

**STATEMENT OF NINA E. OLSON
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**BEFORE THE
UNITED STATES SENATE COMMITTEE ON FINANCE**

**ON
THE TAX GAP**

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Mr. Chairman, Senator Baucus, and Members of the Committee:

Thank you for inviting me to testify before your committee today about closing the tax gap while improving taxpayer service. My testimony will address two major issues: (1) the role of enforcement in increasing compliance and (2) the role that high quality customer service plays in promoting compliance. Moreover, as the IRS attempts to improve compliance, it cannot overlook the contribution that taxpayer rights make to closing the tax gap.

I. Understanding the Tax Gap

The tax gap represents, in essence, a failure to pay tax on the part of some taxpayers.¹ This collective failure to pay imposes greater burdens on other taxpayers who pick up the tax “tab”. The tax gap is an issue of fundamental fairness in the tax system. If honest taxpayers feel like chumps, some will start fudging, too. Thus, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.

According to the preliminary data recently released by the IRS as part of the National Research Program (NRP) study of Tax Year 2001 individual income tax returns, the gross tax gap falls somewhere in the range between \$312 and \$353 billion. After accounting for receipt of late payments and IRS collection activity, the IRS estimates the net tax gap is in the range between \$257 and \$298 billion. The IRS estimates tax noncompliance is in the range of 15.0 percent to 16.6 percent. Or, put differently, the rate of taxpayer compliance with the tax laws in 2001 ranged from 83.4 percent to 85 percent.

The IRS receives approximately 130 million individual income tax returns each year. Given the current size of the net tax gap, the average tax return includes a \$2,000 per year “surtax” to subsidize noncompliance.

II. Composition of the Tax Gap

The tax gap can be looked at through several lenses. For example, we can view the tax gap by the type of noncompliance – nonfiling, underreporting, and underpayment – or by the type of tax – income, employment, estate or excise. The IRS’s 2001 NRP study updates its current tax gap estimates for underreporting of individual income and self-employment taxes, which together

¹ The IRS develops estimates of both the “Gross Tax Gap” and the “Net Tax Gap.” The Gross Tax Gap is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely. The Net Tax Gap is the portion of the Gross Tax Gap that will not be collected after all IRS and taxpayer actions have been completed for a given tax year.

are by far the largest component of the tax gap. In fact, the IRS estimates that underreporting accounts for more than 80 percent of the tax gap.²

The IRS estimates that individual income and self-employment taxes on unreported business income ranges from \$134 to \$155 billion, almost one-half of the gross tax gap. Based on earlier 2001 estimates, fully 67 percent of the gross tax gap is attributable to nonpayment of income taxes and employment taxes by self-employed individuals.³

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

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

- Where payments are subject to withholding, IRS estimates that compliance is almost 100 percent.⁴
- Where payments are reported to the IRS, IRS estimates that compliance is about 96 percent.⁵
- Where payments are not reported to the IRS at all, overall compliance is substantially lower.⁶

The above data tell us what most people intuitively expect: Where a taxpayer knows the IRS is aware of a payment, the taxpayer generally will report it on his

² Individual income and self-employment tax underreporting can arise from a number of sources, including understated income and overstated deductions, expenses, and claims. The preliminary 2001 NRP data estimates that underreporting ranges from \$250 to \$292 billion. IRS National Headquarters Office of Research, Tax Gap Facts and Figures, March 29, 2005.

³ This estimate includes underreporting, non-filing and non-payment of income and employment taxes by all self-employed taxpayers. IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001).

⁴ IRS National Headquarters, Office of Research, July 2004.

⁵ IRS National Headquarters, Office of Research, July 2004.

⁶ The IRS estimates that compliance among informal suppliers is about 20%, officials in the IRS Research function have unofficially estimated the compliance rate among sole proprietors at about 50%, and one IRS study estimates the compliance rate among self-employed persons overall at about 68%. IRS National Headquarters, Office of Research, July 2004.

or her return. Where a taxpayer thinks the IRS has no clue about the payment, the likelihood that the taxpayer will report the payment is substantially lower. The large majority of the tax gap attributable to self-employed persons does not result from payments reported to the IRS on a Form 1099. Most of that tax gap results from payments not reported to the IRS. In other words, the bulk of the tax gap is attributable to the “cash economy.”⁷

III. IRS Enforcement Priorities

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

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

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

The IRS estimates Schedule C underreporting noncompliance to be 32 percent.⁸ Today, the IRS is directing 14 percent of its examination resources to

⁷ It is important to note that some noncompliance in the self-employed sector may be attributable to inadvertent noncompliance, including the complexity of the tax law. Self-employed businesses are small and often marginal businesses; cash is very dear to them. Thus, most self-employed underpayments are attributable to a lack of withholding – or forced saving – mechanism.

⁸ Office of Research, July 2004.

Schedule C returns.⁹ These examinations, however, generally focus on high income taxpayers. The IRS's current examination work plan all but ignores the cash economy, the largest component of the tax gap.

IV. Much More and Better IRS Research Is Needed

I am very concerned that the IRS does not have better research to show how its dollars could be most effectively applied. The IRS should be conducting extensive research now to develop a long-term and sustained strategy for reducing the tax gap. This strategy must focus on the indirect effects as well as the direct effects of IRS initiatives.

Today, the IRS is under enormous pressure to show that it is ramping up enforcement. The traditional way to demonstrate results is to show improvements in performance measures that are objectively determinable, such as collection actions (*e.g.*, the dollars collected and the number of liens filed and levies issued), examinations (the number of audit starts and closures), criminal investigations (*e.g.*, the number of investigation starts and closures, and the number of criminal case referrals to the Department of Justice), as well as cycle time measures for each of these areas.¹⁰

IRS activities, however, have indirect revenue effects as well, and the indirect effects in most cases are probably greater than the direct effects. Assume, for example, that the IRS ramps up audits in a heavily cash-based industry like construction and conducts the audits effectively. The indirect revenue gains resulting from these audits would greatly exceed the direct revenue gains as word spreads throughout the industry that the IRS is back on the street. In economic terms, this indirect effect is referred to as a "multiplier." (Not being an economist, I sometimes call it the "ripple effect.")

For the IRS, the long-term challenge in combating the tax gap is to allocate the bulk of its resources toward initiatives that produce higher multiplier effects – even where the direct revenue effects are not as great. It is essential to recognize that not all audits are created equal. One dollar spent on auditing industries with historically high rates of noncompliance may have a very different multiplier than an audit of a corporate tax shelter. Similarly, one dollar spent on making it easier for taxpayers to comply with their tax obligations – *e.g.*, publishing forms, advertising e-file, answering tax law questions – almost certainly has a multiplier effect as well. We simply don't have adequate research to show where the next dollar is best spent.

⁹ IRS, Report to Congress: IRS Tax Compliance Activities, July 2003; AIMS Database (closed cases), IRS Examination Table 37 – An Examination activity management report and Automated Financial System (AFS) Database.

¹⁰ Each of these measures is a legitimate window into IRS activity. However, each, if not properly explained to employees and properly applied, can lead to inappropriate IRS action and incentives.

Moreover, in terms of improving overall tax compliance, we don't have data that show whether the "multiplier effect" is generally greater at this time for enforcement or for taxpayer service. Thus, a decision to increase enforcement and reduce taxpayer service is, to a large degree, based more on instinct than solid research. To be sure, conducting research on these issues is not easy research to do. But in the absence of better research, it is important to emphasize that current decisions about how much to increase or decrease certain activities represent merely a policy call based on educated guessing.

V. Incorporating Taxpayer Service and Taxpayer Rights Within Enforcement Initiatives

I will discuss later the balance between taxpayer service and enforcement, but I'd like to emphasize here that taxpayer service and taxpayer rights should not be viewed as separable from enforcement. Taxpayer service and taxpayer rights must be integrated within IRS enforcement initiatives as well. In addition to developing a strategic plan that leverages the indirect effect of examination and collection activity, the IRS must gain a better understanding of the causes of noncompliance. Taxpayers do not all think, act, and react in the same way, and a comprehensive approach toward noncompliance must recognize these differences.¹¹

The IRS should apply the appropriate enforcement approach to the particular type of noncompliance it is addressing. For example, the IRS collects about \$18 billion between the first and fourth notice in the collection stream.¹² It would be a waste of resources and, more importantly, an abuse of taxpayers to issue levies when a taxpayer is responding to IRS notices by making payments.

The type of examination can impact the audit outcome. Consider the IRS approach to Earned Income Tax Credit examinations. We do not know how much EITC noncompliance is attributable to fraud and how much to inadvertent error. If we treat each EITC overclaim as fraud, we are likely to discourage eligible taxpayers from claiming the credit. Moreover, if we ignore the fact that a disproportionately large number of EITC taxpayers may not be able to understand extensive documentation requests or respond to complicated notices, we will get incorrect results from our examinations.

As part of my 2004 Annual Report to Congress, the Taxpayer Advocate Service released a study that empirically demonstrates that 43 percent of taxpayers who

¹¹ For a discussion of the categories of taxpayer noncompliance, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003); see also National Taxpayer Advocate, *2004 Annual Report to Congress Volume I – Most Serious Problem: IRS Examination Strategy*, Publication 2104 (Rev. 12-2004) 211.

¹² ERIS Report, *Average Collected Dollars Per Fiscal Year*, FY 1995 through 1st Quarter FY 2001.

sought reconsideration of correspondence examinations that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration.¹³ Where the taxpayer received additional EITC, he or she received, on average, 94 percent of the EITC amount claimed on the original return. Moreover, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased significantly in direct proportion to the number of phone calls made by the TAS employee.

The findings of the study suggest that the IRS's mode of communicating with a taxpayer in the audit environment affects the outcome of the audit. In the study, TAS recommended that the IRS enforce its current policy that IRS examination employees attempt two telephone contacts with the taxpayer. We suggested that the IRS incorporate knowledge of taxpayer characteristics into audit design and train its employees to identify circumstances where an IRS-initiated phone contact may help the taxpayer comply with IRS requests.

VI. Balancing Tax Law Enforcement with Taxpayer Service and Taxpayer Rights

In developing a long-term strategic approach toward noncompliance, the IRS must remember that the “stick” is not the only effective tool for addressing the tax gap; the “carrot” has a critical role to play, too. For taxpayers who will make reasonable but not Herculean efforts to comply with the tax laws, taxpayer service makes all the difference. If we make it easy for taxpayers to get forms, get answers to tax law questions, file returns, and get assistance if they run into problems, the vast majority of taxpayers will meet their tax obligations. If, instead, we increase the burdens of compliance too much, we will lose some of these taxpayers. Just as with indirect revenues on the enforcement side, the indirect revenue gains on the taxpayer service side are not easily measurable. But these gains exist, and they are significant. If we start emphasizing enforcement at the expense of taxpayer service, we ultimately will not achieve the overall revenue gains that we are seeking.

Taxpayer service and enforcement activities work hand-in-hand to promote high levels of compliance. Both are responsible for the estimated 84 percent compliance rate we have today, and both must be strengthened if we are to increase the compliance rate meaningfully. Importantly, in attempting to increase compliance among the lagging 16 percent of taxpayers, we have to be sure that we don't take steps that will decrease compliance among the existing 84 percent.

Recently, the IRS's approach to combating the tax gap has focused almost exclusively on enforcement. Noncompliant taxpayers are often characterized as

¹³ National Taxpayer Advocate, *2004 Annual Report to Congress Volume II – Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104B (Rev. 12-2004).

“cheaters.” In my view, this is a mistake. The carrot and the stick are inextricably intertwined.

We can categorize taxpayers – somewhat simplistically – into three groups. They are either currently complying with the tax laws, or trying to comply, or not trying to comply at all. The taxpayers who aren’t trying to comply may respond only to enforcement, but taxpayers who are seeking to comply will do so if we make it easy. These taxpayers will be much less likely to comply if we make it difficult. Thus, there should be minimal barriers for these taxpayers to get forms and answers to tax law questions, file returns, and obtain assistance if they run into problems. Even enforcement problems.

Today, all we know about noncompliant taxpayers is the nature of their noncompliance, not the underlying reasons for it. We know whether taxpayers are nonfilers, or underreporters, or non-payers. If we don’t understand the reasons for noncompliance, we run the risk of a shotgun approach. We may hit someone with serious enforcement actions when a less drastic approach might work and might have better long-term compliance effects.

VII. The Effect of “RRA 98 Environment” On Compliance

We hear regularly that, in the aftermath of the enactment of RRA 98, taxpayer service was king and enforcement lapsed into a “coma.” First, I do not agree with this characterization. During the fiscal years from 1996 through 2004, although individual audits declined by 48.1 percent,¹⁴ math error notices increased by 110 percent, from 4,750,771 in FY 1996 to 9,987,779 in FY 2004.¹⁵ In fact, between FY 1996 to FY 1998, the number of individual audits declined by 38.6 percent¹⁶ because in those years Congress gave the IRS the authority to use math error and summary assessment procedures for errors pertaining to Social Security Numbers for purposes of the EITC and dependency exemptions, and self-employment tax.¹⁷ As a result of this legislative authority, the IRS was able to discontinue conducting audits in these areas because it could correct the errors in an automated and more cost-effective manner. While the IRS did 748,766 fewer individual audits between FY 1996 and FY 1998, the number of math error assessment notices increased by almost a million during that period, from 4,750,771 to 5,688,906, or an increase of 19.3 percent. In fact, in FY 2004, the IRS issued 9,987,779 math error assessment notices.

¹⁴ 1996 IDRS Data Book, table 11, and 2004 IRS Data Books, table 10.

¹⁵ IRS Report to Congress: Compliance Activities, table 1, July 15, 2003; Office of the Notice Gatekeeper, Master File Notice Volume Report.

¹⁶ 1996 IDRS Data Book, table 11, and 1998 IRS Data Books, table 17.

¹⁷ IRC § 6213(g)(2)(F) - (H).

On the other hand, during the period from FY 1996 through FY 2004, the IRS increased its level of service on the telephones from 50 percent to 87 percent.¹⁸ It conducted a comprehensive review of notice clarity and improved the wording on literally hundreds of notices and publications. Moreover, the IRS created two functions dedicated entirely to outreach and communication with our largest taxpayer populations – the individual wage-earner and the small business person. Most importantly, then-Commissioner Rossotti attempted to instill in the IRS recognition that taxpayers deserve world-class customer service. If taxpayers are trying to file their taxes, we can at least answer their questions promptly and helpfully. If we are asking people to give up their money, we can at least be polite about it.

If enforcement actions – exams, liens, levies, and criminal investigations – truly were the key to taxpayer compliance, one would expect the compliance rate during this period to drop as drastically as these enforcement actions did. Yet the compliance rate in 2001 is about the same as the compliance rate in 1988, before the enforcement decline occurred. Clearly, some other factor is at work here. Perhaps it is the increase in the automated non-audit activity I described above. But perhaps – just perhaps – what made taxpayers compliant is the marked increase in taxpayer service.

What we saw in Senate Finance Committee cases referred to TAS as a result of the RRA 98 hearings was not the extreme series of abuses that grabbed headlines. Instead, what we saw were many little errors that added up – the IRS's unwillingness to call taxpayers, to take the extra step to bring the taxpayer into compliance, coupled with the IRS's assumption that a noncompliant taxpayer was a cheating taxpayer. These cases documented a profound erosion of basic taxpayer service in order to close out case inventory, assess dollars, and collect tax – in short, a one-size-fits-all approach.

To be sure, revenue gains that result from high-quality taxpayer service are difficult to measure, and if the IRS is pushed too hard to produce statistical data to substantiate its enforcement efforts, taxpayer service will continually get the short end of the stick. But in the long run, the tax gap will grow if enforcement is bolstered at the expense of taxpayer service. Simply put, the IRS must find a way to walk and chew gum at the same time.

VIII. Proposed Cuts to Taxpayer Service in FY 2006 and Beyond

The proposed IRS budget for Fiscal Year 2006 sets forth an increase for enforcement funding of eight percent and a decrease in taxpayer service funding of one percent. I support an increase in enforcement resources, and I certainly understand the competing demands of today's fiscal environment. However, for

¹⁸ General Accounting Office, *IRS' 1996 Tax Filing Season – Performance Goals Generally Met; Efforts to Modernize Had Mixed Results*, GAO/GGD-97-25, (Dec. 1996), 5; Enterprise Snapshot Report, week ending September 30, 2004.

all the reasons discussed above, the cuts in taxpayer service raise some significant concerns.

First, I believe this allocation understates the extent of the cuts to taxpayer service. Submission processing – the processing of tax returns, other forms, and documents – accounts for fully 36 percent of the taxpayer service budget. This function is essential to all other IRS activities and is unlikely to sustain any cuts, other than those attributable to modest productivity gains. Thus, it is likely that the IRS will make cuts of more than 1 percent in the other two subcategories under taxpayer service, *i.e.*, in taxpayer assistance and outreach. Indeed, the General Accounting Office analyzed the proposed budget and concluded that it would reduce staffing for taxpayer service by 3.6 percent.¹⁹

Second, the proposed budget for FY 2006 reflects a significant and continuing trend toward more enforcement and less taxpayer service. As compared with the FY 2004 budget as enacted, the proposed FY 2006 budget reflects a cumulative increase of about 14 percent for enforcement funding and a reduction of about 4 percent for taxpayer service funding.²⁰ The Taxpayer Advocate Service's own staffing has declined by eight percent since 2004.

Third, I am concerned that the speed with which the IRS must determine how to cut taxpayer service does not allow the agency adequate time to study where cuts could be made with minimal impact on taxpayers. This inadequacy is a matter of great urgency with respect to the proposal to close a significant number of Taxpayer Assistance Centers (TACs). Historically, the IRS's walk-in sites provided a wide range of services, from tax return preparation to answering tax law and account questions, to providing forms, to helping to resolve examination or collection problems. Today, however, the TACs are withdrawing from any meaningful tax return or other document preparation; are not answering questions it considers "out-of-scope"; are no longer providing computer transcripts of taxpayers' returns or their accounts; and are generally limiting the days and hours of operation. In short, face-to-face taxpayer service is becoming a thing of the past.

The IRS is making these decisions in a vacuum of taxpayer-based information. I was briefed about the IRS-developed model for recommending the closure of walk-in sites for FY 2006 very late in the process. While I applaud IRS employees for doing the best job they could under tight deadlines, the model fails to consider taxpayer needs, as identified by taxpayers themselves.²¹ The IRS

¹⁹ General Accounting Office, GAO-05-416T, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* 6 (April 7, 2005).

²⁰ General Accounting Office, GAO-05-416T, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* 6 (April 7, 2005).

²¹ It is my understanding that the IRS consulted the Internal Revenue Service Advisory Committee (IRSAC) with respect to the weighting of factors used to determine closings. However, the IRS did not consult the Taxpayer Advocacy Panel (TAP), a Treasury panel of

has never, to my knowledge, conducted a comprehensive taxpayer-centric assessment of which taxpayer populations need to interact with the IRS in a face-to-face environment; which services those taxpayers need in a face-to-face environment; and which alternative methods of face-to-face delivery will meet those needs.

More importantly, over a period of less than 6 months, the IRS is deciding to significantly curtail a successful and established way of doing business with taxpayers that has existed for more than 40 years.²² In making this decision, the IRS does not know what face-to-face assistance taxpayers say they need in order to comply with the tax laws. Rather, the IRS is merely using demographic data as a proxy for taxpayer preferences. It is also basing its decisions on TAC service usage over the last few years, which is a distorted measure, since TAC services greatly declined during that period. Such measurement is a self-fulfilling proposition. Businesses rarely make major decisions without surveying their customer bases, and it's not wise for IRS to move forward without doing so.

We do have some credible data to guide us in our decision-making. A recent study conducted by the Pew Internet and American Life Project attempted to measure how Americans communicate with their government. Generally, the study found that most Americans prefer to communicate with the government orally (either by phone or in person), rather than by letter or over the Internet. The study points out that one-third of American adults lack Internet access, and that among all individuals who interact with the government (including Internet users), 51 percent prefer oral communication (telephone or in-person visits) for routine matters and 62 percent prefer oral communication for complex matters or problem-solving. Notably, fully 20 percent of Americans reported that their most recent contact with the government was in person.

These findings are dramatically reinforced by the results of the IRS Oversight Board's recently released 2004 Taxpayer Attitude Survey.²³ Conducted annually,

volunteer taxpayers specifically chartered under the Federal Advisory Committee Act to advise the IRS on matters pertaining to customer service. Nor did the IRS seek comments or suggestions from the Low Income Taxpayer Clinics funded by the IRS under IRC § 7526, which presumably represent the interests of a portion of the taxpayer population affected by these closings.

²² In July 1963, the IRS instituted a year-round Taxpayer Assistance Program, and Taxpayer Service was established as a branch in the Collection Division in the National Office. *IRS Historical Studies - History of the IRS*, Publication 1694 (12-92), p. 178.

²³ IRS Oversight Board, 2004 Taxpayer Attitude Survey, April 2005. The IRS Oversight Board has contracted with a professional survey firm to conduct telephone surveys of taxpayers' attitudes since 2002. Telephone interviews are conducted via OmniTel, a weekly national telephone omnibus service of NOP World. The sample for each week's OmniTel wave consists of 1,000 completed interviews, made up of male and female adults (in approximately equal number), all 18 years of age and over. Each OmniTel study is based on a random digit dialing (RDD) probability sample of all telephone households in the continental United States. The RDD sampling system is totally computer based and provides an equal probability of selection for each and every

the survey asks several questions relevant to (1) determining the appropriate balance between service and enforcement and (2) determining whether to reduce or eliminate face-to-face taxpayer service.

In response to the question, “How important is it to you, as a taxpayer, that the IRS provides each of the following services to assist taxpayers?”, taxpayers stated a given service was very or somewhat important, as follows:

How important is it to you, as a taxpayer, that the IRS provides each of the following services to assist taxpayers?	Very Important + Somewhat Important/%		
	2004	2003	2002
A toll-free telephone number to answer your questions	92	91	90
Office locations you can visit where an IRS representative will answer your questions	90	89	85
A web site to provide you with information	85	84	80
A computer terminal located in a kiosk at a library or shopping mall	66	64	NA
A tax assistance van that visits locations not convenient to IRS offices to provide information and assistance	77	78	NA

When asked which services they would be somewhat likely or very likely to use, taxpayers provided the following responses:

How likely would you be to use each of the following services for help with a tax issue?	Very Likely + Somewhat Likely/%	
	2004	2003
A toll-free telephone number to answer your questions	82	81
Office locations you can visit within 30 minutes travel time where an IRS representative will answer your questions	68	72
Office locations you can visit within 30 to 60 minutes travel time where an IRS representative will answer your questions	49	50
A web site to provide you with information	72	72
A computer terminal located in a kiosk at a library or shopping mall	42	46
A tax assistance van that visits locations not convenient to IRS offices to provide information and assistance	51	57

telephone household. Thus, the sample represents telephone households with both listed and unlisted phones in their proper proportions.

Perhaps the most important indication that we have about how the taxpayers themselves want their tax administrators to proceed comes from the answers to Question 11 of the study. While 62 percent of taxpayers completely or mostly agree that the IRS should receive extra funding to enforce tax laws and ensure that taxpayers pay what they owe, 64 percent of taxpayers completely or mostly agree that the IRS should receive extra funding so it can assist more taxpayers over the phone and in person.

IX. Specific Steps for Closing the Tax Gap

At this committee's hearing on the tax gap in July 2004, Senator Baucus asked the Commissioner to develop a list of options to address the tax gap and asked that they be characterized as "most stringent," "most lenient," and "moderate."²⁴ In my 2004 Annual Report to Congress, I listed 24 steps that could address the tax gap, and without expressing an opinion about the wisdom of any particular item, I identified key benefits and burdens associated with each.

The full list is attached at the end of my written statement, but I will highlight a few of the key principles here.

A. Reduce Opportunities for Noncompliance

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

Since we know that the compliance rate is approximately 96 percent when payments are reported to the IRS, we should explore ways to ensure that a broader array of payments is subject to 1099 reporting. Moreover, since we know that compliance is nearly 100 percent when payments are subject to withholding, we should require withholding in limited circumstances. Withholding imposes significant burdens on the payor, so I am not advocating universal withholding. However, we should at least consider the feasibility of the following:

- Enter into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms, e.g., travel agencies and travel agents, or hair salons and stylists. The IRS, on a case-by-case basis, could agree to provide a safe harbor worker

²⁴ Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (Release Date: July 8, 2004) (Doc 2004-15394), (Q&A of Commissioner Mark W. Everson), 56.

classification where the payor enters into a voluntary withholding agreement.

- Actively encourage self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the Electronic Funds Transfer System (EFTS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene when the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, impose a back-up withholding requirement, as described below.
- Amend IRC § 3406 to require a form of “backup withholding” by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

B. Information Sharing with State and Local Governments

States and localities compile and maintain data that could significantly assist the IRS in collecting taxes due. For example, it is my experience that states are relatively aggressive in enforcing compliance with sales tax requirements. The IRS could verify gross receipts reported on Federal returns with gross receipts reported for state sales tax purposes. In other instances, taxpayers must report gross receipts in order to obtain a business license from the state or locality so that they may bid for contracts or otherwise conduct business in the jurisdiction. The IRS could use this data to validate income information reported to it by the taxpayer. This same approach could apply to data matching information about property tax records.

C. Local Compliance Planning Councils

The IRS should re-establish local Compliance Planning Councils that include representatives of both IRS enforcement and taxpayer service functions. The councils should develop specific compliance initiatives addressing local activities that represent the greatest share of the region’s cash economy and other areas of local noncompliance. The Councils should partner with state and local tax authorities where appropriate.

D. IRS Forms Revisions

The IRS should revise Schedule C, Profit or Loss From Business (Sole Proprietorship), to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC. Anecdotal evidence suggests that many taxpayers only report income on their tax returns that was reported to the IRS on information-reporting documents. For example, suppose a plumber makes \$20,000 working for businesses and \$40,000 working for homeowners.

The law only requires the business clients to issue a Form 1099, and the plumber may feel comfortable reporting only the \$20,000 on his tax return. By simply breaking the “gross receipts” line on Schedule C into two lines – one for “gross receipts reported on Forms 1099” and one for “all other gross receipts,” we would send a message that other receipts are required to be reported, and the plumber would probably be inclined to put some number – even if not the full \$40,000 – on that second line. This simple step could bring in tens of millions, if not billions, of dollars in additional tax each year. To me, this proposal is a no-brainer.

The IRS also should require Schedule C taxpayers and all corporations and partnerships to answer two questions on their income tax returns:

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

These two simple questions will alert uninformed taxpayers of their reporting obligations and enable them to comply. The questions will also alert taxpayers who are knowingly avoiding their reporting obligations that the IRS is looking at this issue and that there is some additional risk to continuing noncompliance.

E. Maintain a Vigorous IRS “Street Presence”

Presently, the IRS’s approach to self-employed taxpayer noncompliance is to increase correspondence examinations. Correspondence examinations alone will not find the type of unreported income that feeds the Tax Gap. The IRS must focus on face-to-face examinations conducted in the field in order to maintain a vigorous “street presence.” Revenue agents must probe for unreported income beyond the usual audit steps taken during the course of a correspondence examination.

Field examinations include a set of minimum income probes for all types of tax returns, in-depth examination techniques, and formal indirect methods of identifying unreported income. The IRS instructs field agents that the audit strategy for completing an examination of income must remain *dynamic* and consideration should be given to tax return information, responses to interview questions, the taxpayer’s books and records, and other financial information.²⁵ Dynamic audit strategies such as these allow agents to find and follow the money trail that leads to unreported income and are strategies that are not followed or not possible in conducting a correspondence examination.

The IRS also maintains a set of required filing checks for field examinations to ensure voluntary compliance of small business taxpayers. This includes checks

²⁵ Internal Revenue Manual 4.10.4.1(2).

of filing requirements of all Federal tax returns, such as employment tax returns and information reporting returns. Required filing checks conducted in the field often lead to an expansion of the audit to include additional years or returns of others.²⁶ These types of required filing checks are set aside in the correspondence exam environment, which focuses on a narrow set of issues.

F. Strengthen OIC program

According to the IRS's own research, we now know that the Offer-in-Compromise program brings noncompliant taxpayers back into compliance at almost the same rate (80 percent) as taxpayers overall (84 percent). That is, 80 percent of the taxpayers whose offers were accepted remained in compliance with their tax obligations over the five-year period following offer acceptance, as required by the terms of the offer.²⁷

This same study demonstrated that the IRS is leaving dollars on the table by returning, rejecting, or seeking withdrawal of offers for tax liabilities on which the Service later collects virtually nothing.²⁸ In RRA 98, Congress instructed the IRS to educate the taxpaying public about the availability of such agreements.²⁹ The IRS's data make clear that there is a strong case to be made for educating taxpayers about the Offer-in-Compromise program – it converts noncompliant taxpayers into compliant ones, and it brings in enforcement revenue that the IRS would not otherwise collect.

X. Transparency Should be a Goal of Fundamental Tax Reform

No discussion of the tax gap is complete without identifying complexity as a major driver of noncompliance. Tax law complexity provides grey areas and loopholes for taxpayers who are not trying to comply. Complexity also trips up taxpayers who are trying to comply – it is just too hard to figure out what the law requires, and honest efforts to comply can result in a “gotcha” situation.

As the Administration and Congress consider fundamental tax reform, I believe that simplifying the tax code should be an overriding goal. In writing the tax laws, Congress should consider how to reduce opportunities for noncompliance. If fewer opportunities exist for fudging, taxpayers will feel reassured that everyone

²⁶ Internal Revenue Manual 4.10.5.1(1)(2)

²⁷ *Id.*

²⁸ In a study that looked at a sample of offers closed in 1998 and subsequent collections through September 8, 2003, the IRS found that it ultimately collected less than 80 percent of what taxpayers were offering in more than half of the offers from individual taxpayers that it rejected or returned. It collected nothing on more than 20% of those offers. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, September 2004.

²⁹ IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998).

is paying their fair share, the job of the IRS will become easier, and taxpayers will be less likely to get into battles with the IRS that leave them soured on the tax system.

XI. Conclusion

The IRS faces significant challenges in the next few years as it attempts to increase taxpayer compliance. I believe the IRS is doing the right thing in targeting corporate tax shelters and high-end cheating in the short-term, but I believe that with two-thirds of the tax gap attributable to the self-employed, the IRS needs to develop a thoughtful and comprehensive strategy to address noncompliance in the cash economy. The strategy should consider not only direct revenue benefits but the indirect effects (*i.e.*, the multiplier) generated by IRS activity.

Among areas for consideration, IRS and Congress should reduce opportunities for noncompliance through increased information reporting and limited non-wage withholding, increase information sharing with state and local governments, develop targeted local initiatives, revise tax forms, and put IRS agents “on the street” to focus on industries that are particularly noncompliant. At the same time, the IRS should keep in mind that taxpayer service is central to maintaining and improving the compliance rate, and it should do more to study taxpayer needs, particularly with respect to face-to-face service, and to meet them.

To achieve these objectives, the IRS needs to do a better job of identifying and balancing both taxpayer needs and enforcement efforts. Rather than making resource-driven decisions that are based on inadequate research and that fail to identify equivalent alternatives, the IRS must develop a world-class research function that is the foundation for all of its customer service and enforcement activities. Research – and truly strategic planning – should inform the IRS’s allocation of resources so that we achieve the maximum compliance possible by obtaining the optimal balance between service and enforcement.

Appendix I – Tax Gap Recommendations

PROBLEM

The IRS estimates that the annual gross tax gap (i.e., the amount of tax that is imposed by law for a given year but is not paid voluntarily) is about \$311 billion, and the annual net tax gap (i.e., the gross tax gap reduced by taxes eventually collected) is about \$255 billion.³⁰ The \$255 billion net tax gap results in an average annual “surtax” of nearly \$2,000 on each taxpayer. While increased IRS compliance activities can help to reduce this burden, such activities themselves have the potential to impair taxpayer rights and impose additional burdens on taxpayers.

At a hearing on the tax gap before the Senate Finance Committee in July 2004, the IRS Commissioner agreed, at ranking minority member Senator Max Baucus’ request, that he would present the Committee with three alternative plans for reducing the tax gap attributable to the cash economy – the most stringent, the most lenient, and the moderate – by March 31, 2005.³¹ In this report, the National Taxpayer Advocate presents a wide-ranging list of options for closing this and other portions of the tax gap. As noted above, while each possible approach has certain compliance benefits, each would also impose various levels of burden on taxpayers. By presenting this list and identifying the burdens as well as benefits, we hope that we will be of assistance to both Congress and the IRS as they work together to solve the challenging problems posed by the tax gap.³²

Addressing the Tax Gap: The Role of the Office of the Taxpayer Advocate

The National Taxpayer Advocate’s contribution to the discussion about the tax gap should focus on the impact it has on taxpayers in the aggregate and on taxpayers individually.

³⁰ The gross tax gap is the amount of tax imposed by law for a given tax year but not paid voluntarily and timely due to nonfiling, underreporting, and underpayment. The gross tax gap for tax year 2001 was an estimated \$311 billion, up from the estimate of \$283 billion in tax year 1998. The net tax gap is computed by subtracting late payments, which the IRS collects for years to come, from the gross tax gap. The IRS estimated the net tax gap at \$255 billion for tax year 2001 and \$233 billion for tax year 1998. IRS National Headquarters Office of Research, *Tax Gap Maps for 1998 and 2001* (July 17, 2003).

³¹ Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (Release Date: July 8, 2004) (Doc 2004-15394), (Q&A of Commissioner Mark W. Everson), 56.

³² Because we intend this particular Key Legislative Recommendation to be a comprehensive list of possible proposals, some items on the list would require Congressional action and some would require administrative action.

The Tax Gap and the Rights of Taxpayers as a Group

The mere fact that honest taxpayers are paying so much extra in taxes due to noncompliance constitutes an extraordinary abridgement of taxpayer rights and raises fundamental issues of fairness. Millions of wage-earning taxpayers, who are subject to income and payroll tax withholding, pay their taxes regularly and dutifully.³³ Moreover, millions of small business and self-employed taxpayers scrimp and save in order to pay their required quarterly estimated tax payments. Yet, because some taxpayers fail to report their income and are not subject to third party reporting or withholding, compliant taxpayers must foot the bill for others' noncompliance and, if they are small businesses, are placed at a competitive disadvantage. The National Taxpayer Advocate's role with respect to the tax gap and the rights of taxpayers as a whole, then, is to ensure that the IRS develops initiatives that address components of the tax gap that place a disproportionate tax burden on compliant taxpayers.

The Tax Gap and the Rights of Taxpayers as Individuals

Any new or enhanced enforcement initiative has the potential itself to abridge taxpayer rights. As we have discussed throughout this report, the IRS' enforcement initiatives impact not only those taxpayers who are noncompliant but also those who are compliant and who are trying to comply. For example, we may all agree that more third party reporting of income will have a positive impact on the compliance rate. Reasonable people can disagree, however, about the details of such a proposal. Which taxpayers should be subject to third party reporting? At what dollar threshold should third party reporting apply? Should third party reporting be expanded to cover services provided to individuals as well as businesses? Should third party reporting extend to goods as well as services provided? Each one of these proposals imposes a burden on the taxpayer that may be required to report the income as well as on the taxpayer earning the income.

Moreover, our analysis cannot just stop at the level of burden. We must look at each proposal from the perspective of taxpayer rights. For example, the IRS could easily increase the amount of dollars it assesses by seeking legislative authority to use IRC § 6213(b) math and clerical error procedures for any mismatch between income reported by third parties and that reported on the taxpayer's return. But such an approach would both undermine the deficiency process which is fundamental to our tax system (including the ability to go to Tax Court before paying a proposed tax assessment) and unfairly impact those taxpayers who, for whatever reason, cannot navigate the tax system well by themselves or obtain representation to help them. It would also result in lots of work for the IRS and taxpayers further along in the tax controversy process – in

³³ Where taxpayers are subject to a withholding at source requirement, their compliance rate is 99 percent. See Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4.

Collection Due Process hearings, in audit reconsideration, in the Taxpayer Advocate Service.

The National Taxpayer Advocate, then, must look at tax gap proposals from the perspective of affected taxpayers, to determine whether and what taxpayer rights are impacted. Among these rights are the following:

- The IRS must provide a fair and equitable justification for the disparate treatment of one group of taxpayers from another.
- The IRS must research and articulate the reasons for noncompliance and design an initiative that takes into account the characteristics of the targeted taxpayer population.
- The IRS must identify specific barriers to compliance, including the barriers that the IRS itself creates (such as extensive documentation requirements, inadequate access to face-to-face or other assistance) and address elimination or reduction of those barriers as part of the compliance initiative.
- The IRS must protect the confidentiality of taxpayer and tax return information under IRC § 6103, which is the bedrock of taxpayer confidence in our tax system.
- The IRS must ensure that taxpayers have the opportunity to request an administrative appeal of the IRS' enforcement action and that taxpayers are informed about and have access to the Taxpayer Advocate Service.
- The IRS must sufficiently test or pilot initiatives that have unknown or unquantifiable impact on taxpayers or unclear benefits to the tax system.

In addition to her day-to-day dealings with IRS program planners and leadership, the National Taxpayer Advocate has several vehicles to influence IRS enforcement initiatives. One is the Taxpayer Rights Impact Statement (TRIS).³⁴ The TRIS is an assessment of an IRS program or policy by the National Taxpayer Advocate with respect to its impact on taxpayer rights, preferably prior to program implementation. To date, the National Taxpayer Advocate has issued two Taxpayer Rights Impact Statements since she instituted this procedure in July 2004.

³⁴ The Taxpayer Rights Impact Statement is discussed in detail in the National Taxpayer Advocate's June 2004 Report to Congress. See National Taxpayer Advocate, *Fiscal Year 2005 Objectives Report to Congress*, Publication 4054 (Rev. 8-2004), 2-4.

A second vehicle for discussing the impact of IRS enforcement initiatives on taxpayer rights is the Annual Report to Congress under IRC § 7803(c). Thus, in this and previous reports, we have discussed in detail several IRS practices that we believe unduly impact taxpayer rights.³⁵ In the context of the tax gap, we here identify not only possible solutions to the tax gap, particularly with respect to the cash economy, but also the taxpayer rights that such solutions may impair.

Components of the Tax Gap

As noted earlier, the IRS estimates that the annual gross tax gap is approximately \$311 billion and the annual net tax gap is about \$255 billion.³⁶ The tax gap consists of several different components – nonfiling (\$30.1 billion), underreporting (\$248.8 billion), and nonpayment (\$31.8 billion). Some of these estimates are more “squishy” than others. For example, the IRS can accurately quantify the amount of tax due on filed returns that has not been paid. On the other hand, it is difficult to estimate with certainty the under-reporting component of the tax gap, since most of its subcomponents are dated. Rigorous research initiatives such as the National Research Program can, of course, improve the accuracy of IRS estimates, particularly in the area of underreported income.

There are two aspects to underreported income: income receipts may be underreported, or deductions, expenses, and tax credits may be overreported. Each of these problems may require different mitigating strategies. Moreover, within each tax gap component, there are different types of taxpayers. Large corporate taxpayers may respond to one type of compliance initiative, which would be completely ineffective if applied to small businesses or the self-employed. High profile investigations of wealthy taxpayer/investors may be a sufficient deterrent to abuse by other high income taxpayers, but education and outreach may be more effective with low income taxpayers.

The single largest component of the tax gap is underreported business income by individuals. Based on the most current IRS data available, \$132 billion – or 42.5 percent – of the \$310 billion gross tax gap for 2001 was attributable to the underreporting of business income by individuals.³⁷ This underreporting

³⁵ See, e.g., our discussion of Offers-in-Compromise, Collection Due Process hearings, and Independence of the Office of Appeals, *infra*; our discussion of Combination Letters in the 2003 Annual Report to Congress; and our discussion of Math Error Authority in the 2002 Annual Report to Congress.

³⁶ See IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (Feb. 24, 2004). Note that tax gap information from 2001 is the most recent IRS tax gap data available. In 2005, the IRS will have updated tax gap data from the National Research Program (NRP). The NRP is a comprehensive cross-functional effort by the IRS to measure reporting, filing, and payment compliance for different types of taxes and different groups of taxpayers.

³⁷ IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (Feb. 24, 2004). Individual business underreporting has two components – underreporting of actual business receipts and overreporting of business expenses.

contributed \$81 billion to the individual income tax gap and \$51 billion to the employment tax gap.³⁸ At a recent hearing on the tax gap held by the Senate Finance Committee, virtually all witnesses agreed that the “cash economy,” including sole proprietors, was the biggest category of noncompliance contributing to the tax gap.³⁹

A Word About the Cash Economy

For purposes of this report, the “cash economy” refers to cash compensation (including checks) that is not subject to third-party information reporting.⁴⁰ We do not use the term to refer to income from an illegal enterprise. In general, the cash economy involves small (even one-person) rather than large enterprises.⁴¹ It also includes individuals who have non-tax reasons for not reporting income, such as undocumented workers or recipients of means-tested government benefits.

As the witnesses at the Senate hearing noted, no one approach will completely address the tax gap attributable to the cash economy. Most of the witnesses advocated for expanding third-party income reporting, utilization of locally-based data sources such as property tax records and professional or business licenses, and audits designed for a maximum indirect as well as direct effect. Both the Acting Treasury Inspector General for Tax Administration and the General Accountability Office reiterated their support for expansion of third-party withholding on certain payments to self-employed persons.

In her 2003 Annual Report to Congress, the National Taxpayer Advocate listed the Federal tax gap attributable to nonfiling and underreporting by self-employed taxpayers as the second most serious taxpayer problem.⁴² Based on the most current IRS data available, self-employed taxpayers accounted for approximately 67 percent of the federal income tax gap and approximately 77 percent of the federal employment tax gap.⁴³ To be effective, any strategy to reduce the tax gap will have to address noncompliance by this segment of the taxpayer population.

³⁸ *Id.*

³⁹ Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (July 8, 2004) (Doc 2004-15394). The assenting witnesses included the Commissioner of Internal Revenue, the Acting Treasury Inspector General for Tax Administration, the Director of Strategic Issues for the Government Accountability Office (GAO), a member of the IRS Oversight Board, Professor Joseph Bankman of Stanford Law School, and the National Taxpayer Advocate.

⁴⁰ See Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (July 8, 2004) (Doc 2004-15394), (Q&A of Professor Joseph Bankman) 24.

⁴¹ *Id.*

⁴² National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 20.

⁴³ IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001.)

Options for Closing the Tax Gap: Benefit and Burden Analysis

Table 2.8.1 presents some ideas for closing the tax gap. We have divided these ideas into two categories: options that would reduce opportunities for noncompliance, and options that would require the IRS to undertake specific enforcement initiatives. We have also attempted to identify the primary benefits and burdens with respect to each option. Finally, we have applied the approach suggested at the July 2004 Tax Gap Hearing, by labeling each initiative as Most Intrusive (MI), Somewhat Intrusive (SI), and Least Intrusive (LI).

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Form 1099-MISC	Increase the Penalty for failing to issue a required Form 1099-MISC (currently the penalty is \$50 per return). ⁴⁴	SI MI	Increased Form 1099-MISC reporting would reduce some income that currently escapes information reporting (sometimes referred to as the “cash economy”.) Increased information reporting results in higher compliance. ⁴⁵	Increased 1099-MISC reporting would impose additional burdens on service-recipients that would be required to process and file more paperwork to comply with any additional compliance. Eliminating the “trade or business” requirement for issuing a Form 1099MISC would impose a new burden on non-business service-recipients, requiring individuals to file information returns on payments for such items as home repairs and yard care.
	Reduce or eliminate the \$600 per year threshold for requiring a service recipient to issue a Form 1099-MISC. ⁴⁶	MI		
	Reduce or eliminate the \$5,000 per year threshold for requiring a Form 1099-MISC to be filed in the case of a direct seller. ⁴⁷	LI		
	Require Forms 1099-MISC to be issued to incorporated service providers. ⁴⁸	SI		
	Eliminate the “trade or business” requirement for issuing a Form 1099-MISC, but also introduce a high dollar threshold for requiring a service recipient to issue a Form 1099 for non trade or business payments. ⁴⁹	MI		

⁴⁴ Up to a maximum of \$250,000 per year. IRC § 6721(a).

⁴⁵ See Alan Plumley and C. Eugene Steuerle, “An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service,” 4. See also, Most Serious Problem, IRS Examination Strategy, *supra*.

⁴⁶ See IRC § 6041A(a)(2).

⁴⁷ See IRC § 6041A(b).

⁴⁸ Incorporated service providers are currently exempt from Form 1099-MISC reporting in most cases. See Treas. Reg. § 1.6041-3(p)(1).

⁴⁹ See IRC § 6041A(a)(1).

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Non-Wage Withholding	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting. ⁵⁰	MI	Nearly 100 percent of income subject to with-holding is reported. ⁵¹	Withholding on current Form 1099-MISC payments would effectively impose employment tax compliance requirements on service recipients for payments to non-employees. Withholding on current Form 1099 MISC payments would require both independent contractors and service recipients to calculate profit margins to estimate the applicable withholding rate. This could impose significant administrative burdens on service
	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting, and specify that service providers that fail to withhold under this requirement are subject to the Federal Trust Fund Recovery Penalty. ⁵³	MI		

⁵⁰ See National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 256-269, where this proposal is explained in detail. Several other Federal agencies have also recommended non-wage withholding: see Hearings on H.R. 3245, The Independent Contractor Tax Status Clarification Act of 1979, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 96th Cong. 11 (1979) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy); Hearing on Compliance Problems of Independent Contractors, GAO-109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Federal Contractor Compliance*, GAO/GGD-92-108, 4 (July 1992), General Accounting Office, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, 37 (May 11, 1994); GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, 12 (August 1996); Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference No. 2001-30-132, ii (Aug. 2001) see also, *Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration), and Q&A of Mike Brostek, Director Strategic Issues, Government Accountability Office.

⁵¹ See Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. See also, Most Serious Problem, IRS Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Encourage service recipients and independent contractors to enter into voluntary withholding agreements.	LI		recipients that use independent contractors for various kinds of work. It could also impose significant burdens on independent contractors that operate at narrow profit margins. ⁵²
	Provide tax or reduced compliance incentives for service recipients that enter into voluntary withholding agreements with independent contractors.	LI		

⁵² See generally, Russell A. Hollrah, Home Care Representative Opposes NTA's Plan to Target Underreporting by Self-Employed, 2004 T.N.T. 73-37, March 22, 2004.

⁵³ See IRC § 6672. See also Key Legislative Recommendation, Small Business Burden Reduction, Protection from Payroll Service Misappropriation, *supra*.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
<p>Increased Backup Withholding</p>	<p>Institute “real time” Taxpayer Identification Number (TIN) verification for service recipients and institute immediate backup withholding on those with invalid TINs.</p>	<p>SI</p>	<p>Expanding the current backup withholding provisions⁵⁴ to target specific noncompliance would be less burdensome than general non-wage withholding.</p> <p>Nearly 100 percent of income subject to withholding is reported.</p>	<p>“Real time” TIN verification presents taxpayer information confidentiality concerns.⁵⁵</p> <p>Withholding targeted at noncompliant service providers would still place compliance burdens on the service-recipients that use these service providers.</p> <p>Establishing standards for “demonstrated noncompliance” for both individuals and specific industries could be difficult.</p>
	<p>Require immediate backup withholding on individual service providers who have demonstrated a history on noncompliance.</p>	<p>SI</p>		
	<p>Require immediate backup withholding in specific service industries that have demonstrated a history of noncompliance.</p>	<p>SI</p>		

⁵⁴ See IRC § 3406.

⁵⁵ See IRC § 6103.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Frequency of Estimated Tax Payments	Mandatory Increase	SI	More frequent payments would reduce the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance. ⁵⁶	More frequent payments would increase self-employed paperwork and compliance burdens. More frequent payments could impose cash flow constraints on self-employed taxpayers that operate at narrow profit margins.
	Voluntary Increase.	LI		
Voluntary Electronic Estimated Tax Payments	Provide system to allow self-employed taxpayers to electronically submit estimated taxes.	LI	Reduces paperwork and compliance burdens associated with nonelectronic payments. Provides a simple means for on-time estimated tax payments, reducing the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.	Minimal, if any, taxpayer burden.
	Provide system that would allow the IRS to automatically withdraw estimated taxes from a self-employed taxpayer's business checking account. Self-employed taxpayers could participate in this system voluntarily. ⁵⁷	LI		

⁵⁶ Valerie Chambers, Evidence of Significant Excess Intangible Utility of Increased Intertemporal Payments over Financial Investment Gain Opportunity in a Tax Budgeting Situation (unpublished paper, on file with the National Taxpayer Advocate), see also, Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration).

⁵⁷ This system could be expanded to impose mandatory withholding through a self-employed taxpayer's business checking account if that taxpayer had demonstrated a history of noncompliance.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Audit and Exam Initiatives	Increase “Required Filing Checks” (a.k.a., package audits). Required Filing Checks are part of an IRS field audit and require the IRS agent(s) to examine the records of a business taxpayer to determine such things as whether the taxpayer has filed all required returns – including information returns, if it has submitted questionable Forms W-4, and if it is a “cash business” that may be subject to additional scrutiny. ⁵⁸	SI	Increased enforcement increases both direct and indirect compliance. ⁵⁹ Increased IRS and taxpayer focus on gross receipt sources and Form 1099-MISC reporting. Compliance would increase directly for those taxpayers selected for audits, both for the tax years at issue and for future years.	Taxpayers selected for audits would need to go through IRS examination procedures. Concerns that taxpayers affected by local and national compliance initiatives and receiving disparate treatment compared to non-affected taxpayers.
	Implement local audit initiatives that are focused on income reporting for specific groups of taxpayers with demonstrated histories of noncompliance (for example, contractors in a particular city). ⁶⁰	SI		

⁵⁸ See IRM 4.10.5 (July 13, 2001). On June 27, 2003, the Deputy Director of Compliance Policy for the IRS SB/SE division issued a memorandum limiting the scope of Required Filing Checks by eliminating information return and employment tax return reconciliations and mandatory inspections for questionable Forms W-4. The procedures set forth in this memorandum were to expire on April 15, 2004, but no memorandum to that effect has been issued. Memorandum from SB/SE Deputy Directory, Compliance Policy re Required Filing Checks (package audit) – IRM 4.10.5, June 27, 2003.

⁵⁹ See Most Serious Problem, Examination Strategy, *supra*.

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
	Implement industry segment compliance initiatives (including, audits, research, education and outreach, and other compliance initiatives) aimed at increasing voluntary compliance within specific market and industry segments nationwide. ⁶¹	SI	Compliance would increase indirectly as word of these audits spread throughout the respective industries and communities.	
	Fully utilize IRS Financial Status Analysis and Financial Status Audit techniques to the extent permitted by IRC §7602(e). These techniques seek to identify unreported income by analyzing a taxpayer's cash flows to estimate whether there are sufficient funds to cover the taxpayer's expenses. ⁶²	SI	Outreach, education and research efforts would increase voluntary compliance in selected local areas and market and industry segments.	

⁶⁰ See also discussion in Most Serious Problem, Examination Strategy, *supra*.

⁶¹ These initiatives could be structured to fit within the IRS' Compliance Initiative Projects program. See IRM 4.17.1 (Feb. 1, 2004).

⁶² IRM 4.10.4.3.3.1 and IRM 4.10.4.6.1 (June 1, 2004). IRC § 7602(e) limits financial status or economic reality examination techniques to cases where the IRS has a reasonable indication that there is a likelihood of unreported income. The IRM Financial Status Analysis procedures are designed to determine whether such a reasonable indication exists to permit the IRS to implement its Financial Status Audit procedures.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
<p>IRS Forms Revisions</p>	<p>Revise Form 1040, Schedule C, to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC.</p>	<p>LI</p>	<p>Receiving specific Form 1099-MISC income information would allow the IRS to better track self-employment income sources and develop measures to reduce the cash economy.</p>	<p>Minimal recordkeeping burden.</p>
	<p>Supplement Form 1099-MISC with a required statement that the issuer must sign, under penalties of perjury, declaring that all required Forms 1099-MISC have been issued for the tax year.⁶³</p>	<p>LI</p>	<p>Specifically requiring Form 1099-MISC income to be separately reported would increase the likelihood that taxpayers would report such income and also increase tax-payer awareness of income sources that should be re-reported on Forms 1099-MISC.</p> <p>A “penalties of perjury” statement would make issuers aware of the significance of the Form 1099-MISC requirements and increase awareness that the IRS is actively monitoring accurate Form 1099-MISC compliance and reporting.</p>	

⁶³ Only one statement would be required per issuer per year. In other words, a Form 1099-MISC issuer would not be required to sign a statement for each Form issued.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Information Sharing Initiatives	Establish local Compliance Planning Councils, involving the IRS (including both compliance and noncompliance division chiefs and local research offices) and state and local taxing authorities, that would focus on improving self-employed and cash economy compliance in their respective areas. ⁶⁴	LI	Self-employed noncompliance and the cash economy affect all levels of government. Information sharing and partnering efforts will allow all government participants to enhance compliance in these areas. ⁶⁵	Minimal, if any, taxpayer burden.
	Information sharing between the IRS and state and local taxing, compliance and licensing authorities. These sharing efforts could involve such information as business licenses and property tax records. ⁶⁶	LI		

⁶⁴ See also Most Serious Problem, IRS Examination Strategy, *supra*.

⁶⁵ See Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).

⁶⁶ See Testimony of Nina E. Olson, National Taxpayer Advocate, Hearing on Bridging the Tax Gap before the Senate Committee on Finance, July 21, 2004, 10.