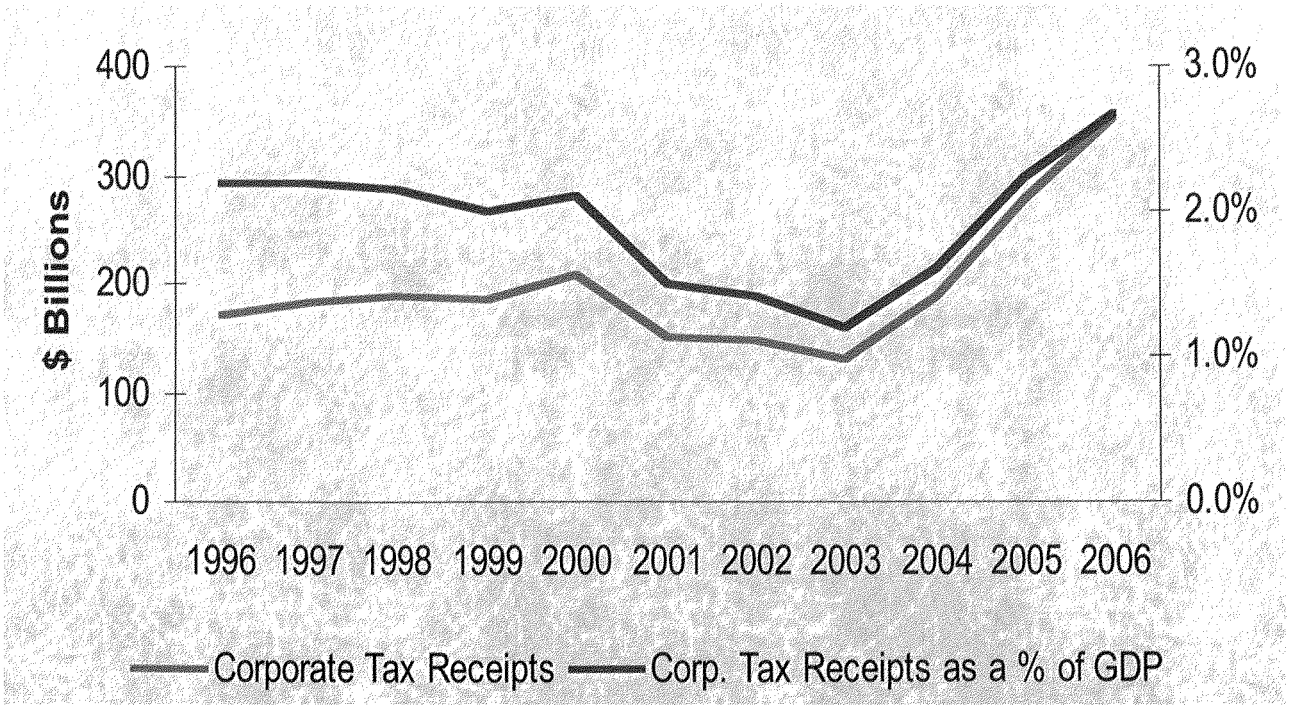
Full funding of the FY 2008 Budget will enable the IRS to improve its research with respect to the tax gap. Despite all of our progress, there is still much we do not know about the sources and causes of the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have many limitations.

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

Growth In Individual Audits Since FY 2001

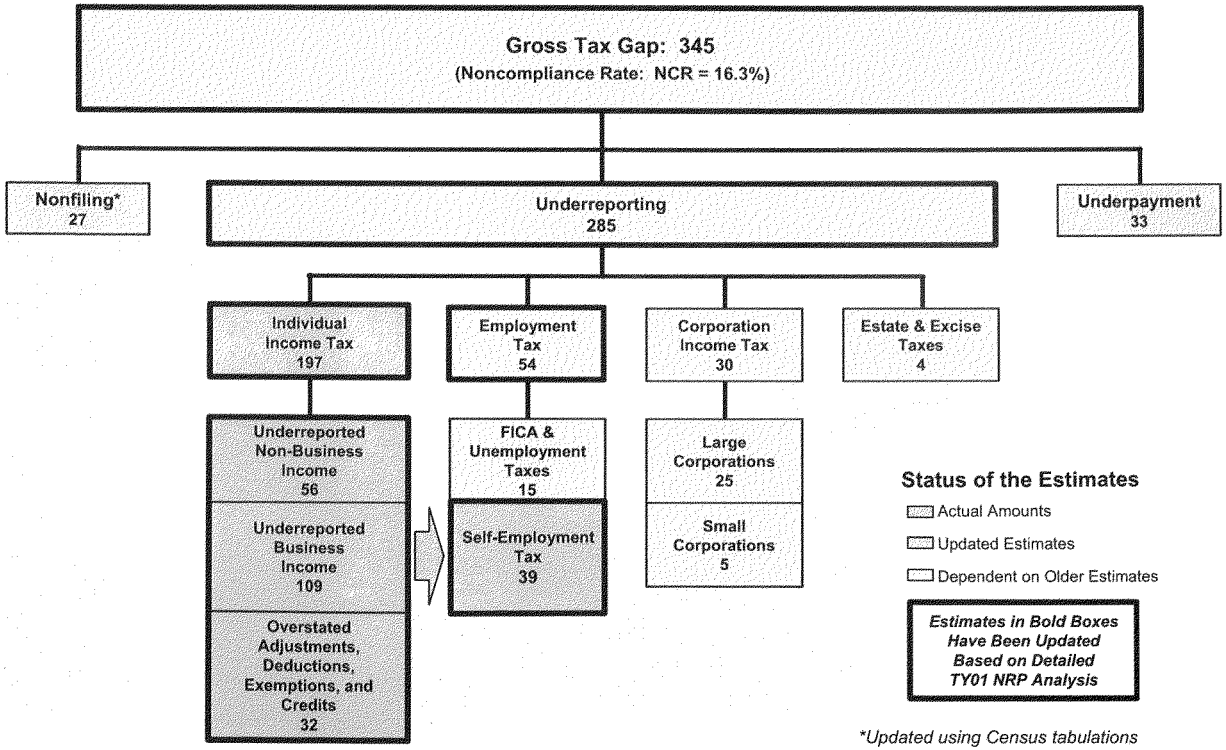


Growth of Corporate Tax Receipts



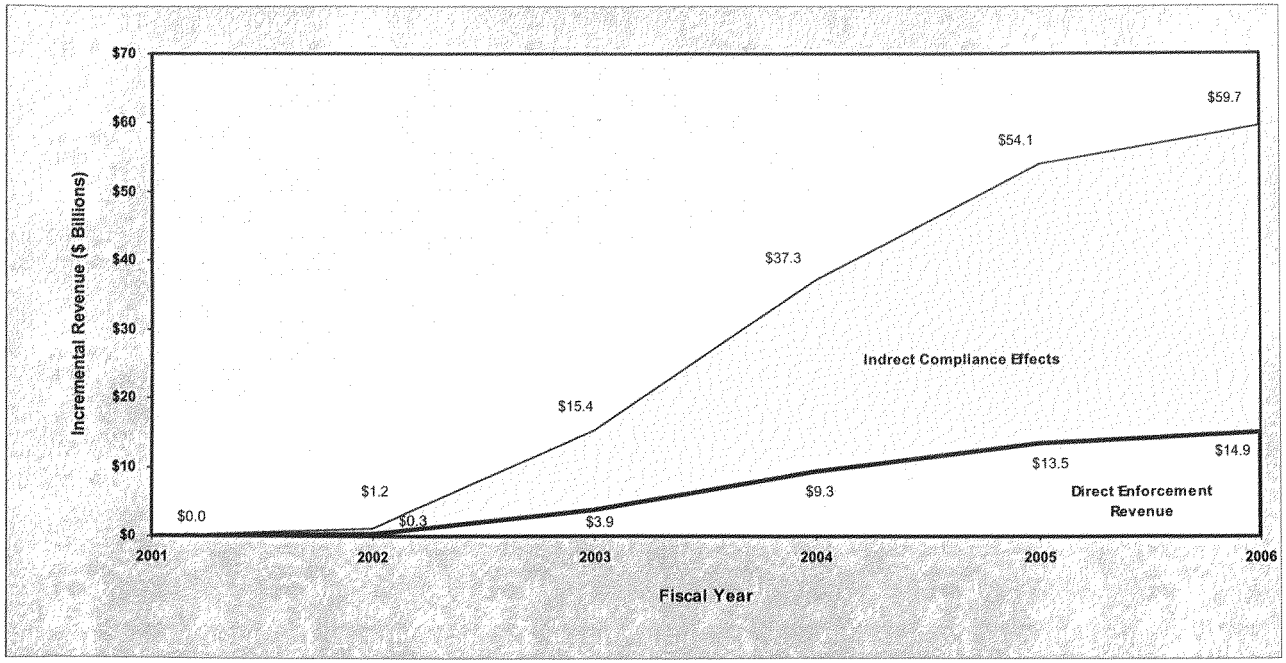
Tax Year 2001 FEDERAL TAX GAP

(in Billions of Dollars)



*Updated using Census tabulations

Even Using Conservative Assumptions For Indirect Compliance Effects, IRS Activities Have Generated Tens Of Billions In Additional Revenue

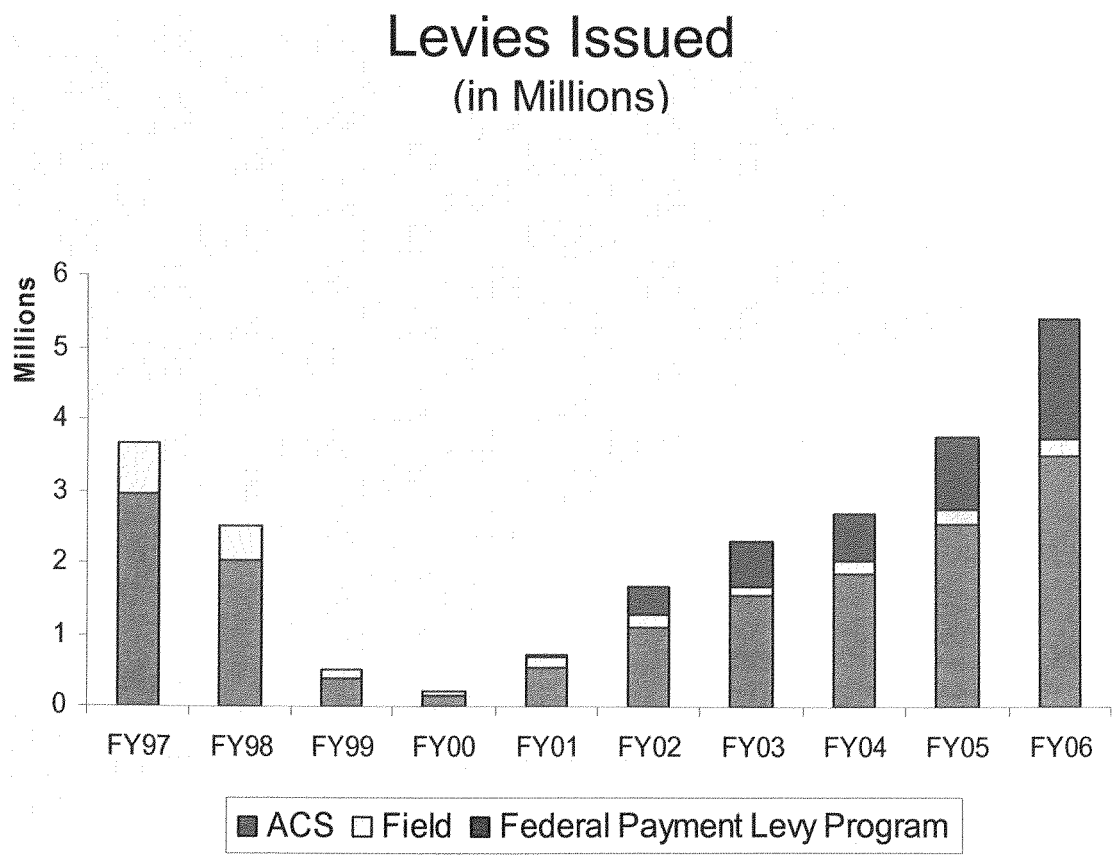


Selected IRS Coverage Rates – FY 2006

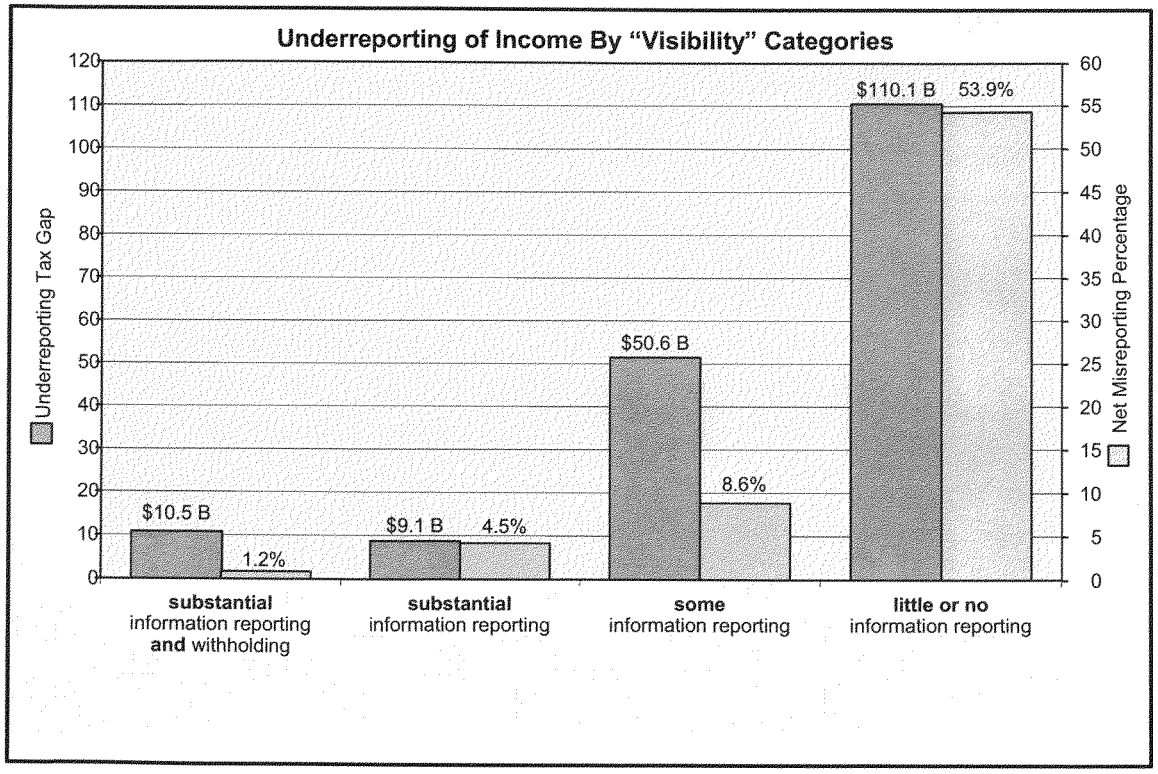
Corporate with Assets > $250M	35.2%
Estate Tax with Gross Estate > $5M	23.5%
Corporate with Assets $10M - $250M	14.1%
Individuals with Income > $1M	6.3%
Individual Business with Schedule C	3.1%
Individual with EITC	2.3%
All Individuals	0.98%
1120S Corporations	0.38%
Employment Tax Returns	0.13%

IRS Corporate Audit Data
2001-2006

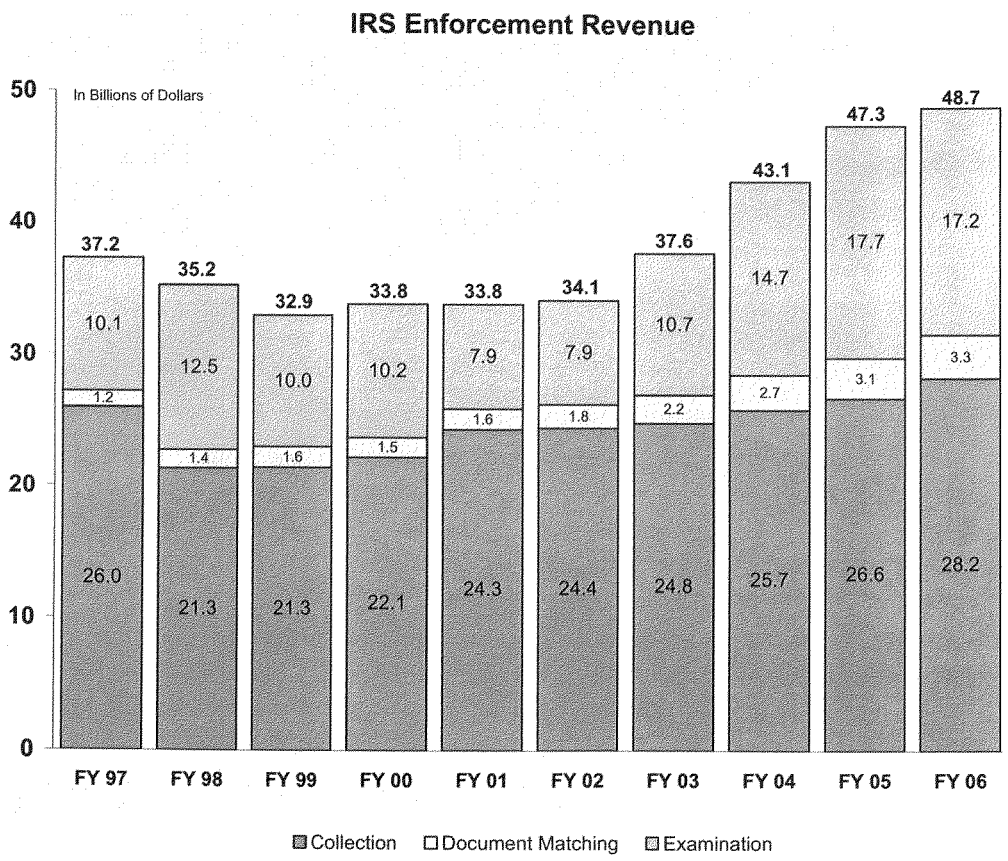
Assets $10 m-$250 m	2001	2002	2003	2004	2005	2006
Returns Audited	5,413	4,694	3,795	5,137	5,970	6,302
Dollars Recommended ($B)	$0.54	$0.63	$0.80	$0.76	$1.42	$1.31
Audit Cycle Time (months)	17.0	17.1	18.3	13.6	12.0	10.0
Assets > $250 m						
Returns Audited	3,305	3,749	3,330	4,386	4,859	4,276
Dollars Recommended ($B)	$12.77	$13.67	$12.29	$15.23	$30.14	$25.53
Audit Cycle Time (months)	31.9	33.2	32.8	29.4	31.2	29.0
Total Assets > $10 m						
Total Returns Audited	8,718	8,443	7,125	9,523	10,829	10,578
Total Dollars Recommended ($B)	$13.31	$14.30	$13.10	$15.99	$31.56	$26.84
Audit Cycle Time (months)	23.0	24.4	25.4	21.1	20.9	17.8


Levies Issued
(in Millions)
Millions
6
5
4
3
2
1
0
FY97
FY98
FY99
FY00
FY01
FY02
FY03
FY04
FY05
FY06
ACS
Field
Federal Payment Levy Program

Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.


IRS Enforcement Revenue
In Billions of Dollars
50
40
30
20
10
0
37.2
35.2
32.9
33.8
33.8
34.1
37.6
43.1
47.3
48.7
10.1
12.5
10.0
10.2
7.9
7.9
10.7
14.7
17.7
17.2
1.2
1.4
1.6
1.5
1.6
1.8
2.2
2.7
3.1
3.3
26.0
21.3
21.3
22.1
24.3
24.4
24.8
25.7
26.6
28.2
FY 97
FY 98
FY 99
FY 00
FY 01
FY 02
FY 03
FY 04
FY 05
FY 06
Collection
Document Matching
Examination

United States Senate
Committee on Finance

Sen. Chuck Grassley · Iowa
Ranking Member

http://finance.senate.gov
Press_Office@finance-rep.senate.gov

Opening Statement of Sen. Chuck Grassley
Hearing, "Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?"
Wednesday, April 18, 2007

I commend the Chairman for holding today's hearing on the tax gap. While the tax gap is an important issue, it is certainly not a new issue. We have had a tax gap problem in this administration, the previous administration and my guess is back to when we first had an income tax.
According to the GAO, the voluntary compliance rate has ranged from around 81 percent to 84 percent over the past three decades. In the Finance Committee, we take the tax gap very seriously, because it's not fair to the vast majority of taxpayers who pay their taxes on time.

But while this Committee has its feet on the ground on this issue, I'm worried that some members have their head in the clouds when it comes to the tax gap. Some members view the tax gap as money in the pocket to spend on favorite proposals. Nothing could be further from the truth. Closing the tax gap is a difficult and grinding process.

We have had several hearings when I was Chairman to examine the size, sources, and solutions to the tax gap, and we have enacted many steps to reduce the tax gap, such as reducing abuse in charitable donations of cars and intellectual property; increased penalties and reporting requirements; expanding the IRS' whistleblower program; and authorizing the private debt collection program.

But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap – and I will work aggressively toward enacting legislative changes to help close it -- but these steps have to be done with care in order to be effective. There are no easy solutions. There seems to be a general consensus that potential solutions to the tax gap fall into four categories:

(1) additional and more efficient enforcement by the IRS;
(2) additional legislative or regulatory tools for the IRS, such as information reporting and withholding;
(3) changes to our tax base – as well as Treasury regulations and IRS guidance – that reduce the complexity of our current system; and

(4) improved service by the IRS to taxpayers; and I would add a new one since our hearing last week:

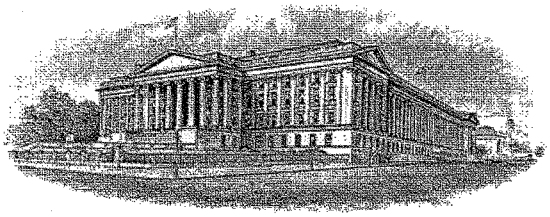
(5) ensuring that paid tax preparers provide taxpayers honest and informed assistance in filing their taxes.

I would give my colleagues an observation from a poet, T.S. Eliot, who said, "It is impossible to design a system so perfect that no one needs to be good." Mr. Chairman, I think that sentence captures part of the challenge with the tax gap. The term "good" here, as I apply it, has two meanings. One notion of "good" taxpayers is taxpayers who intend to comply with the system. The second notion of "good" is taxpayers with the knowledge to competently deal with our complex tax system. Those two groups of taxpayers represent 84 percent of the dollars due and owing. As the Treasury Department's work shows, part of the tax gap problem arises from willful non-compliance. Part of the problem arises from unintended non-compliance – i.e., confusion or the current system's unwieldy complexity.

Of the taxpayers who make up the 16 percent of noncompliance, some do so willingly. There may not be a "perfect" system that can catch every willful noncomplier. Another portion of that 16 percent of dollars that is not compliant are not willful in their noncompliance. And to add to the difficulty, you may often have a situation where a taxpayer is very compliant in one area of their return but either willfully or ignorantly noncompliant in another part of their return. So it's important to remember that the 16 percent noncompliance rate doesn't translate into 16 percent of taxpayers; it may represent a much larger group of taxpayers who are a mix of compliant and noncompliant. A tax system designed to perfection, viewing it solely from the standpoint of the "perfect" rate of compliance, could undermine the efforts of the good folks who do now comply or mostly comply. This balance is a key consideration for the tax-writing committees.

We're accountable to the people who must deal with the changes to the tax system. We're right to insist on a level playing field – that is, ensuring that complying taxpayers are not subsidizing non-compliant taxpayers. At the same time, we must make sure that the system is workable for the vast majority who do comply.

Lastly, I would only repeat a comment made by the Chairman, and echoed in the title of this hearing. I think it is important that we start getting measures for success in closing the tax gap. I know all the comments about uncertainties and difficulties but we will never get to a better place regarding the tax gap if we don't have the focus of reasonable achievements and objectives. I commend the administration for its efforts in the budget for dealing with the tax gap – both in terms of IRS funding and changes in the tax law. I think they are meaningful steps. But just that, steps. I hope this hearing will provide a better picture of what goals these steps, and future steps, can lead to.



U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON, JR. BEFORE THE SENATE FINANCE COMMITTEE ON WAYS TO REDUCE THE TAX GAP

Chairman Baucus, Senator Grassley, Members of the Committee, thank you for considering this important topic and for inviting me to speak about it. It is very appropriate that we have this conversation the day after tax day. Over the last few months, millions of Americans have collected their W-2's, their 1099's, their home mortgage interest statements, and countless other pieces of paper to fill out their tax returns. This is an annual ritual for Americans, completed without great enthusiasm, but with remarkable honesty and effort. The vast majority of Americans pay their taxes without additional prodding by the IRS, out of a sense of fairness and civic duty. They understand the importance of paying what they owe, and they know that when people fail to pay their taxes, it serves as a de facto tax increase on everyone else.

While the current compliance rate is high, it can and should be improved. Our objective must be to increase tax compliance without over-burdening the tens of millions of taxpayers who already pay their taxes honestly and on time.

The amount of taxes that are owed but not paid is commonly referred to as the tax gap. An important part of addressing the tax gap is to understand not only the types of taxpayers – individuals, small businesses, corporations – that don't comply, but also why these taxpayers fail to comply. Answering these questions will help us improve taxpayer service and better target our enforcement efforts.

In September of last year, we released a comprehensive seven-point strategy to address the tax gap. The budget we put forward for 2008 is critical to implementing that strategy. It requests new funding for taxpayer services, research, improved technology, and targeted enforcement. We ask for your help in working with the Appropriations Committee to make sure the IRS has the resources it needs to improve compliance while maintaining its commitment to taxpayer service.

The budget also includes 16 legislative proposals that, if enacted, will help to narrow the tax gap without imposing excessive burdens on compliant taxpayers. Since I last appeared before this committee, my staff has been meeting with your staff on a regular basis to review the 16 legislative proposals. Treasury's Assistant Secretary for Tax Policy, Eric Solomon, and IRS Commissioner Mark Everson are here with me today to provide more detail about these proposals and the IRS's budget request.

Our legislative proposals attempt to balance the burden they impose on taxpayers against the impact they will have on improving compliance. Even so, some of the proposals have generated concern from those who could be affected by them. We must consider the impact of any new rules on the vast majority of Americans who already pay what they owe, and better target our enforcement efforts to minimize additional burdens.

Since I last testified before you, Treasury has explored ways to improve compliance. We held a public discussion a few weeks ago, and heard from a broad cross-section of stakeholders, including a former IRS Commissioner, tax preparers, and business representatives. Several insights emerged: first, we need to know more about the specific sources and causes of the tax gap so we can focus our efforts more precisely; second, great care must be given to ensure that those efforts do not impose unreasonable burdens on already compliant taxpayers; third, simplification of the tax code, as well as taxpayer education and services, would help improve compliance; and fourth, we need to manage expectations, recognizing that every potential solution carries consequences.

I know you have spent a great deal of time exploring this issue. And since I came to Washington, I have taken a hard look as well. The most recent data we have on the tax gap comes from 2001. It indicates that the vast majority of the tax gap was attributable to underreporting of income. Most of the underreporting is attributable to individuals with business income and corresponding self-employment tax liabilities. This includes small businesses, farms, and ranches. It's unclear whether this underreporting is the result of deliberate deception or a simple misunderstanding of what needs to be reported and how to do it.

To substantially improve compliance in this regard, Congress would have to mandate additional requirements, which would affect not only those who don't report all of their income, but also those who already do. I have come to the conclusion that there is a big part of the tax gap we simply won't be able to reach without adding draconian and painful requirements on all taxpayers. And I don't believe any of us really want to do that. We must remember that the tax gap is simply not a pot of gold that we can dip into every time we want to pay for a new or expanded program. Nor should it be viewed as an easy solution to existing challenges, such as the alternative minimum tax.

As you know, narrowing the tax gap is about improving compliance. It is <u>not</u> about changing the baseline to raise more revenue. The budget resolution passed by the Senate assumes revenue collections are raised by hundreds of billions of dollars. Some believe this level of revenue can be achieved largely through measures to reduce the tax gap. I believe it is unrealistic to assume that reducing the tax gap will yield that level of additional revenue.

In developing our 16 proposals, we focused on changes that would narrow the tax gap with minimal additional burdens. Some have suggested that far more expansive proposals should be put forward. Most of these proposals would require steps that I would not recommend because they are bad tax policy and would be unnecessarily painful, expensive, and time-consuming for taxpayers – for example, requiring individuals to file 1099's reporting their transactions with service providers, such as their

doctor, auto mechanic, and dry cleaner; eliminating cash transactions in favor of electronic transactions, with card issuers and banks providing statements to the IRS so the payments can be matched with a business's reported income; or doubling or tripling the number of IRS agents and audits. In theory, each of these measures could bring in some additional revenue, but the cost of compliance for individuals and businesses – most of whom already pay what they owe – would far outweigh the gains. In many cases, such measures would also raise privacy concerns due to the government's heavier focus on the daily transactions in each of our lives.

I hope we can all agree that such extreme measures are not the approach we should take. Instead, as a strong first step toward narrowing the tax gap, I hope you will work with us to approve the additional IRS funding and enact the legislative proposals the President has requested. I am pleased that Congress has recently taken up a number of these proposals. By capitalizing on the direct and indirect effects of IRS enforcement, and by making focused legislative changes, I am confident we can make measurable progress toward reducing the tax gap without adversely affecting already compliant taxpayers.

We should also look for ways to reduce the complexity of the U.S. tax code. Making the tax code simpler and fairer for the average American could help to improve compliance by reducing the number of honest mistakes, removing incentives for cheating, and providing fewer places for tax cheats to hide.

It is critical that we manage expectations and view efforts to reduce the tax gap over the long-term and with a clear understanding of both the costs and the benefits of any action. Making significant progress will require a sustained, focused effort by the Administration, Congress, and the American people. Honest American taxpayers are our allies in this effort, and we must always put their interests first.

Thank you, and I now welcome your questions.

RESPONSES TO QUESTIONS FOLLOWING THE TESTIMONY OF SECRETARY PAULSON BEFORE THE SENATE FINANCE COMMITTEE ON THE TAX GAP

Department of the Treasury
August 20, 2007

Baucus Question 1

What is the IRS doing to increase the rate of individual electronic filing?

Answer

As part of the Taxpayer Assistance Blue print, the IRS has implemented a number of e-strategies for growth, which aim to reduce taxpayer burden and expand the e-File program. Key elements include:

- Make electronic filing, payment, and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increase taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protect transaction integrity and internal processing accuracy.
- Deliver the highest quality products and services as promised.
- Partner with states and other governmental entities to maximize opportunities to reduce burden for the common customer base.
- Encourage private-sector innovation and competition.

Baucus Question 2

What additional actions can the IRS take to increase the rate of individual electronic filing?

Answer

To implement these e-strategies for Growth, the IRS will continue to develop and implement e-File marketing strategies, expand the use of electronic signatures, and enhance its web site services for practitioners, taxpayers, and stakeholders. Ultimately, the IRS' goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

Baucus Question 3

How can the IRS assuage taxpayer concerns about internet security and privacy?

Answer

The IRS is charged with protecting confidential information about every taxpayer. Through press releases and other channels, the IRS makes every effort to assure taxpayers that the security and privacy of taxpayer information is one of its highest priorities. Recognizing its responsibility in this area, the IRS continues to update its systems, processes, and training so that IRS employees who have access to sensitive

information are aware of the steps they must take to prevent taxpayer information from being compromised.

The IRS maintains a computer security incident response center (CSIRC) that continuously monitors the security of IRS IT systems and networks. The IRS uses multiple layers of security protections throughout its network computing enterprise, with over 100 firewalls and several hundred intrusion detection devices installed to prevent external attackers from getting into IRS IT systems and taxpayer databases. One of the more significant initiatives recently implemented by the IRS to improve the security and privacy of taxpayer information included the installation of automatic full disk encryption solution on the total deployed inventory of over 52,000 laptops used by IRS employees. In addition, the IRS has issued numerous updated data protection policies, and processes and has provided extensive security and privacy education and training tools to improve employee awareness and skill levels.

Baucus Question 4

To what extent do you believe that all taxpayers should have the opportunity to file their tax returns for free directly with the IRS?

Answer

Private industry has a proven track record in the field of electronic tax preparation. Leveraging this established expertise and experience, the IRS has collaborated with the private sector in developing a Free On-Line Electronic Tax Filing Agreement. The Free File Program has four main objectives: to increase e-File penetration; provide more free online options to taxpayers; ease tax preparation and filing; and, provide greater access to taxpayers. The e-File option offers the advantages of reduced burden on filers and quicker refunds, and the Free File Program makes these benefits available to taxpayers who may have previously prepared and filed paper returns. Seventy percent of all taxpayers are eligible to use Free File. In 2006, the IRS received almost 4 million Free File returns and, as of May 10, 2007, the IRS received over 3.7 million returns through this program.

Although the IRS continues to consider ways in which the Free File Program can be expanded, the challenges of tax software development by the IRS and the related issues of access, capacity, privacy, security, and cost, continue to make the IRS reliant on the private market to provide free on-line electronic tax filing to the widest population possible.

Baucus Question 5

IRS procedures require suitability, or background, checks on parties who apply for Electronic Return Originator, or ERO, status, including fingerprint checks. It takes just a few minutes for the FBI to conduct a fingerprint check for the IRS; however, the IRS

submits just a fraction of the fingerprints to the FBI. No photographs of applicants are required to be submitted with the ERO application. The IRS has acknowledged that unethical applicants could receive e-filing authorization.

Subpart I

i. Why doesn't the IRS request an FBI check of all fingerprints submitted?

Answer

The IRS has performed fingerprint check analysis several times in past years and has concluded that additional checks are not necessary. The IRS has found that nearly all of those whose fingerprint cards have been sent to the FBI in recent years have been allowed into IRS e-File after appropriate follow-up review by the IRS' Criminal Investigation unit. The IRS continues to consider whether other cost-effective measures might be taken to ensure the integrity of the E-File program.

Subpart II

ii. Why doesn't the IRS require a photograph of each ERO applicant?

Answer

Submission of photographs by electronic return originator (ERO) applicants would require the IRS to verify that the photographs are truly those of the applicant, which could not be done through the mail or electronically. Since applicants are from all over, the difficult, expensive, and time-consuming process of verifying the photographs would not justify the marginal improvement, if any, in security.

Subpart III

iii. How can the IRS be confident that ERO applicants are really who they say they are?

Answer

The IRS validates the Social Security Number (SSN), shared secrets (e.g., adjusted gross income from the taxpayer's last-filed return), and adjusted gross income (AGI) of individuals when they register for e-services. When the applicant submits an e-File application, their personal data is also validated against the IRS Master File to verify their identity.

Subpart IV

iv. How can the IRS be confident that EROs are ethical and competent?

Answer

EROs originate the electronic submission of returns to the IRS and are subject to an initial suitability process. Once the applicants are accepted, they are subject to continuous IRS tax compliance checks.

Different areas of the IRS, including Criminal Investigation and the Enrolled Agent Project Office, also provide referrals of inappropriate activity to the IRS' Electronic Tax Administration office, which then acts upon them. The e-File Monitoring program is responsible for random visits to EROs to ensure e-File rules are being followed.

Baucus Question 6

After ERO authority is granted, that authority can be delegated to the tax firm's workers (delegated users). The IRS requires no background checks on delegated users. Delegated users are not required to register with the IRS. There are no required competency or ethical standards applicable to delegated users.

Subpart I

i. Why has the IRS implemented an ERO process that allows hundreds of thousands of electronic tax preparers to go unidentified by the IRS?

Answer

Delegated Users of e-services are individuals other than those in authority over the e-File operation and, therefore, are not directly subject to suitability checks. Delegated Users perform administrative tasks associated with the e-File application. Delegated Users are input on the e-File application by either a Principal or Responsible Official of the firm who has been subject to a direct suitability check. This treatment is consistent with Code section 7701(a)(36)(B), which excludes individuals performing administrative functions similar to those performed by EROs from the definition of an income tax return preparer.

Subpart II

ii. To what extent do IRS policies and procedures with respect to the ERO process and delegated users affect the rate of tax compliance?

Answer

Since Delegated Users perform administrative functions for e-services, the IRS does not believe that they affect the rate of tax compliance.

Subpart III

iii. To what extent would thorough background checks of ERO applicants and delegated users improve tax compliance?

Answer

Fraud occurs when return filers make false or knowingly incorrect entries on tax returns. This is the domain of the return preparer or taxpayer. Additional background checks on EROs would have no impact on the data entry decisions on tax returns. EROs are part of the electronic process that replaces sending returns through the mail.

The IRS does subject EROs and other providers to an initial suitability process. Other providers include Intermediate Service Providers, Transmitters, Software Developers, and Reporting Agents. The IRS processes all applications by checking the firm and its principals and responsible officials against IRS records for prior IRS e-File sanctions and tax compliance issues. If applicants check 'yes' to any of the compliances questions on the application, a criminal background check is performed. The IRS also performs criminal background checks on a sample of all other applicants. Once entered into IRS e-File, the applicants are subjected to continual tax compliance checks and monitoring visits, when appropriate. Referrals from other departments within IRS are also reviewed for sanctioning action within IRS e-File.

Delegated Users perform administrative tasks related to e-services and are therefore not subject to direct suitability checks. A Delegated User is appointed by the Principal or Responsible Official. The actions of the Delegated User are the responsibility of the Principal or Responsible Official who appoints the individual and who can be held accountable for the actions of such subordinates.
The ERO is the originator of the electronic submission of the returns and therefore may or may not also be the preparer of the returns. If the ERO is the preparer of the returns, other penalty provisions and controls apply.

Baucus Question 7

How can the IRS assure American taxpayers that its ERO processes are sufficient to protect private and confidential financial information?

Answer

Although problems in this area are rare, the IRS is constantly evaluating its suitability process for further enhancements. The suitability process along with the e-File Monitoring of the originators of electronic returns, enables the IRS to protect the integrity of e-File.

The IRS has a publication entitled Safeguarding Taxpayer Information, which provides information concerning this area. Providers are required to abide by the Gramm-Leach

Bliley Act and ensure the security and confidentiality of customer records and information. Providers are required to report any information security incident to the Federal Trade Commission.

Baucus Question 8

Are there any plans to change the ERO process so the IRS a) can be assured of the identity of the applicants and b) can be assured of the identity of the delegated users?

Answer

In addition to reviewing its suitability process for future enhancements, as discussed above, the IRS also verifies the identity of EROs and other Providers. In order to use e-services, Providers must register, using their SSNs and their AGIs from a prior tax year. This information is validated against the IRS Master File. The Provider must then submit shared secrets that are used to verify the identity after the registration is completed.

In order to submit an e-File application, the Provider must submit his SSN again and this is also verified against the IRS Master File.

Baucus Question 9

More than 60 percent of the tax returns filed are prepared by so-called professionals. What specific actions has Treasury taken to improve the professionalism of paid preparers and the quality of the tax returns they file?

Answer

Tax preparers covered by Treasury Department Circular 230 are subject to a variety of requirements intended to ensure professionalism and competency. Enrolled Agents (EAs) must take and pass the Special Enrollment Examination (SEE). The SEE is a three-part examination covering individual income tax returns, business tax returns, and Representation, Practice and Procedures, which includes ethics. Certified Public Accountants (CPAs) and Attorneys must pass competency tests administered by their respective states. All Circular 230 practitioners must meet Continuing Professional Education requirements and EAs must take regular courses in ethics. Circular 230 mandates certain due diligence requirements for tax professionals and contains best practices for tax advisors, and standards for advising with respect to tax return positions, and for preparing and signing returns and other aspirational standards.

For taxpayer representatives who unreasonably delay or hinder an examination, the IRS employs bypass procedures to work with the taxpayer directly to request whatever additional information is needed to conclude the examination. Unreasonable delay or hindrance includes, but is not limited to, failing to submit requested taxpayer records or

information promptly, failing to respond to telephone messages or correspondence, or failing to keep scheduled appointments. The procedure starts with the issuance of a warning letter to the representative. The purpose of this letter is to advise the representative of his/her responsibility in the conduct of the examination and convey advance notice of a possible bypass for failure to provide requested information. If that fails to correct the behavior, then the representative and the taxpayer are issued a final letter advising them that the examiner will contact the taxpayer directly in the future.

For those tax preparers who file returns electronically, the application process to begin filing returns electronically includes a provision that they must appoint an individual as a responsible official who is accountable for ensuring that the firm meets IRS e-File rules and requirements. Each year, the IRS conducts monitoring visits of a sample of these Electronic Return Originators to ensure compliance with the multitude of requirements for e-filing. Those providers with problems involving fraud and abuse may be suspended or expelled from the program, be assessed civil and preparer penalties, or be subject to legal action.

The Stakeholder Liaison function within the IRS' Communication, Liaison and Disclosure office conducts practitioner outreach. In the first 6 months of this fiscal year, this office participated in 1,714 events with a total of 113,895 participants. The specialists in this office focus on building relationships with payroll, practitioner, and industry groups to educate small business owners on their tax obligations. They provide outreach products such as the Small Business Workshop DVD, which explains basic concepts such as inventory costs, accounting methods, business entities (such as Partnerships and S-Corps), and their respective tax implications. Another outreach effort centers around a newsletter called e-News for Tax Professionals sent via email to subscribers, which provides the latest national and local IRS news edited for the tax professional community. A third effort is the IRS phone forum presented by IRS subject matter experts, which allows the call-in audience to ask questions at the end of the presentation.

The Nationwide Tax Forums, hosted by the IRS, are accredited by NASBA (National Association of State Boards of Accountancy) for CPAs and through consultation with the IRS Office of Professional Responsibility (OPR) for EAs. These forums directly reach 14,000 tax preparers and professionals each year. Many seminars offered at the forums focus on the proper treatment of tax situations and the completion of the applicable tax form. The forums also provide several seminars that qualify for Ethics Training for CPAs and EAs. These seminars usually focus on ethical treatment of tax issues per Circular 230. The forums also historically meet accreditation criteria for Continuing Legal Education for several State Bars.

Through the Internal Revenue Service Advisory Council (IRSAC) and the Information Program Reporting Advisory Committee (IRPAC), highly skilled tax professionals assist the IRS in reviewing IRS policies and procedures on how preparers interact with both the IRS and their clients. The most recent IRSAC public report (November 2006) specifically addressed improving the performance of tax preparers.

The Office of National Public Liaison (NPL) also hosts less formal Liaison Meetings with representatives from numerous tax professional organizations, such as the American Bar Association, the American Institute of Certified Public Accountants (AICPA), the National Association of Enrolled Agents, and many more. These regular bi-monthly meetings create a platform for assisting these organizations in correcting their members' common errors during the filing season, as well as outreach and communication during the rest of the year.

Baucus Question 10

What percentage of IRS resources are devoted to oversight of the paid preparer industry, including education, monitoring, and compliance enforcement?

Answer

Preparer Oversight:

During the course of all IRS examinations (field and correspondence), examiners look for issues attributable to return-preparer negligence or misconduct. The IRS does not require its examiners to account specifically for their time on the search for preparer negligence or misconduct.

In addition, in the Small Business and Self-Employed Division (SB/SE) compliance program, 5 percent of Tax Auditor time and a meaningful percentage of Revenue Agent time is spent conducting compliance enforcement related to tax preparers.

The Office of Professional Responsibility has planned for 58 FTEs for FY 2007 to enforce standards of professional conduct involving tax practitioners. This represents approximately twice the 27 FTEs for FY 2003, and is up from a total of 15 in FY 2002.

With respect to Criminal Investigation, approximately 350-400 FTEs are applied annually in support of return-preparer compliance at a cost of around $50 million.

Education:

The Communications and Liaison function, through its Office of National Public Liaison, conducts multiple "Nationwide Tax Forums" each year as part of the IRS' education and outreach efforts. These forums usually occur between June and September, are spread among several locations, and annual attendance is historically about 14,000 total tax practitioners. Approximately three FTEs (two fulltime, two half-time) are dedicated to planning, implementing, and measuring the effectiveness of the Forums. In addition, Stakeholder Liaison, the external outreach function within SB/SE, considers practitioners one of their primary stakeholders, especially since approximately 80 percent of small businesses engage a paid preparer. They have approximately 265 FTEs engaged in

outreach, education, and communication. Stakeholder Liaison has an aggressive outreach strategy geared toward practitioners to provide key tax-law messages, as well as current policy and procedural information, through an established network of practitioner organizations such as the AICPA, National Association of Enrolled Agents (NAEA), and National Association of Tax Practitioners (NATP) at both the national level and locally.

Pertinent educational information is shared with practitioners at regularly scheduled national and local practitioner liaison meetings, phone forums, and through electronic communication. Stakeholder Liaison has also partnered with the Office of Professional Responsibility and local practitioner groups to host Ethics Seminars. These seminars provide detailed instruction to practitioners on their conduct and responsibilities regarding return preparation and representation of clients before the IRS. In addition to these seminars, Stakeholder Liaison also includes discussion of Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the IRS, as an agenda item in their meetings with practitioners in order to ensure practitioners are aware of the contents of the Circular 230, including any current revisions. In addition to these ongoing strategies, Stakeholder Liaison is also expanding their strategic approaches to educate practitioners. Stakeholder Liaison is currently developing an educational outreach targeting unaffiliated practitioners — those return preparers who do not hold a membership with a practitioner association. There is also an outreach under development to provide the same educational information to tax preparers employed by the larger chain tax-preparation organizations.

Baucus Question 11

Given the importance of paid preparers to tax administration in the United States, how does the IRS measure and track the performance of the paid preparer industry?

Answer

The IRS tracks and publicizes on its web site the top 20 errors made by paid tax return preparers. However, the IRS does not track errors or performance by individual preparers.

Baucus Question 12

Given the importance of paid preparers in our tax administration system, to what extent would it be useful for the IRS to devote more resources to oversight of the paid preparer industry?

Answer

Ensuring that taxpayers are dealing with well-educated, competent tax preparers is an important objective. Testing and licensing of the estimated 850,000 preparers who might apply for licensure, as well as educating consumers about the benefits of using a licensed tax preparer, could help to avoid mistakes on returns, but it is not clear that the burden that this would impose on preparers (which would, in turn, be passed on to taxpayers) justifies the benefit. Moreover, based on the experience of states that have implemented a regime for regulating paid preparers, the benefits in terms of improved compliance have not been clearly established.

Ensuring that taxpayers only use licensed preparers is a much more difficult goal to achieve. Developing the appropriate penalties for unethical return preparers, providing disincentives to taxpayers who use unlicensed return preparers, ensuring that all preparers sign the returns they preparer, monitoring return preparers, and creating the infrastructure to ensure fair treatment of those tax preparers accused of unethical and/or non-compliant behavior would be a resource intensive, time-consuming, and costly undertaking.

Baucus Question 13

To what extent have you personally reached out to the CEOs of leading tax preparation firms and leaders of professional tax organizations to a) determine their roles and responsibilities to improve tax compliance, b) how Treasury and the IRS can partner with them to improve tax compliance and, c) how Treasury and the IRS can more effectively monitor preparer performance and behavior?

Answer

The Treasury Department and the IRS have an active program of coordinating with paid return preparers, tax practitioners, and other tax professionals. Within the IRS' SB/SE Division, the Stakeholder Liaison office has been instrumental in partnering with professional tax organizations and other stakeholders to design, develop, and deliver educational products and services aimed at improving compliance. The IRS has also taken steps to significantly increase the resources and activities of the Office of Professional Responsibility, in order to ensure that practitioners are aware of their responsibilities and that appropriate action is taken against them when these responsibilities are violated.

Paid return preparers and practitioners play a critical role in making certain that taxpayers understand and comply with their obligations under the tax law. Reflecting the importance of this issue, on May 30, 2007, senior Treasury Department and IRS officials met with representatives of the return preparer industry to discuss a wide range of issues focused on efforts the industry could take that would improve compliance with the tax law.

Baucus Question 14

What is your position on the Senate's proposals in S. 1321 to strengthen the regulation of preparers and to increase preparer penalties?

Answer

The Treasury Department and the IRS have concerns with some aspects of the proposal described in S. 1321. The proposal would amend 31 U.S.C. § 330(a)(1) to include "compensated preparers of Federal tax returns, documents, and other submissions" within the class of representatives regulated by the IRS. It is unclear whether this legislation intends to apply provisions in existing Treasury Department Circular 230 to the new class of compensated preparers subject to regulation. There are other, more technical concerns that Treasury Department and IRS staff have raised with Finance Committee staff regarding the proposal. The IRS and Treasury Department share the Finance Committee's concerns about preparer conduct that underlie the proposal, and continues to consider regulatory alternatives that would balance the burden placed on return preparers (and, ultimately, on taxpayers) against the need for improvements in compliance.

The creation of a new system to test and monitor paid return preparers will not address the complexity of the Federal tax law, which is a primary reason for many erroneous return positions. An extension of regulatory authority to paid return preparers would create administrative burdens, including the extension of credentialing activities to hundreds of thousands of paid return preparers, with commensurate costs to the IRS in its oversight capacity. Although the proposal anticipates that the IRS would contract the administration of an examination to outside vendors and charge user fees, these fees will not fully absorb the costs of regulation and the other enforcement-related provisions included in the proposal.

Current law provides tools for the IRS to pursue aggressively preparers who facilitate the preparation of returns that take unsupportable positions. Among the tools available to the IRS under current law are: (1) preparer penalties under sections 6694 and 6695 of the tax Code (as recently amended by the Small Business and Work Opportunity Tax Act, Pub. L. No. 110-28); (2) civil penalties under sections 6700 and 6701 for promoting abusive tax shelters and aiding and abetting the understatement of tax; (3) the injunction provisions under section 7407; and (4) criminal sanctions under section 7206 for fraud and false statements by return preparers.

Baucus Question 15

What is the Administration doing to ensure that federal contractors are paying their taxes on time?

Answer

In February 2004, the Administration established the Federal Contractors Tax Compliance (FCTC) task force. The FCTC task force participants include agencies within Treasury (IRS and FMS) other agencies responsible for the Federal acquisition process (e.g., the Office of Management and Budget (OMB), General Services Administration (GSA), Department of Defense (DoD)). The purpose of the task force is to develop and enhance programs both in the contracting process and the Federal debt-collection process to ensure that Federal contractors comply with their tax obligations and other Federal debts.

For example, in the contracting process, the task force is developing taxpayer identification number (TIN) matching programs to ensure that accurate reporting information is obtained from contractors before any payments are made. The task force is also developing programs to ensure that contractors self-certify that they have no tax-compliance issues. The task force is also developing ways to identify contractors that have Federal debts so that the contractors are only paid using a method that will be subject to a Federal payment offset or levy. The agencies also have ensured that their payment files are available to FMS' Treasury Offset Program, which can help deter non-compliance for those contractors who wish to do business with the Federal government. For the debt-collection process, the IRS has developed a program to flag all Federal contractors to ensure delinquent contractors are quickly identified and accelerated for the proper collection strategy. IRS and FMS are continuing to operate the Federal Payment Levy Program (FPLP) to ensure that those who are not timely paying their taxes are brought into compliance by reducing their Federal payment in whole or in part to satisfy the outstanding debt. The IRS has included all the delinquent contractor cases that are statutorily and operationally allowed to be in the FPLP. Only cases that are being negotiated for resolution between the IRS and the contractor are excluded.

Baucus Question 16

Should federal contractors be awarded contracts when they are behind on their taxes?

Answer

The Treasury Department does not establish policy, regulations, or laws governing the award of Federal contracts. Current Federal law does not prohibit a contractor with unpaid Federal taxes from receiving contracts from the Federal government. Federal agencies are required by law to award contracts to responsible sources. This statutory requirement is implemented through the Federal Acquisition Regulation (FAR), which requires that government purchases be made from, and government contracts awarded to, responsible contractors.

All taxpayers are responsible for paying and filing their tax returns on time and an appropriate penalty should be imposed for those who fail to comply.

Baucus Question 17

How can Treasury check contractor compliance before federal contracts are awarded?

Answer

With the consent of the taxpayer, the IRS could provide Federal contracting offices with a historical record of a contractor's account, which indicates any periods of unpaid taxes. The IRS is not able to provide information on tax periods not yet filed and posted on its Masterfile. As with any new program, operational and resource issues would need to be addressed before an account-disclosure program could be implemented.

Baucus Question 18

How can Treasury assure that back taxes owed by any federal contractors are withheld from payments to the contractors before the payments are sent out?

Answer

The IRS and FMS currently operate the FPLP. The FPLP includes all or most delinquent Federal contractors, and their disbursements are subject to levy prior to pay out. Part of the FPLP also includes ensuring any due-process actions are taken at the time the contractor is awarded the contract, which ensures that down the line, the subsequent payments are subject to being levied prior to disbursement.

Baucus Question 19

What legislative changes are necessary to improve federal contractor compliance?

Answer

The Treasury Department and the IRS have been actively working with other Federal departments and agencies to develop and implement administrative programs to improve Federal contractor tax compliance. These efforts are focused on subjecting a broader range of Federal payments to offset when the payee has an outstanding Federal tax liability, and they have resulted in a significant increase in the amount of Federal tax offsets.

Amendments to the continuous-levy rules enacted as part of the American Jobs Creation Act in 2004 have helped to increase the effectiveness of the Federal levy program and improve contractor compliance. In addition, the Treasury Department is working with Finance Committee staff to consider changes to the Jobs Act provision so that it applies to all Federal vendor payments, not just those for "goods or services." If enacted, this change would further improve the effectiveness of the levy program and, in turn, improve Federal contractor compliance.

In addition, the Administration's FY 2008 Budget proposes to increase the effectiveness of the Federal tax levy program by amending the Collection Due Process (CDP) procedures to allow the IRS to levy for unpaid employment tax liabilities prior to affording the taxpayer an opportunity for hearing before the IRS Office of Appeals. Under this proposal, the taxpayer would be afforded such a hearing on a post-levy basis. Congress recently enacted a version of the proposal in the Small Business and Work Opportunity Tax Act, Pub. L. No. 110-28, which creates an exception to pre-levy CDP procedures if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. This provision should improve employment tax compliance by Federal contractors and other employers who may allow outstanding employment tax liabilities to pyramid during pending CDP review, to the detriment of both the Treasury and employees.

Baucus Question 20

For the 2007 filing season, the IRS publicly announced that it was reprogramming its electronic filing software so returns filed using both Individual Taxpayer Identification Numbers (ITINs) and false or stolen W-2s would be processed expeditiously.

Subpart I

i. What is the rationale for the IRS to make it easier to file a tax return that might contain a stolen or false social security number?

Answer

Resident aliens are generally subject to U.S. income tax and return filing requirements in the same manner as U.S. citizens.

The IRS changed its policy to allow electronic filing of ITIN returns with SSN W-2 information in order to make the process consistent with paper returns. A related benefit associated with this change includes the fact that when returns are e-Filed, the IRS captures the Form W-2 data, a process that does not happen when returns are filed on paper. Capturing the Form W-2 data enables the IRS to track the returns where wage income is reported irrespective of whether the taxpayer identification number on the Form W-2 matches the taxpayer identification on the return. Without this information, if the name and SSN used on the W-2 matches the name and SSN of an identity theft victim, the true owner of the SSN would likely be contacted by the IRS to determine why he or she had not report the W-2 income on their tax return. In these situations, the case is closed by IRS when the true owner of the SSN provides evidence that he or she was a victim or identity theft.

By capturing the W-2 information through e-File, IRS can use the data to remove these cases from its Automated Underreporter processes.

Subpart II

ii. To what extent does the IRS notify the true owner of the social security number when the number also is used on a return filed under an ITIN?

Answer

Under current law, the IRS cannot notify true owners of SSNs when the number is used in a W-2 attached to a return filed under an ITIN. However, as noted above, the IRS does work with identity theft victims to resolve any underreporter cases arising from unauthorized use of their SSNs for employment.

Baucus Question 21

Why should the IRS automatically notify an identity theft victim when someone else is using his or her social security number?

Answer

The IRS cannot automatically distinguish the identity-theft perpetrator from the victim when it receives two tax returns with the same SSN. In the course of conducting tax administration duties, through the Electronic Fraud Detection System, Automated Underreporter program, or Scrambled SSN process, the IRS requests information to authenticate the identity of the real taxpayer and resolve the identity theft victim's account issues.

Baucus Question 22

If the IRS revealed only the fact that someone falsely was using another party's social security number, but did not reveal who it was using the stolen social security number, does that constitute an unauthorized disclosure under IRC section 6103?

Answer

It would not constitute an unauthorized disclosure under IRC section 6103 for the IRS to reveal the fact of SSN misuse to the apparent victim when the IRS, in the course of conducting its tax administration duties, determines such an incident has occurred.

Baucus Question 23

Is using a false or stolen social security number to file a tax return is against the law?

Answer

Stolen SSNs can be used by criminals to prepare and file false tax returns in order to obtain false refunds, which is against the law. Identity theft and refund crimes are usually committed hand-in-hand. The IRS' Criminal Investigation unit primarily uses the authority under 18 U.S.C. §§ 286 and 287 to prosecute refund crimes. It is also a crime under the tax law (IRC section 7206) for any person to willfully make a false statement on a tax return under penalties of perjury.

Baucus Question 24

To what extent do current IRS identity theft policies and procedures facilitate identity theft?

Answer

The IRS does not have any policies that tolerate or encourage fraudulent use of stolen identities. Under the Internal Revenue Code, the IRS is required to process all tax returns that appear on their face to be valid. The IRS employs multiple policies that identify suspicious tax returns to combat against processing returns with stolen or false SSNs.

Baucus Question 25

Should IRS identity theft policies and procedures be revised to protect victims and to comply with all applicable laws?

Answer

Current IRS identity theft policies are in full compliance with all applicable laws. Although research shows that the IRS has one of the lowest rates of identity theft in the Federal government, the agency takes this issue very seriously and is continuously looking for ways to improve its efforts in this area. The IRS continues to update its systems, processes, and training to prevent taxpayer information from being compromised. The IRS is holding an Identity Theft Summit that will include key IRS program areas affected by identity theft. This summit will help the IRS update its current enterprise strategy and identify areas for new initiatives and improvements to existing processes.

The IRS coordinates its efforts to address identity theft with several other Federal agencies. The IRS led a Multi-Agency Working Group to share information and best

practices about identity theft, including members from the SSA, the FTC, the Department of Homeland Security (DHS), and the Treasury Department.

The President's Identity Theft Task Force initiative replaced the Multi-Agency Working Group and issued a report that provides a comprehensive overview of the threat posed by identity theft and a proposed strategic plan for combating the threat. Since the initial draft of the report was released in April 2007, the IRS has been reviewing the report findings and recommendations to identify opportunities for improvements within the IRS.

Baucus Question 26

Specifically, what is the IRS doing to improve its ability to detect and deter filing scams, schemes and fraud?

Answer

The IRS has taken proactive steps to improve its ability to detect and deter filing scams, schemes, and fraud. Systemically, the IRS utilizes filtering mechanisms that segregate returns possessing certain characteristics to allow for further evaluation and appropriate civil or criminal actions. The Questionable Refund Program (QRP) housed within IRS Criminal Investigation utilizes the Electronic Fraud Detection System (EFDS) to screen returns that appear to be "questionable" at the onset of return processing operations. The QRP data models within EFDS are modified based on identified schemes, which allow CI to evaluate returns flagged as suspicious. Both the filtering mechanisms and EFDS serve as quality control techniques and are designed to reduce the potential for erroneous and fraudulent return submissions.

The IRS also has undertaken several outreach initiatives to provide taxpayers and other stakeholders with the information they need to avoid becoming victimized by schemes, as well as guidance to resolve issues. For example, the IRS has provided extensive information and guidance on identified phishing schemes, identity theft, and abuses concerning the Telephone Excise Tax Rebate.

The Joint Anti-Phishing Task Force is focusing on identifying improvements for more robust authentication capabilities for the tax return submission process. The IRS is currently in the exploratory stages of evaluating technologies that electronically "brand" authorized e-File partners, as well as more robust technologies that crawl through Internet sites across the World Wide Web to look for indications of fraudulent schemes related to electronic tax transactions.

Baucus Question 27

In the movie "Indiana Jones and the Fate of Atlantis", there is a scene where Indy is trying to persuade Omar, the shopkeeper, to reveal information about a German dig site.

Indy finds a map handing from a clothesline – a map with nothing but a red X on it. Omar says, "That map won't do you any good. There are no names on it!" This sounds like a metaphor for trying to reduce the tax gap without a plan.

Subpart I

i. Without a map - or a plan – to reduce the tax gap, how will you know where Treasury and the IRS are going, how you will get there, or when you have arrived?

Answer

The Treasury Department's Comprehensive Strategy for Reducing the Tax Gap (the Strategy), released in September 2006, provides an integrated set of steps that should be taken to improve compliance and reduce the tax gap. The Strategy provides a general roadmap for Congress, the Treasury Department, and the IRS to use in identifying, enacting, and implementing concrete proposals to reduce the tax gap. In order to develop a more detailed plan, the Strategy identifies as an initial step the need to conduct further research to identify the sources of non-compliance. This is necessary in order to ensure that additional steps to improve compliance are properly targeted and minimize the burden on compliant taxpayers. Consistent with the Strategy, the IRS is taking concrete steps toward improving its understanding of the sources of non-compliance. Results from the latest national research program (NRP) study of S-corporation compliance are due to be released next year. In addition, the Administration's FY 2008 budget request includes $41 million to fund additional compliance research studies. In addition, the IRS will conduct an annual study of compliance among Form 1040 filers to provide updated compliance data each year. By combining samples over several years, these annual studies will provide a regular update to the estimate of individual compliance. The IRS is also in the initial stages of implementing a broad compliance study of exempt organizations.

On August 2, 2007, the IRS issued a comprehensive follow-up report titled "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," This report details steps currently being taken by the IRS, as well as those under development, to address key elements of the tax gap. The report builds on the seven components of the "Comprehensive Strategy for Reducing the Tax Gap," which the Treasury Department released in September 2006.

While improved research on the sources of non-compliance is an important initial step, other efforts to improve compliance must move forward based on currently available information. Over the past several months, senior Treasury Department officials and staff have worked with Finance Committee and Joint Committee staff on a number of legislative proposals to improve compliance. In addition, the Administration included in the President's Fiscal Year 2008 Budget a request for a significant increase in funding for IRS enforcement efforts along with 16 legislative proposals aimed at reducing the tax gap. The Treasury Department has also worked with the IRS to identify a number of

areas in which administrative resources can be better targeted. These efforts are further described in the Strategy.

Significant progress has been made since the IRS' release of the results of the NRP for the 2001 tax year with respect to better identifying sources of non-compliance. As further progress is made in this area, more detailed proposals to improve compliance will be made. A better understanding of the sources of non-compliance will also help link these proposals to anticipated improvements in compliance.

Baucus Question 28

At the hearing, you commented, "You see, I think speaking in terms of broad goals are helpful, but I think the only way we can really make meaningful progress is to approach these things from the bottom up."

i. Are you suggesting that a comprehensive plan to reduce the tax gap is not necessary?

ii. You seem to suggest that the many IRS functions should operate autonomously and we should just hope for the best and take what we get. What successful business operates without company-wide specific goals and plans?

iii. Why should the IRS operate without organization-wide specific goals and plans?

Answer

As described in the response to Question 27, the Treasury Department has released a comprehensive Strategy for improving compliance and reducing the tax gap. The reference to a "bottom up" approach to improving compliance refers to implementation of the specific steps outlined in that Strategy and further refining and adding to those steps, rather than starting with a compliance goal and trying to determine later how to get there. Setting a goal without first identifying the tools and resources needed to reach that goal will result only in unmet promises and commitments. Using the road map analogy, before picking a destination on the map, we must first identify the resources we will need to get there.

Baucus Question 29

In its 2006 Annual Report, the IRS Oversight Board stated that "IRS customer service does not match what modern financial services institutions can provide their customers." The Board noted that the IRS's Business Systems Modernization lags far behind where it should be and the IRS information technology infrastructure is aging. At the committee's April 13, 2007 filing season hearing, Mr. Soukas', the prisoner's, testimony made it very

clear that something needs to be done to enhance IRS technology to stop fraud before it starts.

Subpart I, Question 1

i. During filing season 2006, the IRS had no tax filing fraud detection system in place because it spent $21 million on a computer system that failed.

   1. How many false refunds were issued as a result of this failure?

Answer

Although the IRS does not know exactly how many false refunds were issued as a result of problems with the Electronic Fraud Detection System (EFDS), it has been estimated by the Treasury Inspector General for Tax Administration (TIGTA) that failure to have a system in place for the 2006 processing year cost the Government between $200 million and $300 million.

Subpart I, Question 2

   2. What is the status of the new Electronic Filing Detection System now? When will it be operational?

Answer

The original client/server version of EFDS was restored for production operations, as planned, on January 16, 2007. It has been in full operation with no significant problems since then, and, as of April 25, 2007, it has processed approximately 103 million individual returns. EFDS has detected nearly twice the volume of fraudulent electronic returns versus this point in the filing season in 2005.

Regarding a new EFDS system, the IRS has begun planning activities for the modernized version of EFDS and will proceed with those activities based on business priorities and funding. The IRS has also established an EFDS Advisory Council, which is currently conducting a study to evaluate future technology alternatives for the Questionable Refund Program.

Subpart I, Question 3

   3. What assurances can you give us that the causes of the problems in 2006 are being addressed and will not surface again?

Answer

It was determined that three inter-related factors contributed to the lack of an operational EFDS system for the 2006 processing year, including: 1) lack of proper governance over

development activities; 2) inadequate project management discipline; and 3) lack of proper contractor oversight. The IRS has taken the following steps to address all three of these factors and ensure that the problems with EFDS will not occur again:

→ Revamped the governance structure so that not only EFDS, but all of IRS' 400+ IT projects, report to the appropriate level of Governance up to an Executive Steering Committee (ESC). Part of the ESC's responsibility is to ensure that significant risks and issues are elevated early to the appropriate executive level for effective mitigation.

→ Instituted project control disciplines whereby IT projects must complete monthly status reports using a standard template, and such "project status questionnaire" information is monitored by the IRS' Program Management Office and accessible by all levels of management. Projects that do not meet development standards in their monthly reporting are folded into the Monthly IT Project Control Review, where they report out to appropriate IT and business leadership on current performance and discuss mitigation strategies for risks that are in red and yellow status.

Regarding contractor oversight, the IRS has taken steps to ensure that the government project team members are better equipped with the requisite skills and training to provide adequate oversight and review of contract performance and deliverables. In addition, the IRS has assigned an experienced executive to oversee current efforts on EFDS and bolstered the qualifications for the position of the direct project manager.

In addition, pursuant to Treasury Earned Value Management (EVM) guidance, the IRS is requiring that all major projects utilizing contractor resources be required to provide consistent EVM data on the contractor's performance. EVM is an established technique that integrates schedule, cost, and technical requirements to manage projects and mitigate risks. For EFDS, the use of EVM will begin in October 2007.

Subpart I, Question 4

4. What is the IRS doing to improve its oversight of modernization and information technology projects and to hold contractors accountable?

Answer

Realizing that a lack of proper governance over development activities, inadequate project management discipline, and lack of proper contractor oversight were primary factors that caused EFDS failure, the IRS took the steps outlined in response to question 29(i)(3) with respect to all of its modernization and information technology projects.

Subpart II, Question 1

ii. How can technology be used to avoid situations like the prisoner Mr. Soukas described to the Committee on April 13 - filing from the same IP address from outside the country, and having every refund deposited into the same bank account?

1. What is the IRS doing to prevent similar schemes?

Answer

Systemically, the IRS utilizes filtering mechanisms and data models that segregate returns possessing certain characteristics (i.e., IP addresses) to allow for further evaluation and appropriate civil or criminal actions. However, the IRS faces the constant challenge of detecting, deterring, and stopping new tax fraud schemes. The sophistication and complexity of the schemes are always evolving, making it necessary to adjust filtering mechanisms and data models every year to keep up with current trends in criminal activity. While always in need of improvement, the systems the IRS currently has in place have produced concrete results. For example, as the Committee pointed out, Mr. Soukas is currently serving 97 months in prison as a result of his criminal convictions, which included 10 counts of submitting fraudulent claims to the IRS, six of which were filed using the identity of other individuals, as well as wire fraud, mail fraud, and identity theft charges.

This processing year, as of mid-May 2007, the Fraud Detection Centers (FDCs) used the Electronic Fraud Detection System (EFDS) to identify more than 140,000 potentially fraudulent returns claiming almost $1 billion. This is about double the number and triple the dollars identified in the 2005 filing season during the same time frame. One of the factors contributing to this growth was implementing changes to the data-mining model that improved its performance. Going forward, the IRS continues to monitor trends in criminal activity and has processes and governance in place to adjust to these trends and deter these types of activities to the best of its ability.

Subpart II, Question 2

2. When will it be effective?

Answer

The filtering mechanisms and data models described above are currently operational.

Subpart II, Question 3

3. **How much will it cost?**

Answer

No additional costs will be required for implementing the filtering mechanisms and data models described above. These costs are included in the Operations and Maintenance costs for EFDS.

Subpart III

iii. To what extent should IRS resources be prioritized to develop the technological capability to detect and deter fraud and other indicators of noncompliance?

Answer

To ensure a consistent, agency-wide approach to detect and deter fraud, the IRS formed the Pre-Refund Program Office. This office, led by an experienced IRS executive, is facilitating cross-functional efforts to devise an agency-wide strategy to address fraud that is potentially detectable in the pre-refund process. In terms of prioritizing IRS resources to develop technological capability, the IRS has instituted an agency-wide governance process covering all phases of technology investments, including selecting projects for funding. All IT funding decisions are reviewed and approved though the governance process by Executive Steering Committees and the Modernization Executive Governance (MEG) Committee. This governance process includes executives from the business units to ensure the highest business priorities are funded with the available resources. To address specific EFDS technology issues, there is an EFDS Advisory Council that meets regularly to oversee the ongoing operations of the EFDS system and to align the technology efforts around questionable refunds. The Advisory Council reports to the Criminal Investigation Executive Steering Committee, which is responsible for the overall governance.

Baucus Question 30

IRS filing season statistics show the Free File usage rate is down almost 5% - only 3.3 million taxpayers have taken advantage of this free filing option during the 2007 filing season.

- Why are the Free-File numbers down?

Answer

Overall, the volume of electronically filed returns was up sharply from 2006 levels. In addition, the Free File usage rate has substantially recovered. As of May 10, 2007, Free File volumes were within 1.7 percent of 2006 levels. Two possible factors contributing to this minor decline from last year:

- Major tax preparation sites (Intuit, TaxAct, etc.) offered and advertised their own free tax preparation services;
- Major tax preparation sites and preparers (Intuit, H&R Block, Jackson-Hewitt, and Liberty Tax) advertised their paid services at significant levels.

Subpart I

i. What is the IRS doing to increase the use of Free-File?

Answer

In 2006, the IRS established a logo that will brand the Free File program much in the way that the e-File logo identifies e-File. This logo will be included on IRS informational and marketing materials that the public will begin to associate with Free File on IRS.gov. IRS will be making extensive use of its internal outreach programs to provide measured and specific messages to the audiences targeted by Free File.

The IRS' Stakeholder Partnership Education and Communication Program (SPEC) organization targets outreach to Free File eligible taxpayers. This includes outreach specifically targeted to taxpayers who receive Child Tax Credit, Earned Income Tax Credit (EITC), and Child Care Credit. The IRS also provides messages to key stakeholder groups, including small businesses, payroll providers, and trade associations. In addition, the IRS obtained the services of a marketing contractor who designed, scheduled, and implemented marketing activities and messages throughout the filing season.

Specific Free File Marketing Highlights for the 2007 filing season include:

- Campaign launched January 16
- Free File logo and tagline created for brand identity to be used on www.irs.gov and in marketing materials
- Paid search placements on Google, Yahoo
- Spanish banner ads on Univision
- Free File online banner ads on myspace, Tacoda, and Radio spots with supporting online ads
- Focus on search terms used during tax season when searching for electronic tax filing options
- Optimized content and meta tags on the Electronic IRS and Free File home pages to drive results in natural search
- Impression based advertising to reach largest number of people
- 21 radio network interviews
- 25 Spanish language broadcast stations interviews
- 60 journalists participated in 2 English language news conferences
- 37 journalists participated in a Spanish language news conference
- Media Tour

- 89 National/Field media outlets
  - 52 English language newspaper reporters participated
  - 10 English language national newspapers participated
  - 27 Spanish language media outlets participated
- 17 Radio networks received one-on-one interviews, resulting in almost 900 affiliated stations carrying interviews
- 250 stories on Google
- Interview with Soldiers Radio & TV (Army) with 15 million viewers worldwide for TV and 3 million listeners for radio

- Distributed electronically 5 English & 2 Spanish PSAs to 8,000 radio stations nationwide
- Designed a postcard targeting Extension filers and V-coders regarding IRS e-File
- Ran static ad on over 2,000 movie theatre screens nationwide in communities with household income of 52K or less; total impressions 6.5 million
- Targeted press release for military
- Targeted placement outreach on selected TV stations in five markets
- Implemented a targeted placement on Yahoo specifically for the GenX/GenY demographic

Subpart II

ii. Why are there income restrictions to use Free-File?

Answer

Consistent with Congressional direction, the goal of the IRS and the Free File Alliance is to offer the Free File program primarily to those taxpayers who are the most underserved by the tax system. The preamble of the Supplemental Memorandum of Understanding signed by the IRS and the Free File Alliance in January 2004 clarified this purpose by describing the program as being principally designed to advance electronic filing and assist lower income, disadvantaged, and underserved taxpayer populations.

House Report 108-243 – Departments of Transportation and Treasury and Independent Agencies Appropriations Bill 2004 addressed the purpose of the Free File Program in a section titled "Electronic Tax Filing and the Free File Alliance". The Congressional Report identified the program as being limited to a specific population.

The Report stated:

> Accordingly, the IRS shall ensure that the mission and execution of the initiative is first and foremost to provide electronic federal tax return preparation and e-filing services at no cost to the working poor, and other disadvantaged and underserved taxpayers. The IRS Electronic Tax Administration's related

> marketing and promotional activities shall be consistently carried out in a manner to advance this key mission objective.

House Report 108-671 - Departments of Transportation and Treasury and Independent Agencies Appropriations Bill 2005, reaffirmed the target audience in the 2004 Report stating:

> "The Committee reaffirms its position that the free file alliance initiative is first and foremost to provide electronic federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers."

In the Fiscal Year 2006 Appropriations Bill, the conferees acknowledged a new, four-year agreement signed by the IRS and Free File Alliance. The conferees further directed us to abide by the terms and condition of the new agreement. The new agreement stipulates that the Free File program will cover 70 percent of the individual taxpayer population. Additionally, the new agreement states, "The IRS and the Alliance agree that to serve the greater good and to ensure the long-term stability of the Alliance, the scope of this program is focused on covering the taxpayers least able to afford e-filing their returns on their own."

Subpart III

iii. What more can the IRS do to increase the use of Free-File so that more taxpayers do not have to pay to file their tax returns electronically?

Answer

The IRS will increase its marketing and profiling of the Free File program as identified in the answer to question 30(ii). The IRS believes that if this program is more visible and if more taxpayers know about the location and availability of the program, they will take advantage of it.

Baucus Question 31

An article in the April 15, 2007 Washington Post called, "You Paid Your Taxes? Sucker.," says that Americans have $1.34 trillion dollars in foreign tax havens, a 68% jump since 2003. The article explained that a person can create his own dummy corporation and bank account for less than $1000 with a few clicks of a mouse.

i. Is there any legitimate reason for a U.S. company to have a subsidiary in the Cayman Islands? Please explain your answer.

ii. Do you believe that using offshore accounts to avoid paying US taxes should be tolerated?

iii. Specifically, what is the Administration doing to stop offshore abuse?

Answer

U.S. taxpayers should not be able to use offshore accounts or entities to avoid their U.S. tax obligations. To address this issue, the Treasury Department has undertaken a multi-faceted approach to deal with the abusive use of offshore accounts and entities. Under this approach, the Treasury Department has taken, and continues to take, regulatory corrective actions when we determine that current U.S. tax rules are facilitating abuse. The multi-faceted approach also makes full use of the information exchange provisions in our tax treaties and tax information exchange agreements, and we continue to negotiate new agreements and update old treaties. In addition the IRS has, and continues to undertake, significant enforcement actions in this area. Implementing the multi-faceted approach is, however, a long-term process and one that requires the cooperation of other jurisdictions.

U.S. individuals and companies invest in foreign entities for a variety of reasons. In some countries, the creation of a corporation is the only way that a U.S. company can do business there. More specifically, there are a number of possible reasons for a U.S. company to have a subsidiary in the Cayman Islands. For example, the Cayman Islands has a strong tourist industry, providing investment opportunities for U.S. companies that want to operate hotels, restaurants, and activities that appeal to travelers. In addition, forming a subsidiary in the Cayman Islands may have foreign tax efficiencies. We understand that many Cayman Islands corporations are formed for specific purposes or to perform specific transactions involving multiple jurisdictions. For example, there have been many press reports mentioning the use of Cayman Islands special purpose vehicles in financing and securitization transactions. In those transactions, the participants (often located in different jurisdictions) may employ an entity in a low- or no-tax jurisdiction to avoid subjecting the transaction to additional levels of taxation, i.e., taxation on top of the tax incurred in the home countries of the participants and the place where the business activity is actually taking place.

Baucus Question 32

Some states, including California and Minnesota, require applicants for certain business licenses to prove they are up-to-date on their taxes before the license will be granted.

i. What would be the effect on tax compliance if all business license applicants were required to demonstrate tax compliance before the license would be granted or renewed?

ii. What legislative and administrative actions are necessary to authorize and implement such a process?

Answer

Many states require license holders to be current with state taxes (both filing and payment compliance) prior to granting various professional and business licenses. Approximately 13 states also require Federal tax compliance as a requirement for issuance of some licenses. However, the majority of states do not link Federal tax compliance to issuance of state licenses since under current law, this would typically require state legislation.

Based on our experience with those states that require Federal tax compliance for license holders, we believe that linkage to Federal compliance could have a positive effect on enhancing tax compliance for those occupations requiring licenses. Based on feedback from states that currently require state tax compliance for license holders, almost all believe that they have seen a significant increase in compliance among those in licensed occupations, many of whom are self-employed.

Federal legislation, including amendments to section 6103, would be necessary to facilitate the states' ability to require Federal tax compliance prior to issuance of a license.

Baucus Question 33

A 2006 change to federal law reduced the amount of child support debt to $2500 that will trigger the denial of a passport. What would be the effect on tax compliance if passports were denied to taxpayers who owed more than $2500 to the IRS and had not made arrangements to pay it?

Answer

Denying the right to travel internationally to taxpayers with significant unpaid, assessed tax liabilities would likely have only a marginal impact on compliance. Of the estimated $345 billion gross tax gap for 2001, less than $25 billion is attributable to underpayments by individuals. A significant portion of this amount is either already subject to installment agreements or other payment arrangements, or is uncollectible.

Baucus Question 34

Describe IRS efforts to coordinate information sharing with the states to improve tax compliance. How can these efforts be improved? To what extent does the IRS coordinate with the states' data-warehousing systems to detect noncompliance?

Answer

The IRS has had a robust FedState program for many years.

- The program is designed to facilitate information sharing with the states to improve tax compliance.
- The IRS has data sharing agreements with almost every state Department of Revenue (DOR) and approximately half of the State Workforce Agencies (SWAs).
- The IRS has a formal data exchange program for providing these agencies with a wide range of Federal Tax Information (FTI)
- There are currently 14 data extracts that the states use to identify underreporters and nonfilers. In turn, these agencies provide IRS with data which has proven effective in improving taxpayer compliance.

Through its FedState program, the IRS has developed a number of significant initiatives with the state Departments of Revenue (DORs) and State Workforce Agencies (SWAs). These initiatives include:

- Agreements with almost every DOR, which facilitate the mutual sharing of abusive transaction data and which have resulted in numerous assessments and generated a significant amount of positive media coverage
- Precedent-setting use of DOR audit results from over 30 states as a basis for IRS audit assessments has allowed for efficient identification of under reporters
- A new automated process in which the states provide the IRS with a database of taxpayers who have filed with the state but either have not filed with the IRS or have reported substantially less income to the IRS than to the state; preliminary results indicate that this process will have a significant compliance impact
- Agreements with many state licensing agencies to include IRS tax gap and compliance information in their license application and renewal mailings, newsletters, and web sites
- Offsetting state income tax refunds to the IRS when the taxpayer owes Federal tax
- Agreements with many state agencies that regulate money services businesses to share information with the goal of enhancing compliance with the Bank Secrecy Act
- Partnering with the DORs to identify the best methods for sharing information on flow-through entities with the goal of mutually addressing compliance problems
- Enhanced partnerships with the SWAs provide the IRS with myriad data that is being used to improve compliance including:
  - Agreements to share worker classification audit results that will be used as the basis for IRS audits
  - Data on all employees in a given state that is used for IRS wage levies

- Information on out-of-business companies that is used to efficiently close related IRS investigations involving the nonfiling of tax returns

These initiatives are examples of the wide range of IRS activities designed to leverage cooperation with states to improve Federal tax compliance.

- The IRS plans to expand its efforts to include a wider range of information that can be shared between the IRS and the DORs and SWAs.
- The IRS is exploring the possibility of partnering with the states on data-mining initiatives. The IRS is planning a test to determine the effectiveness of a state data-warehousing system to detect non-compliance. The test will compare the current IRS system for identifying and prioritizing audit leads against a state data-warehouse system to determine which is most effective.

Baucus Question 35

Treasury's September, 2006, "Strategy for Reducing the Tax Gap" listed improved coordination with state and foreign governments, practitioner organizations and taxpayers as a key component to reduce the tax gap. Over the last three months, I have met with senior IRS leaders at IRS headquarters, Comptroller General David Walker, several former IRS Commissioners, and other national leaders to discuss tax policy and ways to improve tax compliance. Many good ideas have been raised during these meetings, and they have been very informative.

i. To what extent have you personally reached out to experts and stakeholders to find solutions to the tax compliance problem?

ii. What did you learn during these meetings and how will you put this knowledge into action to improve tax compliance?

Answer

As described in the response to Question 13, the Treasury Department and the IRS have an active program of coordinating with paid return preparers, tax practitioners and other professional stakeholders. The IRS also has been working to increase its partnership and cooperation with state and foreign governments to find mutually beneficial ways to improve compliance. As described in the response to Question 34, with the states these efforts have been focused on improving the exchange of information, going beyond existing programs of sharing tax audit information to include information about state business and other licensing activities, particularly with respect to non-filing taxpayers. As described in the response to Question 31, with foreign governments, our efforts are focused on negotiating new tax treaties and tax information exchange agreements, which allows the IRS to obtain from foreign tax authorities information needed to enforce U.S. tax laws and improve compliance. In addition, the United States participates in information-sharing regarding broader, non-taxpayer-specific information. For example, through the Joint International Tax Shelter Information Centre (JITSIC), the IRS and tax

authorities in other participating countries will continue to share information regarding abusive tax avoidance transactions.

Baucus Question 36

Mr. Secretary, is collecting the taxes that are legally owed "raising" taxes?

Answer

The IRS' recent update to its estimate of the tax gap measured the amount of tax that, for the 2001 tax year, was due and owing but not paid. The estimate of the tax gap reflects both intentional errors by taxpayers who are evading their obligations and unintentional errors by others who may be confused by the complexity of the tax law. In both situations, the tax gap estimate represents amounts that are due and owing under current law (as it existed in 2001). Collecting tax that is due under existing law does not amount to a tax increase.

In developing the 16 legislative proposals set forth in the President's Fiscal Year 2008 budget request, the Administration was careful to distinguish proposals that, while they might address an area of compliance concern, would require many taxpayers who are fully compliant with current tax law to pay more. In contrast to these proposals, the 16 legislative proposals made in the budget request are each focused on improving compliance with existing law.

Baucus Question 37

What is Treasury's response to those who criticize efforts to reduce the tax gap as an effort to increase taxes?

Answer

As explained in more detail in the response to Question 36, we do not believe that efforts to collect all taxes that are due under existing law (i.e., the $290 billion net tax gap estimated for 2001) should be viewed as an effort to increase taxes.

Baucus Question 38

Some have suggested that reducing the tax gap will require turning the IRS into a "beast".

i. Do you believe the IRS will have to turn into a "beast" to improve tax compliance?

ii. During the hearing, I announced a goal of 90% voluntary tax compliance by 2017. You did not join me in that goal, saying "... I do not see the steps that we can take. I cannot see a clear path." Describe what tax administration would look like with a 90% voluntary compliance rate.

iii. You would not agree to a goal of 90% voluntary compliance by 2017. In your opinion, what is a realistic, achievable rate of voluntary compliance by 2017?

iv. What is an acceptable balance of increased tax compliance and increased burden on taxpayers?

v. In your written testimony, you stated that you need to "manage expectations". Please explain what you mean by this statement. Are you saying you will just give up and allow noncompliant taxpayers to cheat on their taxes?

a) What is an acceptable level of noncompliance?

b) What effect does tolerating noncompliance have on tax administration?

c) Wouldn't that encourage honest taxpayers to change their behavior so they, too, can avoid paying taxes?

Answer

While the United States already enjoys a level of voluntary tax compliance higher than most other industrialized countries, more always can and should be done to improve compliance. The Department of the Treasury is committed to reducing the tax gap and improving compliance, and has advanced legislative and administrative proposals to do so without requiring invasive actions by the IRS, or otherwise fundamentally changing the relationship between the Government and taxpayers. More draconian measures for tax administration could always be enacted to achieve a particular compliance rate, but at some point these measures erode public confidence in the tax system (and in government generally) and lead to a decrease, rather than the intended increase, in compliance. Because any level of non-compliance is unacceptable, the IRS seeks to ensure the highest level compliance with the tax law, without announcing that any particular compliance rate would be an acceptable end-point.

Baucus Question 39

How credible is the information-reporting burden argument in this age of computer generated recordkeeping and reports? Does the burden on a small business to issue 5 or 10 additional Forms 1099 outweigh the resulting benefits of increased tax compliance?

Answer

Information reporting based on computer-generated records is clearly less burdensome than reporting from manual records, although it is difficult to generalize. While fewer and fewer small businesses are without computerized systems, the burden/benefit balance would depend in part on the information being requested and the ease with which the firm could aggregate it for reporting purposes. Also, it should be noted that the burden associated with new information reporting goes beyond simply filing out a return. It also involves, among other steps, learning about and understanding the new law (which can be quite complicated in the context of reporting on items like basis), soliciting a taxpayer identification number from the payee, and complying with backup withholding requirements where applicable. The initial burden to prepare the system to generate a set of information returns, particularly for individuals or entities who have never been subject to information reporting (and related backup withholding) requirements, would be greater than the burden to produce additional Forms 1099 in future years.

Baucus Question 40

The IRS says there is a 99% compliance rate for W-2 income.

Subpart I

i. To what extent is it fair that W-2 wage earners must report all of their income because it is reported to the IRS, while those who do not receive W-2s or Forms 1099 can understate their income because the IRS doesn't know about it?

Answer

According to former Commissioner Mark W. Everson, "The vast majority of Americans pay their taxes accurately and are shortchanged by those who do not pay their fair share." (February 14, 2006).

In order to bring more taxpayers into compliance, in its Fiscal Year 2008 budget request, the Administration proposed several legislative changes to combat reporting non-compliance:

- Require information reporting on payments to corporations.
- Require basis reporting on security sales.
- Expand broker information reporting.
- Require a certified Taxpayer Identification Number from contractors.
- Increase information return penalties.

Additional information on these proposals can be found in the General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals from the Department of the Treasury (February 2007).

Subpart II

ii. Is it acceptable for some taxpayers to avoid or evade paying what they legally owe simply because the IRS has no way of tracking down the income they earned?

Answer

Federal income tax is imposed on all income, regardless of whether or not it is reported, and no level of non-compliance for unreported income is acceptable. Amounts that are not reported to the taxpayer or the IRS are, however, more likely to be unreported by the taxpayer, due to taxpayer confusion in not remembering that a payment was made or due to intentional avoidance. To help address this issue, the Administration's FY 2008 budget request recommended a number of information–reporting proposals, including requiring information reporting on merchant payment card reimbursements. Payment cards (both credit cards and debit cards) are an increasingly common form of payment for many merchant transactions. This information can aid in accurately determining the gross income of a business and in identifying taxpayers that may be underreporting their cash receipts.

Baucus Question 41

In 2006, the United Nations released "The Millennium Development Goals Report." Six years ago, leaders from every country agreed on a vision for the future – for example, less poverty, hunger and disease. Eight Millennium Development Goals were established, providing the world a framework for development, with time-bound targets by which progress can be measured. The 2006 report shows where the UN stands in achieving those goals.

i. What prevents the Administration from committing to a credible and comprehensive plan to reduce the tax gap, with benchmarks and timelines, when the United Nations clearly considers such a plan to have merit?

Answer

As described in the response to Question 27, in September 2006, the Department of the Treasury released a Comprehensive Strategy for Reducing the Tax Gap to set forth principles commensurate with the scope and complexity of the issue. In February 2007, the Treasury set forth legislative proposals to reduce the tax gap and increase compliance, including revenue estimates through 2017. The Treasury and IRS continue to work on reducing the tax gap, making credible commitments to incremental proposals.

Baucus Question 42

Since 2004, the Administration's requests for IRS funding have generally been flat – suggesting that the IRS budget is "right-sized" to do its job. Yet, the estimated voluntary compliance rate has declined from 85.1% to 83.7% during the time the IRS has estimated 2001 figures. $2.1 trillion in legally owed taxes have gone uncollected since 2001.

Subpart I

i. What are the IRS's long-term funding needs?

Answer

Significant increases in funding for the IRS were requested in the President's Budget for FY 2006 and FY 2008. The additional funding for FY 2006 has played a significant part in the IRS' efforts to improve compliance over the past two years, particularly in the area of abusive tax shelters. There is no comparable, accurate data to measure the change in compliance since 2004, although we have every reason to believe that compliance has improved over the past three years. As identified in the Treasury Department's Comprehensive Strategy for Reducing the Tax Gap, conducting further research into the nature, amount, and sources of the tax gap — and updating this research on a regular basis so that more contemporaneous data on compliance is available — is a high priority. As described in the response to Question 27, the IRS is already taking concrete steps in this direction.

The Voluntary Compliance Rate estimates cited in Question 42 are both for Tax Year 2001 and, therefore do not reflect a compliance trend of any kind, much less a negative one. The first estimate (85.1 percent) was based on extrapolations of data from the 1980s; the second one included data from the TY2001 National Research Program, and is more reliable. The two estimates are not comparable since the data and estimating methodologies underlying them were very different; these estimates therefore do not suggest that compliance has declined.

- The $2.1 trillion figure cited in Question 42 appears to have been derived by multiplying the IRS' $345 billion estimate of the TY2001 gross tax gap by 6 to cover the number of years that have passed since 2001. This number is not based on any empirical evidence of which the IRS is aware. Moreover, the gross tax gap does not take into account enforced collections and other late payments that recover a significant portion of the gross gap. Over the six year time from 2001 through 2007, enforced collections and late payments totaled hundreds of billions of dollars. These amounts do not appear to be reflected in the $2.1 trillion figure cited.

The IRS' Strategic Plan outlines a long-term need for steady, predictable, but modest, funding increases over the next several years. The IRS budget is built to support the Strategic Plan. The Treasury Department's September 2006 Comprehensive Strategy for Reducing the Tax Gap, emphasized a need for a comprehensive, integrated, multi-year strategy to reducing the tax gap. This strategy includes (1) reducing opportunities for

evasion through the development of legislative proposals; (2) making a multi-year commitment to research to identify sources of non-compliance so that IRS resources can be properly targeted; (3) continuing improvements in information technology to provide better tools to assist with early detection, better case selection, and better case management; (4) improving enforcement activities; (5) enhancing taxpayer service to help taxpayers avoid unintentional errors; (6) reforming and simplifying the tax law to reduce the number of unintentional errors caused by lack of understanding; and (7) coordinating with partners and stakeholders to share information and compliance strategies.

Although enforcement and taxpayer service personnel both contribute to reducing future tax gaps by strengthening voluntary compliance and enforcement activities help to recover past tax gaps, the IRS cannot simply expand its workforce by large amounts to address the tax gap. New hires are trained by experienced staff who must be taken away from their normal duties to provide the required training. Moderate, sustained growth over a number of years is the most effective way to re-build the IRS workforce.

In addition to staffing needs, modernizing the IRS information systems will also continue to require steady increases in funding. Again, the IRS has found the most successful approach to modernizing the generations-old technology and fragmented architecture is taking a systematic, incremental approach to building new technologies and gradually replacing aged infrastructure components.

Subpart II

ii. What is the "right-sized" IRS budget to increase voluntary compliance by 1%? 5%?

Answer

It is not clear how to quantify the impact that IRS enforcement and service activities have on the Voluntary Compliance Rate, although most commentators agree that the impact is significant. IRS and academic estimates of the indirect effect of audits on the compliance of the general population, for example, have ranged from 4 to 11 times the revenue collected directly from those who were audited. Part of the emphasis in the new research funding is to conduct sustained research projects to estimate the impact of IRS service and enforcement activities on the voluntary compliance of the general population. However, while expanded and better-targeted IRS programs surely will be necessary to improve voluntary compliance, legislative changes also will be necessary to reduce opportunities for evasion and to reform and simplify the tax law, as described by the Treasury Department's Comprehensive Strategy for Reducing the Tax Gap.

Subpart III

iii. How would the rate of voluntary tax compliance be affected by sustained growth in the IRS budget of $500 million over each of five years, e.g., $500 million in year one, $1 billion in year two, $1.5 billion in year three, etc.? What

would be the optimal use of these resources – improved services, stronger enforcement, enhanced information technology?

Answer

As indicated above, the IRS does not have reliable estimates of the impact of the many IRS activities on the voluntary compliance of the general population. However, modest but sustained growth to expand and enhance taxpayer services, enforcement, and information technology over a number of years is sure to have a significant impact.

Baucus Question 43

At the April 13 filing season hearing, the Finance Committee heard concrete suggestions for technological improvements to IRS systems that could detect and deter the filing of fraudulent tax returns. For example, the prisoner, Mr. Soukas, suggested using a Personal Identification Number (PIN) or some other type of filter that would make it more difficult for fraudsters to file false returns. Commissioner Everson said he would look into it, but adding a PIN would be very expensive to do.

Subpart I

i. Should taxpayers be given a PIN, or be asked to answer a series of questions only they know the answer to (similar to security tools used in the financial services sector), to file electronically?

Answer

The IRS follows security guidance from the Office of Management and Budget (OMB) and the National Institute for Standards and Technology (NIST) in determining the set of appropriate security controls that could be considered for implementation on IRS web-based applications that are taxpayer-facing. The use of a PIN or some other type of filter can be easily compromised by "phishing" sites, as these Internet web sites can also ask the taxpayer for the private information and dupe the taxpayer into providing that private information to the fraudsters. The IRS is conducting research into determining what could be more secure technical approaches to ensure the positive identification of any taxpayer or other organization that needs to communicate with the IRS. The overall poor security that exists on the Internet presents a number of major challenges.

To increase the security of e-filing, the IRS is moving toward requiring PINs as the preferred method for taxpayers to sign their e-filed returns. Starting with the 2008 filing season, the IRS will require PINs and will no longer accept paper signature documents for returns received from Electronic Return Originators. Starting with the 2009 filing season, the IRS plans to also require the use of PINs for on-line filers. In addition, the IRS has started an e-signature group to develop the next generation of e-signature methods to further increase security and to help eliminate fraud. The recommendation of this group is expected to be available by December 2007.

Subpart II

ii. What other filters or tools could be utilized to improve taxpayer security and privacy?

Answer

The IRS has four available options to improve taxpayer security and privacy:

1. Single-Factor Authentication: A Personal Identification Number (PIN) provides single-factor authentication level of assurance (i.e., "something you know.") Shared secrets (e.g., SSN and refund amount or AGI) provide an alternative single-factor solution but are generally considered less secure than a PIN, especially where the secrets are shared by more than two parties, as is the case with Electronic Return Originators (EROs).
2. Multi-Factor Authentication (MFA): MFA requires presentation of two or three independent factors to establish identity and access privileges. Multi-factor authentication elements are typically deployed as something you know (a password or PIN), something you have (a card or electronic certificate) and something you are (fingerprint). For example, financial institutions rely on two-factor authentication to secure ATM inquiry, deposit, and withdrawal transactions. Multi-factor solutions provide much greater security and privacy levels than single-factor, but are also more costly and may be burdensome, discourage compliance, or dampen electronic filing rates.
3. Fraud Detection: Fraud detection algorithms are enhanced each year to detect fraudulent activity. The IRS works with third-party filers to identify new fraud patterns.
4. Improved phishing scheme prevention, detection exposure and deactivation: Criminals are using increasing sophisticated methods to entice taxpayers to provide them with the necessary information that enables them to carry out the attack. IRS can identify fraudulent Internet preparers by levying more stringent requirements on Electronic Return Originators (EROs). IRS can also use more advanced tools, tactics, techniques, and procedures to enable IRS to seek out and take down fraudulent tax web sites.

Subpart III

iii. Can existing IRS information systems accommodate such filters and tools?

Answer

PINs/shared secrets are currently used by the IRS's Integrated Customer Communications Environment (ICCE) to allow taxpayers to check refund status and establish payment options. Two-factor authentication has also recently been implemented to support remote IRS employee access to IRS resources. Multi-factor authentication is not currently used for taxpayer access.

Current IRS infrastructure components provide support for single-factor authentication, and could be enhanced to utilize multi-factor authentication. There would be application costs for implementing single- or multi-factor authentication. Current fraud detection

applications could be updated to detect new fraud patterns in order to provide additional filtering before "trusting" the submitted returns from an authenticated taxpayer. Depending on the authentication requirements and volume, complexity, and security of transactions, significant infrastructure costs would be incurred to support increased taxpayer access to IRS systems and data.

Subpart IV

iv. What would be the cost to develop, install and implement these tools and filters? How long would it take to implement them?

Answer

A rough cost estimate for an IRS enterprise electronic authentication solution is projected at over $100 million over a 5 to 10 year period, with a key basis of this estimate being access by up to 50 million taxpayers over time, There are many components to this estimate, including various categories of requirements from providing e-authentication registration and issuance of PIN, password, or second-factor credentials for taxpayers, to the need to manage taxpayer identities to include additional information for further validation, filtering and authorization. Additional monies would be needed to modify IRS systems and applications that would utilize an enterprise solution to provide improved identity and access management.

The IRS is currently working to identify and evaluate alternatives to provide for electronic authentication of taxpayers, to include alignment with the GSA E-Authentication Initiative and with the efforts of other government agencies, as well as the identification and analysis of industry best practices. The result of this analysis will enable the IRS to provide a better estimate on what it would take to provide levels of authentication and access control to increase taxpayer service, and to assist in detecting and deterring the filing of fraudulent tax returns.

Baucus Question 44

Former IRS Commissioner Rossotti recommended steadily increased funding to modernize the IRS technology.

i. To what extent is the Administration recommending adequate funding to give the IRS the technological tools to work smarter and more efficiently to improve tax compliance?

Answer

The President's Budget requests the appropriate level of resources in FY 2008 to provide the IRS with the technological tools needed to more efficiently improve tax compliance. In recent years, the IRS' Business Systems Modernization (BSM) program has made

significant improvements to its governance, controls, and processes that are essential to continued success in managing the complex system development efforts. As recognized by GAO in their February 15, 2007 report to Congress, the BSM program has sustained a very good record of success and is implementing systems that yield tangible IRS efficiencies, benefits for the American taxpayers, and improved tax compliance.

The IRS' Modernization Vision and Strategy and Infrastructure Blueprint establish a governance structure and plan to systematically and incrementally build new technologies and replace aged infrastructure components based on business priorities and available funding. The IRS' BSM request for FY 2008 will continue to yield operational efficiencies, benefits to taxpayers, and improved tax compliance in various ways:

- Modernized e-File (MeF) will continue to build on electronic-filing successes beyond the corporate (1120), tax exempt (990), and partnership (1065) return families, funding the first segment toward a modernized IRS 1040 e-filing capability. Modernizing 1040 e-filing will improve customer service and expand capacities such as e-filing of amended returns and attachment of pdf (portable document) files. The IRS will also gain downstream service and compliance benefits as the captured data from the 1040s becomes available and is leveraged by other systems.

- CADE will eventually replace the antiquated master file, which is critically important to enable the IRS to show improvements in service and compliance. For Filing Season 2008, CADE will continue to expand the number of individual returns it posts and maintains on a modernized and secure platform. (During Filing Season 2007, CADE posted more than 11 million individual returns and issued over $11 billion in refunds.)

- Account Management Services (AMS), IRS' newest BSM project, will provide a virtual case folder on each taxpayer as well as on-line tools for IRS customer service representatives and revenue agents to view and update taxpayer data, eliminating the need not access multiple different systems to obtain information on a given taxpayer. This has obvious service benefits, but will also enable the IRS to do a better job of audit case selection and to drive efficiencies in its collections operations.

- Common Services Projects are modernization projects that include 1) upgraded and expanded internet portals to meet secure, industry-standard protocols to interface with external taxpayers and employees and to support enforcement initiatives such as "Under Reporter" and "Under Payment;" 2) the use of state-of-the-art access technology (called integration broker) to standardize and thereby eliminate a multitude of the interfaces among IRS' systems, reducing development, testing, and maintenance costs; and 3) work on simplifying the data environment, reducing the number of databases the IRS must maintain and improving the data quality to enable better "data"-

based decision making. All of these projects work to simplify the IRS' IT environment, which reduces costs and helps drive modernization.

Lastly, the FY 2008 budget request includes an additional $60 million for replacement of aged IT infrastructure such as Automated Call Distributor, servers, routers and switches, and employee workstations. This is crucial to the IRS' modernization efforts. Modernizing applications is of paramount importance, but the IRS must continue to make the proper investment in its ongoing infrastructure to ensure that the agency can properly deploy, operate, and maintain these modernized systems as well as sustain uninterrupted service to taxpayers and employees.

Baucus Question 45

Why has the Administration over the years failed to ask the Congress for sufficient funding for the IRS to make a dent in the annual $345 Billion tax gap?

Answer

The Administration is committed to working with Congress to reduce the tax gap. As stated in the Treasury Department's September 2006 Comprehensive Strategy for Reducing the Tax Gap, there must be a comprehensive, integrated, multi-year strategy to reducing the tax gap. The IRS applies a balanced and targeted approach to improving taxpayer service, tax compliance, and its infrastructure by evaluating its capacity to hire additional staffing and/or enhance existing or develop additional systems to ensure that such requests do not have an adverse impact on program productivity and performance. The IRS estimates that approved funding for the enforcement initiatives proposed in the FY 2008 Budget will generate almost $700 million of additional revenue annually once the new hires are fully trained. In addition, the President's Budget includes a number of legislative proposals intended to improve tax compliance with minimum taxpayer burden, which over ten years, would result in $29.5 billion.

Baucus Question 46

What does the Administration plan to do to "right size" the IRS? Does the Administration intend to recommend a long-term budget plan for IRS that recognizes the unique role of the IRS in collecting the funds that keep our nation operating?

Answer

The IRS Strategic Plan sets forth its strategic priorities and lays the foundation for formulating future budgets. Similar to other Federal appropriated agencies, the IRS makes decisions on a year-to-year basis using a strategic planning approach. As part of the IRS' process for formulating annual budget requirements, the IRS identifies the most important internal and external issues affecting its ability to achieve its strategic goals of

improving taxpayer service, enhancing enforcement of the tax law, and modernizing the agency through its people, processes, and technology, as well as the solutions and resources necessary to address those issues. This enables the IRS to identify program and resource adjustments necessary to address changing dynamics (such as new tax laws) and priorities, which are ultimately identified and proposed in the President's Budget submitted annually to the Congress. However, as mentioned in the previous response, requests for additional IRS resources are balanced with its capacity to increase its programs and maintain performance.

Baucus Question 47

To what extent will future Administration budget requests provide adequate funding to implement a credible tax gap plan?

Answer

The Administration is committed to ensuring future budget requests incorporate realistic, achievable targets in IRS service, enforcement, and modernization programs and that the requests are sufficient to meet these targets.

Baucus Question 48

At the Finance Committee's hearing on April 12, Commissioner Everson said the IRS would not prosecute a $40,000 tax fraud.

Subpart I

i. Does this message encourage American taxpayers to cheat?

Answer

The Commissioner did not intend to convey the impression to tax evaders that if they only evade certain amounts of tax they will be immune from criminal prosecution. Quite the contrary, the IRS would like to prosecute all tax evaders. The Commissioner was referring to the necessity of prioritizing investigations because of the finite investigatory and prosecutorial resources available. Given these limitations, it is important for the IRS to concentrate its efforts on the most egregious, high-profile, high-impact investigations. The dollar amount at stake is one of many factors taken into consideration when selecting these cases. All law enforcement agencies confront similar challenges.

One of the IRS' greatest concerns is that over the past decade, tax evaders have capitalized on advancements in technology, the globalization of the world's economy, and the proliferation of tax havens to carry out increasingly ambitious and sophisticated tax schemes. Concentrating the IRS' efforts on these cases is a high priority, and it has

produced substantial results. The past several years have witnessed the successful prosecution of the largest abusive case ($3.4 billion), the largest personal income tax case ($170 million), and the largest employment-tax evasion case ($51.7 million) in the history of tax administration. These are only a few of the most egregious examples, cases where the amount of tax evaded routinely runs into the millions or even tens of millions of dollars are not uncommon.

Another overarching consideration in case selection involves Congressionally-mandated Federal Sentencing Guidelines. In tax prosecutions, the severity of the sentence imposed depends to a significant degree on the tax loss. As a general rule, the greater the tax loss, the more severe the sentence imposed. It is vitally important that the sentence imposed in tax evasion cases be commensurate with the seriousness of the offense. The appropriate use of criminal sanctions is an important element in any comprehensive effort to address the tax gap because they foster deterrence and enhance voluntary compliance.

Subpart II

ii. Should the IRS tolerance amounts for prosecution be reconsidered?

Answer

The IRS is constantly reviewing its case-selection criteria. During the period FY 2001 through FY 2006, 30 percent of all cases sentenced involved tax liabilities of $40,000 or less. Currently, many prosecutions involve significantly larger tax liabilities. However, even in judicial districts where the United States Attorney's Office might prefer all prosecutions involve large amounts of tax, the IRS regularly institutes investigations involving smaller amounts. Exceptions are made in particularly flagrant cases, or cases involving promoters of tax evasion schemes based on frivolous arguments. Nevertheless, case selection remains challenging because of the many priorities faced by both the IRS and Department of Justice.

Baucus Question 49

A 2006 TIGTA statistical sample of 750 of the approximately 407,000 licensed tax practitioners (attorneys, CPAs and enrolled agents) found 34 (4.5 percent) who were not compliant with their individual tax obligations. These 34 practitioners had a total of 81 tax periods with balances due of $826,709, and 34 tax periods for which required tax returns had not been filed. Based on its sample, TIGTA estimated there are approximately 22,500 licensed tax practitioners who are not compliant with their tax obligations but who have not been identified by the IRS for sanctions.

i. Why isn't the IRS monitoring attorneys, CPAs and enrolled agents more effectively?

ii. How can the IRS expect that these tax professionals are doing a good job when they don't comply with their own tax obligations?

iii. What has the IRS done since this report to improve its oversight of these tax professionals?

Answer

TIGTA's estimates, in the abstract, may be correct. However, the number of practitioners in "willful" violation of Circular 230 is far fewer. In early 2006, OPR and the IRS Office of Performance Evaluation and Risk Analysis (OPERA) began a project to identify attorneys, CPAs, and EAs who have represented clients before the IRS and have personal tax problems. Based upon specific criteria such as failing to file multiple returns and incurring specific penalties, the IRS prioritized this list down to the roughly 1,200 attorneys, CPAs, and EAs who appear to be in violation of Circular 230. To date, OPR has initiated over 500 actions in these cases. Of the 500, 218 have been closed. More than 70 percent of the closed cases resulted either in a sanction or are currently pending a hearing before an Administrative Law Judge. The results to date indicate this project is a success and should be continued and expanded.

To monitor the tax compliance of tax professionals more effectively, the IRS continues to pursue the development and use of a Practitioner Taxpayer Identification Number (PTIN) for all tax professionals. As TIGTA identified in its report, there are limitations currently preventing an automated crosscheck of the Central Authorization File (CAF) with the tax professional's tax accounts. It is anticipated that the use of a PTIN would help overcome these barriers. Previously, for a brief period of time, the IRS attempted to require tax professionals to provide their SSNs when filing a power of attorney to represent a client. While this would have enabled the IRS to link the tax professional more directly with his or her tax account, the tax professional community objected to this requirement on privacy grounds. As a result, the requirement was withdrawn.

OPR believes that a tax professional's fitness to represent other taxpayers is directly related to the tax professional's fitness to represent himself before the IRS through satisfying his own tax filing obligations. In addition to the project identified above, OPR performs a tax-compliance check on all tax professionals upon receiving a credible allegation of misconduct. OPR also requires EAs to certify or explain as part of the renewal process whether they have timely filed all tax returns and timely satisfied all tax obligations during the past three years.

Finally, as an integral part of OPR's outreach efforts, the office routinely highlights the importance of satisfying one's own tax filing and paying obligations, explains this is an integral part of fitness to practice, and underscores the enforcement efforts the IRS is taking in the tax compliance area.

Baucus Question 50

Last week's filing season hearing highlighted the influence that paid preparers have on tax compliance. In 2006, 60%, or 80 million, of individual tax returns were prepared by paid preparers. Yet, anyone can prepare tax returns – there are no competency tests, no educational requirements. A GAO undercover investigation last year found that 19 out of 19 paid preparers failed to prepare a simple return accurately.

i. Do you believe the IRS's oversight of paid tax preparers is adequate?
ii. How can the accuracy of tax returns prepared by paid preparers be improved?
iii. To what extent would increased regulation of paid preparers improve tax compliance?
iv. To what extent would competency standards for paid preparers improve tax compliance?
v. Do you support increased regulation of paid preparers and standardized competencies?

Answer

Ensuring that taxpayers have the best pool of paid return preparers to choose from is an important goal. Although more work can always be done, the IRS has committed available compliance resources to identify and correct both the returns and the non-compliant behavior of the most egregious return preparers who prepare non-compliant returns. Once identified, the IRS then takes the necessary steps to ensure that the preparer is either brought into compliance or no longer prepares returns.

California and Oregon, the two states that license return preparers, do not have studies that compare the quality of paid preparer's work products before and after their licensing requirements were put into effect. While testing of paid preparers could raise the level of competency, enforcement would still be needed to weed out those who choose to prepare non-compliant returns. Taxpayers, ultimately, are responsible for choosing competent and ethical tax preparers.

Baucus Question 51

In 2004, Congress enacted strong penalties for failing to disclose a tax shelter. Form 8886 must be filled out completely and attached to the individual tax return. If it is not attached, or if it is incomplete, an automatic penalty of $10,000 applies. If it is a "listed" tax shelter, the penalty goes up to $100,000. Yet, information recently received from the IRS shows that not one of these penalties has been asserted.

i. Please explain why the IRS has not asserted a single tax shelter disclosure penalty. It's been 2 ½ years since Congress passed the law.

ii. How can the IRS say it takes tax shelters seriously when it is unwilling to utilize the tools that Congress enacted in response to IRS pleas for help?

iii. What is the effect on tax compliance when taxpayers and their tax professionals figure out the IRS is not willing to enforce the laws it is given?

Answer

The IRS takes tax shelters seriously and is actively pursuing the use of the tools provided by the American Jobs Creation Act of 2004 ("AJCA"). The implementation of the AJCA tax-shelter provisions requires the Treasury Department and the IRS to publish regulations, develop appropriate technical and procedural guidance for IRS field personnel, and revise certain forms and letters.

To ensure the effective implementation of the section 6707A penalty, the IRS has (1) issued a memorandum from the Division Commissioners and Chief, Appeals to field personnel highlighting the penalty and providing information on special procedures and technical information; (2) published regulations pertaining to sections 6011, 6111, and 6112 and several additional pieces of guidance; (3) completed the draft IRM 4.10.6; (4) revised the 30-day Letter, including necessary computer programming changes; (5) modified the Notice and Demand Letter, including mandated computer programming changes; (6) developed Pro Forma Revenue Agent Report language; (7) revised Form 8886; and (8) initiated work on operational and security refinements stemming from the Certification and Accreditation process for full deployment of the new Office of Tax Shelter Analysis (OTSA) database.

It is important to note that the IRS cannot assess the penalty on any taxpayer until it has a sufficient basis to believe that a taxpayer has participated in a reportable transaction during a specific taxable year and failed to file a Form 8886 with respect to that tax year. If a taxpayer does not disclose his participation in a reportable transaction, the IRS generally will not know of the taxpayer's participation in such a transaction until it examines the taxpayer's tax return or investigates the promoter of the transaction. In this regard, section 6707A applies to returns and statements that are due after the date of enactment, October 22, 2004, and that have not previously been filed by the taxpayer. For calendar-year taxpayers, this means that the first year to which the section 6707A penalty would apply would be the TY 2004 return, filed in 2005. Those tax returns are only now coming under examination. Regardless of these time considerations, the IRS has been able to assess successfully a section 6707A penalty of $200,000 on an entity with an agreement and full payment. This penalty had not posted at the point of your last request for penalty data. At this time, there are additional penalty cases in the pipeline at various stages of development. Thus, the IRS has begun vigorous implementation of the section 6707A penalty provision.

Baucus Question 52

On a scale of 1 through 10, where does the Administration rate the tax gap on its list of priorities? Where do you rate it?

Answer

The Treasury Department and the Administration share your concern about the tax gap and are committed to continuing to work on a strategy to increase the level of compliance. A key economic priority for the Administration has been to implement the broad-based tax relief enacted in 2001 and 2003, which has been a critical component of the nation's economic growth over the past five years. Taxes that are due and owing, but unpaid, result in increased tax liability for compliant taxpayers, contrary to the Administration's broader economic policy. Accordingly, reducing the tax gap is a critical element of that broader policy.

Baucus Question 53

How many speeches have you given since becoming Secretary in which you have mentioned the tax gap? Please provide copies of them.

Answer

Within the past two years, senior Treasury Department and IRS officials have made dozens of public speeches and presentations on the importance of improving compliance and reducing the tax gap. Copies of these speeches are generally not created or made public, although the tax press regularly reports on them.

Baucus Question 54

Treasury and IRS frequently mention the lack of reliable data as an impediment to better tax administration. Unfortunately, like the weather, everyone talks about it, but no one does anything. What specific steps is Treasury taking to ensure there is regular and reliable research available?

Answer

As described in the response to Question 27, the IRS is continuing and expanding the NRP to compile data on the biggest portion of the tax gap: underreporting. An NRP reporting compliance study of TY 2003 and TY 2004 S-Corporation returns is under way, with the study expected to be completed later this year. The IRS plans to undertake a reporting compliance study of individual income tax returns, to begin with TY 2006 returns. Other studies will commence as resources become available, including a long-term research effort to estimate the impact of service and enforcement on voluntary

compliance. The FY 2008 budget request includes funding for additional reporting compliance studies ($41 million) and for research into the effect of service on compliance.

Baucus Question 55

The most recent data we have on compliance is from 2001. When are we going to get updated information on voluntary compliance rate for individuals? For corporations? Non-filers?

Answer

As described in the responses to Questions 27 and 54, the NRP reporting compliance study of S-Corporations will generate data to be used in conjunction with the TY 2001 NRP reporting compliance study of individuals to develop updated estimates of the individual income tax gap. The S-Corporation data should become available for analysis in 2008, and an updated estimate of the individual income tax gap should be available by September 2009. Updated estimates of the individual income tax nonfiling and underpayment gaps will also be included in that estimate. The NRP is planning to conduct a reporting compliance study of small corporations as resources become available, but the standard NRP approach to studying reporting compliance likely will not be practical for large corporations, whose unique reporting positions do not lend themselves to broader statistical analysis. The IRS is currently exploring alternative data sources and methodologies for estimating the underreporting gap for corporate income tax for the largest corporations.

Baucus Question 56

The most recent data we have on compliance is from 2001. Some of the figures date back to 1988. Should the fact that the tax gap figures are old limit Treasury's ability to develop a plan to reduce the tax gap?

Answer

The dated nature of some information has not prevented the Treasury Department and the IRS from developing and beginning to implement a strategy to improve compliance. Although it is important to keep abreast of emerging non-compliance trends, many of the key findings from older studies are repeated in the compliance studies the IRS has conducted. For example, studies consistently show that reporting compliance is best in the presence of comprehensive information reporting by third parties. This implies that the greatest opportunities for improving compliance will likely involve at least some expansion of information reporting.

Baucus Question 57

What are three specific actions Treasury has recently taken to address the tax gap and demonstrate effectiveness and competence in reversing the decline in tax compliance?

Answer

As described in the response to Question 42, the best available information on trends in compliance comes from estimates that the IRS has done for selected years between 1985 and 2001, most recently through the NRP. Over this period, according to IRS research, voluntary compliance rates have remained fairly steady and do not reveal any discernable trend showing either an improvement or worsening of tax compliance.

We remain committed to reducing the tax gap. In recent years, the Administration has taken a number of steps to reduce the tax gap. These actions are consistent with the Treasury Department's Comprehensive Strategy for Reducing the Tax Gap, which was released in September 2006.

- Reduce Opportunities for Evasion. The Administration's FY 2008 Budget contains 16 legislative proposals to reduce opportunities for tax evasion. Three of these proposals have since been enacted, albeit in modified form. We are continuing to work with Congress on the remaining proposals.

- Make a Multi-Year Commitment to Research. Since 2001, the IRS has conducted substantial research into the sources of non-compliance, so that IRS resources can be properly targeted. The 2001 NRP focused on the compliance behavior of individual taxpayers. An NRP reporting compliance study of S-corporation tax returns is currently underway. The Administration's FY 2008 Budget includes funding to undertake additional compliance studies.

- Continue Improvements in Information Technology. The IRS has taken steps to improve its information technology. The IRS is expanding and enhancing compliance activities through early detection, better case selection, and improved case management. For example, data from the NRP is being used to refine the selection of returns to be examined. The FY 2008 budget request includes a total of $282 million to continue the development and deployment of the IRS' BSM program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue to progress on projects, which will improve the accuracy, timeliness and completeness of taxpayer information available to both service and enforcement employees. This will help them improve productivity and quality and ultimately reduce the tax gap. These projects include the Customer Account Data Engine (CADE), Accounts Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

- Improve Compliance Activities Since 2001, the IRS has increased both examinations and the coverage rate in virtually every major category. These

activities increase compliance – not only among those directly contacted by the IRS, but also among those who are deterred from non-compliant behavior as a consequence of a more visible IRS enforcement presence. The Administration's FY 2008 Budget request includes $410 million for new enforcement initiatives as part of a strategy to improve compliance.

- Enhance Taxpayer Service. To reduce taxpayer confusion that lead to unintentional errors, the IRS is continuously improving taxpayer service. The share of taxpayers choosing to file electronically continues to increase; the level of service for toll-free assistance is up substantially from 2001; and utilization of the IRS web site expands each year. In April 2007, the IRS released Phase 2 of the Taxpayer Assistance Blueprint (TAB), outlining a vision for taxpayer service delivery over the next five years. Since publication, the IRS has taken several steps to begin implementing recommendations in the TAB Strategic Plan, including development of a service governance body and process; allocation of resources for a Taxpayer Services Program Management Office; and integration of the TAB Strategic Plan into existing business units planning, budgetary, and assessment activities.

- Reform and Simplify the Tax Code. Simplification of the tax code would reduce taxpayer confusion and unintentional errors. The Administration's FY 2008 Budget contains additional proposals to simplify the tax treatment of families and savings.

- Coordinate with Partners and Stakeholders. The IRS is partnering and leveraging resources with local, state, and Federal agencies. Examples of accomplishments include centralizing the process for IRS assessments based on state audit reports; implementing a Questionable Employment Tax Practices (QETP) Initiative to develop a Federal and state interagency approach to combat employment tax schemes and increase voluntary compliance; and establishing the Leeds Castle Group with the tax administration agencies of China, India, South Korea, the United Kingdom, Japan, Australia, Canada, France, and Germany to meet regularly to consider and discuss issues related to global and national tax administration.

Baucus Question 58

The country is facing significant fiscal challenges. According to GAO, government has $50 Trillion in unfunded future commitments. To what extent does the government have an obligation to make to a serious effort to collect revenues that are legally owed before considering benefit cuts and/or tax increases?

Answer

The Treasury Department and the IRS have an obligation to collect all revenues that are owed under current law. The IRS annually deploys a budget of some $10 billion and a hundred thousand employees to apply and enforce the tax laws, amounting to a serious effort to collect revenues owed. Other agencies within the Federal government, including

the Tax Division of the Department of Justice, assist in this effort. To the extent that the IRS' efforts to collect revenue fall short of the government's funding commitments as a result of legally due and owing but unpaid taxes or otherwise, alternative sources of funding must be considered. The Administration's current priorities in balancing revenue and spending are set forth in the FY 2008 budget request for the Federal government.

Baucus Question 59

In January, 2005, and August, 2006, in response to requests from Senator Grassley and me, the Joint Committee on Taxation made recommendations to improve tax compliance. I would like for you to review and comment on JCT's tax gap recommendations and report back to the Committee within 60 days.

Answer

The Office of Tax Policy has been working closely with the IRS in the development of a strategy to increase the level of compliance. As part of the Fiscal Year 2008 budget process, we considered various legislative ideas, including the proposals described in "Options to Improve Tax Compliance and Reform Tax Expenditures" prepared by the staff of the Joint Committee on Taxation (JCT). Indeed, the Administration's Fiscal Year 2008 budget request included a proposal similar to the proposal made by the JCT staff to require that brokerage firms report basis in securities to their customers and to the IRS. The Administration's proposal to expand broker (auctioneer) information reporting is also similar to a proposal developed by JCT staff. As described in the responses to Questions 36 and 37, however, in developing the legislative proposals set forth in the Administration's FY 2008 budget request, the Treasury Department and the IRS focused on proposals that would collect more of the tax revenue due under current law. Because the vast majority of JCT's proposals, while addressing areas of non-compliance, would also change the baseline against which tax revenue is measured, they were not considered to be strictly tax-gap proposals.

Baucus Question 60

In 2002, former IRS Commissioner Charles Rossotti issued his final report to the IRS Oversight Board assessing the IRS and the tax system. He pointed out that the IRS was not pursuing identified tax debtors and non-compliant taxpayers. The numbers in his report were very troubling. Can you tell the Committee how much progress has been made since 2002?

Answer

While Potential Collectible Inventory (PCI) has increased from $76.7 billion in September 2002 to $95.6 billion in September 2006, much of this increase is a direct result of compliance actions taken to address underreporting and nonfiling aspects of the

tax gap. The IRS has significantly increased efforts in the Substitute for Return, 6020(b), Automated Under-Reporter (AUR) and Examination programs over the past several years. As a result, compliance assessments rose from 21.2 percent of new PCI dollars in FY 2002 to 42.6 percent of new PCI dollars in FY 2006. Over the same period, the dollars collected by the IRS on delinquent accounts and delinquent returns rose from $34.2 billion to $44.7 billion -- a 31 percent increase.

Baucus Question 61

In 2002, 60 percent of identified tax debts were not pursued by the IRS. How many identified tax debts are pursued today?

Answer

As of September 2006, unpaid assessments totaled $270.4 billion. Of this total, $95.6 billion was regarded as "Potential Collectible Inventory" (PCI). PCI represents the total amount of unpaid assessments available to be worked by the IRS' collection operations. It is determined by eliminating that part of the unpaid assessments already found to be uncollectible or already being collected through installment agreements. Of the $95.6 billion in PCI, $72.1 billion, or just over 75 percent, were in an active collection status and were being pursued through the notice process, the Automated Collection System, or the Collection Field Function.

Baucus Question 62

In 2002, 75 percent of taxpayers who did not file a tax return were not pursued by the IRS. What is that figure today?

Answer

In FY 2006 (TY 2004, the most recent information available), there were 7.5 million total individual return delinquencies out of a total of [130] million returns filed. From this, almost 3.1 million cases were selected to be worked, which equals 41 percent — a substantial improvement since 2002. The balance of the return delinquencies includes a significant number of cases that, if pursued, would likely result in a refund, no balance due, or a late filed return. The IRS targets is enforcement resources in this area on those taxpayers, including high-income non-filers, who are most likely to have an unreported liability.

Baucus Question 63

In 2002, 79 percent of identified taxpayers who use abusive devices (e.g. offshore accounts) to evade tax were not pursued. Has there been any improvement in this area?

Answer

In order to improve IRS efforts to pursue taxpayers who use abusive devices to evade taxes, the IRS created a separate Abusive Transactions division within SB/SE to focus exclusively on such activities. Within this division are groups of experienced agents with specialized expertise in identifying abusive schemes, devices, and issues, both domestic and offshore, and developing coordinated approaches to addressing those abuses.

In addition to specialized groups that focus on particular abusive schemes, devices and issues (e.g., abusive trusts, abusive promoters, etc.), the Abusive Transactions division maintains an Offshore Compliance Initiatives group that develops proactive and strategic approaches to identifying, profiling, and investigating taxpayers involved in offshore abusive transactions. Among these proactive initiatives are the Offshore Credit Card Project and the Brokerage Initiative, with additional initiatives under development.

The IRS' various abusive transactions programs have increased the number of cases being investigated where taxpayers use abusive devices to evade taxes.

Baucus Question 64

In 2002, 56 percent of identified taxpayers with income of $100,000 or more and underreport tax were not pursued. How much progress has been made in this area?

Answer

The IRS has made significant progress in a number of key enforcement categories. The IRS is showing consistent improvements in areas critical to running a fair, efficient tax system, bringing in billions of additional dollars to the Treasury through its expanded enforcement activity. The IRS' enforcement activity is up from the low points following the IRS Restructuring and Reform Act of 1998, and has climbed significantly in recent years. Although changes to the IRS' classification and selection methods will not allow it to replicate in future years exactly the methodology used to arrive at the 56-percent figure used in 2002, the IRS estimates that for tax year 2006 it pursued approximately 65 percent of the taxpayers identified with income of $100,000 or more and underreported tax.

The bottom line for IRS enforcement efforts shows that dollars collected rose again last year, continuing a strong upward trend. FY 2005 was a watershed year for the IRS, with a number of big initiatives that helped push enforcement revenues up 10 percent to $47.3 billion. In FY 2006, enforcement revenues – the monies received from collection, examination, and document matching activities – increased again to a record $48.7 billion. The IRS' overall dollars collected jumped nearly 3 percent in 2006, principally because of a strong rise in collection activity.

An important part of the IRS' enforcement effort has targeted high-income taxpayers. The IRS has put significant emphasis on increasing audits in this area, because it is critical to ensuring the integrity of the tax system.

- Audits of individuals with income of $1 million and higher increased to over 17,000 from 12,800, a nearly 33-percent increase in just one year. About one in every 16 of these taxpayers faced audits last year.

- Audits of individuals with incomes over $100,000 surpassed 257,000, an 18 percent increase from 2005. That is the highest figure in more than a decade, and well over double the 92,000 completed in FY 2001.

Baucus Question 65

Over the past ten years, the size and complexity of our tax system has increased enormously. How confident are you that IRS is up to the challenge of closing the gap?

Answer

A comprehensive strategy to improve compliance and reduce the tax gap must be approached with realistic expectations and perspectives. The IRS will not be able to audit away the tax gap, and continuous changes to and additional complexity in the tax law will present significant challenges. There must also be a balanced approach in providing service and focusing on taxpayer rights while improving and targeting enforcement activity with more specificity around sources of non-compliance. In order to make significant improvements in compliance rates, it will take a focused effort, ensuring the IRS has the appropriate budget to accomplish both short term and long-term goals set forth in Treasury's Strategic Plan presented in September 2006. It also means having a concentrated effort to enact legislative proposals affecting compliance, as well as a commitment to reducing opportunities for evasion, ensuring additional research, improving technology, improving compliance activities, enhancing taxpayer service, reforming and simplifying the tax law, and enhancing coordination with partners and stakeholders.

Baucus Question 66

Staffing levels at IRS are lower than they were a decade ago (120,000 vs. 100,000) while the number of tax returns filed has increased (132 Million). How does this imbalance contribute to the tax gap, if at all, in terms of IRS's ability to enforce the tax laws?

Answer

The IRS is committed to building and maintaining the workforce needed to carry out its mission in an efficient and effective manner, thereby, "Linking Human Achievement

with Business Results." Accountability measures from the IRS Human Capital Strategic Plan (HCSP) and Human Capital Strategic Implementation Plan (HCSIP) are used to assess progress in achieving our strategic objectives. Human Capital Outcome Indicators, which are based on the OPM Human Capital Assessment and Accountability Framework (HCAAF), are also used to assess the effectiveness of human capital strategies and set goals for continued improvement. Our efforts support Treasury's "Green" status in the area of human capital management on the President's Management Agenda.

While overall staffing at the IRS has decreased in recent years, actions have been taken to increase enforcement positions and ensure that staffing levels do not negatively impact compliance. Enforcement staffing for Revenue Officers, Revenue Agents, and Special Agents have increased from a low of 19,691 in FY 2003 to 21,185 in FY 2006.

Baucus Question 67

Other than budget recommendations, how should IRS allocate existing resources or change its operations and procedures to ensure quality taxpayer service and enhance compliance?

Answer

The Treasury Department's Strategy for Reducing the Tax Gap recognizes that a critical component of improving compliance is providing taxpayers with the assistance they need in order to understand and comply with their obligations under the tax law. The Taxpayer Assistance Blueprint Strategic Plan (TAB Strategic Plan), released earlier this year, outlines several areas for service improvement identified after careful analysis of research. A Performance Measures Portfolio, Service Improvement Portfolio, and Implementation Strategy together comprise the TAB Strategic Plan for taxpayer service in the next five years. Each element represents a dynamic set of factors that must be considered together when examining taxpayer service as a whole. Improvement recommendations align with opportunities to enhance the value of IRS service delivery while balancing government value when making resource decisions.

The TAB Strategic Plan provides recommendations to expand, simplify, standardize, and automate services and to improve and expand technology infrastructure and support for employees, partners, and taxpayers. Recommended service enhancements include formalizing an integrated service investment decision-making process; developing service evaluation criteria that align with the TAB Performance Measures Portfolio; and incorporating an understanding of taxpayer and partner needs, preferences, and behaviors. Work is already underway to develop of a service governance body and process; allocate resources to establish a TAB Program Management Office; and integrate the TAB Strategic Plan into existing business units planning, budgetary, and assessment activities.

Baucus Question 68

In the Jackson Hewitt indictment, the preparer is quoted as saying "Jackson Hewitt employees are not the police, we're not the IRS and it is not the responsibility of tax preparers or managers to prevent customers from filing bogus returns." How do you respond to that statement?

Answer

The Treasury Department and the IRS generally do not comment on specific taxpayer matters or investigations. Although taxpayers are ultimately responsible for what goes on their tax returns, return preparers have a responsibility to the system and to their clients. The IRS always urges taxpayers to spend time reviewing their tax return, and watch for warning signs that could indicate problems with their preparer. When the IRS detects a false return, the taxpayer — not the return preparer — must pay the additional taxes and interest and may be subject to penalties.

Nonetheless, OPR has the ability to sanction practitioners and firms where misconduct occurs (such as preparing false returns) and the firm knows or should have known of the misconduct.

Baucus Question 69

Unlike extractors of other minerals or fossil fuels from public lands, miners do not pay royalties to the government on the value of hardrock minerals that they remove. Instead, holders of more than 10 mining claims on public lands pay an annual maintenance fee of $125 per claim. Holders also pay a one-time $32 location fee when recording a claim.

i. What is the Administration's position on requiring that hard rock mining on public lands be subject to royalty payments like other mineral and fuels extractors?

Answer

This question does not appear to relate to any matter within the jurisdiction of the Department of the Treasury.

Grassley Question 1

The President's budget contains proposals that would expand information reporting for credit card transactions, broker transactions, payments to corporations, and cost basis for securities transactions. Some members on the other side of the aisle have criticized these proposals as not going far enough, because they only bring in about 1 percent of the tax gap.

Mr. Secretary, I have three questions to ask you about information reporting proposals.

i. In light of the criticisms that your proposals don't go far enough, how could these proposals be strengthened?
ii. What other types of income should be considered for expanded information reporting or withholding?
iii. What are the factors that impact the time frame in which Congress should expect revenues to come in from additional information reporting proposals?

Answer

The legislative proposals set forth in the President's budget are only one element of the Treasury Department's Comprehensive Strategy to Reduce the Tax Gap. While this element is the only one that has a revenue impact under conventional legislative scoring conventions, each of the other six elements of the Strategy are also important to improving compliance and may, in the end, have a more meaningful impact on improving compliance than the legislative proposals — albeit one that cannot be easily measured.

While some have criticized the proposals because they may not go far enough, others have commented that the proposals may go too far in collecting information beyond gross income for a taxable year. The Department of the Treasury and the IRS continue to consider proposals to reduce the tax gap and increase compliance with respect to all types of income. Many factors may affect the timing of expected revenue increases from enacting information reporting proposals. Information filers may have to build systems to capture and report as required. The IRS may have to create protocols to analyze and act on information reports. Taxpayers may change their behavior in response to reports and resulting compliance actions.

Grassley Question 2

Mr. Secretary, another angle of attack on the tax gap is tax reform and simplification, including reforming or eliminating some tax expenditures, as recommended by the staff of the Joint Committee on Taxation in a report called "Options to Improve Tax Compliance and Reform Tax Expenditures". I would note that some of the JCT staff's recommendations have been enacted, but there are many other proposals in that report that have not been enacted, such as repealing the deduction for interest on home equity loans, modifying the social security tax and self-employment tax rules, and moving to a territorial system for foreign business income. Others have suggested even more fundamental reform, like shifting to a consumption tax. Many of these changes, of course, would create winners and losers, making them controversial.

Mr. Secretary, I have 3 questions on tax reform and the tax gap.

i. What role should tax reform and simplification play in reducing the tax gap?
ii. Has Treasury considered any specific reform or simplification proposals that would reduce the tax gap?
iii. What factors impact the timing of expected tax gap revenues that would result from enacting reform or simplification proposals?

Answer

Both unintentional and intentional errors contribute to the tax gap. Any strategy to reduce the gap must address taxpayer confusion due to the complexity of the code as well as intentional evasion.

Simplifying the tax code would reduce unintentional errors caused by a lack of understanding of the tax law. Simplifying the tax code would also reduce the opportunities for intentional evasion and make it easier for the IRS to administer the tax laws. For example, the Administration's Fiscal Year 2008 Budget includes proposals to simply the tax treatment of savings and the family by consolidating existing benefits and clarifying eligibility requirements. These legislative initiatives are supplemented by IRS efforts to reduce taxpayer burden through simplifying forms and procedures.

Many factors may affect the timing of expected tax gap revenues from enacting reform or simplification proposals. Simplification proposals that effectively codify current practices (e.g., by legitimizing what taxpayers actually do) may have an immediate impact on the tax gap. In contrast, simplification proposals that affect the tax gap through changes in taxpayer behavior may take longer to have an impact, but in the long run, their impact may be greater. Implementation hurdles may also delay the impact of a simplification or reform proposal on the tax gap.

Grassley Question 3

Mr. Secretary, while Congress passes the law, the details are often left to the Treasury and IRS to provide in terms of guidance through regulations and notices. I am worried that the Treasury Department too often fails to take advantage of the tools they have to deal with the tax gap through additional guidance.
In fact, it is often the case that Treasury guidance makes a problem worse. For example, the problems of charitable supporting organizations - cited by the Commissioner as one of the top dirty dozen -- are primarily the creation of Treasury regulations. It then took Congress to take steps last year to undo the Treasury regulations that created the opportunities for abuse.

Similarly, Congress last year also sought to deal with the problems of the $9 billion dollars a year in clothing donations that people claim by requiring that the clothes be in "good used condition." Congress did this so that someone can't put old, dirty torn clothes in a sack and claim a big deduction.

I'm very frustrated that Treasury officials have now decided they aren't going to issue any guidance to taxpayers - so that we can deal with this area and also give taxpayers who want to do the right thing a better sense of what they can deduct.

I would like to understand what are the top priorities you are taking to address the tax gap through guidance and what you think will be the revenue effect of those efforts. I would also ask that you revisit immediately this poorly considered decision by low-ranking Treasury and IRS officials to give a pass when it comes to the $9 billion dollar a year in clothing donations.

Answer

The Treasury Department's Comprehensive Strategy to Reduce the Tax Gap identified our published guidance program as an important component of the multi-pronged strategy to improve compliance. Each year, the Treasury Department and the IRS publish a Priority Guidance Plan. The 2006-2007 plan includes 264 guidance projects scheduled for completion between July 2006 and June 2007. Recent published projects that will improve compliance and that target potential areas of abuse include guidance on transfer pricing, the foreign tax credit, private annuities, trust information reporting, and reportable transactions. While these projects will improve compliance by clarifying applicable rules, regulatory guidance generally is not scored for revenue effect under accepted scoring conventions. Presumably, the revenue effect was taken into consideration in the enactment of the underlying legislation. The Treasury Department and the IRS are currently considering requests for guidance on "good used condition." At the same time, we are unable to confirm that any particular revenue effect would attach to such guidance.

Grassley Question 4

Mr. Secretary, at your confirmation hearing we discussed the importance of charities. Something that I know is very near and dear to your heart from your time in the private sector. At your hearing, you stated that you agreed it was vital that we have good governance at charities and particularly boards that perform their fiduciary duty. I think the recent headlines about the Smithsonian have served to bring that point home again.

You also stated that as Treasury Secretary you would look at donations of in-kind to charities. You cited art, land and others as areas of abuse -- and I would add part of the tax gap. I would like you to outline what you have been doing in this area and what leadership you have taken or see taking to ensure that charities understand the importance of proper governance. We cannot keep having these problems that we see at the Smithsonian.

And as an additional point, I would ask you or your colleagues at the table to speak to me about where we are on reviewing tax exempt hospitals. Mr. Secretary, at a speech at

Columbia University you spoke of challenges facing our economy to include uneven income distribution.

Speeches are fine, but Treasury with a stroke of a pen could repeal the ill-considered guidance it issued in 1969 that stated that tax-exempt hospitals that receive billions in tax breaks did not have to provide charity care to the poor.

I am very worried that Treasury is more interested in jawing about the tax-exempt hospitals and is not showing any progress in making common sense changes in IRS and Treasury guidance in this area that will ensure that those most in need of health care benefit from the billions in tax breaks we provide tax exempt hospitals.

Answer

The Treasury Department and the IRS are concerned about ensuring that charities understand the importance of proper governance, to the extent that proper governance, which may be a matter of State law, may compel compliance with Federal tax laws under IRS jurisdiction. For example, the IRS Division Commissioner for Tax-Exempt and Government Entities recently spoke about charity governance at Georgetown University in an effort to educate the sector about this important topic. On donations in-kind, the Treasury and the IRS recently published Notice 2006-96, 2006-46 I.R.B. 902, on appraisal requirements for charitable deductions.

We also are concerned about charitable health care for the poor. Our efforts in this area include conducting a major survey of the exempt hospital sector, which the IRS is in the process of analyzing. The survey results will help guide IRS efforts to ensure that exempt hospitals furnish a proper level of benefit to the community. This community benefit standard, as articulated by Rev. Rul. 69-545 and other authorities, has been recognized by the courts and other bodies over the decades. We recognize that the role played by tax-exempt hospitals has changed over the past 40 years, and would be happy to work with Congress should it wish to reconsider the standards for hospital exemption.

Grassley Question 5

An April 5, 2007 memorandum to IRS Chief Counsel Don Korb from George J. Blaine, Deputy Associate Chief Counsel, states that Treasury has not controlled a formal published guidance project to implement the new IRC section 170(f)(16) that generally denies charitable deductions for clothing and other household items not "in good used condition or better" because the statutory standard – "good used condition"- is commonly understood and largely factual.

Please describe what you consider to be "good, used condition."

Answer

We understand that the requirement of "good used condition" was expected to ensure that donated clothing and household items are "of meaningful use to charitable organizations." JCT, Technical Explanation of H.R. 4 (JCX-38-06), at 304. Consequently, the requisite condition may depend upon a given item and the use to which a charity means to apply it. In this case, the effectiveness for tax administration of delineating the condition of used clothes and household items, vis-à-vis the sundry uses to which various charities may mean to apply them, would be unclear. For example, while used socks may be of little or no value to most charities, they might be in strong demand for an organization running a homeless shelter. Nevertheless, "good used condition" may be a question of public interest to which the IRS could respond as a matter of general information, without affecting contributions to organizations that have a genuine need. The Treasury Department and the IRS are currently considering taxpayer requests for guidance in this area.

Cantwell Question 1

Mr. Secretary, as you, know there is a coalition of business interests that are opposed to additional withholding, reporting, and recordkeeping requirements.

Has the Treasury Department gotten input from the folks from the Chamber of Commerce, National Federation of Independent Businesses, and the National Small Business Association on what steps can be taken to improve compliance? Given that so much of the gap is attributable to unreported income, what recommendations have these groups made to help us solve this problem?

Answer

The staff of the IRS Small Business & Self Employed Division's Communications, Liaison & Disclosure (CLD) Stakeholder Liaison function has a robust relationship with organizational representatives comprising the Coalition for Fairness in Tax Compliance. Members of the Coalition attend regularly scheduled liaison events, which provide a forum for two-way communication to discuss the business interests of their constituents, as well as IRS policies and procedures. In addition, members of the Coalition have met with high-ranking IRS officials to discuss their views on legislative proposals, which would affect voluntary compliance and reduce the tax gap. The Coalition has also presented to their IRS liaisons a Discussion Draft on Improving Tax Compliance, which includes proactive simplification/relief proposals, modifications to current tax gap proposals, and suggestions related to education and outreach.

In addition, Stakeholder Liaison is working with the Coalition to jointly develop innovative educational opportunities, including an initiative currently underway to provide outreach targeted at first-time Schedule C filers.

Cantwell Question 2

We have heard that the complexity in the tax code is also a contributor to the tax gap, and I agree. It was refreshing in 2005 when President Bush appointed an outside advisory panel to present ideas for fundamental reform.

That panel presented a very thought provoking document in November 2005 and I know this committee held some general hearings last year.

Mr. Secretary, why hasn't the Treasury Department advanced this ball any farther? I don't recall the Administration issuing any specific rebuttal to the report or providing to the Congress any guidelines for how fundamental reform of the tax code should be pursued.

When Mr. Solomon came before this committee in July 2006, he described the complexity of the current tax code as the "foremost challenge" facing tax policymakers because it "breeds perceptions of unfairness and creates opportunities for avoidance." He also told the committee at that time that the Treasury was in the process of considering options for tax reform and preparing recommendations.

Does the Treasury plan to make any recommendations for tax reform, or have any strategy for how you plan to pursue fundamental tax reform?

Answer

As reflected in the Administration's Budget, incremental reform of the tax law is a key component of the Treasury Department's current approach to reducing the tax gap and improving compliance. For FY 2008, the Treasury advanced 16 tax gap and compliance proposals, which expanded on the five proposals in the FY 2007 Budget. In addition, the Administration's Budget contains numerous outstanding tax simplification proposals, such as those to simplify and encourage saving, and to simplify the tax laws for families. While the Administration continues to evaluate the efforts of the President's Advisory Panel on Federal Tax Reform, it appears that taking incremental steps toward working with Congress on proposals that may be accepted may be more realistic in the short term than generating fundamental proposals that may remain theoretical.

Kerry Question 1

Last year, I contacted you to express my concerns about the backdating of stock options. What steps has the IRS taken to collect taxes owed due to the backdating of stock options? How successful has the IRS's initiative to provide relief to rank-and-file employees been?

Answer

The steps taken by the IRS to collect taxes owed as a result of backdating stock options are to

identify the companies involved, to initiate examinations to determine if the options had an impact on tax, and to collect any additional taxes resulting from the examination. The identification of a company involved in backdated stock options is determined through company press releases, Securities and Exchange Commission filings, and voluntary disclosures.

The IRS has identified approximately 180 companies that were involved in backdated stock options. Currently, of the 180 companies, approximately 100 are under examination. Based on these examinations, four companies have agreed to the disallowance of $300 million of compensation expense. However, since complete examination reports for these companies have not been finalized, the additional tax has not been determined.

The IRS announced a Compliance Resolution Program, Announcement 2007-18, to allow employers to pay additional taxes and interest for their employees generated by the exercise of certain stock options in 2006. Eighty (80) companies with over 13,500 affected employees volunteered to participate. As of June 15, 2007, the IRS has processed over $79 million of payments from 23 employers.

Kerry Question 2

The IRS has argued that the private debt collection does not currently have the resources to work the type of cases being handed over to these companies, and that hiring and training a sufficient number of IRS employees to perform this work would take several years. How many employees among the three companies have been trained before the contract was not renewed for one of the companies? How many employees are currently trained?

Answer

The IRS has noted that it lacks the resources to work the types of cases in the Private Debt Collection program, not that private debt collection lacks resources. The number of trained Private Collection Agency (PCA) employees does not equal the number of IRS employees needed to make an impact on all the priority IRS collection inventory requiring resources.

PCA	Trained prior to contract renewal	Employees currently trained
PCA 1	68	68
PCA 2	72	-
PCA 3	24	24
Total	164	92

The remaining PCAs will be increasing their staffing levels and training additional employees over the upcoming months.

Kerry Question 3

A recent article in the Buffalo Times describing the training process for employees at one of the private collection companies noted that employees were only required to pass a two-week training course. Can you describe in detail the training program?

Answer

PCA employees go through a two-week IRS-related topics training course, which covers 172 technical issues that relate to the PCA Policy & Procedures Guide they have been provided. PCA trainers teach the class with IRS subject matter experts in attendance, providing oversight and ensuring topics are covered thoroughly and adequately before certifying the training conducted. Besides collection issues being covered, specific issues such as privacy, taxpayer rights, disclosure, and the role of the Taxpayer Advocate Service are also covered.

Each PCA conducts their own additional training that is geared toward general collection techniques and the use of their respective automation and other systems to get the job done. Typically, this consists of two weeks of classroom training and then varying levels of on the job training shadowing experienced collectors. PCA employee calls are monitored by PCA supervisors once they start taking live taxpayer calls. Finally, both PCA management and IRS quality analysts monitor random taxpayer calls to determine if additional training may be needed.

The IRS requires that all PCAs pass a background investigation and pass the IRS course with at least a 70-percent rating or better before being allowed to work on IRS cases. However, the PCAs' internal standards require a higher pass rate percentage than the 70 percent to work on the contract.

Kerry Question 4

If IRS employees can do this work much more cost effectively, which the IRS has admitted, why is the IRS not retraining IRS employees to do this collection work?

Answer

Retraining for collection cases IRS employees who are currently seasonal employees or may be released because of reductions in force in different areas would come at a significant cost and is not feasible. The Small Business Self-Employed Division recently participated in several initiatives to provide placement and/or buyouts for employees from submission processing centers whose positions were being abolished. Due to a variety of initiatives, many of the employees have been placed into compliance positions. Unfortunately, almost 70 percent of the employees are grades 3 and 4 clerical employees who cannot compete for compliance positions due to lack of qualifying experience. Most

of these employees had duties such as opening mail, coding returns, or performing data-entry work.

Employees in the 592 (tax examiners) series were aggressively pursued for open Automated Collection System (ACS) positions. Many of the employees had very limited computer skills and no phone skills, which creates a poor match for them and for ACS. Even with a training course and additional training, additional coaching was found to be necessary. Despite these efforts, the IRS was not able to bring them to a fully successful level and many requested reassignments to other operations.

Many seasonal employees may face the same challenges for a transition to collection. Although your suggestion makes sense and the IRS did pursue this option, the examples above illustrate that this did not yield the best results in all cases. The IRS will continue to make all efforts to retrain employees wherever possible.

The Private Debt Collection (PDC) initiative was implemented at the direction of Congress due to a lack of IRS resources. The initiative, however, was never intended to replace IRS appropriations or eliminate IRS positions. Rather, it was designed to go after those cases that the IRS would likely never get to because they do not score sufficiently high in terms of evaluating the next best case to pursue with available IRS resources. If the IRS were to redirect the funds from the PDC program, they would likely be used to go after higher priority cases than those that the PCAs are currently working. IRS training requirements for working these higher priority cases are the same as ACS. Based on lessons learned, retraining employees for an open position that does not fit their skill set would likely yield the unsatisfactory results similar to what the IRS has already experienced. Based on experience, retraining in those cases is not in the best interest of the individual employee, the IRS, or the taxpayer.

Kerry Question 5

In Massachusetts, the IRS Andover Processing Center employees more than 1,700 and it is scheduled to close in 2009. Has the IRS looked at retraining these employees? Wouldn't it make more sense than using private collection agencies that keep a percentage of what they collect?

Answer

Based on its consolidation strategy, the IRS will close the Andover Submission Processing Center in September 2009. Several years ago, the IRS began hiring term employees in Andover to mitigate the impact of consolidation on career conditional employees. In April 2007, there were 776 term employees working at the Andover Submission Processing Center.

After the submission-processing site is closed, the Andover IRS campus will continue to be a viable employment center for other IRS operations, including Compliance and

Accounts Management. The IRS is committed to exploring every option that will minimize negative employee impact. For example, even though it is too early for specific details to be available, the IRS already knows that additional positions will be created to support a residual mail support operation and that the e-File help desk operation will remain in Andover.

When the IRS begins to work more exclusively on the Andover consolidation, it will have the cumulative benefit of lessons learned in Brookhaven, Memphis, and Philadelphia, and will leverage those lessons in order to make the Andover consolidation as smooth as possible. For example, job fairs can be organized to support employees in their job search efforts and job swaps can be approved to further reduce the number of employees who might be subject to involuntary separation. Andover Submission Processing employees who secure jobs in other areas on the Andover campus or elsewhere in the IRS will receive appropriate training.

The benefit of more formal mitigation strategies, such as Reassignment Preference Notices (RPNs) and, subject to OPM approval, VERA/VSIP (early out/buyout) opportunities, will also be extended to affected employees. Based on the IRS' current experience in Philadelphia and in accordance with the National Agreement with NTEU, these options will become available to employees approximately one full year in advance of an anticipated Reduction in Force (RIF).

Roberts Question 1

There's no question that those who owe their taxes should pay them Under-reporting, under-payment, and failure to file increases the tax burden on honest taxpayers who already pay their fair share and who pay it on time.

That being said, I'd like to get your thoughts on how we close the tax gap while making certain that we don't create an undue burden on taxpayers. I understand that the IRS estimates that under-reporting of small business income accounts for a significant portion of the tax gap (in the neighborhood of $64 billion).

First, I'd like you to elaborate on your testimony about efforts the IRS is undertaking to work with small business taxpayers in a proactive fashion to make certain they meet their tax obligations.

Second, I'd like you to respond to concerns I hear from Kansas small businesses and tax preparers who tell me that small businesses are being targeted by the IRS and that it is creating an undue burden, Can you elaborate further about how the IRS is stepping up compliance efforts with regards to small businesses? And, can you tell me, specifically, what benefits you are seeing from these increased efforts? These small businesses are the ones that are driving our economy and creating jobs. I want your assurance that any action the IRS takes to increase compliance doesn't create an undue burden on these

small businesses, and I want to make certain that we're seeing a significant benefit from these efforts.

Answer

In October 2005, the IRS started taking a more strategic approach to the delivery of services to the small business and self-employed taxpayer community. The IRS realigned its SB/SE outreach and education resources to optimize the services provided. The IRS used research data to determine locations with the highest concentration of small business and self-employed taxpayers and that data drove the decision on employee placement. This was to ensure the small business community would be properly served with educational opportunities related to their tax obligations. External stakeholders in all 50 states and Washington, DC have a liaison contact in the SB/SE Stakeholder Liaison (SL) function.

SL has relationships with over 1,500 small business industry and tax professional organizations. In FY 2006, the IRS coordinated or participated in 2,069 events across the country with more than 122,000 direct participants, sharing education and outreach messages and information about IRS policies and procedures. In the first quarter of FY 2007, the IRS coordinated or participated in over 1,100 events with approximately 81,000 direct participants.

One of SL's most successful ongoing events with small business industries are Small Business Forums, which the IRS co-hosts with the U.S. Chamber of Commerce, the National Federation of Independent Business (NFIB), and the Small Business Legislative Council (SBLC). Through the two-way communication during these forums, small business organizations alert the IRS about issues that are a burden to their members, provide feedback to IRS on policies, practices and procedures, and receive information to assist small businesses to meet their tax obligations and navigate the IRS. The forums – held in both Washington, D.C. and in field locations across the country – are attended by multiple small business industry organizations, including Small Business Administration representatives.

In addition, SL is working with the Coalition for Fairness in Tax Compliance, a group comprised of several organizations geared to the interests of the small business community, to develop jointly innovative educational opportunities, including an initiative currently underway to provide outreach targeted at first-time Schedule C filers.

SL also considers practitioners as one of their primary stakeholders, especially since approximately 80 percent of small businesses engage a paid preparer. SL has an aggressive outreach strategy geared toward practitioners to provide key tax law messages, as well as current policy and procedural information, through an established network of practitioner organizations, such as the AICPA, National Association of Enrolled Agents (NAEA), and National Association of Tax Practitioners (NATP), at both the national level and locally. Pertinent educational information is shared with practitioners through regularly scheduled national and local practitioner liaison meetings, telephone forums,

and electronic communication. SL has also partnered with the Office of Professional Responsibility and local practitioner groups to host Ethics Seminars. These seminars provide detailed instruction to practitioners on their conduct and responsibilities regarding return preparation and representation of clients before the IRS.

To supplement these ongoing strategies, SL is also expanding their strategic approaches to educate practitioners. SL is currently developing an educational outreach targeting unaffiliated practitioners — those return preparers who do not hold a membership with a practitioner association. There is also an outreach under development to provide the same educational information to tax preparers employed by the larger chain tax-preparation organizations.

Issue resolution is a major element in the IRS' relationship with small business and practitioner stakeholders. To have a true partnership with these groups, the IRS must be willing to listen to feedback and concerns. A vital element is the Issue resolution Management System, which the IRS uses to collect, catalogue, and resolve issues elevated to us by stakeholders. Through this system, the IRS has made improvements in operations to benefit small businesses, practitioners, and the agency.

IRS research indicates that a large portion of the tax gap comes from understated net business income (underreported receipts and overstated expenses) of small business entities, such as sole proprietorships filing individual income tax returns (Form 1040 with a Schedule C) and corporations, partnerships, trusts, and limited liability companies (LLC's) with less than $10 million in assets.

The IRS has stepped up enforcement to address this area of non-compliance. Over the past several years, overall audit coverage has increased substantially, especially with respect to high-income individual taxpayers, which has risen 180 percent, the highest level in a decade. A high number of the non-compliant sole proprietorships are included in the high-income individual taxpayer category. The average amount of additional tax recommended has also increased, with the most substantial growth in audits of high-income taxpayers.

At the same time, the IRS has made improvements to its processes and procedures and leveraged technology that have reduced burden to taxpayers. The IRS has achieved this in several ways, including:

- Increased use of automated systems, such as document matching
- Improved return-selection systems to assist in identifying returns with the most audit potential, thus decreasing the number of audits of compliant taxpayers
- Improved effectiveness and efficiency to reduce the time spent on face-to-face examinations

In summary, the IRS has focused on achieving an appropriate overall level of audit coverage in areas of significant non-compliance. The IRS' efforts to step up enforcement have been made through leveraging its automated processes, making improvements in

selecting the best returns for examination, addressing areas of specifically known abusive tax-avoidance transactions, and becoming more efficient in examining returns.

Roberts Question 2

The administration has offered a number of proposals to reduce the tax gap by approximately $29 billion over 10 years. However, during this year's budget debate, we heard some overly optimistic projections about the amount of revenue that can be recovered by closing the tax gap. How do you respond to folks who believe the administration's proposals don't go far enough and that the IRS should take even more drastic steps to close the tax gap? Don't we also need to be careful in our discussions of the tax gap that we clearly distinguish between those proposals that actually collect tax revenue that is owed but not paid, and those proposals that are simply tax increases guised as ways to close the tax gap?

Answer

The Administration's proposals to increase compliance are credible inasmuch as they are realistic. If the IRS were mandated to take drastic steps to close the tax gap, there could be undesirable consequences, including a decline, rather than the intended improvement, in compliance levels as such measures cause taxpayers to lose confidence in the tax system generally and the IRS in particular. The Administration's proposals to expand information reporting, impose penalties, and otherwise improve tax administration are designed to reduce the tax gap rather than change the baseline against which tax revenue is measured.

Roberts Question 3

You've mentioned that it is difficult to determine which taxpayers willfully fail to meet their tax obligations and those who make honest mistakes. Can you tell me what steps the IRS is taking to differentiate between these taxpayers and how you see tax gap policy developing to take into account these differences?

Answer

In determining an understatement of tax, there is generally no distinction between willful failures and honest mistakes, although the IRS does assess accuracy-related penalties when appropriate standards are met. Consequently, there may be no justification in the course of tax administration to differentiate between taxpayers on this basis. Determining taxpayer intent under a regular examination is very difficult, and any analysis of the nature of an error by IRS examiners is inherently subjective. Some researchers have applied econometric techniques to measure intentional evasion, but the results have been inconclusive. Potentially, regulatory guidance or simplifying legislation may help to alleviate honest mistakes. At the same time, clarifying the rules also may facilitate compliance efforts with respect to willful failures. Thus, tax gap policy should include both research, which would assess the effectiveness of tax administration, and simplification of the tax law.

OPENING STATEMENT
SENATOR KEN SALAZAR
FINANCE COMMITTEE HEARING: "EXAMINING THE ADMINISTRATION'S PLAN FOR REDUCING THE TAX GAP"
APRIL 18, 2007

Thank you, Chairman Baucus, for holding this morning's hearing, and thank you, Secretary Paulson, for being here with us today to discuss how we can do a better job of closing our nation's tax gap. Today's hearing is especially timely given last night's federal tax return filing deadline, and I am glad that you could be with us this morning.

Our nation faces a deficit of about $250 billion for fiscal year 2008. Simply put, we are spending more than we are collecting in revenue. Part of the solution to this problem is restoring fiscal responsibility in Congress. But given the approximate $300 billion disparity between taxes owed and taxes collected, it's clear that another part of the solution must be narrowing our nation's tax gap.

The premise is simple: the federal government must do a better job of making sure that Americans pay the taxes that they owe.

Some of my colleagues will liken the revenue the tax gap represents to a fictional "pot of gold" and suggest that actions we take to minimize it would overburden taxpayers. These statements are deceiving and misinformed. They also fly in the face of the notion of personal responsibility and the civic duty of all Americans to pay our taxes.

The revenue represented by the tax gap is not a figment of anyone's imagination. It is real money owed—real money that should be included in the federal coffers.

Furthermore, responsible taxpayers are already needlessly overburdened by the tax gap. Noncompliance costs each and every one of them about $2,200 a year.

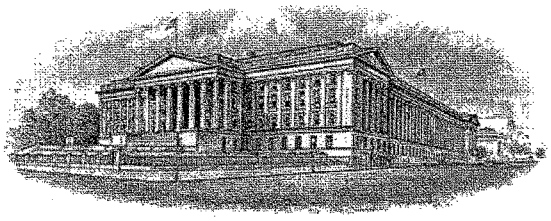
I am encouraged that the President and Department of the Treasury have announced a strategy for reducing the tax gap, and, for the most part, I agree with this strategy. I am concerned, however, that it doesn't go far enough.

According to the Joint Committee on Taxation, the sixteen tax gap-reducing proposals the President put forth in his budget would only raise $19.5 billion over ten years—less than one cent of every dollar included in the tax gap for that same period.

We can and should do more to close the tax gap. According to the IRS, the underreporting of income tax, employment taxes, and other taxes represents about 80 percent of the tax gap. Whether that underreporting is the result of confusion caused by an overly complicated tax code or deliberate noncompliance, Congress, the President, and the IRS should take action to address this part of the problem in a way that is both effective and fair.

In the end, we may not be able to collect every dollar that Americans owe in taxes. But we can do much, much better than we are doing right now. Toward that end, I am hopeful that today's hearing will produce some concrete ideas for a meaningful reduction in the tax gap, and for moving forward as we examine how reducing the tax gap fits in the broader goal of balancing our federal budget.

Chairman Baucus, thank you again for holding this important hearing.



U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR TAX POLICY ERIC SOLOMON BEFORE THE SENATE FINANCE COMMITTEE ON WAYS TO REDUCE THE TAX GAP

Mr. Chairman, Ranking Member Grassley, and distinguished Members of the Committee, thank you for the opportunity to discuss our strategy to reduce the tax gap, including the legislative proposals included in the President's Fiscal Year (FY) 2008 Budget request to Congress.

The vast majority of Americans pay their taxes voluntarily and on time. The voluntary compliance rate is approximately 85 percent. Nonetheless, there remains a substantial difference between what taxpayers should pay and what they actually pay. The IRS estimates that the tax gap was $290 billion in 2001, after accounting for late payments and enforcement activities. Each year, compliant taxpayers are required to make up for this shortfall.

The Administration is committed to reducing the tax gap without unduly burdening honest taxpayers who currently meet their tax obligations. In September 2006, the Office of Tax Policy released a comprehensive strategy (the Treasury Strategy) to reduce the tax gap. This strategy forms the basis for our legislative and IRS appropriation proposals in the FY 2008 Budget, while also emphasizing that any strategy must take into account additional components such as a commitment to research, improvements to information technology, and strengthening taxpayer service.

Magnitude and Source of Tax Gap

In recent months, there has been a significant level of discussion about the tax gap. Much of this discussion has focused on the IRS's release last February of estimates of the tax gap in 2001. These estimates included the results from the 2001 National Research Program (NRP), which examined compliance with the individual income and self-employment (SECA) taxes. The estimates of compliance with other types of taxes were projections derived from older studies.

Before focusing on our proposals, it is important to differentiate between the gross tax gap and the net tax gap. The "gross tax gap" is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time. The IRS estimates that the gross tax gap

was $345 billion in tax year 2001, resulting in a voluntary compliance rate of 83.7 percent. This estimate, however, does not take into account taxes that were paid voluntarily but late, or recoveries from IRS enforcement activities. Taking these factors into account, the "net tax gap" was an estimated $290 billion in tax year 2001, which represents a net compliance rate of 86.3 percent. Thus, $55 billion of the gross tax gap for 2001 is in the government coffers.

These compliance rates are consistent with historical patterns. IRS estimates of voluntary compliance rates have ranged between 80 and 85 percent for over two decades, although research limitations generally prevent us from measuring fluctuations during this time period. The tax gap is not a new problem, and it will not be eliminated overnight.

The tax gap results from a variety of errors, including non-filing, underreporting of taxes, or underpayment of taxes. It is estimated that over 80 percent of the gross tax gap is attributable to underreporting of tax (including underreported income or overstated deductions and credits). Over 40 percent of the gross tax gap is attributable to underreporting of net business income by individuals (affecting both individual income and self-employment taxes).

Noncompliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements. For 2001, it was estimated that 54 percent of net income from proprietors (including businesses, farms, and ranches), rents and royalties was misreported. In contrast, only one percent of tax due on wage income, which is reported by employers and subject to withholding, was not reported to the IRS by return filers in 2001.

IRS data do not reveal the extent to which the tax gap results from intentional evasion rather than unintentional errors by well-meaning taxpayers who are confused by the increasing complexity of the tax law. Determining taxpayer intent during a regular examination is very difficult. For obvious reasons, taxpayers do not concede that their erroneous reporting is intentional, and any analysis of the nature of the error by IRS examiners is inherently subjective. Moreover, complexity provides those taxpayers who are predisposed to taking aggressive positions the opportunity to argue that their errors were unintentional.

It is safe to assume that both intentional and unintentional errors contribute to the tax gap and that any strategy to reduce the gap must address both intentional evasion as well as taxpayer confusion due to the complexity of the tax code.

Treasury's Tax Gap Strategy

These findings suggest the need for a targeted response designed to address the most significant sources of noncompliance. Four key principles have guided the development of our tax gap strategy:

- Unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Sources of noncompliance should be targeted with specificity.
- Enforcement should be combined with a commitment to taxpayer service.
- Tax policy and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to improve tax compliance. Components of this strategy must include: (1) legislative proposals to reduce opportunities for evasion; (2) a multi-year commitment to compliance research; (3) continued improvements in information technology; (4) improvements in IRS compliance activities; (5) enhancements of taxpayer service; (6) simplification of the tax law; and (7) coordination between the government and its partners and stakeholders.

Since release of the Treasury Strategy last September, the Administration has taken a number of steps to implement each of its seven components. The FY 2008 Budget requests $409.5 million in new funding for initiatives aimed at reducing the tax gap. These initiatives include additional compliance research, investments in information technology, enhancements of front-line enforcement activities, and improvements in taxpayer service aimed at increasing voluntary compliance. The Budget also includes 16 legislative proposals designed to reduce opportunities for evasion. In addition, the FY 2008 Budget contains legislative proposals to simplify the tax treatment of families and savings incentives which, if enacted, would help to eliminate some of the complexity that gives rise to unintentional noncompliance.

We have also been working with our partners and stakeholders to develop and refine our tax gap strategy. Commissioner Everson and I held a public roundtable at the IRS last month to discuss ways to address the tax gap. Panelists at the roundtable included a former IRS Commissioner and a former Assistant Secretary for Tax Policy, researchers, and members of organizations representing businesses and preparers. In addition, we have been meeting regularly with Finance Committee staff to discuss and refine our legislative proposals to reduce the tax gap.

Legislative Proposals

As outlined above, development of legislative proposals to reduce opportunities for evasion is one element of our broader strategy to increase taxpayer compliance, improve tax collection, and reduce the tax gap. As presented in the FY 2008 Budget, our compliance legislative proposals fall into four categories: (1) expand information reporting; (2) improve compliance by businesses; (3) strengthen tax administration; and (4) expand penalties. On the front end, the legislative proposals would help to apprise the IRS of the payment of income through third-party information reporting, one of the most effective tools in improving compliance. On the back end, the legislative proposals would increase incentives to comply with existing law through strengthened penalties. The package of legislative proposals includes targeted provisions that, if enacted, would assist the IRS in enforcing the tax law more efficiently and effectively in targeted areas that present risks of noncompliance.

The legislative proposals are designed to reduce the tax gap, not to raise revenue through a change in the baseline against which compliance is measured. In addition, the legislative proposals attempt to reduce the tax gap by making compliance more efficient while balancing the burden placed on compliant taxpayers. If, on the other hand, draconian measures were to be enacted, they could become so burdensome as to detract from voluntary compliance, compounding rather than reducing the tax gap.

Although the legislative proposals set forth an approach toward improved tax compliance, we recognize that they do not come close to eliminating the tax gap. Making collection of the entire tax gap a reality, however, would require universal audits followed by draconian collection practices, imposing prohibitive costs and burdens on taxpayers as well as the IRS, and fundamentally changing the relationship between taxpayers and the government. Through the multi-pronged approach set forth in the Treasury Strategy, however, we can make significant progress in improving compliance.

In addition to the sixteen legislative proposals, the FY 2008 Budget indicates that the Treasury is continuing to develop proposals to improve compliance and reduce the tax gap. In particular, the

Budget mentioned that IRS coordination with State governments could be improved. Under current law, State tax agencies may adjust taxpayer returns in response to an IRS audit. A proposal under development would permit reciprocal adjustments by the IRS in response to a State audit determination. This proposal raises technical issues relating to the assessment limitations period that we are currently working to resolve. Another aspect of Federal-State tax coordination could involve expanded information sharing. In particular, State governments maintain databases in connection with numerous licenses issued pursuant to State law, such as driver's and professional licenses. In some cases, States may suspend certain licensing privileges in connection with State tax noncompliance. Access to such State data could assist the IRS in improving Federal tax compliance. The Treasury Department continues to consider the advantages and disadvantages of these additional proposals to improve tax compliance.

Technical Issues

The President's FY 2008 Budget recommends sixteen changes to the tax code that, if enacted, would improve compliance and reduce the tax gap. Since the Budget was released in early February, members of my staff and I have been meeting regularly with Finance Committee staff to discuss and refine the Administration's proposals and to address a number of technical issues that they present. Those discussions have been useful both in improving the proposals and in helping to highlight the challenges that we face in reducing the tax gap through targeted changes to the tax law. A brief description of some of the technical issues arising under several of the legislative proposals will help to frame the issue and illustrate the limitations of legislative solutions to this problem.

Basis Reporting. One of the Budget proposals would require that brokerage firms report to their customers basis information in connection with the sale of certain publicly traded securities. This proposal builds on section 6045 of the Code, which requires reporting of gross sale proceeds, which must be combined with basis information to determine the tax treatment of the sale. The proposal also builds on a growing trend in the securities industry to provide basis information voluntarily to customers.

The basis-reporting proposal raises a number of technical issues that are derived from the complex treatment of securities sales under our tax laws. Those issues include, for example: (1) defining the universe of "securities" subject to basis reporting; (2) putting mechanisms in place to ensure that brokers subject to the proposal have relevant basis information from both their customers and from issuers of securities; (3) determining basis for so-called "transferred-in" securities that were not purchased through the broker, including securities purchased separately and transferred into a brokerage account, gifts and inheritances; (4) addressing the interaction of the proposal with taxpayer-specific basis adjustment provisions that operate independently of the broker, such as the wash-sale rules in section 1091, the straddle rules in section 1092, and rules requiring capitalization of certain interest and carrying costs under section 263(g); and (5) determining an appropriate effective date to ensures a smooth transition to the new basis reporting regime.

Payment Card Reporting. Technical issues presented by the Budget proposal regarding information reporting on merchant payment card reimbursements also highlight the challenges of our work in this area. Proprietors, merchants, and other business taxpayers frequently receive income through their customers' use of credit or debit cards. While the use of such payment cards creates a paper trail, that trail does not lead to the IRS, unless a revenue agent were to seek it on a case-by-case basis. At the same time, that existing paper trail would make it relatively easy to generate information reports to the IRS, systematically addressing the possibility of unreported income. Because the existing payment-card system routinely delivers exact dollar and cents amounts to the correct payees, often at the speed of electronic dispatch, it is certain that the information that the IRS needs is accessible. Information reports

regarding payment-card reimbursements would result in better compliance by merchants who accept these cards.

Nevertheless, there are numerous technical issues to be addressed. The payment-card system is complex, involving payment-card organizations, merchant acquiring banks, various service providers, and other entities. In the case of a payment card branded with the name of a particular retail chain, the bank may reimburse the retail chain, which in turn may reimburse a franchise proprietor. In this situation, who should obtain the merchant's Taxpayer Identification Number and generate an information report? We have met with representatives of the payment card industry to understand their concerns with the proposal. Many in this industry are concerned with the incremental burden of reporting, including potential duplication of reporting responsibilities, and have requested greater clarity regarding the party responsible for the reporting when there are other agents involved as intermediaries between the banks and the merchants. Others are concerned about how the IRS will use the data. We recognize these concerns and, while the gross reimbursements reported would not be an equivalent to gross income, the proposed information reporting would assist the IRS by providing the merchant's overall volume of payment card sales in relation to expenses claimed and cash transactions reported. The reporting would also assist the IRS in analyzing the accuracy of reporting for payment card sales.

There are also other technical issues presented by the proposal, such as treatment of "charge backs," in which a merchant is debited for the amount that a credit-card company refunded to a consumer attributable to a defective item, as well as payment-card transactions in which a merchant may sell some goods but also provide "cash back" to consumers. The Budget proposal would grant explicit authority to promulgate administrative rules that address such technical complications, by eliminating duplication of reporting requirements and creating exceptions to reporting of amounts that are not useful for compliance purposes.

Erroneous Refund Penalty. Another legislative proposal raising some technical questions is the erroneous refund penalty. Under current law, the accuracy-related penalty that a taxpayer might pay generally would depend on the amount of underpayment of tax. If a taxpayer wrongfully claims a refund, however, there may be no penalty as long as no additional tax liability is attributable to the wrongful claim, as often happens when there has been overwithholding. Consequently, the IRS has observed aggressive behavior that is undeterred by the tax code's current accuracy-related penalty framework, which is geared toward deterrence of reported tax deficiencies. As a practical matter, some taxpayers and their advisors may be taking advantage of the existing penalty structure by aggressively claiming credits that generate refunds, in an effectively risk-free gamble. To address this problem, our proposal would impose a penalty on an unreasonable claim for refund or credit.

The proposal seeks to create a parallel system of deterrence applicable even if the taxpayer is in a refund, rather than a deficiency, procedural posture, thus stemming the tide of aggressive claims that are made without reasonable basis or reasonable cause, regardless of the procedural context. There remain open questions about the scope of this proposal. In addition to refunds, should the proposal cover erroneous claims that purport to reduce tax liability? Should there be a threshold amount below which the proposed penalty would not apply? If a taxpayer were subject to penalties in addition to the proposed penalty, in which stacking order should the multiple penalties apply? Should the proposed penalty apply to excise or other types of taxes in addition to income taxes? The goal of the Treasury proposal would be to assert the highest applicable penalty, without duplication of penalties. In this regard, the Treasury proposal's creation of the new penalty would carve out Earned Income Tax Credit (EITC) refund claims from the scope of the penalty because these claims are already governed by their own compliance regime.

Prison Scam Disclosure Authorization. The Treasury Department's proposal for disclosure of certain tax violations by Federal and State prisoners would allow the IRS to disclose limited information about such violations so that prison officials could deter such conduct through administrative sanctions. Under existing law, when the IRS discovers that prison inmates are making fraudulent refund claims, taxpayer privacy laws do not permit the IRS to share this information with prison officials, who may be most proximately positioned to address this misconduct. While cooperation among law enforcement officials would appear to be reasonable, numerous technical questions have arisen. What information should be disclosed? When would be the proper time for disclosure, during or after an investigation? To whom should a disclosure be made, Federal officials, State employees, or local wardens? What limitations should be imposed on further use of the IRS information? Does the proposal properly preserve prisoner rights?

Collection Due Process. Similar questions may arise regarding the Treasury Department's proposal to amend the Collection Due Process (CDP) procedures as they apply to employment taxes. Employment taxes include employer and employee shares of Federal Insurance Contribution Act (FICA) tax as well as Federal Unemployment Tax Act amounts and income tax withheld from employee wages. Employee FICA shares and withheld income tax constitute the largest portion of employment taxes. These taxes are often referred to as "trust fund" taxes, because employers are supposed to hold them in trust for the government after they are withheld from employee wages. These amounts include Social Security Trust Fund taxes credited to employees, whether or not actually paid to the Treasury.

Unpaid employment tax liabilities are some of the most difficult taxes for the IRS to collect. In some cases, an employer may be able to retain employees and stay in business by paying only net wages, even if he or she cannot pay employment tax. Employment taxes are due quarterly and, when there are successive failures to pay quarterly employment tax installments, they continue to accrual over successive periods resulting in a "pyramid" of liability. In a case like this, employment taxes often pile up while the IRS attempts to collect, ultimately by imposing a levy. Under the CDP provisions in the Code, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative hearing, with judicial review, before levy. In the employment tax context, an opportunity for a CDP hearing must be provided for every quarter that there are unpaid taxes the IRS seeks to collect. By the time this CDP procedure is completed, the employment taxes may have become uncollectible, even if determined to be due by the end of the review.

The Treasury Department's proposal would add employment taxes to the exception that allows a CDP hearing to be held within a reasonable time after, rather than before levy. While collection of employment taxes would be in the best interest of employees and the Federal Trust Fund, there nevertheless may be concerns that amendment to the CDP provision might abridge taxpayer rights. On the other hand, the opportunities available to the taxpayer who in good faith seeks to address an unpaid employment tax balance prior to levy and the urgency of the pyramiding problem are factors that support the adoption of the proposal. To be clear, under the proposal, employment tax returns showing a balance due would not be subject to levy until after the IRS has made several attempts to correspond with the taxpayer regarding the balance due a process whereby taxpayers have several opportunities to contact the IRS and enter into a voluntary payment arrangement prior to enforced collection. Those taxpayers who fail to address payment would be subject to a levy, and would have the opportunity for a post-levy CDP hearing.

We are pleased that a number of the Budget proposals have been introduced and considered in different legislative vehicles this year. We look forward to working with the Committee to address the technical issues so these proposals can achieve their intended purposes.

Regulatory Projects and Other Initiatives

The Treasury Strategy identified our published guidance program as an important component of the multi-pronged strategy to improve compliance. Published guidance clarifies ambiguous areas of the law, increasing voluntary compliance. With the increasing complexity of the tax law, it is more important than ever for us to publish timely guidance to give direction to those taxpayers who make a good faith effort to comply with the law, but have difficulty doing so because of uncertainty in its application. Published guidance is also an important tool to target specific areas of noncompliance and prevent abusive behavior.

Each year, the Treasury Department and the IRS publish a Priority Guidance Plan. The 2006-2007 plan includes 264 guidance projects scheduled for completion between July 2006 and June 2007. Numerous projects are added during the year as new tax laws are enacted or new compliance issues are identified.

Recent published guidance projects that will improve compliance and that target potential areas of abuse include:

Transfer Pricing: We have produced, and continue to produce, significant guidance in the area of transfer pricing. In an increasingly globalized economy, cross-border transactions between controlled entities present significant compliance challenges, making guidance in the transfer pricing area an important part of our administrative efforts to address the tax gap. In August 2006, we issued temporary and final regulations addressing the treatment of cross-border services, and followed them up with additional guidance in December 2006. We issued proposed transfer pricing regulations addressing cost-sharing in August 2005 We intend to finalize both sets of regulations, with appropriate modifications.

Foreign Tax Credit: We have taken strong steps to halt misuse of the foreign tax credit. Last month we issued proposed regulations that would disallow foreign tax credits tied to participation in certain artificially engineered, highly structured transactions. In August 2006, we issued proposed regulations that would address the inappropriate separation of creditable foreign taxes from foreign source income. We intend to make appropriate modifications and finalize both sets of regulations as soon as possible.

Information Sharing: We continue to update and expand our network of tax treaties and tax information exchange agreements ("TIEAs"). We are also renegotiating tax treaties that do not have sufficient limitation on benefits or exchange of information provisions. We are entering into new TIEAs, such as the one signed with Brazil in March 2007, and bringing signed TIEAs into force, with jurisdictions such as the Netherlands Antilles, the British Virgin Islands, and the Cayman Islands. These information-sharing agreements are critical tools for the IRS to combat cross-boarder aspects of compliance.

Private Annuities: In October 2006, we published proposed regulations regarding the Federal tax treatment of private annuity contracts. Recent Congressional hearings have highlighted how taxpayers were applying prior law treatment of these contracts to facilitate abusive private annuity arrangements, often involving off shore issuers. The proposed regulations, when adopted as final, will shut down those arrangements.

Trust Information Reporting: In 2006, we published a series of regulations that provide a comprehensive set of information reporting rules for grantor trusts where ownership interests in those trusts are held indirectly. Historically, taxpayers who held such interests were often unable to comply fully with their tax obligations because they lacked necessary information about the activities of the trust. This project highlights work that can be done administratively to ensure that taxpayers who make every effort to meet their obligations have the information they need to determine and report their liability accurately.

Reportable Transaction Rules: In the American Jobs Creation Act, Congress enacted a number of changes to the statutory rules requiring disclosure to the IRS of potentially abusive transactions, strengthening the IRS' hand in this area. In October 2006, we published proposed regulations that follow prior interim guidance and, when adopted as final, will build on the expanded statutory provisions to ensure that the IRS knows about and is able to react quickly to, emerging problematic transactions.

Conclusion

An effective approach to dealing with the tax gap requires multiple, interrelated strategies. I have discussed the work that the Treasury Department is doing with regard to the legislative and regulatory components of the Treasury Strategy. Each of the multiple components of the strategy is necessary, but none is sufficient in isolation. We look forward to continuing our work with this Committee and others in Congress to implement our strategy and looking for new ways to reduce the tax gap.

Thank you again, Mr. Chairman, Ranking Member Grassley, and other Members of the Committee for the opportunity to appear before you today. I would be pleased to answer any questions you may have.

COMMUNICATIONS

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HEARING BEFORE THE SENATE FINANCE COMMITTEE

Examining the Administration's Plan for Reducing the Tax Gap:
What Are the Goals, Benchmarks and Timetables

April 18, 2007

The purpose of this statement is to bring to the attention of the Subcommittee on Oversight Internal Revenue Service misconduct concerning instructions that produce illegal "**Double or Nothing Taxation**" of the income and recovery related to an itemized deductions, specifically, deductible taxes. Because IRS instruction are not consistent with section 111(a) of the Internal Revenue Code, some taxpayers are defrauded by numerous IRS instructions, at least one of which, the instruction for the calculation of taxable Social Security benefits, goes back to 1984. On the other hand, the bollixed IRS instruction for Line 7 on Form 6251, Alternative Minimum Tax - Individuals, has caused the loss of billions of dollars to the United States Treasury since 1988.

I began raising these issues with the Internal Revenue Service in early 1994 after discovering that my state income tax refund from the prior year was going to reduce my medical expense deduction. That discovery lead to other discoveries that I can best describe as "**IRS's Fraudulent Double or Nothing Taxation of Itemized Deduction Recoveries**". Since 1994 I have had numerous contacts with the Internal Revenue Service employees and officials but IRS has refused to correct the instruction to comply with the Code.

A few weeks after my initial contact with IRS, Professor Matthew J. Barrett of Notre Dame Law School published "Determining an Individual's Federal Income Tax Liability When the Tax Benefit Rule Applies: A Fifty-Year Checkup Brings a New Prescription for Calculating Gross, Adjusted Gross, and Taxable Incomes." I reached the same conclusion as Professor Barrett regarding the tax treatment of itemized deduction recoveries long before I read his article. Our conclusion is that under the Code the gross income as well as the taxable income attributable to an itemized deduction recovery cannot exceed the amount of the recovery. Anyone is free to disagree with this conclusion but I simply ask that they review the section 111(a) of the Internal Revenue Code, "Tax Benefit Rule", a couple of facts presented below and answer the following question.

Here is section 111(a) of the Internal Revenue Code, "Tax Benefit Rule":

Deductions.
(a) Gross income does not include income **attributable** to the recovery during the taxable year of any amount deducted in any prior taxable year to the **extent** such amount did not reduce the amount of tax imposed by this chapter.

Here are the facts:

- An itemized deduction included on Schedule A (Form 1040) can not reduce the amount of gross income reported on Form 1040.

- Inclusion of an itemized deduction recovery in the calculation of taxable Social Security benefits can result in the gross income attributable to a recovery being up to 1.85 times the amount of the recovery.

Here is the question:

Precisely, what is about the language in section 111(a) of the Internal Revenue Code that permits the Internal Revenue Service to issue instructions can result in the gross income attributable to an itemized deduction recovery exceeding the amount of the recovery?

In examining the tax treatment of itemized deduction recoveries, I discovered that fourteen states tax Social Security benefits and include state income tax refunds in the determination of taxable Social Security benefits but exclude the refund from taxable income.

One of the states that taxes Social Security benefits and includes tax refunds and other itemized deduction recoveries in the calculation of the taxable portion of those benefits is Iowa, the home state of Senator Grassley, the Ranking Minority Member of the Finance Committee. Did the Iowa Legislature or Department of Revenue think that nobody would notice the **"Double Taxation"** of the state income tax refund? Montana, the home state of Senator Baucus, the Chairman of the Senate Finance Committee does taxes Social Security benefits but does not include state income tax refunds in the calculation of the taxable portion of those benefits and thus is not guilty of **"Double Taxation"** of the state income tax refund.

Late in 1994, I discovered that IRS instructions exclude the refunds of tax overpayments that provided a tax benefit in a prior year when the regular tax was paid from alternative minimum taxable income (AMTI). This leads to an obvious question:

If the income used for a deductible tax overpayment in a year the regular tax is paid is not include in taxable income and the refund of that overpayment is excluded from AMTI, just when is the income or the refund tax directly?

Based on published estimates of tax refunds reported on Form 6251, the inappropriate exclusion of tax refunds from AMTI has cost the Untied States Treasury billions of dollars since 1988.

Interestingly, the income used for the overpayment is used to reduce medical expense deductions when the regular tax is paid and the refund is used to reduce medical expense deductions when the AMT is paid. **The income used for the overpayment and the refund are the same real income.**

When the two-tier capital gains rate was introduced in 1997, it became possible for there to be a tax benefit from a deductible tax overpayment when the AMT was paid. If the regular tax was paid in the following year, the refund would be taxed at the regular tax rate after the income used for the overpayment **(the same real income)** was taxed at the AMT rate. Obviously, IRS has ignored the law and bollixed the instructions for the tax treatment of tax refunds again. So there you have it. The income/refund related to a deductible tax can be taxed "Double or Nothing" depending on the sequence in which the regular tax and the AMT is paid.

When the AMT is paid in both the tax overpayment year and the refund year and capital gains are taxed at both the higher and lower rates, IRS instructions will produce a zero sum game. The inclusion of the refund in regular taxable income when determining the long-term capital gains will increase the capital gains portion of the AMT and the exclusion of the refund from AMTI will preclude "double taxation" of the refund.

Before launching into a more a more detailed discussion of issues introduced above, I must reveal that I have filed a total of four tax returns on which tax refunds were treated in accordance with the Internal Revenue Code rather than IRS instructions. IRS accepted all four of the returns. I view this as a tacit admission by IRS that its instructions are not in accordance with the Internal Revenue Code.

IRS's Bollixed Interpretation of Section 56(b)(1)(D):
A Multi-billion Fraud on the United States Treasury

In 1999, two letters from me to IRS and two letters from IRS to me were released without my knowledge by IRS as Tax Correspondence and published in *Tax Analyst*.[1] The letter from a respondent in the IRS Office of Chief Counsel presented a detailed response to my concerns about the tax treatment of itemized deduction recoveries. Unfortunately, the respondent seemed to subscribed to the philosophy of John Sears, an advisor to Ronald Regan, "reality is an illusion that can be overcome." Here is how the respondent tried to justify the IRS instruction (currently line 7 on Form 6251) that has produced a multi-billion dollar fraud on the United States Treasury.

> *As stated in prior correspondence we disagree with your assertion that recoveries of taxes described in paragraphs (1), (2), or (3) of section 164(a) should only be excluded from gross income in computing AMTI to the extent deduction of the taxes did not reduce the taxpayer's income tax liability. Under your interpretation section 56(b)(1)(D) would be unnecessary; it would only apply to exclude items from gross income when such items are already excluded from gross income under section 111.*

Comment:

When the respondent's letter was published in 1999 his assertion that a tax deduction taken in a year that the Alternative Minimum Tax(AMT) was paid could not have reduced a taxpayer's income tax liability and therefore the refund should not be included in gross income on Form 1040 was no longer true. In fact, beginning in 1997, a tax deduction claimed on Schedule A (Form 1040) could have reduced a taxpayer's tax liability when the AMT was paid as a result of what I have described below as the limited long-term capital gains rate-based tax benefit which results from the two tier capital gains rate structure. See page 2 of Form 6251. The benefit of a tax overpayment is revealed by application of IRS instructions in Publication 525.

The IRS respondent then stated:

> *Section 56(b)(1)(D) provides that no recovery of any tax to which section 56(b)(1)(A)(ii) applied shall be included in gross income for*

purposes of computing AMTI. By its terms section 56(b)(1)(A)(ii) denies any deduction in computing AMTI for taxes described in section 164(a)(1)-(3). It does not limit its application to taxable years in which the taxpayer is liable for AMT. Because these taxes are never deductible in computing AMTI, recoveries of such taxes are always excluded from gross income, under section 56(b)(1)(D), for purposes of computing AMTI.

Comment:

What the IRS respondent is saying is that section 56(b)(1)(D) provides that refunds of taxes that were allowed as itemized deductions under section 164(a) and as such produced a tax benefit when the regular tax was paid are excluded from AMTI in addition to the taxes that were not allowed as a deduction under section 56(b)(1)(A)(ii) and therefore produced no tax benefit because the AMT was paid.

When the respondent stated, "It does not limit its application to taxable years in which the taxpayer is liable for AMT", he was simply wrong. Section 56(b)(1)(D) means exactly what it says: "no recovery of any tax to which subparagraph (A)(ii) **applied** shall be included in gross income for purposes of determining alternative minimum taxable income". For subparagraph (A)(ii) to have applied to the tax being refunded, payment of the AMT would have been required. Section 56(b)(1)(D) is necessary to appropriately preclude the inclusion in AMTI of a refund of a tax overpayment that produced a limited long-term capital gains rate-based tax benefit in a year the AMT was paid. When the tax benefit is the result of paying tax on less taxable income rather than the result of paying tax at a lower rate on a portion of capital gains, the tax refund must be included in AMTI based on a rational interpretation of the tax benefit rule.

If it were the intent of Congress not to include the refunds of all taxes claimed as itemized deductions on Schedule A (1040), section 56(b)(1)(D) would state the following:

Treatment of certain recoveries
No recovery of any tax claimed as a itemized deduction under subparagraphs (1), (2), or (3) of section 164(a) shall not be included in gross income for purposes of determining alternative minimum taxable income.

But that is not what 56(b)(1)(D) states.

This is a question for the Internal Revenue Service and the Treasury Department to answer:

If a tax overpayment is allowed as a deduction and produces a tax benefit in a year that the regular tax is paid and the refund of that overpayment is to be excluded from alternative minimum taxable income in a year the AMT is paid as indicated by the IRS respondent, just when is the income/refund taxed directly?

IRS's Defective Interpretations of the Tax Benefit Rule, Section 111(a) of the Internal Revenue Code, Produces Double Taxation of Itemized Deductions Recoveries

Section 111(a) of the Internal Revenue Code provides,

Deductions.
Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

Here are two fundamental facts related to the impact of itemized deductions on the taxes paid on an individual's federal income tax return.

- An itemized deduction included on Schedule A (Form 1040) does not reduce the amount of gross income reported on Form 1040.

- The reduction in taxable income attributable to an itemized deduction cannot reduce taxable income by more than the amount of the itemized deduction.

Here are some of the results of instructions related to the Internal Revenue Service's erroneous interpretation of section 111(a) of the Internal Revenue Code:

- Inclusion of an itemized deduction recovery in the calculation of taxable Social Security benefits can result in the gross income attributable to a recovery being up to 1.85 times the amount of the recovery. (Remember, the income used for the payment of the deductible expense could have produced a similar result the a prior year.)

- Inclusion of itemized deduction recoveries in the calculation of taxable Social Security benefits and in adjusted gross income (AGI) or one of the numerous versions of modified adjusted gross income, when calculating deductions, credits, exemptions, exclusions, or eligibilities, can result in the taxable income attributable to a recovery being more than twice the amount of the recovery.

- In the case of some credits, the reduction in the allowable tax credit attributable to a itemized deduction recovery may be many times the amount of the recovery. Take the retirement savings contribution credit for example where a tax refund of only a few dollars can eliminate a $400 credit.

The *National Taxpayer Advocate 2006 Annual Report to Congress* lists 23 provisions, in addition to those cited above with income-based phase-outs.[ii] In addition, there is now the refundable AMT credit provision that was included in late 2006 legislation that is subject to a MAGI phase-out. The effect of including an itemized deduction recovery in the calculation of these items are adverse to the interest of the individual taxpayer in every case.

Here is how the Internal Revenue Service defined the "tax benefit rule", section 111 of the Internal Revenue Code in IRS Publication 525:

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

The Internal Revenue Service omitted a very important word in defining the tax benefit rule. The rule should read to be consistent with the language in section 111(a). You must include a recovery in your **taxable** income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. ...

Parsing the language in section 111(a) of the Internal Revenue Code yields the inescapable conclusion that it must be applied to every provision in the Internal Revenue Code that affects the determination of taxes. When this is done, taxable income will be increased by a recovery by the amount that IRS instructions indicate that is to be entered on either line 10 or line 21 of Form 1040. The Committee should find the 1994 law review article by Professor Matthew J. Barrett of interest with respect to the application of the tax benefit rule. [iii]

If the Senate Finance Committee has any concern about IRS conduct here is a question that the Committee must demand that IRS and Treasury officials answer.

Precisely, what is about the language in section 111(a) of the Internal Revenue Code that permits the Internal Revenue Service to issue instructions can result in the gross income attributable to an itemized deduction recovery exceeding the amount of the recovery? (Remember the inclusion of itemized deduction recoveries in the calculation of taxable Social Security benefits!)

IRS's Interpretation of Section 56(b)(1)(D Yields a Multi-billion Fraud on the Treasury

While the Internal Revenue Service abuses taxpayers with instructions that result in taxes in excess of those permitted under the Internal Revenue Code as described above, other taxpayers are the beneficiaries of a bollixed IRS interpretation of a code section that defrauds the Treasury of the United States.

Here are the applicable sections of the Internal Revenue Code that are relevant to the tax treatment of deductible taxes and tax refunds when payment of the AMT is involved..

Section 56(b)(1)(a)(ii) and 56(b)(1)(D)

(b) Adjustments applicable to individuals
In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax):

(1) Limitation on deductions

(A) In general
No deduction shall be allowed

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a). Clause (ii) shall not apply to any amount allowable in computing adjusted gross income.

(D) Treatment of certain recoveries
No recovery of any tax to which subparagraph (A)(ii) applied shall be included in gross income for purposes of determining alternative minimum taxable income.

Section 164(a)

(a) General rule
Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes

Here two fundamental facts related to tax deductions reported on Schedule A when the alternative minimum tax is paid:

- Deductions claimed for taxes reported on Schedule A (Form 1040) are not allowed as deductions in determining alternative minimum taxable income (AMTI).

- Deductions claimed for taxes reported on Schedule A (Form 1040) may provide a limited long-term capital gains rate-based tax benefit in a year the AMT is paid if the tax deduction increases the portion of capital gains being tax at 5 percent and reduces the portion being taxed at 15 percent. This tax benefit is reveal by application of instructions in IRS Publication 525.

Here are the results of IRS instructions when the AMT is paid in the year of a tax overpayment and the year that the refund of the overpayment is received.

- Provided there is no long-term capital gains rate-based tax benefit, a tax overpayment would have not have produced a tax benefit and the refund in a subsequent year is not included in gross income based on section 111(a) of the Internal Revenue Code.

- However, if there was a limited long-term capital gains rate-based tax benefit, when the AMT is paid, the portion of the refund that produced the benefit would be included in gross income and then appropriately excluded from AMTI by the instruction on line 7 of Form 6251. The refund amount included in gross income would flow to regular taxable income and thus increase the portion of long-term capital gains taxed at 15 percent and reduce the portion taxed at 5 percent thus offsetting the tax benefit from the tax overpayment in the prior year.

- When there is a long-term capital gains rate-based tax benefit from a tax overpayment in a year that the AMT is paid, IRS instructions erroneously include the refund of the overpayment in AGI when calculating a medical expense deduction thus reducing the deduction.

Now consider the result of IRS instructions when there is a tax overpayment and refund and the regular tax is paid in one of the years and the AMT is paid in the other.

- When an itemized deduction is claimed for a tax overpayment in a year that only the regular tax is paid and the refund of the overpayment is received in a year that the alternative minimum tax (AMT) is paid, neither the income used for the overpayment nor the refund of the overpayment is taxed directly because of IRS's bollixed interpretation of section 56(b)(1)(D) of the Internal Revenue Code. The instruction that results from this bollixed interpretation is currently on line 7 of Form 6251. The consequence of this instruction has been the loss to the United States Treasury of billions of dollars since 1988. My estimate of the loss for tax year 2006 is about $500,000,000.

- Even though neither the income nor the refund related to a tax overpayment are taxed directly under the circumstances described above, both the income used for the overpayment and the refund can reduce medical expense deductions. Inclusion of the refund in AGI when calculating medical expense deductions violates section 111(a) of the Internal Revenue Code.

- When an itemized deduction is claimed on Schedule A (Form 1040) for a tax overpayment in a year that the AMT is paid and there is a limited long-term capital gains rate-based tax benefit (under the circumstances described above) and the regular tax is paid in the year that the tax refund is received, the refund will be included in gross income per IRS instructions. Thus the income used for the tax overpayment will be taxed at the AMT rate and the refund will be taxed at the regular tax rate. Based on section 111(a) the refund of a tax overpayment that produced a limited long-term capital gains rate-based benefit should only be include in gross income for the purpose of determining the capital gains portion of a person's income tax in the refund year.

To summarize, based on IRS instructions when the regular tax is paid in one year and the AMT is paid in the other, and there is a tax benefit as a result of a tax overpayment included on Schedule A, the sequence in which the regular tax and the AMT is paid determines whether the income/refund related to the tax overpayment is taxed **"Double or Nothing".** I believe that it was Nina Olsen, the National Taxpayer Advocate, who described the tax treatment of income under the AMT as being "counterintuitive" . I believe that because of IRS instructions a better term would be **fraudulent**.

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

Based on its mission, IRS would have us to believe that under the law all taxpayers are created equal. The reality is based on IRS's conduct, to paraphrase George Orwell, all taxpayers are created equal, but some taxpayers are more equal than others in the eyes of the Internal Revenue Service. If this assessment of IRS attitude were not true, there would be no "**Double or Nothing Taxation**" of the income/recovery related to an itemized deduction.

Anecdotal Experience - Eliminating Double Taxation With an Amended Return

On March 8, 2004, I amended the 2000 and 2001 Federal Income Tax returns for my father, who had died in early 2002, to reduce the taxable income attributable to state income tax refunds on those returns from being more than twice the amount of the refunds to being equal to the refunds. Tax professional were responsible for determining estimated taxes and preparing his tax returns.

Before receiving the second of the two refunds, I received Letter 3175 SC (Rev. 1999). I believe this letter was in response to information that I provided the IRS Office of Chief Counsel and which was reviewed by the Office of Treasury Inspector General for Tax Administration. The letter closed with "Federal courts have consistently ruled against the arguments you have made. Therefore, we will not respond to future correspondence concerning these issues." If the courts have consistently ruled against my arguments, why did I subsequently receive a refund based on my arguments? Examination of the Title 26, United States Code, Annotated section 111 suggests that the courts have ruled in favor of my arguments.

Two days after I filed the two amended returns, March 10, 2004, Newsday reported that Commissioner Mark Everson had announced that he had paid the AMT for the first time. Taxpayers, especially Social Security recipients who have been double taxed on their tax refunds, can only wonder if Commissioner Everson was the beneficiary of the fraudulent instruction on line 7 of Form 6251.

Any continuing failure of the Senate Finance Committee to reign-in IRS's misconduct related to "**Double or Nothing Taxation"** under sections 111(a) and 56(b)(1)(D) will bring into question the commitment of the Committee to effective oversight of the Internal Revenue Service.

I look forward to seeing IRS instructions for the tax treatment of itemized deductions for 2007. They will reveal the Finance Committee's commitment to effective oversight of IRS.

Here is Letter 3175 (SC) (Rev. 2-1999) with notations of errors in the heading.

Department of the Treasury
Internal Revenue Service
1973 North Rulon White Blvd.
Ogden, UT 84404

Taxpayer Identification Number: XX6-XX-XXXX
(The third number in my SSN is not a 6.)
Form: Tax Year(s): Omitted
Person to Contact: Dennis Parizek
Employee Identification Number 29-61699
Contact Telephone Number 1-866-855-9083
(BOGUS NUMBER)
(Correct Telephone Number 1-866-899-9083)
Contact Fax Number: Omitted
Contact Hours: 7 a.m. -7 p.m.

Date: Ddecember 14, 2004 (yes, Ddecember)

William D Kiebschull (Correct spelling is Kebschull)
216 Goucher Way
Churchville, Maryland 21028

Dear Taxpayer(s):

This is in reply to you recent correspondence. Federal tax laws are passed by Congress and signed by the President. The Internal Revenue Service is responsible for administering Federal tax laws fairly and ensuring that taxpayers comply with the laws. We do not have authority to change the laws.

The Internal Revenue Service strives to collect the proper amount of revenue at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency, and fairness. In accomplishing this, we continually strive to help taxpayers resolve legitimate account problems as effectively as possible. While tax collection is not a popular function of government, it clearly is a necessary one. Without it all other function would cease.

There are people who encourage others to deliberately violate our nation's tax laws. It would be unfortunate if you were to rely on their opinions. These persons take legal statements out of context and claim that they are not subject to tax laws. Many offer advice that is false and misleading, hoping to encourage others to join them. Generally, their advice isn't free. Taxpayers who purchase this kind of information often wind up paying more in taxes, interest, and penalties than they would have paid simply by filing correct tax returns. Some may subject themselves to criminal penalties, including fines and possible imprisonment.

Federal courts have consistently ruled against the arguments you have made. Therefore, we will not respond to future correspondence concerning these issues.

Sincerely yours,
Facsimile signature for Dennis Parizek
Operations Manager
Exam SC Support
Enclosure
Publication 2105

Letter 3175 (SC) (Rev. 2-1999)
Cat. No. 26859J

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[i] Tax Analyst,Tax Notes Today ,March 18, 1999 Thursday, Department: Official Announcements, Notices, and News Releases; IRS Tax Correspondence, Cite: 1999 TNT 52-53. HEADLINE: 1999 TNT 52-53 Taxpayer Irate About IRS's Position on AMT and Tax Benefit Rule (Section 111 -- Tax Benefit Recovery Items;) (Release Date: DECEMBER 08, 1998) (Doc 1999-10275 (28 original pages))

[ii] National Taxpayer Advocate 2006 Report to Congress, Table 2.4.1, pp. 473 – 476.

[iii] Matthew J. Barrett, "Determining an Individual's Federal Income Tax Liability When the Tax Benefit Rule Applies": A Fifty-Year Checkup Brings a New Prescription for Calculating Gross, Adjusted Gross, and Taxable Incomes" Tax Analyst, Tax Notes Today Cite: 94 TNT 87-34, May 5, 1994

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Written Testimony Submitted by

Kristie Darien, Executive Director
The National Association for the Self-Employed

"Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?"

Senate Committee on Finance

April 18, 2007

Introduction

The goal of increased tax compliance is one that is shared by citizens, legislators and businesses big and small. No taxpayer wants to pay for another's free ride. This goal becomes increasingly important as we begin to take a hard look at our nation's fiscal state. As we take the necessary steps to readjust our financial priorities, we must make certain the path we choose is balanced and effective, rather than detrimental to those sectors contributing most significantly to our economic stability and growth. The micro-business community is one of these important sectors, rich in job opportunities and the capacity for revenue growth.

The Internal Revenue Service and the micro-business community are well acquainted with each other. A chief complaint of the self-employed and micro-businesses is the lack of a fair and level playing field, which would allow them to compete equitably with other businesses. Equity in the tax code, clear and simple regulations, and accurate tax reporting and compliance is extremely important to micro-business. They cannot compete with those receiving additional benefits or deductions via the tax code, those able to afford accountants or a whole team of tax specialists, or those willfully disregarding their tax liability. Thus, our community also has an interest in addressing the issue of the tax gap and increased tax compliance.

Currently, the self-employed and micro-business communities face an unfair tax code which gives preference to larger businesses and specific industries. Additionally, the cost and overwhelming regulatory burden in complying with complex IRS regulations negatively affects their business. According to the General Accounting Office, a small business owner faces more than 200 IRS forms and schedules that could apply in a given year. Vague and complex rules and forms can mean the demise of their business. According to a study by the Tax Foundation, in 2005 individuals, businesses and nonprofits spent an estimated 6 billion hours complying with the federal income tax code, with an estimated compliance cost of over $265.1 billion. Businesses bear the majority of tax compliance costs, totaling nearly $148 billion or 56 percent of total compliance costs.

Despite the time and cost spent on compliance, a tax gap still exits and there have been numerous proposals by the Administration and in Congress regarding how to effectively increase compliance and minimize the tax gap. In review of current tax gap recommendations, we note two key deficiencies. First, current proposals presented in the Administration's FY2008 budget are frameworks or ideas which lack specifics as to how these ideas will be implemented and how the information obtained will be used in coordination with enforcement activities. In order to determine their potential effectiveness and impact on small business, we need to find out the details of these proposals presented to Congress. Secondly, a significant component overlooked is the cost to government to implement these proposals. All expand current systems or create new regulations which will require additional manpower, infrastructure and technology.

Without data on cost, we are unable to determine whether the reported return on investment of these recommendations would be worth the cost to implement them.

Based on the information we have access to, the National Association for the Self-Employed would like to highlight some pros and cons of a few of these proposals and include alternate recommendations to increasing compliance.

Increasing Information Reporting on Payment Card Transactions

The Administration has proposed in their FY2008 budget an increase in information reporting by requiring credit and debit card issuers to report to the IRS annually on aggregate reimbursement payments made to businesses. Capturing information can have a positive impact particularly in light of those taxpayers who consciously choose to avoid reporting income. However, based on the information at hand on this recommendation, the NASE believes that this particular proposal could have a negative impact on the self-employed and small businesses. The main concern is what would be done with the information that is provided.

The IRS has indicated that this information could be utilized to create industry profiles, taking the total credit card receipts reported for a particular business and then extrapolating total income based on industry averages. If these profiles stemming from credit card receipts were then used to make judgments regarding other items on the tax return such as estimations on cash payments, problems will arise. The averages will only provide additional discrimination against those businesses that have higher than average credit card receipts. That higher average could be a function of the affluence of their community, their own efforts in managing the cash flow of their business and even their own decision of whether to accept a particular credit card. It will be very difficult to determine an applicable average for a particular small business that is relevant. Therefore, any action taken by the IRS based on these profiles such as examinations, requests for additional information or even tax assessments would be both burdensome to micro-business and most especially, could be irrelevant and frivolous.

Another concern regarding this proposal is that these amounts are most likely already reported anyway. The taxpayer who willingly underreports income would not knowingly choose to exclude credit card receipts since those items show up on their bank statements anyway. It is clear that the sales via credit cards are well documented and would be revealed upon review and therefore it is unlikely that those amounts would be the key source for intentional underreporting. Additionally, this new level of regulatory burden place on credit card issuers will likely lead to increased fees being passed on to businesses which conduct credit card transactions. Increased fees will have a negative impact on revenues and sales of micro-business owners.

Therefore, the NASE is concerned that this approach may not be targeting the source of underreporting and could serve to increase the costs associated with credit card usage

without identifying any additional taxable income that would not have already been reported.

Requirement on Businesses to Obtain and Verify a Certified Taxpayer Identification Number for Contractors

Under the current system, businesses that pay contractors (non-employee providers) $600 or more for services in a calendar year are required to file an information return (Form 1099) to the IRS and contractor at the end of the year. The information on that return is not verified by the IRS.

In the FY2008 Budget, the Administration recommends that a contractor be required to furnish to the business (on Form W-9) the contractor's certified Taxpayer Identification Number (TIN). The business would then be required to verify the contractor's TIN with the IRS, which would be authorized to disclose for this purpose only, whether the certified TIN-name combination matches the IRS records. If the contractor fails to furnish an accurate certified TIN, the business would be required to withhold a flat rate percentage of gross payments to that contractor.

The NASE supports the requirement of a TIN number to be furnished by the contractor to the business on Form W-9. However, we have trepidation regarding the requirement on businesses to verify a contractor's TIN and withhold if it is inaccurate. Our concern lies in the lack of specifics as to what type of system the IRS plans to set up for businesses to fulfill this requirement. A system with substantial paperwork for requests and long wait times to receive needed approvals would impair businesses and self-employed contractors. If the IRS produces a user friendly, quick response TIN-name match system via online or phone, then the NASE would have minimal objections to this proposal. However, the NASE feels that there is still the potential for increased compliance issues due with this system. The Department of Treasury is asking business owners to be in part IRS compliance officers, a role for which they are not trained for. The additional regulatory burden could cause an increase in unintentional errors if Taxpayer Identification Numbers or names are accidentally reported inaccurately by business owners, contractors and the IRS.

Voluntary Withholding at the Request of Contractors

Included in the above proposal, is the creation of a voluntary withholding system. Contractors receiving payments of $600 or more in a calendar year from a business could require the business to withhold a flat rate percentage of their gross payments, with the flat rate of 15, 25, 30, or 35 percent being selected by the contractor.

The extensive regulatory burden and compliance hurdles this provision would create would significantly hurt the micro-business community and create a disincentive to utilize contractors. Additionally, this voluntary withholding system would undermine the quarterly estimated tax payments system currently in place for independent contractors and transfers the compliance burden from the contractor to another business owner. The NASE opposes implementation of this provision or any provision instituting additional

withholding regulations and believes this would further hurt rather than enhance compliance amongst the micro-business and self-employed communities.

Less Burdensome Approaches to Compliance

The overall goal of the Administration and Congress is to increase tax compliance and minimize the tax gap. It is not possible to completely close the tax gap. There will always be those who employ tax shelters, willfully do not comply, or inaccurately report their income. The goal should be to find ways to increase compliance without negatively affecting businesses to the extent that they are unable to manage cost and regulatory burden and must close their doors.

Key elements of the tax gap are the underreporting of income and concern of the accuracy of cash payments reported on tax returns, particularly amongst sole proprietors. Under current practices, checks made out to corporations must be deposited and cannot be cashed. The NASE recommends extending that practice to sole proprietor requiring that payments they receive for goods and services in the form of a check must be deposited and cannot be cashed at financial institutions. The expansion of this practice would increase the documentation of revenues and lessen potential underreporting.

Additionally, the NASE recommends modifying the Form 1040 Schedule C form in a manner that may encourage further compliance. First, in Part 1 of the form, alter line item 1 for gross receipts/sales to request two separate line items: one gross receipts/sales for credit/debit card transactions and the other gross receipts/sales for check and cash transactions. Visibly requiring the taxpayer to list separately their cash/check transactions may trigger the necessity for them to accurately track these payments and incorporate them into their tax return. Additionally, it offers to the IRS additional data on the types of transactions being conducted by businesses.

Second, in Part 2 of Form 1040 Schedule C, line 11 allows sole proprietors to include and deduct the payments they made to contractors over the year. We recommend the inclusion of a check box accompanied by a statement indicating that they have complied with the 1099 filing reporting requirement (i.e. "Check the box if you have filed Form 1099's for all contractors which have provided $600 or more in services to your business this year.") If business taxpayers do not check the box, they are not allowed the deduction for contract labor.

These two minor adjustments to the Form 1040 Schedule C would encourage additional compliance, increase pertinent data for the IRS and minimally burden micro-business owners.

Service vs. Enforcement

The IRS has made positive changes over the past years through taxpayer education and outreach efforts. The NASE supports increased funding for the IRS to allow to properly enforce current tax regulations and provide taxpayer compliance assistance. Our concern is with the large scale shifting of resources from taxpayer education and services to enforcement. In the FY2008 budget proposed by the Administration, the IRS will receive additional funding for enforcement services. We have already seen in the previous two years an adjustment of financial resources and manpower by the IRS from education to enforcement. IRS Commissioner Mark Everson has indicated that the IRS model is education plus enforcement equals compliance. However, we feel that the balance between education and enforcement is clearly changing to focus more heavily on enforcement.

The NASE feels that any recommendations seeking to increase compliance and lessen the tax gap should also seek to refrain from increasing the regulatory burden on taxpayers. We believe that ensuring comprehensive, effective taxpayer services is essential to accomplish taxpayer compliance. The more taxpayer education assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. However, increased enforcement at the expense of taxpayer education will not in the long term accomplish sustained, improved compliance.

The NASE supports the utilization of federal programs such as the Small Business Development Center program, the Women Business Center program and SCORE to assist in taxpayer education services. These programs provide direct assistance to current business owners and future entrepreneurs and could play an invaluable role in efforts to increase tax compliance.

Conclusion

The NASE supports proposals that are fair and reasonable to address the issues of the tax gap and to increase tax compliance. The complexity of the IRS tax code is particularly troublesome for the self-employed business owner and is a snare for unintentional noncompliance. Vague rules and poorly defined regulations understandably result in mistakes. We believe efforts to address the tax gap and compliance must focus on overall simplification, eliminating issues of inequity within the tax code, and enhancing taxpayer education and outreach. The majority of small business taxpayers want to comply with existing tax laws, thus making tax regulations easier to understand is the most effective and equitable way to improve compliance and to reduce the tax gap.

Additionally, as we review current proposals to address the tax gap, we see that they solely focus on business to business transactions. Business to business transactions are already highly regulated and have substantial reporting requirements. A large area of potential non compliance and underreporting stems from business to consumer transactions. These dealings are currently not subject to reporting requirements and the

creation of those requirements would likely be prohibitive to consumers and politically unappealing to legislators. However, we feel that it is not possible to have a striking change in the tax gap without addressing business to consumer transactions.

In our efforts to increase tax compliance and minimize the tax gap, it is essential we work together to ensure that our actions do not have a lasting, negative impact on our nation's economy. The NASE believes that our collective focus should be on supporting efforts for survival, growth and innovation of micro-businesses and the self-employed as a foundation for long-term economic vitality.

Leslie Peralta
PO Box 41275
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408/401-1221

STATEMENT FOR THE RECORD and
LETTER TO SENATE FINANCE COMMITTEE

May 1, 2007

Senate Committee on Finance
ATTN: Editorial and Document Section
Room SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200b

Re: IRS Testimony Before This Committee, April 12, 2007;
Treasury Secretary Paulson and Treasury Assistant Secretary for Tax Policy
Eric Solomon Testimony Before This Committee, April 18, 2007

Hon. Senate Committee:

I watched with great interest the above referenced hearing of April 12, and downloaded the subsequent testimony of April 18 before this committee, also as referenced above, all relative to ways to reduce the federal tax gap.

According to Secretary Paulson's testimony, in pertinent part for purposes of this statement, he testified:

> "The budget we put forward for 2008...requests new funding for...research...and targeted enforcement. We ask for your help in working with the Appropriations Committee to make sure the IRS has the resources it needs to improve compliance...we need to know more about the specific sources and causes of the tax gap so we can focus our efforts more precisely...the vast majority of the tax gap was attributable to underreporting of income...It's unclear whether this underreporting is the result of deliberate deception...To substantially improve compliance in this regard, Congress would have to mandate additional requirements...By capitalizing on the direct and indirect effects of IRS enforcement...we can make measurable progress toward reducing the tax gap without adversely affecting already compliant taxpayers...It is critical that we manage expectations and view efforts to reduce the tax gap over the

long-term and with a clear understanding of both the costs and the benefits of any action."

According to Secretary Paulson's testimony, my interpretation of that testimony is that he is clearly interested in recovering tax revenues the federal government is legitimately entitled to, and testified that, to achieve that objective, his Department (IRS Division) is desirous of additional funding for research and targeted enforcement, that the Department needs to know more about the specific causes of the tax gap, that the Department needs to improve compliance in this regard, that he is desirous of IRS enforcement with respect to collection which will result in reduction of the tax gap, without harm to already compliant taxpayers, and finally that he is interested in achieving these goals and objectives with a critical eye on the cost-benefit factors involved.

As an American taxpayer (compliant), I agree.

That is why I am baffled as to why, when a private citizen and taxpayer such as myself contacts the Department, on advice of my SBA small business counselor, and proposes to the federal government to assist in its mission of tax revenue collection a minimal to no cost method, available for implementation to the Department immediately within the framework of their existing resources and personnel, and which method achieves the goals and objectives Secretary Paulson refers to in his testimony, the IRS responds that they will not use the method. How can IRS management, as a division of Treasury, be so in conflict with the Secretary's stated intentions?

For the record:

On advice of my SBA counselor, I wrote a letter to former Treasury Secretary John Snow in May 2006, referring to a new method to assist the federal government with respect to recovery of outstanding tax revenues in lien status I had developed while studying Intellectual Property Law at the University of California at Berkeley in 2004-2005 (US Pat. App. No. 11/336,576). The method is articulated in detail in its patent application, however, simply and very briefly stated, and for the Committee's convenience, it is carried out as follows (the essence of the invention):

1. A property owner initiates a property transaction (sale, refinance, transfer, other).

2. When title on subject property is run, any outstanding liens on subject property which are liens by parties other than a regulated entity such as a regulated financial institution, will be subject to such lienholder being checked for outstanding tax liability. This will be accomplished by the settlement agent (title insurance company, attorney at law, mortgage broker, etc.) checking on such current liability, either via direct contact with the IRS and state of residence taxing authority, or utilizing the subject county recorder, who will contact subject taxing authorities, and will be by telephonic or electronic means, or both.

Statutory Authority: Internal Revenue Code Section 6320 et seq., State and Local corresponding authorities; the Uniform Tax Lien Registration Act, US Constitution, Article IV, Section 1; and any and all other applicable legal authorities.

3. Upon locating a tax lien against such lienholder on subject real property, should such an outstanding obligation exist, the settlement agent is required to withhold such tax lien amount from subject lienholder's proceeds and remit same to governmental taxing authority entitled to such outstanding revenue. Should there continue to be a balance due by said lienholder after subject transaction closes, the government shall file an amended tax lien, reflecting the new balance which continues to be due. Conversely, should the proceeds exceed the amount due subject governmental taxing authority, that/those governmental taxing authority(ies) shall be paid first, with the balance, if any, being remitted to said lienholder.

As a result of the above new method, tax lien revenues such as these which are impossible for IRS to locate and are otherwise uncollectable due to real property in escrow being owned by a party entirely separate and unknown to IRS with respect to collection and asset searches, as IRS could not possibly make the connection without the method, are now easily settled, either fully or partially, without the government taxing authority incurring any new costs such as additional personnel, etc., as the personnel needed to perform the lien check certainly exist within such taxing authorities, and settlement agents simply withhold and remit to the governmental taxing authorities said escrow proceeds the government has a legal right to, the statutory authorities having been described above.

* * *

Method Background/History

The method I invented to assist the federal government (as well as state and local governments, though the IRS is clearly the largest beneficiary of the method) as indicated above resulted from the following experience, summarized as briefly as possible here, and for background and informative purposes, prior to continuing the main portion of the statement for the record.

In 2002, a small lien ($2,795) was placed on my real property (principal place of residence) in California as a result of a legal dispute. The lienholder, an out of state attorney, proceeded to domesticate the judgment and attach my property. In 2003, I refinanced the property and, naturally, this lien appeared on the title. Though this is the normal course of business in such situations, problems arose when I went to close escrow, and at the signing, noticed the HUD-1 Settlement Statement contained this item as a debit, of course, however the amount claimed was approximately $700 in excess of what the courts in both states had ordered, even with interest included. I declined to close escrow until the lienholder reduced his demand to what the courts had legally allowed, and no more. He refused – and so did the title company. I

informed the title company that what they were doing was clearly illegal, amounting to altering a court judgment. They refused to change the amount of proceeds they intended to withhold from my property transaction on his behalf, and as a result I then advised them that their services were terminated. This necessitated my locating another title company to conduct the escrow, one which would obey the judgment exactly. Ultimately, that is what occurred (I reported the first title company to the California Insurance Commissioner's Office), and escrow finally closed. This wasn't the end of the matter, however, and what I subsequently discovered about this lienholder led me to create the method I designed to assist the governmental taxing authorities recover tax revenues in lien status.

In 2004, I searched the Secretary of State's Office public database, in the location of the above-referenced lienholder on my property, to inquire if a lien had ever been filed against this individual. I immediately found:

a) An outstanding 1996 Federal Tax Lien in the amount of over $6,000;

b) An outstanding 1996 State Tax Lien in the amount of nearly $3,000; and

c) An outstanding 1996 Municipal Tax Lien totaling approximately $100.

In other words, this person owed, dating back to 1996, over $9,000 in government tax liens then (likely double that now), yet filed a lien on my real property in 2002, concealed this asset from the government, and walked off with over $3,000 in unreported cash proceeds when my escrow closed, without ever paying a cent toward his tax liability. And to date, he never has; those liens remain outstanding and unpaid. For the record, I contacted the IRS back in 2004 numerous times to report this. No response whatsoever, despite their enforcement claims and even website information to this effect. They did nothing. This is unacceptable.

As I have long suspected, and as Treasury Assistant Secretary for Tax Policy Eric Solomon acknowledged in his April 18 testimony, "...The IRS estimates that the tax gap was $290 billion in 2001...Each year, compliant taxpayers are required to make up for this shortfall."

Under Internal Revenue Code Sections 6321, 6322 and 6323, the authorities cited on the Notice of Federal Tax Lien, the language clearly states:

> *"As provided by sections 6321, 6322, and 6323 of the Internal Revenue Code, we are giving a notice that taxes (including interest and penalties) have been assessed against the following-named taxpayer. We have made a demand for payment of this liability, but it remains unpaid. Therefore, there is a lien in favor of the United States on all property and rights to property belonging to this taxpayer for the amount of these taxes, and additional penalties, interest, and costs that may accrue."*

It is this specific area of the law, 6320 et seq. of the Internal Revenue Code, as well as the exceptions contained within Section 6103, that I based the method on and designed it around for the federal government, with the objective of assisting Treasury in its mission of tax revenue recovery after my own personal experience led to the realization that likely this type of situation in fact occurs, and possibly to a substantial extent, the implications of which may be highly significant to the IRS with respect to missed revenue readily available for collection simply by applying existing statutory authority Congress has long since authorized and enforcing it. Tax debts of this nature, in particular, are, absent any taxpayer disclosure of this contingent asset the federal government has every right to attach based on 6320 et seq., impossible for the federal government to collect on without the use of a method such as proposed by the undersigned, due to the fact that, by default, they are undetectable and therefore uncollectable. The reason for this invisibility is that the subject property in escrow, from which such escrow proceeds will be paid to the described lienholder, does not belong to the delinquent taxpayer, and further such property is owned by a party who has no ownership relationship with the delinquent taxpayer (lienholder). As a result, when IRS agents and collectors look in all the usual places for assets (property, bank accounts, etc.), they are entirely unable to ever locate this type of an asset, short of using the method, because it is hidden by default. Though the lienholder, by law, has every right to encumber the real property of another by way of a legally existent lien in his/her favor, currently only the "honor system" of voluntary disclosure by that taxpayer the IRS uses by way of its standard "permission" forms could ever locate such an asset, if only such a lienholder/taxpayer would disclose this asset and its location, which by law belongs to the Government, not that lienholder (IRC 6321, 6322, 6323). That will never happen, and the IRS and/or its collectors could not possibly ever, short of using the method, even remotely locate this type of an asset. Using my real-life case as an example, in order to have known about and timely collected the $3,000 the lienholder collected from my escrow proceeds and that IRS had every legal right to attach, the IRS would have had to imagine that this taxpayer, who at that point owed approximately $10,000 in 2003 to IRS alone, had a lien on my real property, and further that my real property was located in another state, and that it just happened to be in escrow and if they could get to it in time before escrow closed, they might collect it. The IRS has not ever done this, but with the method, which does the work for them, they now can.

The above is at least one answer to the problem of the ever exploding federal tax gap, as Secretary Paulson testified he is interested in determining the reasons for. It is an extremely effective way, at minimal to no cost, to let the everyday escrow process, occurring countless times every business day in the US, do the work for the agency and collect this revenue for the federal government, which it has every legal right to collect.

* * *

In late June 2006, an IRS employee by the name of Joe Magana in Chicago contacted me and indicated he had been assigned the matter of my May 5, 2006 correspondence from the Treasury Secretary's office for follow up. Thereafter, Mr. Magana contacted me but once about the method, and never followed up any further. Further, he failed repeatedly to respond to phone messages. As a result, in August 2006, I sent a follow up letter on the matter, this time to Treasury Secretary Paulson's Office, as well as the Commissioner of Debt Management Service, also part of Treasury, as the method, in my opinion, appears to be much more consistent with collection by that particular division of Treasury. I received a response from Debt Management Services in September 2006, informing me that someone from IRS would be in contact with me on the matter.

In October 2006, I received, inexplicably, a form letter from IRS' campus operations center, stating that it was in response to my August 2006 correspondence as indicated above, and warning me about the consequences of those who do not pay their taxes (I did not have any outstanding tax liability), that my August 2006 correspondence was a frivolous tax submission with no merit, that I could face jail and fines for making such arguments, the "argument" being the August 2006 letter I sent to Treasury on use of the method to assist the IRS in its mission. At this point in time, I requested the assistance of the office of my California Senator, Hon. Barbara Boxer. I was advised that they would look into the matter.

In November 2006, I finally received a response from IRS, this one also purporting to respond to my letters to Treasury. It was from Joe Magana, the individual identified above, advising me to submit my proposal on an unsolicited proposal basis. I had already informed Treasury in my August 2006 letter that while I was certainly aware of the unsolicited proposal process, it was my opinion that the method did not fit that approach, as the method itself is a process not to be performed by an outside contractor, but within the agency itself, for its own use. Nonetheless, since it appeared the matter was perhaps finally going somewhere, I contacted the individual named as a contact on this particular letter, one Frank Trotta in IRS Procurement in Oxon Hill, MD. Mr. Trotta was cordial and advised me to send the proposal to his attention. I did so, but intentionally sent an incomplete package, as I was concerned, based on the October letter from IRS, as to the competence of those handling the proposal, and without written assurances it would be treated competently and with appropriate care. This was due to the fact that I intended to share with IRS my actual patent application, which clearly contains extremely confidential information, and which patent application included a non-publication request with the US Patent and Trademark Office. I received a response back from the IRS Director of Procurement Policy, Tim Shaughnessy, indicating that IRS would not sign a nondisclosure agreement with respect to the method, but that if the complete proposal was submitted in its entirety and consistent with FAR Subpart 15.609, it would be considered. In mid-December, I submitted such a proposal to IRS Procurement. In late December, I received word from Senator Boxer's office that they had been advised that the matter had been assigned to IRS' Collection Policy function for evaluation, and that that evaluation would include the assistance of IRS' Office of Chief Counsel. Finally, I believed the proposal was in the right hands and would be competently evaluated. Not so.

In January 2007, I received a call from Catia Ellsworth of IRS' Office of Procurement Policy (Mr. Shaughnessy's staff). Ms. Ellsworth is a very polite, pleasant individual at IRS to deal with, a

credit to the agency. She informed me that though the intention had been to respond to the proposal by the first week in February, the staff attorney assigned the matter was now out indefinitely due to a serious injury and the matter had to be reassigned to another individual, who needed a 60-day extension. As a result, the estimated response due date was now estimated to be sometime in April.

On April 9, 2007, I finally received the IRS response to the unsolicited proposal, as summarized for the Committee above. It was a rejection of the method based on "statutory" and "practical" reasons, as follows:

Statutory reasoning: The evaluator cited but one section of the Internal Revenue Code, specifically 6103, as the sole legal basis for rejecting the method and in an attempt to defeat it. This is an entirely erroneous application of 6103 by the evaluator, for the following simple reason:

Though 6103 does prohibit unauthorized disclosure of tax return and liability information generally, the evaluator clearly did not find, failed to properly apply, or chose to omit, the critical exceptions contained within that same code which I, as previously stated in this document, based the method on and designed it around for the government's use in collecting these hidden revenues, which the government has every right to. Specifically, IRC 6103(k)(6)-1 unequivocally states, in pertinent part:

> (a) **"In connection with the performance of official duties relating to any...collection activity...under the internal revenue laws...an officer or employee of the Internal Revenue Service or Office of the Chief Counsel therefore is authorized to disclose taxpayer identity Information (as defined in section 6103(b)(6)[noted below], the fact that the inquiry pertains to the performance of official duties, and the nature of the official duties in order to obtain necessary information relating to performance of such official duties or where necessary in order to properly accomplish any activity described in subparagraph (6) of paragraph (b) of this section [included below].** Disclosure of taxpayer identity information to a person other than the taxpayer to whom such taxpayer identity information relates or such taxpayer's legal representative for the purpose of obtaining such necessary information or otherwise properly accomplishing such activities as authorized by this paragraph should be made, however, only if the necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably by obtained in accurate and sufficiently probative form ***or in a timely manner, and without impairing the proper performance of the official duties, or if such activities cannototherwise properly be accomplished without making such disclosure."***[1]*;*
>
> **(b)(3) "To establish or verify the liability...of any person...for any tax...under the internal revenue laws or the amount thereof to be collected;**

[1] Certainly, given the fact that a real property escrow process is underway, and that such process is inherently time-limited, the ability of the IRS to collect on such proceeds which are otherwise payable to such delinquent taxpayer, who has failed to disclose this asset to IRS, falls within this disclosure exception.

> **(b)(6) "To establish or verify the financial status or condition and location of the taxpayer against whom collection activity is or may be directed, *to locate assets in which the taxpayer has an interest*, to ascertain the amount of any liability described in subparagraph (3) of this paragraph to be collected, or *otherwise to apply the provisions of the Code relating to establishment of liens against such assets, or levy on, or seizure, or sale of, the assets to satisfy any such liability;***

Clearly, 6103 **does** contain the legal exception regarding disclosure and allowing IRS to collect the revenues described in the proposal they improperly evaluated. They need to enforce the authority long ago granted them by Congress. Additionally, I have located case law to support this position, and which case law also defeats their non-existent "interpleader" action concerns, another non-credible excuse they included in an attempt to resist use of the method.

I was stunned, when watching C-Span's April 12 hearing involving this Committee and IRS Commissioner Everson and a member of IRS' Office of Chief Counsel, Eileen O'Connell, that Ms. O'Connell actually testified, in response to a request from Senator Grassley for certain documentation from the agency, that only if "appropriate" would she provide him the requested information. When asked by the Senator why it could possibly not be appropriate, she also cited 6103 to him, and its prohibitions with respect to disclosure. In reality, that testimony was incomplete and a half-truth. Certainly, IRS Chief Counsel knows this. The fact is, 6103, in addition to the legal exceptions cited above, and in response to Senator Grassley, also contains the following exception: ***the 'material interest' exception under the Code permits the disclosure of returns and return information to specific persons with a material interest in the information.***[2] If the federal government representing American taxpayers on the whole, represented by a senate committee investigating the agency, doesn't have a material interest, I don't know who does. Thus, the Senator's request was proper; the Chief Counsel's response was not; it should have included reference to this exception, and compliance with the request as a result.

"Practical" reasoning: The "reasoning" provided here is almost an embarrassment to the agency to have stated such "reasons" in writing, but they did anyway. They are unacceptable, entirely non-credible, and are as follows, in a nutshell: IRS' problem, as they see it, is that they do not have consistently cordial relationships with state and local government agencies, and that in proposing such a relationship for purposes of the common goal of revenue collection, I ignored the "independence" of these jurisdictions. This is ludicrous. IRS' own website touts its various partnerships and programs with state and local agencies for tax collection cooperation. It is completely inappropriate, therefore, for this IRS evaluator to have attempted to reject the method on such a trivial, unchecked assumption basis. In other words, forget about recovering substantial amounts of tax revenues readily available under the method, because some at IRS don't get along with some at state and county governments. Nonsense. State and county governments are ever in need of additional revenue, and would be pleased to cooperate, in particular to earn filing fees. IRS also remarkably claimed that they didn't want to use the method because some counties require payment in advance for filing tax liens. What? Is IRS actually stating in writing that they actually do not file tax liens because they are

[2] Source: Internal Revenue Bulletin, June 7, 2004; Revenue Ruling 2004-53

required to pay the $10 fee for such filing in advance? That is unbelievable, and, if true, extremely irresponsible and unjust to taxpayers who do pay and carry such tax evaders. However, let us consider that for a moment:

It typically costs $10 per UCC Financing Statement, which is where IRS files a Notice of Federal Tax Lien at the state level, with the Secretary of State. Using my real life case as an example, the subject lienholder walked off with over $3,000 in unreported escrow proceeds*, which he retained in full and never paid a cent toward his seven-year old tax liability to IRS and his home state. If IRS had recovered that $3,000 using the method described in the proposal to IRS, that is a 3,000% return on the $10 investment. 3,000%. I know Treasury Secretary Paulson has an extensive Wall Street background, and can certainly appreciate a 3,000% return to the federal government/taxpayer.

**Even if settlement agents ever reported these proceeds to IRS, it would not serve the agency with respect to collection, as the lienholder/delinquent taxpayer would have long since received and retained such payment; the IRS would simply end up in the same collection process with respect to these proceeds its experiences now, with its dismal 6% recovery rate. This is precisely why the method seizes the proceeds at close of escrow.*

Further, the method, in its preferred embodiment, does not even require (though it certainly allows and illustrates) the settlement agent to locate a UCC Financing Statement, which $10 fee this IRS evaluator conveys the agency is unwilling to pay – it directs that settlement agent to perform the tax lien search on any lienholder on the subject property who is other than a regulated financial entity/institution, via telephonic (800 number) or electronic means, or both, with IRS and, if located, to withhold those proceeds and remit same out of escrow to IRS. This costs the agency nothing; it need only respond to the telephonic and/or electronic inquiry in the affirmative (providing the current lien payoff amount) or negative. This is not complicated, yet IRS has attempted to make it so, all to the detriment of the federal government/taxpayer, who is legally entitled to these proceeds. I am convinced with every passing business day, substantial revenues are being missed. Every business day.

I sincerely hope that this communication/statement for the record is of use to this Committee in its evaluation of the agency and its performance, or lack thereof where enforcement of the internal revenue laws are concerned, specifically with collection of outstanding revenue in lien status. It is unknown how many others, like myself, have come forward and proposed an effective method to assist the agency in its mission, which benefits all Americans in the sense that it tracks down those who fail to comply with their known obligations and thereby place a heavier burden on the remaining taxpaying population, and yet the agency has completely resented such proposals and as a result resisted them vehemently, as appears to be the case here. This is unacceptable; the agency is not a privately held corporation which can do business with whomever it chooses; the agency exists to serve the public and must consider any and all options to enforce the law equally with respect to tax obligations, even if those options and proposals do come from the outside. And given the GAO's September 2006 Report on Tax Debt Collection, their collection rate (contracted) is an dismal 6%; further, their own internal collection rate must be worse still, as they won't even disclose it, according to that report (this figure is described as a goal to be to be developed according to IRS projection models). It goes without saying that in private industry, one would not last in any position where he/she missed his/her target a full 94% of the time. This is an agency that clearly needs all the help it

can get. As a result they should be receptive, not resentful and resistant, of clearly effective outside assistance.

In closing, it is my intention to continue to work to see the method implemented. It is entirely too effective, too readily available, and too promising not to use, in particular due to the fact that it appears the sole reason the IRS is resisting it is that they refuse to change their current, 6% return work habits and processes as described above. Additionally, it does not help matters when one reviews a news article such the inflammatory January 12, 2007 New York Times expose entitled, *'Agents Say Fast Audits Cost IRS'*, which article includes the statement that **supervisors within the agency "receive cash bonuses, promotions and other benefits based on closing cases within the time allowed, not on the quality of audits or the *dollars collected*."** As noted above, I have already refuted, legally, their one legal objection and further there is case law to support my position; their other reasoning, as also previously stated, is entirely non-credible. Therefore, their resistance is baseless, entirely irresponsible to the Government that employs them and the taxpayers they are supposed to serve. And until they implement new and improved methods such as the subject method described herein, the compliant American taxpayer will continue to make up, on an annual basis, billions of dollars in the tax gap shortfall causes by non-payers as described in the method. This is wrong, and changes must be made to their processes.

Thank you for your time.

Very respectfully,

Leslie Peralta

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