JOINT COMMITTEE ON TAXATION
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JOINT COMMITTEE ON TAXATION

AT A HEARING OF THE SENATE COMMITTEE ON FINANCE ON "THE $350 BILLION QUESTION: HOW TO SOLVE THE TAX GAP"

April 14, 2005

Mr. Chairman, Senator Baucus, members of the Committee, I am pleased to testify today about the "tax gap" and ways to reduce it.

The "tax gap" is the difference between the amount of tax owed by taxpayers (from legal activities) and the amount voluntarily paid on time. According to recent estimates provided by the IRS, the gross tax gap is over $300 billion per year, representing about 16 percent of the total tax owed by taxpayers from legal activities. The noncompliance rate for just the individual income tax, which represents the most reliable portion of the latest IRS study, is estimated to be between 19 and 22 percent. To the extent a tax system fails to collect from taxpayers the amount of tax owed by them, every other policy objective of the system, whether it be horizontal equity, redistribution, efficiency, providing social or economic incentives, or simply financing governmental functions, is undermined. Thus, effective tax compliance and enforcement are core principles underlying any successful tax system.

As you know, the Joint Committee staff recently completed a report on "Options to Improve Tax Compliance and Reform Tax Expenditures,"[1] which was prepared in response to a request from the Chairman and Ranking Member. The report describes a range of options that attempt to address one or more of the many contributing factors to the tax gap and noncompliance. The report focuses on tax legislative changes that could be expected to improve compliance.

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[1] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005.

In my testimony today, I will briefly describe five general principles to follow in crafting tax legislation to enhance compliance. In addition to offering proposals to curtail specific loopholes, shelters, and unintended consequences under current law, the Joint Committee staff report contains a number of options that illustrate these general principles. I have appended to my testimony brief, non-technical summaries of each option in the report, with further detail and analysis provided in the report itself. I will be happy to respond to any questions regarding any of the proposals included in the report.

General Principles for Tax Legislation to Improve Compliance and Reduce the Tax Gap

1. Simplify the tax laws.

Much has been written about the benefits of simplification. In terms of ways to reduce the tax gap, I believe that simplification ranks as the most important.

Complex laws spawn many inadvertent errors as well as opportunities for intentional noncompliance. Complex laws also contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be compliant if they perceive the tax system to be inequitable.

A number of the proposals in the Joint Committee staff report attempt to simplify the tax law and make it more fair. For example, the report proposes to simplify areas, such as those dealing with education and dependent care, in which there currently exist multiple tax provisions with similar goals but differing specific requirements. Another example is a proposal to simplify the taxation of minor children. The 2001 Joint Committee staff report on simplification[2] contains many other simplification proposals, including one to eliminate both the individual and corporate alternative minimum tax.

2. Rely on objective, third-party verification.

Raising the visibility of transactions increases the likelihood that their tax consequences will be reported correctly. It is not surprising, then, that information reporting and tax withholding by objective, third-parties to a transaction improve compliance. As between the two, withholding generally improves compliance more, both by collecting some tax from the transaction and by persuading taxpayers that any information reports accompanying the withholding will not be overlooked by the IRS. Thus, withholding may help to stimulate improved, voluntary reporting and payment of tax apart from any amounts actually withheld. Withholding also provides taxpayers with a gradual and systematic method to pay their taxes, thereby reducing the potential for a large liability at year end and resulting motivation to underreport income.

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[2] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001. The recommendations are in Volume II of the report.

According to the most recent IRS report and consistent with earlier reports, the underreporting of “non-farm proprietor net income” -- in general, compensation income of sole proprietors not subject to wage withholding -- is the single largest contributor to the tax gap. To address this compliance problem, prior proposals have recommended the imposition of withholding on such payments. Withholding, however, may present significant burdens on the payor.

The Joint Committee staff report includes a proposal to impose withholding on certain government payments for goods and services that are not currently subject to withholding. Because such payments represent a significant part of the economy, the proposal can be expected to improve compliance to an important extent without burdening any private sector payors. The proposal thus attempts to balance the goals of improving compliance and not creating undue administrative burdens. The proposal exempts smaller governmental entities from the withholding requirement.

The staff report includes other options that follow this principle, including proposed information reporting for tax-exempt interest (the amount of which may be pertinent to a number of tax determinations) and consistent basis reporting for estate and income tax purposes.

3. Avoid having tax consequences depend upon difficult factual determinations.

Compliance difficulties often arise when tax outcomes are dependent on difficult factual determinations. Such rules present compliance burdens for the taxpayer, noncompliance opportunities, and law enforcement difficulties. The Joint Committee staff report contains a number of proposals designed to avoid having tax consequences depend upon such determinations. For example, the report includes proposals reducing reliance on the determination of fair market value in the estate and gift tax, charitable contribution, and other areas. Another example is a proposal to have alcohol excise taxes depend upon the alcoholic content of the beverage, a fairly straightforward factual determination, rather than the classification of type of beverage, a much more difficult factual inquiry.

In certain cases, reliance upon a difficult factual determination is unavoidable because it is an inherent feature of the tax system. For example, an income tax must be able to distinguish business from personal expenses, often a difficult factual issue. In these cases, compliance can be improved by providing rough, more administrable “rules of thumb” that attempt to approximate the result that would arise if facts were fully known and undisputed. Examples of this approach in the staff report include the application of the luxury auto limitations to sport utility vehicles, the allocation of nonrecourse deductions and the exclusion of nonrecourse liabilities from outside basis in the partnership area, and the employment tax treatment of owners of passthrough entities.

4. Treat income and deductions consistently.

The mismatched treatment of income and related deductions is a common sheltering technique. The mismatching can occur in a variety of different ways, including inconsistent treatment as to the amount, timing, and character of the items. For example, the allowance of a deduction with respect to income that is exempt from tax may result in a net loss that can be used to shelter other, unrelated income from taxation.

The staff report contains a number of proposals to prevent this type of inconsistency. For example, the proposal to adopt a dividend exemption system for foreign business income addresses, among other things, the allowance under current law of deductions attributable to what is often effectively exempt income. Other examples include the proposed treatment of deductions (1) of interest on indebtedness allocable to tax-exempt income, (2) for the personal use of company aircraft and other entertainment expenses, and (3) for certain income attributable to property transfers in connection with the performance of services.

5. Supplement technical rules with standards.

Recent tax avoidance transactions have demonstrated that sophisticated taxpayers may rely on the interaction of highly technical legal provisions to produce tax consequences not contemplated by the Congress. Such efforts, if successful, increase the tax gap by allowing taxpayers to obtain unintended tax relief and by undermining overall respect for the tax system.

A strictly rule-based tax system cannot prescribe the appropriate outcome of every conceivable transaction or uncommon combination of steps that might be devised by taxpayers. As a result, to improve compliance, technical tax rules should be supplemented with anti-tax avoidance standards to assure that the Congressional purpose is achieved. On the other hand, excessive reliance upon tax avoidance standards may create undesirable uncertainty with respect to the tax treatment of ordinary business transactions.

The staff report contains a proposal to apply a higher level of judicial scrutiny only to the relatively uncommon transactions bearing the characteristics of tax shelters. In developing this proposal, the staff examined the characteristics of each listed transaction and a number of others, including transactions described in the Joint Committee staff report on Enron Corporation.[3] By signaling to tax advisors and courts that tax rules should be interpreted in a manner consistent with Congressional objectives, the proposal may be expected to reduce tax shelter activity and the size of the tax gap.

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The Joint Committee staff looks forward to working with the Committee on the proposals contained in the report, as well as in developing additional proposals to improve taxpayer compliance and reduce the tax gap.

Thank you for the opportunity to testify.

[3] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.